

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, 2019. 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, 2019 should be read in conjunction with the consolidated financial statements for the year ended December 31, 2018 prepared in accordance with International Financial Reporting Standards.

OVERVIEW

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

We are involved in the following activities:

- exploration and production of gas;
- transportation of gas;
- sales of gas within the Russian Federation and abroad;
- gas storage;
- production of crude oil and gas condensate;
- processing of oil, gas condensate and other hydrocarbons and sales of refined products;
- electric and heat energy generation and sales.

Other activities include production of other goods, other works and rendering of other services.

The official Russian Ruble ("RUB") to US Dollar foreign exchange rate as determined by the Central Bank of the Russian Federation was as follows:

- as of June 30, 2019 – 63.0756 (as of June 30, 2018 – 62.7565);
- as of December 31, 2018 – 69.4706 (as of December 31, 2017 – 57.6002).

The official RUB to Euro foreign exchange rate as determined by the Central Bank of the Russian Federation was as follows:

- as of June 30, 2019 – 71.8179 (as of June 30, 2018 – 72.9921);
- as of December 31, 2018 – 79.4605 (as of December 31, 2017 – 68.8668).

The average exchange rates of RUB for the six months ended June 30, 2019 and for the six months ended June 30, 2018 were:

- to US Dollar – 65.3384 and 59.3536, respectively;
- to Euro – 73.8389 and 71.8223, respectively.

RESULTS OF OPERATION

(in RUB million)

	Three months ended June 30,		Six months ended June 30,	
	2019	2018	2019	2018
Sales	1,784,930	1,833,224	4,076,751	3,971,555
Net loss from trading activity	(26,020)	(9,295)	(32,615)	(2,294)
Operating expenses	(1,414,471)	(1,384,303)	(3,196,687)	(3,035,649)
Impairment loss on financial assets	<u>(22,323)</u>	<u>(27,934)</u>	<u>(66,571)</u>	<u>(54,339)</u>
Operating profit	322,116	411,692	780,878	879,273
Finance income	95,415	168,559	353,638	259,939
Finance expense	(55,502)	(287,409)	(124,493)	(394,832)
Share of profit of associates and joint ventures	<u>51,323</u>	<u>47,903</u>	<u>115,255</u>	<u>91,583</u>
Profit before profit tax	413,352	340,745	1,125,278	835,963
Current profit tax expense	(77,230)	(56,379)	(197,494)	(103,221)
Deferred profit tax expense	<u>(16,991)</u>	<u>(12,984)</u>	<u>(49,140)</u>	<u>(69,191)</u>
Profit tax	(94,221)	(69,363)	(246,634)	(172,412)
Profit for the period	319,131	271,382	878,644	663,551
Other comprehensive income (loss):				
Items that will not be reclassified to profit or loss:				
Gain arising from changes in fair value of financial assets measured at fair value through other comprehensive income, net of tax	70,666	42,929	47,499	71,006
Remeasurement of provision for post-employment benefits	<u>(53,739)</u>	<u>26,706</u>	<u>(77,852)</u>	<u>15,343</u>
Total other comprehensive income (loss) that will not be reclassified to profit or loss	16,927	69,635	(30,353)	86,349
Items that may be reclassified subsequently to profit or loss:				
Share of other comprehensive (loss) income of associates and joint ventures	(2,433)	170	(4,329)	1,658
Translation differences	(24,663)	78,474	(140,628)	90,937
Gain from hedging operations, net of tax	<u>4,668</u>	<u>19,867</u>	<u>10,024</u>	<u>26,951</u>
Total other comprehensive (loss) income that may be reclassified subsequently to profit or loss	(22,428)	98,511	(134,933)	119,546
Total other comprehensive (loss) income for the period, net of tax	<u>(5,501)</u>	<u>168,146</u>	<u>(165,286)</u>	<u>205,895</u>
Comprehensive income for the period	313,630	439,528	713,358	869,446
Profit for the period attributable to:				
Owners of PJSC Gazprom	300,589	259,181	836,497	630,804
Non-controlling interest	<u>18,542</u>	<u>12,201</u>	<u>42,147</u>	<u>32,747</u>
	319,131	271,382	878,644	663,551
Comprehensive income for the period attributable to:				
Owners of PJSC Gazprom	296,378	424,510	679,588	831,384
Non-controlling interest	<u>17,252</u>	<u>15,018</u>	<u>33,770</u>	<u>38,062</u>
	313,630	439,528	713,358	869,446

Sales

The following table sets out volumes and sales prices:

(in RUB million unless indicated otherwise)

	Three months ended June 30,		Six months ended June 30,	
	2019	2018	2019	2018
Sales of gas				
<i>Europe and other countries</i>				
Gross sales ⁽¹⁾	742,550	840,226	1,806,757	1,780,324
Customs duties	(132,829)	(175,521)	(340,625)	(342,909)
Excise tax	(13,526)	(11,707)	(32,541)	(26,110)
Net sales	596,195	652,998	1,433,591	1,411,305
Volumes in bcm	55.5	57.0	117.9	128.5
Average price, US Dollar per mcm ⁽²⁾ (including excise tax and customs duties) ⁽³⁾	207.5	238.4	235.3	233.1
Average price, RUB per mcm ⁽²⁾ (including excise tax and customs duties)	13,392.1	14,741.1	15,331.0	13,858.9
<i>Former Soviet Union countries</i>				
Gross sales ⁽¹⁾	68,687	59,966	202,637	183,779
Customs duties	(6,446)	(4,421)	(22,899)	(16,755)
Net sales	62,241	55,545	179,738	167,024
Volumes in bcm	6.9	6.5	19.1	20.6
Average price, US Dollar per mcm ⁽²⁾ (including customs duties) ⁽³⁾	154.5	148.9	163.2	150.3
Average price, RUB per mcm ⁽²⁾ (including customs duties)	9,969.1	9,205.7	10,637.1	8,935.2
<i>Russian Federation</i>				
Gross sales (net of VAT)	169,326	158,218	518,256	508,765
Net sales	169,326	158,218	518,256	508,765
Volumes in bcm	42.1	41.4	126.4	129.6
Average price, RUB per mcm ⁽²⁾ (net of VAT)	4,020.3	3,822.8	4,100.8	3,925.8
<i>Total gas sales</i>				
Gross sales (net of VAT)	980,563	1,058,410	2,527,650	2,472,868
Customs duties	(139,275)	(179,942)	(363,524)	(359,664)
Excise tax	(13,526)	(11,707)	(32,541)	(26,110)
Retroactive gas price adjustments	8,009	37,603	8,009	37,795
Net sales	835,771	904,364	2,139,594	2,124,889
Volumes in bcm	104.5	104.9	263.4	278.7
Net sales of refined products (net of excise tax, VAT and customs duties)	536,462	522,029	1,043,371	991,573
Net sales of crude oil and gas condensate (net of VAT and customs duties)	192,558	195,184	382,947	345,656
Electric and heat energy net sales (net of VAT)	104,482	98,687	277,895	274,173
Gas transportation net sales (net of VAT)	54,653	55,101	110,154	113,754
Other sales (net of VAT)	61,004	57,859	122,790	121,510
Total sales (net of excise tax, VAT and customs duties)	1,784,930	1,833,224	4,076,751	3,971,555

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 the RUB and US Dollar.

Total sales (net of excise tax, VAT and customs duties) increased by RUB 105,196 million, or 3 %, to RUB 4,076,751 million for the six months ended June 30, 2019 compared to the same period of the prior year. The increase in sales was mainly due to an increase in sales of refined products, crude oil and sales of gas.

Net sales of gas accounted for 52 % of total net sales for the six months ended June 30, 2019 (54 % for the same period of the prior year).

Net sales of gas increased by RUB 14,705 million, or 1 %, from RUB 2,124,889 million for the six months ended June 30, 2018 to 2,139,594 RUB million for the six months ended June 30, 2019.

Net sales of gas to Europe and other countries increased by RUB 22,286 million, or 2 %, to RUB 1,433,591 million for the six months ended June 30, 2019 compared to the same period of the prior year. The change was due to the increase in average prices (including excise tax and customs duties) denominated in the Russian Ruble, by 11 % that was partially compensated by the decrease in volumes of gas sold by 8 % for the six months ended June 30, 2019 compared to the same period of the prior year. At the same time average prices denominated in US Dollar increased by 1 % compared to the same period of the prior year.

Net sales of gas to Former Soviet Union countries increased by RUB 12,714 million or 8 %, to RUB 179,738 million for the six months ended June 30, 2019 compared to the same period of the prior year. The change was due to the increase in average prices (including customs duties) denominated in the Russian Ruble by 19 % that was partially compensated by the decrease in volumes of gas sold by 7 % for the six months ended June 30, 2019 compared to the same period of the prior year. At the same time average prices denominated in US Dollar increased by 9 % compared to the same period of the prior year.

Net sales of gas in the Russian Federation increased by RUB 9,491 million, or 2 %, to RUB 518,256 million for the six months ended June 30, 2019 compared to the same period of the prior year. This change is explained by the increase in average prices (net of VAT) denominated in the Russian Ruble by 4 % that was partially compensated by the decrease in volumes of gas sold by 2 %.

Net sales of refined products (net of excise tax, VAT and customs duties) increased by RUB 51,798 million, or 5 %, to RUB 1,043,371 million for the six months ended June 30, 2019 compared to the same period of the prior year. The increase in net sales of refined products was mainly due to an increase in average prices denominated in the Russian Ruble in all geographic segments.

Net sales of crude oil and gas condensate (net of VAT and customs duties) increased by RUB 37,291 million, or 11 %, to RUB 382,947 million for the six months ended June 30, 2019 compared to the same period of the prior year. The change was mainly due to an increase in average prices denominated in the Russian Ruble and an increase in Gazprom Neft Group's crude oil sales volumes in all geographic segments.

Operating expenses

Operating expenses increased by RUB 161,038 million, or 5 %, to RUB 3,196,687 million for the six months ended June 30, 2019 compared to RUB 3,035,649 million for the same period of the prior year. Operating expenses as a percentage of sales increased from 76 % for the six months ended June 30, 2018 to 78 % for the six months ended June 30, 2019. The table below presents a breakdown of operating expenses in each period:

(in RUB million)	Three months ended June 30,		Six months ended June 30,	
	2019	2018	2019	2018
Taxes other than on profit	357,204	345,866	733,509	668,485
Purchased gas and oil	325,917	345,766	729,779	744,542
Staff costs	194,315	189,010	381,134	378,771
Depreciation	175,223	160,261	347,875	318,547
Transit of gas, oil and refined products	167,351	156,894	336,053	303,483
Materials	83,550	73,670	147,393	128,545
Cost of goods for resale, including refined products	69,780	61,625	125,846	123,749
Electricity and heating expenses	23,948	25,122	57,144	57,608
Repairs and maintenance	35,294	32,943	53,361	52,676
Foreign exchange rate differences on operating items	4,139	9,821	51,390	(8,791)
Social expenses	9,522	7,343	16,315	16,440
Insurance expenses	7,955	8,085	15,477	15,592
Rental expenses	5,581	9,699	12,884	19,466
Processing services	5,129	4,963	10,496	9,121
Derivatives loss	2,987	3,703	10,051	16,155
Transportation services	3,446	7,855	9,714	16,961
Research and development expenses	4,152	1,714	9,367	7,529
Impairment loss (reversal of impairment loss) on non-financial assets	(351)	1,505	1,802	5,158
Other	80,605	78,058	219,217	176,723
	1,555,747	1,523,903	3,268,807	3,050,760
Change in balances of finished goods, work in progress and other effects	<u>(141,276)</u>	<u>(139,600)</u>	<u>(72,120)</u>	<u>(15,111)</u>
Total operating expenses	1,414,471	1,384,303	3,196,687	3,035,649

Taxes other than on profit

Taxes other than on profit consist of:

(in RUB million)	Three months ended June 30,		Six months ended June 30,	
	2019	2018	2019	2018
Mineral extraction tax	289,795	259,326	589,467	492,748
Property tax	37,681	41,756	74,749	83,662
Excise tax	19,443	40,279	53,850	85,126
Other taxes	10,285	4,505	15,443	6,949
Total taxes other than on profit	357,204	345,866	733,509	668,485

Mineral extraction tax (MET) increased by RUB 96,719 million or 20 % to RUB 589,467 million for the six months ended June 30, 2019 compared to RUB 492,748 million for the same period of the prior year. MET for the six months ended June 30, 2019 increased compared to the same period of the prior year mainly as a result of an increase in coefficient values in the MET formula for gas.

Excise tax decreased by RUB 31,276 million, or 37 %, to RUB 53,850 million for the six months ended June 30, 2019 compared to RUB 85,126 million for the same period of the prior year. Excise tax decreased due to an implementation of crude oil materials excise duty deduction including dempfer part since January 1, 2019, which was trimmed by an excise rates increase for several petroleum products since January 2019.

Purchased gas and oil

Cost of purchased gas and oil decreased by RUB 14,763 million, or 2 %, to RUB 729,779 million for the six months ended June 30, 2019 compared to RUB 744,542 million for the same period of the prior year.

Cost of purchased gas included in the purchased gas and oil decreased by RUB 36,041 million, or 7 %, to RUB 487,738 million for the six months ended June 30, 2019 compared to RUB 523,779 million for the same period of the prior year. The change was mainly due to a decrease in volumes of purchased gas that was partially compensated by an increase in average prices denominated in the Russian Ruble.

Cost of purchased oil included in the purchased gas and oil increased by RUB 21,278 million, or 10 %, to RUB 242,041 million for the six months ended June 30, 2019 compared to RUB 220,763 million for the same period of the prior year. This change was mainly due to an increase in volumes of oil purchased on the domestic market and an increase in prices of oil denominated in the Russian Ruble.

Depreciation

Depreciation increased by RUB 29,328 million, or 9 %, to RUB 347,875 million for the six months ended June 30, 2019 compared to RUB 318,547 million for the same period of the prior year. The change was mainly due to charging of depreciation of right-of-use assets caused by the application of IFRS 16 Leases since January 1, 2019.

Transit of gas, oil and refined products

Transit of gas, oil and refined products increased by RUB 32,570 million, or 11 %, to RUB 336,053 million for the six months ended June 30, 2019 compared to RUB 303,483 million for the same period of the prior year.

Materials

Materials increased by RUB 18,848 million, or 15 %, to RUB 147,393 million for the six months ended June 30, 2019 compared to RUB 128,545 million for the same period of the prior year.

Foreign exchange rate differences on operating items

Foreign exchange rate loss on operating items amounted to RUB 51,390 million for the six months ended June 30, 2019 compared to the foreign exchange gain in the amount of RUB 8,791 million for the same period of the prior year. This change was mainly due to the depreciation of US Dollar and Euro against the Russian Ruble by 9 % and 10 %, respectively, for the six months ended June 30, 2019 compared to the appreciation of US Dollar and Euro against the Russian Ruble by 9 % and 6 %, respectively, for the same period of the prior year.

Other operating expenses

Other operating expenses increased by RUB 42,494 million, or 24 %, to RUB 219,217 million for the six months ended June 30, 2019 compared to RUB 176,723 million for the same period of the prior year. Other expenses include gas and gas condensate production expenses, services from gas distribution companies, bank charges, security services, legal and consulting services, charity and financial aid and advertising.

Change in balances of finished goods, work in progress and other effects

The line item Change in balances of finished goods, work in progress and other effects decreased by RUB 57,009 million, or 377 %, to the negative amount of RUB 72,120 million for the six months ended June 30, 2019 compared to the negative amount of RUB 15,111 million for the same period of the prior year. The change in this line item was due to an increase in the balances of finished goods for the six months ended June 30, 2019 was more than an increase in the balances of finished goods for the same period of the prior year.

Impairment loss on financial assets

Impairment loss on financial assets increased by RUB 12,232 million, or 23 %, to RUB 66,571 million for the six months ended June 30, 2019 compared to RUB 54,339 million for the same period of the prior year. The change is mainly due to an increase in the accrual of the allowance for expected credit losses on accounts receivable due from debtors from south regions of the Russian Federation and NJSC Naftogaz of Ukraine for the six months ended June 30, 2019 compared to the same period of the prior year.

Operating profit

As a result of the factors discussed above, operating profit decreased by RUB 98,395 million, or 11 %, to RUB 780,878 million for the six months ended June 30, 2019 compared to RUB 879,273 million for the same period of the prior year. The operating profit margin decreased from 22 % for the six months ended June 30, 2018 to 19 % for the six months ended June 30, 2019.

Net finance income (expense)

(in RUB million)	Three months ended June 30,		Six months ended June 30,	
	2019	2018	2019	2018
Foreign exchange gain	70,848	149,780	305,451	223,091
Foreign exchange loss	<u>(36,346)</u>	<u>(274,744)</u>	<u>(86,964)</u>	<u>(369,153)</u>
Net foreign exchange gain (loss)	34,502	(124,964)	218,487	(146,062)
Interest income	24,567	18,779	48,187	36,848
Interest expense	<u>(19,156)</u>	<u>(12,665)</u>	<u>(37,529)</u>	<u>(25,679)</u>
Net finance income (expense)	39,913	(118,850)	229,145	(134,893)

The net foreign exchange gain of RUB 218,487 million for the six months ended June 30, 2019 compared to the net foreign exchange loss of RUB 146,062 million for the same period of the prior year were explained by the depreciation of US Dollar and Euro against the Russian Ruble by 9 % and 10 %, respectively, for the six months ended June 30, 2019 compared to the appreciation of US Dollar and Euro against the Russian Ruble by 9 % and 6 %, respectively, for the same period of the prior year.

Interest income increased by RUB 11,339 million, or 31 %, to RUB 48,187 million for the six months ended June 30, 2019 compared to RUB 36,848 million for the same period of the prior year.

Interest expense increased by RUB 11,850 million, or 46 %, to RUB 37,529 million for the six months ended June 30, 2019 compared to RUB 25,679 million for the same period of the prior year.

Share of profit of associates and joint ventures

Share of profit of associates and joint ventures increased by RUB 23,672 million, or 26 %, to RUB 115,255 million for the six months ended June 30, 2019 compared to RUB 91,583 million for the same period of the prior year. This change was mainly caused by an increase in the share of profit of JSC Achimgaz, JSC Messoyakhaneftegaz, Sakhalin Energy Investment Company Ltd. and JSC Arcticgas.

Profit tax

Total profit tax increased by RUB 74,222 million, or 43 %, to RUB 246,634 million for the six months ended June 30, 2019 compared to RUB 172,412 million for the same period of the prior year. The effective profit tax rate was 21.9 % and 20.6 % for the six months ended June 30, 2019 and for the six months ended June 30, 2018, 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 205,693 million, or 33 %, to RUB 836,497 million for the six months ended June 30, 2019 compared to RUB 630,804 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 9,400 million, or 29 %, to RUB 42,147 million for the six months ended June 30, 2019 compared to RUB 32,747 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, 2019 and for the six months ended June 30, 2018:

(in RUB million)	Six months ended June 30,	
	2019	2018
Net cash from operating activities	1,256,653	947,494
Net cash used in investing activities	(958,604)	(785,968)
Net cash from (used in) financing activities	71,326	(134,887)

Net cash from operating activities

Net cash from operating activities increased by RUB 309,159 million, or 33 %, to RUB 1,256,653 million for the six months ended June 30, 2019 compared to RUB 947,494 million for the same period of the prior year. This change was mainly driven by a decrease in short-term deposits within working capital for the six months ended June 30, 2019 compared to their increase for the same period of the prior year.

Net cash used in investing activities

Net cash used in investing activities increased by RUB 172,636 million, or 22 %, to RUB 958,604 million for the six months ended June 30, 2019 compared to RUB 785,968 million for the same period of the prior year. The change was mainly due to an increase in loans issued for the six months ended June 30, 2019 compared to the same period of the prior year.

Net cash from (used in) financing activities

Net cash from financing activities amounted to RUB 71,326 million for the six months ended June 30, 2019 compared to net cash used in financing activities in the amount of RUB 134,887 million for the same period of the prior year. This change was mainly due to an increase in proceeds from and decrease repayments of long-term borrowings.

Capital expenditures

Total capital expenditures (excluding the effect of acquisitions of subsidiaries) denominated in the Russian Ruble by segments for the six months ended June 30, 2019 and for the six months ended June 30, 2018 amounted to the following:

(in RUB million)	Six months ended	
	June 30,	
	2019	2018
Transportation	191,304	287,657
Refining	147,831	119,906
Production of crude oil and gas condensate	118,150	103,856
Production of gas	97,292	82,059
Electric and heat energy generation and sales	26,144	20,202
Distribution of gas	8,233	16,727
Gas storage	5,655	4,125
All other segments	<u>62,573</u>	<u>46,805</u>
Total	657,182	681,337

Total capital expenditures decreased by RUB 24,155 million, or 4 %, from RUB 681,337 million for the six months ended June 30, 2018 to RUB 657,182 million for the six months ended June 30, 2019.

Debts obligation

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) decreased by RUB 457,760 million, or 15 %, from RUB 3,014,403 million as of December 31, 2018 to RUB 2,556,643 million as of June 30, 2019. This change was mainly due to an increase in cash and cash equivalents balances.