

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of financial condition and results of operations should be read in conjunction with the unaudited consolidated interim condensed financial information for the six months ended June 30, 2018. This consolidated interim condensed financial information is prepared in accordance with International Accounting Standard 34 Interim Financial Reporting. The consolidated interim condensed financial information for the six months ended June 30, 2018 should be read in conjunction with the consolidated financial statements for the year ended December 31, 2017 prepared in accordance with International Financial Reporting Standards.

OVERVIEW

We are one of the world's largest gas and oil companies in terms of reserves, market capitalization and production. Our revenues are primarily derived from sales of natural gas, crude oil and other hydrocarbon products to Western and Central Europe, the Russian Federation and other Former Soviet Union countries.

We divide our operations into the following principal activities:

- Production of gas – exploration and production of gas;
- Transportation – transportation of gas;
- Distribution of gas – sales of gas within the Russian Federation and abroad;
- Gas storage – storage of extracted and purchased gas in underground gas storages;
- Production of crude oil and gas condensate – exploration and production of oil and gas condensate, sales of crude oil and gas condensate;
- Refining – processing of oil, gas condensate and other hydrocarbons, and sales of refined products;
- Electric and heat energy generation and sales.

Other activities comprise production of other products and sales of various goods, works, and services.

The official Russian Ruble (“RUB”) to US Dollar (“USD”) foreign exchange rates as determined by the Central Bank of the Russian Federation were as follows:

- as of June 30, 2018 – 62.7565 (as of June 30, 2017 – 59.0855);
- as of December 31, 2017 – 57.6002 (as of December 31, 2016 – 60.6569).

The official RUB to Euro (“EUR”) foreign exchange rates as determined by the Central Bank of the Russian Federation were as follows:

- as of June 30, 2018 – 72.9921 (as of June 30, 2017 – 67.4993);
- as of December 31, 2017 – 68.8668 (as of December 31, 2016 – 63.8111).

The average exchange rates of RUB for the six months ended June 30, 2018 and for the six months ended June 30, 2017 were:

- to USD – 59.3536 and 57.9862, respectively;
- to EUR – 71.8223 and 62.7187, respectively.

RESULTS OF OPERATION

(RUB million)	Three months ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
Sales	1,833,224	1,394,633	3,971,555	3,209,934
Net loss from trading activity	(9,295)	(6,124)	(2,294)	(20,327)
Operating expenses	(1,384,303)	(1,184,040)	(3,035,649)	(2,661,902)
Impairment loss on financial assets	<u>(27,934)</u>	<u>(14,167)</u>	<u>(54,339)</u>	<u>(43,354)</u>
Operating profit	411,692	190,302	879,273	484,351
Finance income	168,559	52,912	259,939	236,044
Finance expense	(287,409)	(186,939)	(394,832)	(239,627)
Share of net income of associates and joint ventures	<u>47,903</u>	<u>26,414</u>	<u>91,583</u>	<u>55,969</u>
Profit before profit tax	340,745	82,689	835,963	536,737
Current profit tax expense	(56,379)	(16,082)	(103,221)	(83,162)
Deferred profit tax expense	<u>(12,984)</u>	<u>(8,940)</u>	<u>(69,191)</u>	<u>(45,521)</u>
Profit tax	(69,363)	(25,022)	(172,412)	(128,683)
Profit for the period	271,382	57,667	663,551	408,054
Other comprehensive income (loss):				
Items that will not be reclassified to profit or loss:				
Gain (loss) arising from change in fair value of financial assets at fair value through other comprehensive income, net of tax	42,929	(13,420)	71,006	(40,227)
Remeasurements of post-employment benefit obligations	<u>26,706</u>	<u>22,334</u>	<u>15,343</u>	<u>(14,236)</u>
Total items that will not be reclassified to profit or loss	69,635	8,914	86,349	(54,463)
Items that may be reclassified subsequently to profit or loss:				
Share of other comprehensive income of associates and joint ventures	170	1,678	1,658	2,125
Translation differences	78,474	104,785	90,937	23,113
Gain (loss) from cash flow hedges, net of tax	<u>19,867</u>	<u>(2,209)</u>	<u>26,951</u>	<u>(4,423)</u>
Total items that may be reclassified subsequently to profit or loss	98,511	104,254	119,546	20,815
Other comprehensive income (loss) for the period, net of tax	<u>168,146</u>	<u>113,168</u>	<u>205,895</u>	<u>(33,648)</u>
Total comprehensive income for the period	439,528	170,835	869,446	374,406
Profit for the period attributable to:				
Owners of PJSC Gazprom	259,181	47,893	630,804	381,346
Non-controlling interest	<u>12,201</u>	<u>9,774</u>	<u>32,747</u>	<u>26,708</u>
	271,382	57,667	663,551	408,054
Total comprehensive income for the period attributable to:				
Owners of PJSC Gazprom	424,510	151,861	831,384	343,027
Non-controlling interest	<u>15,018</u>	<u>18,974</u>	<u>38,062</u>	<u>31,379</u>
	439,528	170,835	869,446	374,406

Sales

The following table sets out volumes and realized prices:

(RUB million unless indicated otherwise)	Three months ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
Sales of gas				
<i>Europe and Other countries</i>				
Gross sales ⁽¹⁾	840,226	587,005	1,780,324	1,323,605
Customs duties	(175,521)	(116,740)	(342,909)	(247,025)
Excise tax	(11,707)	(10,355)	(26,110)	(22,791)
Net sales	652,998	459,910	1,411,305	1,053,789
Volumes in bcm	57.0	53.5	128.5	119.1
Average price, US Dollar per mcm ⁽²⁾ (including excise tax and customs duties) ⁽³⁾	238.4	192.4	233.1	192.1
Average price, RUB per mcm ⁽²⁾ (including excise tax and customs duties)	14,741.1	10,983.3	13,858.9	11,117.2
<i>Former Soviet Union countries</i>				
Gross sales ⁽¹⁾	59,966	53,509	183,779	167,194
Customs duties	(4,421)	(4,376)	(16,755)	(15,926)
Net sales	55,545	49,133	167,024	151,268
Volumes in bcm	6.5	5.9	20.6	18.4
Average price, US Dollar per mcm ⁽²⁾ (including customs duties) ⁽³⁾	148.9	160.2	150.3	157.4
Average price, RUB per mcm ⁽²⁾ (including customs duties)	9,205.7	9,145.3	8,935.2	9,107.4
<i>Russian Federation</i>				
Gross sales (net of VAT)	158,218	154,270	508,765	466,525
Net sales	158,218	154,270	508,765	466,525
Volumes in bcm	41.4	42.4	129.6	124.1
Average price, RUB per mcm ⁽²⁾ (net of VAT)	3,822.8	3,646.3	3,925.8	3,760.7
<i>Total sales of gas</i>				
Gross sales (net of VAT)	1,058,410	794,784	2,472,868	1,957,324
Customs duties	(179,942)	(121,116)	(359,664)	(262,951)
Excise tax	(11,707)	(10,355)	(26,110)	(22,791)
Retroactive gas price adjustments	37,603	(7,055)	37,795	(7,304)
Net sales	904,364	656,258	2,124,889	1,664,278
Volumes in bcm	104.9	101.8	278.7	261.6
Net sales of refined products (net of excise tax, VAT and customs duties)	522,029	387,149	991,573	780,812
Net sales of crude oil and gas condensate (net of VAT and customs duties)	195,184	134,461	345,656	273,298
Electric and heat energy net sales (net of VAT)	98,687	103,165	274,173	263,155
Gas transportation net sales (net of VAT)	55,101	58,895	113,754	117,482
Other revenues (net of VAT)	57,859	54,705	121,510	110,909
Total sales (net of excise tax, VAT and customs duties)	1,833,224	1,394,633	3,971,555	3,209,934

Notes:

⁽¹⁾ VAT is not charged on sales to Europe and Other countries as well as Former Soviet Union countries.

⁽²⁾ One mcm is equivalent to 35,316 cubic feet.

⁽³⁾ Calculated on the basis of average exchange rate between RUB and US Dollar.

Total sales (net of excise tax, VAT and customs duties) increased by RUB 761,621 million, or 24 %, to RUB 3,971,555 million for the six months ended June 30, 2018 compared to the same period of the prior year. The increase in sales revenues was mainly due to an increase in sales of gas, refined products, crude oil and gas condensate.

Net sales of gas accounted for 54 % of total net sales for the six months ended June 30, 2018 (52 % for the same period of the prior year).

Net sales of gas increased by RUB 460,611 million, or 28 %, from RUB 1,664,278 million for the six months ended June 30, 2017 to RUB 2,124,889 million for the six months ended June 30, 2018.

Net sales of gas to Europe and Other countries increased by RUB 357,516 million, or 34 %, to RUB 1,411,305 million for the six months ended June 30, 2018 compared to the same period of the prior year. The change was driven by the increase in average Russian Ruble prices (including excise tax and customs duties), by 25 % and the increase in volumes of the gas sold by 8 % for the six months ended June 30, 2018 compared to the same period of the prior year. At the same time the average US Dollar prices increased by 21 % compared to the same period of the prior year.

Net sales of gas to Former Soviet Union countries increased by RUB 15,756 million, or 10 %, to RUB 167,024 million for the six months ended June 30, 2018 compared to the same period of the prior year. The change was due to the increase in volumes of gas sold by 12 % that was partially compensated by the decrease in average Russian Ruble prices (including customs duties) by 2 % for the six months ended June 30, 2018.

Net sales of gas in the Russian Federation increased by RUB 42,240 million, or 9 %, to RUB 508,765 million for the six months ended June 30, 2018 compared to the same period of the prior year. This change is explained by the increase in volumes of gas sold by 4 % and the increase in average Russian Ruble prices (net of VAT) by 4 %.

Net sales of refined products (net of excise tax, VAT and customs duties) increased by RUB 210,761 million, or 27 %, to RUB 991,573 million for the six months ended June 30, 2018 compared to the same period of the prior year. The increase in sales of refined products was mainly due to an increase in average prices in all geographic segments and an increase in the Gazprom нефт Group sales volumes.

Net sales of crude oil and gas condensate (net of VAT and customs duties) increased by RUB 72,358 million, or 26 %, to RUB 345,656 million for the six months ended June 30, 2018 compared to the same period of the prior year. The increase in sales of crude oil was mainly due to an increase in average prices by more than 30 % in all geographic segments that was partially compensated by a decrease in sales volumes.

Operating expenses

Operating expenses increased by RUB 373,747 million, or 14 % for the six months ended June 30, 2018 to RUB 3,035,649 million compared to RUB 2,661,902 million for the same period of the prior year. Operating expenses as a percentage of sales decreased from 83 % for the six months ended June 30, 2017 to 76 % for the six months ended June 30, 2018. The table below presents a breakdown of operating expenses in each period:

(RUB million)	Three months ended June, 30		Six months ended June, 30	
	2018	2017	2018	2017
Purchased gas and oil	345,766	248,695	744,542	565,600
Taxes other than on income	345,866	271,152	668,485	566,177
Staff costs	189,010	171,393	378,771	341,074
Depreciation	160,261	153,609	318,547	303,303
Transit of gas, oil and refined products	156,894	140,818	303,483	287,831
Materials	73,670	64,918	128,545	124,513
Cost of goods for resale, including refined products	61,625	55,835	123,749	112,839
Electricity and heating expenses	25,122	22,954	57,608	53,084
Repairs and maintenance	32,943	35,776	52,676	59,183
Rental expenses	9,699	10,218	19,466	20,880
Transportation services	7,855	7,930	16,961	15,736
Social expenses	7,343	8,620	16,440	15,220
Derivatives loss (gain)	3,703	2,670	16,155	(7,351)
Insurance expenses	8,085	7,167	15,592	14,532
Processing services	4,963	3,895	9,121	7,451
Research and development expenses	1,714	109	7,529	6,207
Impairment loss on non-financial assets	1,505	4,667	5,158	10,850
Foreign exchange rate differences on operating items	9,821	(9,647)	(8,791)	(8,760)
Other	78,058	68,283	176,723	177,832
	1,523,903	1,269,062	3,050,760	2,666,201
Change in inventories of finished goods, work in progress and other effects	(139,600)	(85,022)	(15,111)	(4,299)
Total operating expenses	1,384,303	1,184,040	3,035,649	2,661,902

Purchased gas and oil

Cost of purchased gas and oil increased by RUB 178,942 million, or 32 %, to RUB 744,542 million for the six months ended June 30, 2018 compared to RUB 565,600 million for the same period of the prior year.

Cost of purchased gas increased by RUB 113,937 million, or 28 %, to RUB 523,779 million for the six months ended June 30, 2018 compared to RUB 409,842 million for the same period of the prior year. The change was due to an increase in average prices and an increase in volumes of gas purchased from external suppliers.

Cost of purchased oil included in the purchased gas and oil increased by RUB 65,005 million, or 42 %, to RUB 220,763 million for the six months ended June 30, 2018 compared to RUB 155,758 million for the same period of the prior year. This change was mainly due to an increase in prices of oil.

Taxes other than on income

Taxes other than on income consist of:

(RUB million)	Three months ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
Mineral extraction tax	259,326	188,518	492,748	406,549
Excise tax	40,279	39,558	85,126	74,591
Property tax	41,756	36,093	83,662	76,008
Other taxes	<u>4,505</u>	<u>6,983</u>	<u>6,949</u>	<u>9,029</u>
Taxes other than on income	345,866	271,152	668,485	566,177

Mineral extraction tax (MET) increased by RUB 86,199 million or 21 % to RUB 492,748 million for the six months ended June 30, 2018 compared to RUB 406,549 million for the same period of the prior year, mainly as a result of an increase in crude oil prices and an increase in the coefficient of the crude oil MET formula for the six months ended June, 30 2018 compared to the same period of the prior year.

Cost of goods for resale, including refined products

Cost of goods for resale, including refined products increased by RUB 10,910 million or 10 % to RUB 123,749 million for the six months ended June 30, 2018 compared to the RUB 112,839 million for the same period of the prior year mainly due to an increase in gas condensate for resale purchases in the GAZPROM Germania Group.

Derivatives loss (gain)

Derivatives loss amounted to RUB 16,155 million for the six months ended June 30, 2018 compared to derivatives gain amounted to RUB 7,351 million for the same period of the prior year. Derivatives loss (gain) occurred as a result of the revaluation of derivatives, mainly contracts for purchase / sale of goods, as at the reporting date.

Impairment loss on financial assets

Impairment loss on financial assets increased by RUB 10,985 million, or 25 %, to RUB 54,339 million for the six months ended June 30, 2018 compared to RUB 43,354 million for the same period of the prior year. The change is mainly due to the increase in the amount of the allowance for expected credit losses on receivables NJSC Naftogaz of Ukraine and JSV Moldovagaz.

Operating profit

As a result of the factors discussed above, operating profit increased by RUB 394,922 million, or 82 %, to RUB 879,273 million for the six months ended June 30, 2018 compared to RUB 484,351 million for the same period of the prior year. The operating profit margin increased from 15 % for the six months ended June 30, 2017 to 22 % for the six months ended June 30, 2018.

Net finance expense

(RUB million)	Three months ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
Foreign exchange gain	149,780	30,595	223,091	191,381
Foreign exchange loss	(274,744)	(171,103)	(369,153)	(208,684)
Net foreign exchange loss	(124,964)	(140,508)	(146,062)	(17,303)
Interest income	18,779	22,317	36,848	44,663
Interest expense	(12,665)	(15,836)	(25,679)	(30,943)
Net finance expense	(118,850)	(134,027)	(134,893)	(3,583)

The net foreign exchange loss increased by RUB 128,759 million to RUB 146,062 million for the six months ended June 30, 2018 compared to the net foreign exchange loss of RUB 17,303 million for the same period of the prior year. The change is due to the appreciation of US Dollar and Euro against the Russian Ruble by 9 % and 6 %, respectively, for the six months ended June 30, 2018 compared to the depreciation of US Dollar against the Russian Ruble by 3 % and appreciation of Euro against the Russian Ruble by 6 % for the same period of the prior year.

Interest income decreased by RUB 7,815 million, or 17 %, to RUB 36,848 million for the six months ended June 30, 2018 compared to RUB 44,663 million for the same period of the prior year.

Interest expense decreased by RUB 5,264 million, or 17 %, to RUB 25,679 million for the six months ended June 30, 2018 compared to RUB 30,943 million for the same period of the prior year.

Share of net income of associates and joint ventures

Share of net income of associates and joint ventures increased by RUB 35,614 million, or 64 %, to RUB 91,583 million for the six months ended June 30, 2018 compared to RUB 55,969 million for the same period of the prior year. This change was mainly caused by an increase in the share of net income of Sakhalin Energy Investment Company Ltd., JSC Arcticgas and JSC Messoyakhaneftegaz.

Profit tax

Total profit tax increased by RUB 43,729 million, or 34 %, to RUB 172,412 million for the six months ended June 30, 2018 compared to RUB 128,683 million for the same period of the prior year. The effective profit tax rate was 20.6 % and 24.0 % for the six months ended June 30, 2018 and June 30, 2017, respectively.

Profit for the period attributable to owners of PJSC Gazprom

As a result of the factors discussed above, profit attributable to owners of PJSC Gazprom increased by RUB 249,458 million, or 65 %, to RUB 630,804 million for the six months ended June 30, 2018 compared to RUB 381,346 million for the same period of the prior year.

Profit for the period attributable to non-controlling interest

Profit attributable to non-controlling interest increased by RUB 6,039 million, or 23 %, to RUB 32,747 million for the six months ended June 30, 2018 compared to RUB 26,708 million for the same period of the prior year.

Liquidity and capital resources

The following table summarises the cash flows for the six months ended June 30, 2018 and June 30, 2017:

(RUB million)	Six months ended June 30,	
	2018	2017
Net cash from operating activities	947,494	446,577
Net cash used in investing activities	(785,968)	(749,019)
Net cash (used in) from financing activities	(134,887)	179,087

Net cash from operating activities

Net cash from operating activities increased by RUB 500,917 million to RUB 947,494 million for the six months ended June 30, 2018 compared to RUB 446,577 million for the same period of the prior year. This change was mainly driven by an increase in cash from operating activities before working capital changes and by a decrease in a replace of cash on short-term deposits included within other current assets compared to the same period of the prior year.

Net cash used in investing activities

Net cash used in investing activities increased by RUB 36,949 million, or 5 %, to RUB 785,968 million for the six months ended June 30, 2018 compared to RUB 749,019 million for the same period of the prior year. The change was mainly due to an increase of capital expenditures for the six months ended June 30, 2018 compared to the same period of the prior year.

Net cash (used in) from financing activities

Net cash used in financing activities amounted to RUB 134,887 million for the six months ended June 30, 2018 compared to RUB 179,087 million of net cash from financing activities for the same period of the prior year. This change is mainly due to the excess of repayment of borrowings over proceeds from borrowings for the six months ended June 30, 2018, compared to the excess of proceeds from borrowings over repayment of borrowings for the same period of the prior year.

Capital expenditures

Total capital expenditures (excluding the effect of acquisitions of subsidiaries) by segments for the six months ended June 30, 2018 and June 30, 2017 in Russian Ruble terms, amounted to the following:

(RUB million)	Six months ended June 30,	
	2018	2017
Transportation	287,657	173,888
Refining	119,906	96,770
Production of crude oil and gas condensate	103,856	171,080
Production of gas	82,059	52,464
Electric and heat energy generation and sales	20,202	15,536
Distribution of gas	16,727	11,766
Gas storage	4,125	6,611
All other segments	<u>46,805</u>	<u>11,472</u>
Total	681,337	539,587

Total capital expenditures increased by RUB 141,750 million, or 26 %, from RUB 539,587 million for the six months ended June 30, 2017 to RUB 681,337 million for the six months ended June 30, 2018.

Debts

Net debt balance (defined as the sum of short-term borrowings, current portion of long-term borrowings, short-term promissory notes payable, long-term borrowings, long-term promissory notes payable, net of cash and cash equivalents) increased by RUB 35,836 million, or 1 %, from RUB 2,397,511 million as of December 31, 2017 to RUB 2,433,347 million as of June 30, 2018. The change was mainly due to an increase in the amount of long-term borrowings denominated in Russian Ruble terms caused by the appreciation of US Dollar and Euro against the Russian Ruble that was partially compensated by an increase in cash and cash equivalents balances.