

## **Information about Major Business Risks and Uncertainties of PJSC LUKOIL**

PJSC LUKOIL Management pays great attention to the risk management issues in order to ensure reasonable achievement of the set goals in the conditions characterized by uncertainties and adverse factors. PJSC LUKOIL is constantly identifying, describing, estimating and monitoring the potential events that may affect the Company's activities, and is elaborating measures to prevent them or mitigate their negative impact to the greatest extent possible if such events do take place.

The Company seeks to actively promote risk management and is presently focusing its efforts on the improvement of an enterprise-wide risk management system (ERM) based on the best international practices. The Company is constantly improving the applicable regulatory methodological risk management base which establishes requirements, uniform for all of the LUKOIL Group organizations, aimed at organizing the risk management process at all stages, and defines management standards for certain risk types of utmost importance. The Risk Committee, a dedicated body under the President of PJSC LUKOIL, was set up and began its work in 2011.

The information on the Risk Management and Internal Control Policy of PJSC LUKOIL that prescribes the uniform basic principles and approaches to the organization of the risk management and internal control system that are binding upon the LUKOIL Group, as well as its key goals and key objectives of the System participants can be found on the Company's official website.

In order to enhance the efficiency of the corporate-wide governance system through the establishment of a unified information environment, an automated information risk management system has been established and is being constantly improved across the LUKOIL Group entities.

The following information reflects the Company's current vision of the major risks that may affect its financial performance, and may not be exhaustive.

### **Macroeconomic Risks**

Macroeconomic changes resulting from the global price volatility for energy carriers, foreign exchange rate fluctuations, inflation processes may have an adverse impact on the Company's financial performance.

Q4 saw the oil price up trend accompanied by rising geopolitical risks and aggravated supply problems. Stringent implementation discipline of the Production Limiting Agreement concluded between OPEC and some independent oil producers at 2016 end contributed to the global oil reserves decline. A decision to extend the Agreement through 2018 end supported the price growth. At the same time the world witnessed sustainable oil demand growth on the part of large global economies. Consequently, due to the above factors the oil prices approximated the USD 70/bbl level at 2017 end.

The global economy continued to demonstrate the up trend in Q4. The year end was marked by positive economic growth rate in the US and EU. The US Senate approved the tax reform suggested by Donald Trump's administration, which led to positive US economic expectations in terms of the near-term outlook. Major developing economies, such as India and China, continue to demonstrate a relatively high economic growth rate as well. Thus, on the whole, the global economic situation favors the global oil demand growth. A sharp interest rate increase due to the excessive tightening of the monetary policy by the world regulators remains a key risk factor for the global financial system.

The US shale oil served as a major source of the oil supply growth in Q4 along with the extended OPEC+ Agreement. The US oil output has completely recovered after a hurricane season thus reaching a historical peak of 9.8 million bbl/day. Analysts forecast the US oil output growth in the near future due to the oil price growth. However, high growth rates may be slackened by the shale companies' conservative investment policy and increased maintenance services costs. Nevertheless, we can expect the oil price growth in the mid-term perspective due to the delayed effect of the investment reduction by the oil and gas companies in terms of major long-term projects, production decline in the old well stock and increased global consumption of liquid hydrocarbons. Growing global oil demand will be subject to continued "automobilization" and industry expansion in the developing countries.

The Russian economy is recovering after the recession due to the oil price growth and reduced interest rates and inflation. The 2017 inflation rate came to 2.5%, the lowest value throughout the contemporary Russian history. According to the Rosstat data, the Russian GDP rose by 1.8% in Q3 as compared to the similar period of the previous year. The oil price growth in Q4 2017 did not result in abrupt ruble appreciation to the US dollar, which provided support to the Russian exporters. Toughening sectoral sanctions imposed by the US at 2018 start may pose a significant threat to the national economy. However, the oil price fluctuations are likely to produce a greater impact on the Russian economy as compared to the international sanctions. The Russian economy is expected to demonstrate the up trend in 2018, while the oil price is expected to exceed 50 USD/bbl. The Company has been employing a scenario approach to forecast macroeconomic indicators. One of them is defined as a base-case

scenario and describes the most likely macroeconomic development trends according to the Company's management. In addition, best-case and worst-case scenarios are being developed. They assess the potential consequences of changes in macroeconomic indices for the Company.

The Company is fully committed to minimizing the potential effects resulting from the realization of macroeconomic risks. The application of the worst-case scenario makes it possible to identify assets and investment projects that are most vulnerable to negative macroeconomic changes. The data of this analysis serve as the basis for top management decisions to optimize the Company's asset portfolio.

## **Country Risks**

Among other things, PJSC LUKOIL has operations in a number of countries with high political and economic risks. Should they be realized, such risks may significantly complicate the Company's business or even cause the Company to suspend its operations in a certain region. In particular, the Company has launched a number of projects in Iraq, Egypt, Uzbekistan, West African countries where country risks are deemed high.

The Company seeks to diversify its operations and alongside with its activities in unstable regions has been managing projects in Europe and the US, where regional risks are considered minimal.

The major part of the Company's development and refining assets is located in the Russian Federation. The political environment in the RF is characterized by a fair degree of stability and high support of the population of the policies undertaken by the President and the Government.

The main factors which are capable of affecting PJSC LUKOIL's activities include:

- Instability of the political situation in the countries where the Company's is implementing its investment projects, due to regime changes;
- Escalation of military conflicts in the countries of the Company's presence;
- Macroeconomic instability in the countries of the Company's presence;
- Expropriation of the Company's assets;
- Inefficiency of the legislation regulating economic relations, and of the court system.

When implementing projects with high country risks, the Company applies more stringent return level requirements to such projects. Besides, should the political or social and economic situation deteriorate in a region of the Company's presence, PJSC LUKOIL shall implement a set of crisis response measures, including cost saving, optimization of the investment program based on the new conditions, equity drawdown, and invite partners to share project risks.

## **Industry-Specific Risks**

### **Risks Associated with Well Construction and Hard-to-Recover Hydrocarbon Field Development**

The risk associated with the prohibition of supply of the equipment and materials currently used for well construction is essential to the Company. The fact that a considerable share of the materials and equipment required for well construction is purchased today by the Company and its contractors from foreign contractors is regarded as a risk factor.

The greatest part of the chemical agents intended for preparation and processing of drill muds, as well as for preparation of grouting mixtures currently purchased from the EU and the US manufacturers, can be replaced with the products manufactured by the enterprises of China, Thailand, the RF and the Belarus Republic. It is also worth mentioning that the chemical products currently purchased from the EU and the US manufacturers are low-tonnage;

Based on the information received from the Company's contractors providing maintenance services during well construction, as of today the Company's projects have now stocked spare parts, equipment and supplies for one year.

Due to the sanctions imposed against Russia there is a risk of constraints arising as hard-to-recover-hydrocarbon fields are developed with application of the multi-zone hydrofracturing technique. The equipment for multi-zone hydrofracturing used today as part of the Company's projects knows no equals produced by the enterprises of the RF or China.

### **Risks Associated with the Growth of Tariffs and Suppliers' Prices for Goods/Work/Services in Operations, except Critical Raw Material**

The risk associated with tariff growth is accounted for the activities of such monopolies as JSC RZhd, PJSC Gazprom and other monopolies in the countries of the Company's presence, since the prices for their services grow on a regular basis.

The expenses on product logistics as the product volumes rise directly affect PJSC LUKOIL profit.

There is also a risk of price growth for the services of other suppliers, including motor transportation, the services of customs brokers, warehouse storage cost, etc.

In order to minimize the risks associated with tariff growth of JSC RZhd, and other similar monopolies in the countries of its presence the Company:

- diversifies ways to transport the Company's products;
- in order to reduce the risks of advanced tariff growth of the above monopolies the Company participates in the coordinated operations aimed at the prevention of advanced tariff growth together with other consumers;
- when suppliers are selected to cooperate on a long-term basis, the Company holds bidding procedures.

### **Risk of Restricted Access to Petroleum Product Transshipment Infrastructure**

The risk scenario depends on:

- inability to ensure safety of goods in transit on the part of the natural monopolist in petroleum product pipeline transport;
- limited infrastructure capabilities given the growth in third-party transportation, and changes in the quality of transported goods.
- the political situation;

The Company invests great efforts to find ways to reduce these risks:

- diversifies types of transport and petroleum product export destinations;
- conducts systematic work with natural monopolies in terms of pipeline transfer to increase transportation output through the PJSC Transneft system given the ever-growing oil production rates and/or increasing refining output at the Company's refineries;
- develops its own transportation and logistics infrastructure to satisfy oil and petroleum product export.

## **Financial Risks**

### **Price Risks**

Oil and petroleum product price fluctuations may significantly affect the issuer's financial performance and the value of its securities. The issuer has a limited influence on its output prices, which depend a lot on the market situation and measures taken by the regulatory authorities.

High oil price volatility is expected to persist in the near term as a result of the uncertainty as to the outlooks of the global economic growth, oil supply interruptions to the market, the gap between the global oil demand and supply, and high geopolitical tensions.

The issuer is a vertically integrated oil company which embraces production, refining and distribution assets. This structure serves as a natural hedging mechanism, where multidirectional risk factors compensate one another.

In addition to this, the Company uses a number of measures to reduce the negative price risk impact:

- As long-term programs are developed, several price scenarios are considered, while the investment project portfolio is shaped in view of the tolerance analysis of the project performance figures to the changes in price parameters;
- A commodity supply management system has been implemented which makes it possible to respond to market changes very quickly and conduct arbitrary shipments;
- In its trading activities, the Company uses hedging operations which help significantly reduce the negative impact of the price fluctuations on the oil and petroleum product markets as part of the Group operations.

## **Liquidity Risks**

High volatility of oil prices, exchange rates of foreign currencies to the US dollar, refining margin, petrochemistry and power generation margin, sales margin, growth of tariffs and suppliers' prices, as well as possible international economic sanctions in response to the RF foreign policy may create an imbalance in the figures included into the plans, budgets and investment programs of the LUKOIL Group, thus leading to the shortage of liquidity and financing sources.

This risk is managed through sensitivity assessment of the performance figures included into the plans, budgets and investment programs to the changes in macroeconomic indicators. The Company also develops proposals related to plan adjustments, possible sequestering of expenses associated with the transition to the stress scenario, shifting of due dates and project implementation dates or inclusion of optional projects in the plan in case of improvements in the macroeconomic situation, as well as the proposals to ensure well-timed financing of its business activities. Much attention is paid to cost minimization by means of bidding procedures.

LUKOIL Group's liquidity is managed on a centralized basis, with the rolling liquidity forecast serving as a key tool; there is also an efficient global system in place to manage LUKOIL Group's liquidity, which includes an automated system of concentration and re-distribution of funds, as well as corporate dealing. The liquidity indicators are controlled on a regular basis.

Despite the complicated market situation for the Russian borrowers, the volume of approved credit lines required to provide a sufficient level of liquidity in line with the requirements of the rating agencies is maintained at the required level.

Currently, PJSC LUKOIL has investment ratings from three largest international rating agencies, including: S&P (BBB rating), Fitch (BBB+ rating) and Moody's (Baa3 rating). The last rating was raised in January of 2018. It is worth noting that the fact that its credit rating exceeds the sovereign credit rating of the Russian Federation testifies to high financial stability of PJSC LUKOIL.

The Company is monitoring and ensuring compliance of its financial indicators with the rating agencies' requirements on a regular basis.

## **Foreign Exchange Risks**

The fact that the Company's assets are mainly concentrated in the RF makes its financial indicators dependent on the ruble to dollar exchange rate. The Company's proceeds are mainly shaped by US dollar proceeds from the oil and petroleum product sales, while operating and capital expenses are denominated in rubles. The Company has to sell foreign currency to finance ruble denominated expenses. When the ruble appreciates, the Company needs to sell an extra amount of its foreign currency proceeds to finance ruble denominated expenses, which will have an adverse effect on the Company's net profit in rubles.

The Company's foreign currency revenue and expenses mix serves as natural hedging. For instance, the oil price reduction, as a rule, is accompanied by a weaker ruble exchange rate, which helps partially offset the negative impact of the oil price reduction on the Company's financial indicators.

In order to mitigate the negative consequences of the changes in the currency exchange rates the Company takes advantage of its geographic diversification. The Company also applies hedging tools to its currency proceeds.

## **Risk of Contractor's Default, Failure to Pay on the part of the Contractor**

The risk manifests itself in the possibility of untimely proceeds from the supplied goods. As related to export sales, untimely and/or incomplete proceeds may require additional funds to ensure fulfillment of the Company's financial obligations.

This risk is minimized by the contractual terms in view of which the settlements with third parties, non-members of the LUKOIL Group are either made on a pre-paid basis or secured by letters of credit or bank guarantees on the part of end buyers. The list of banks issuing letters of credit and bank guarantees is subject to approval by the Company's corporate center.

## **Legal Risks**

### **Tax and Customs Regulation Risks**

The actions of the RF government focused on amending the taxation and customs policy are primarily dictated by the state of the RF budget system and the way the domestic market is regulated. Increased tax burden, unexpected changes in the tax and customs duty rates, cancellation of the applicable incentive rates for a number of the Company's fields may affect financial performance of the LUKOIL Group and its entities.

Due to considerable fluctuations of the ruble to dollar exchange rate in the recent months and a persisting trend towards further depreciation of the Russian ruble, there is a risk of additional payments of customs duties accompanied by occasional declaration of oil and petroleum product export supplies to exceed the planned amounts (except for pipeline transport supplies).

At the same time, in accordance with the Russian Law “On Customs Tariff” the Government of the Russian Federation reconsiders export customs duties on oil and petroleum products on a monthly basis. Customs duties are calculated based on what the oil price on the global oil markets is, therefore, as the oil price falls, the duty rates are reducing as well, however starting next calendar month.

Strong ruble rate volatility continues to bear significant risks and uncertainty in terms of the amount of the export duties paid in rubles.

To manage the specified risks the Company conducts continuous monitoring of the taxation and customs policy changes, participates in the discussions of legislative initiatives, promptly assesses the influence produced by the probable changes in the taxation and customs legislation upon the LUKOIL Group performance indicators, and takes respective measures in order to either mitigate or offset the negative consequences of the changes in the taxation policy and customs policy, for example, if possible, to be able to submit customs declarations as the ruble to US dollar exchange rate is on the rise.

### **Risks Associated with Changes of the Russian Legislation on Joint-Stock Companies and Securities Markets**

Changes in the Russian corporate governance regulations, including those related to the structure and competences of the regulatory bodies of a joint-stock company, due to the amendments expected to be introduced into the Federal Law “On Joint-Stock Companies”, as well as transition to practical application of the provisions of the Corporate Governance Code (Letter of the Bank of Russia No.06-52/2463 of April 10, 2014) in view of the reporting recommendations in accordance with the Corporate Governance Code (Letter of the Bank of Russia No. IN-06-52/8 of February 17, 2016) may lead to changes in the Company’s corporate structure and corporate governance procedures, which in its turn may affect the Company’s decision-making process and performance.

The Company is constantly monitoring legislation changes in this field. The Company also takes measures to collect information on such changes at the stage of preliminary discussion, and to ensure participation of the Company’s representatives in such discussions in order to provide a detailed explanation of the Company’s standpoint on these issues, risks and uncertainties which may arise as a result of the proposed legislative initiatives.

The Company also takes measures to ensure participation of its representatives in the activities focused on the development of efficient solutions in the area of practical application of the effective legislative innovations.

### **Risks Associated with Circulation of the Company’s Securities**

The Company’s securities circulate in regulated markets in Russia and abroad. Changes in the requirements to the issuers on the part of the regulatory authorities for securities and stock exchanges, as well as the changes in the listing structure may induce the Company to amend its corporate governance procedures and assume extra obligations as to information disclosure and shareholder relations. Should the Company fail to ensure compliance with these requirements and fulfill the required obligations, it may result in transfer of the Company’s securities to lower listing segments, including delisting, which may have an adverse impact on the liquidity and cost of the securities.

The Company monitors changes in the listing rules of stock exchanges and other requirements of stock exchanges and regulatory authorities to the issuers whose securities are admitted to trading. The Company’s representatives participate in the working meetings and other issuer events arranged by stock exchanges and other organizations that provide consulting and educational services to the issuers of the securities traded in regulated markets. The Company also seeks to introduce the best global practice in corporate governance and shareholder relations.

In order to maintain its securities listing the Company adheres to certain obligatory information disclosure procedures within the timelines set by the requirements of the regulatory authorities and stock exchanges. The information is disclosed in digital form by transferring it to the organizations authorized to disclose information in stock markets by regulatory authorities (hereinafter, information disclosure services), via the websites of the said organizations and e-mails. Should websites of the information disclosure organizations be unreachable (due to hacker attacks, technical failures, etc.), as well as in case of malfunction of the Company’s own computer systems, the necessary information cannot to be disclosed within the set timelimits, which may be considered as a violation of the Company’s obligations and result in imposition of administrative fines on the Company and/or its executive employees by the securities regulatory authorities.

In order to mitigate these risks the Company shall conclude information disclosure agreements with several information disclosure services, seek to submit the information prior to its disclosure thus ensuring extra time to tackle possible technical failures before the deadline arrives. If the need be, the Company’s authorized employees can promptly contact the assigned employees of the information disclosure services.

## **Geological Risks**

### **The Risk of Failure to Discover Geological Reserves or Discovery of the Reserves below the Initially Expected Level**

The Company's business is exposed to the risk that while implementing new projects, and exploratory drilling, we might not discover any productive (commercially efficient) oil and gas reserves, and/or that the discovered reserves will be considerably below the initially expected level. Therefore, the Company may have to incur additional expenses or even cease operations in a number of license areas.

PJSC LUKOIL manages this risk at the level sufficient for prompt risk response, by means of additional geological exploration operations, processing seismic materials and improving the 3D field seismic observation techniques.

### **Risks Associated with Subsurface Use and Licensing**

The applicable Russian legislation on subsurface use and licensing of exploration and production activities, as well as their practical application expose oil companies to a number of risks. The most important are the following ones:

- risk of subsoil license early termination for failure to comply with the terms of license agreements;
- risk of failure to provide the companies with equal access to the subsoil resources of the Continental shelf;
- risk of having no legislative guarantees to grant the right to subsurface use to a legal entity that discovered a field of federal significance or a field located in the subsurface area of federal significance (Russian continental shelf, internal and territorial seas of the RF, as well as the Russian sector of the Caspian sea bottom), including the subsurface users with the share of foreign investors in the companies' authorized capital);
- risk of refusal to accept bidding documents for participation in competitive sales/biddings in view of technicalities from subsurface users of the LUKOIL Group entities;
- risk of fines imposed for administrative offenses for failure to fulfill the terms of license agreements.

The Company is fully committed to minimizing the potential effects resulting from the realization of the above risks, including the following:

- conducts monitoring of the changes in the legislation and in the area of subsurface use and licensing, forwarding proposals to update the applicable regulatory framework;
- creates a list of sites associated with the Unallocated Subsoil Stock, which are of interest to the Company, in the oil and gas production companies, to ensure timely decision-making on participation of the LUKOIL Group entities in the bidding procedures for subsoil use rights. Prepares feasibility studies of new geological areas in the context of the existing basic USC;
- has established permanent working groups in the LUKOIL Group entities to develop the bidding documents to participate in the bidding procedures and re-register licenses.
- holds annual advanced training workshops for specialists in the area of licensing and subsoil use, participates in workshops with governmental officers;
- monitors current subsoil use state with application of a special information system;
- interacts with the regulatory authorities in order to mitigate the risk of early subsoil license termination.

### **Risk of Terrorist Attacks, Wrongful Acts by Third Parties**

As the number of terrorist organizations increases, as well as that of terrorist attacks in the countries of the Company's presence, there is a possibility of terrorist attacks and other wrongful acts against the Company's assets.

Tense military and political climate in the Middle East accompanied by a persisting armed conflict in Syria and Iraq jeopardizes the Company's assets.

There are also risks related to wrongdoings on the part of LUKOIL's competitors (specifically, risks of unfair competition), risks of financial and other abuses on the part of the LUKOIL Group employees, as well as those related to theft of financial resources and commodity stocks.

The Company manages this risk in the following key areas:

- participates in the events organized by the National Anti-terrorism Committee of Russia, the RF Federal Security Service, the RF Ministry of Internal Affairs;

- identifies persons who are intentionally inflicting harm on the Company's interests for the benefit of competing and other third-party (including criminal) structures and persons;
- plans and arranges events aimed at information security improvement;
- implements the Information Safety Program in the LUKOIL Group entities;
- obtains licenses issued by the RF Federal Security Services to use encryption-based information security tools.

## **HSE Risks**

The Company is exposed to the risk of failure of technical equipment at hazardous production facilities, which may result in accidents, shutdowns, harmful emissions, negative environmental impact, fire and occupational injuries, including those occurring as a result of offshore oil and gas field development. This risk may result in unscheduled shutdowns of the production capacities and, consequently, failure to receive the expected level of operating income.

In order to mitigate these risks the Company has created and is successfully implementing its industrial safety system, including:

- the use of corporate standards, including without limitation those governing environmental safety matters;
- production control over the operation of hazardous production facilities;
- dedicated expert training;
- diagnostics (non-destructive inspection) and monitoring of equipment parameters;
- assessment of workplaces based on working conditions;
- repairs and timely replacement of equipment;
- elaboration of the Emergency Response Plans at hazardous production facilities, oil spill response plans, creation of a pool of rescue teams and reserves for emergency response, training of service personnel at hazardous production facilities and rescue teams in the area of emergency and oil spill response;
- other measures to minimize accident rates at the Company's production facilities.

The applicable HSE Management System certified for compliance with the requirements of ISO 14001 and OHSAS 18001 international standards ensures prompt detection of discrepancies in work organization and equipment operation, as well as development and implementation of corporate target industrial and fire safety programs and plans, emergency response plans at hazardous production facilities, oil spill response plans, training of service personnel and accident prevention services in emergency response.

## **Risks of Failure to Implement the Investment Program**

While implementing investment projects, the Company has to face the risk of higher costs and untimely commissioning of production assets.

Delays in project implementation, including those caused by the delays in preparing design and estimate documentation, obtainment of approvals, conclusion of contracts, work execution period, as well as changes in field development plans in connection with the collection of additional geological information may result in a failure to implement the investment program. This may lead to the deteriorated performance indicators for the subsequent years, undermined efficiency of investment projects and the need to raise "excessive" funds.

The Company pays great attention to managing this risk by means of quarterly monitoring of project implementation progress as well as by investment program adjustment. As the investment program is developed, the greenfield development projects without sufficient design and estimate documentation are excluded from the plans for the coming year.

## **Risk Associated with the Lack of Qualified Personnel**

The competence and expertise of the newly recruited employees may prove insufficient for them to adequately fulfill their duties, which, in its turn, may adversely affect the financial performance indicators of the Company.

To mitigate the negative impact of this risk, the Company focuses on integrated development of the personnel potential. The Company has created and replenishes its personnel pool consisting of the most experienced and the most promising employees; it pays special attention to the recruitment of young specialists and graduates.

## **Responsibility statement**

I hereby confirm that to the best of my knowledge:

(a) the financial statements, prepared in accordance with the International Financial Reporting Standards, give a true and fair view of the assets, liabilities, financial position and profit or loss of the Company and the undertakings included in the consolidation taken as a whole,

(b) the management report includes a fair review of the development and performance of the business and the position of the Company and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

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