

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 three months ended March 31, 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 three months ended March 31, 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 March 31, 2018 – 57.2649 (as of March 31, 2017 – 56.3779);
- 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 March 31, 2018 – 70.5618 (as of March 31, 2017 – 60.5950);
- as of December 31, 2017 – 68.8668 (as of December 31, 2016 – 63.8111).

The average exchange rates of RUB for the three months ended 31 March, 2018 and for the nine months ended 31 March, 2017 were:

- to USD – 56.8803 and 58.8366, respectively;
- to EUR – 69.8727 and 62.6474, respectively.

RESULTS OF OPERATION

(RUB million)	Three months ended March 31,	
	2018	2017
Sales	2,138,331	1,815,301
Net gain (loss) from trading activity	7,001	(14,203)
Operating expenses	(1,651,346)	(1,477,862)
Impairment loss on financial assets	<u>(26,405)</u>	<u>(29,187)</u>
Operating profit	467,581	294,049
Finance income	91,380	183,132
Finance expense	(107,423)	(52,688)
Share of net income of associates and joint ventures	<u>43,680</u>	<u>29,555</u>
Profit before profit tax	495,218	454,048
Current profit tax expense	(46,842)	(67,080)
Deferred profit tax expense	<u>(56,207)</u>	<u>(36,581)</u>
Profit tax	(103,049)	(103,661)
Profit for the period	392,169	350,387
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	28,077	(26,807)
Remeasurements of post-employment benefit obligations	<u>(11,363)</u>	<u>(36,570)</u>
Total items that will not be reclassified to profit or loss	16,714	(63,377)
Items that may be reclassified subsequently to profit or loss:		
Share of other comprehensive income of associates and joint ventures	1,488	447
Translation differences	12,463	(81,672)
Gain (loss) from cash flow hedges, net of tax	<u>7,084</u>	<u>(2,214)</u>
Total items that may be reclassified subsequently to profit or loss	21,035	(83,439)
Other comprehensive income (loss) for the period, net of tax	<u>37,749</u>	<u>(146,816)</u>
Total comprehensive income for the period	429,918	203,571
Profit for the period attributable to:		
Owners of PJSC Gazprom	371,623	333,453
Non-controlling interest	<u>20,546</u>	<u>16,934</u>
	392,169	350,387
Total comprehensive income for the period attributable to:		
Owners of PJSC Gazprom	406,874	191,166
Non-controlling interest	<u>23,044</u>	<u>12,405</u>
	429,918	203,571

Sales

The following table sets out volumes and realized prices:

(RUB million unless indicated otherwise)	Three months ended March 31,	
	2018	2017
Sales of gas		
<i>Europe and Other countries</i>		
Gross sales ⁽¹⁾	940,098	736,600
Customs duties	(167,388)	(130,285)
Excise tax	(14,403)	(12,436)
Net sales	758,307	593,879
Volumes in bcm	71.5	65.6
Average price, US Dollar per mcm ⁽²⁾ (including excise tax and customs duties) ⁽³⁾	231.5	191.3
Average price, RUB per mcm ⁽²⁾ (including excise tax and customs duties)	13,155.2	11,226.3
<i>Former Soviet Union countries</i>		
Gross sales ⁽¹⁾	123,813	113,685
Customs duties	(12,334)	(11,550)
Net sales	111,479	102,135
Volumes in bcm	14.1	12.5
Average price, US Dollar per mcm ⁽²⁾ (including customs duties) ⁽³⁾	155.0	154.9
Average price, RUB per mcm ⁽²⁾ (including customs duties)	8,809.8	9,089.7
<i>Russian Federation</i>		
Gross sales (net of VAT)	350,547	312,255
Net sales	350,547	312,255
Volumes in bcm	88.2	81.7
Average price, RUB per mcm ⁽²⁾ (net of VAT)	3,974.2	3,819.9
<i>Total sales of gas</i>		
Gross sales (net of VAT)	1,414,458	1,162,540
Customs duties	(179,722)	(141,835)
Excise tax	(14,403)	(12,436)
Retroactive gas price adjustments	192	(249)
Net sales	1,220,525	1,008,020
Volumes in bcm	173.8	159.8
Net sales of refined products (net of excise tax, VAT and customs duties)	469,544	393,663
Electric and heat energy net sales (net of VAT)	175,486	159,990
Net sales of crude oil and gas condensate (net of VAT and customs duties)	150,472	138,837
Gas transportation net sales (net of VAT)	58,653	58,587
Other revenues (net of VAT)	63,651	56,204
Total sales (net of excise tax, VAT and customs duties)	2,138,331	1,815,301

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 323,030 million, or 18 %, to RUB 2,138,331 million for the three months ended March 31, 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 and refined products.

Net sales of gas accounted for 57 % of total net sales for the three months ended March 31, 2018 (56 % for the same period of the prior year).

Net sales of gas increased by RUB 212,505 million, or 21 %, from RUB 1,008,020 million for the three months ended March 31, 2017 to RUB 1,220,525 million for the three months ended March 31, 2018.

Net sales of gas to Europe and Other countries increased by RUB 164,428 million, or 28 %, to RUB 758,307 million for the three months ended March 31, 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 17 % and the increase in volumes of the gas sold by 9 % for the three months ended 31 March 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 9,344 million, or 9 %, to RUB 111,479 million for the three months ended March 31, 2018 compared to the same period of the prior year. The change was due to the increase in volumes of gas sold by 13 % that was partially compensated by the decrease in average Russian Ruble prices (including customs duties) by 3 % for the three months ended March 31, 2018.

Net sales of gas in the Russian Federation increased by RUB 38,292 million, or 12 %, to RUB 350,547 million for the three months ended March 31, 2018 compared to the same period of the prior year. This change is explained by the increase in volumes of gas sold by 8 % 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 75,881 million, or 19 %, to RUB 469,544 million for the three months ended March 31, 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 to customers in the Russian Federation and Former Soviet Union countries.

Operating expenses

Operating expenses increased by RUB 173,484 million, or 12 % for the three months ended March 31, 2018 to RUB 1,651,346 million compared to RUB 1,477,862 million for the same period of the prior year. Operating expenses as a percentage of sales decreased from 81 % for the three months ended March 31, 2017 to 77 % for the three months ended March 31, 2018. The table below presents a breakdown of operating expenses in each period:

(RUB million)	Three months ended 31 March	
	2018	2017
Purchased gas and oil	398,776	316,905
Taxes other than on income	322,619	295,025
Staff costs	189,761	169,681
Depreciation	158,286	149,694
Transit of gas, oil and refined products	146,589	147,013
Cost of goods for resale, including refined products	62,124	57,004
Materials	54,875	59,595
Electricity and heating expenses	32,486	30,130
Repairs and maintenance	19,733	23,407
Derivatives loss (gain)	12,452	(10,021)
Rental expenses	9,767	10,662
Transportation services	9,106	7,806
Social expenses	9,097	6,600
Insurance expenses	7,507	7,365
Research and development expenses	5,815	7,398
Processing services	4,158	3,556
Impairment loss on non-financial assets	3,653	6,183
Foreign exchange rate differences on operating items	(18,612)	887
Other	98,665	108,249
	1,526,857	1,397,139
Change in finished goods, work in progress and other effects	124,489	80,723
Total operating expenses	1,651,346	1,477,862

Purchased gas and oil

Cost of purchased gas and oil increased by RUB 81,871 million, or 26 %, to RUB 398,776 million for the three months ended March 31, 2018 compared to RUB 316,905 million for the same period of the prior year.

Cost of purchased gas increased by RUB 61,307 million, or 25 %, to RUB 302,014 million for the three months ended March 31, 2018 compared to RUB 240,707 million for the same period of the prior year. The change was due to an increase in volumes of gas purchased from external suppliers and an increase in average prices.

Cost of purchased oil included in the purchased gas and oil increased by RUB 20,564 million, or 27 %, to RUB 96,762 million for the three months ended March 31, 2018 compared to RUB 76,198 million for the same period of the prior year. This change was mainly due to an increase in oil prices.

Taxes other than on income

Taxes other than on income consist of:

(RUB million)	Three months ended 31 March	
	2018	2017
Mineral extraction tax	233,422	218,031
Excise tax	44,847	35,033
Property tax	41,906	39,915
Other taxes	<u>2,444</u>	<u>2,046</u>
Taxes other than on income	322,619	295,025

Mineral extraction tax (MET) increased by RUB 15,391 million or 7 % to RUB 233,422 million for the three months ended March 31, 2018 compared to RUB 218,031 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 three months ended 31 March 2018 compared to the same period of the prior year.

Derivatives loss (gain)

Derivatives loss amounted to RUB 12,452 million for the three months ended March 31, 2018 compared to derivatives gain amounted to RUB 10,021 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.

Foreign exchange rate differences on operating items

Foreign exchange rate gain on operating items amounted to RUB 18,612 million for the three months ended March 31, 2018 compared to a net loss of RUB 887 million for the same period of the prior year. This change was mainly explained by the depreciation of US Dollar against the Russian Ruble by 1 % and by the appreciation of Euro against the Russian Ruble by 2 % for the three months ended March 31, 2018 compared to the depreciation of US Dollar and Euro against the Russian Ruble by 7 % and 5 %, respectively, for the same period of the prior year.

Other operating expenses

Other operating expenses decreased by RUB 9,584 million, or 9 %, to RUB 98,665 million for the three months ended March 31, 2018 compared to RUB 108,249 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, financial aid and advertising.

Change in finished goods, work in progress and other effects

The line item Change in finished goods, work in progress and other effects increased by RUB 43,766 million to the RUB 124,489 million for the three months ended March 31, 2018 compared to the RUB 80,723 million for the same period of the prior year. The change in this line item is explained by the fact that a decrease in the balances of finished goods for the three months ended March 31, 2018 was more than a decrease in the balances of finished goods for the same period of the prior year.

Impairment loss on financial assets

Impairment loss on financial assets decreased by RUB 2,782 million, or 10 %, to RUB 26,405 million for the three months ended March 31, 2018 compared to RUB 29,187 million for the same period of the prior year.

Operating profit

As a result of the factors discussed above, operating profit increased by RUB 173,532 million, or 59 %, to RUB 467,581 million for the three months ended March 31, 2018 compared to RUB 294,049 million for the same period of the prior year. The operating profit margin increased from 16 % for the three months ended March 31, 2017 to 22 % for the three months ended March 31, 2018.

Net finance (expense) income

(RUB million)	Three months ended 31 March	
	2018	2017
Foreign exchange gain	73,311	160,786
Foreign exchange loss	<u>(94,409)</u>	<u>(37,581)</u>
Net exchange (loss) gain	(21,098)	123,205
Interest income	18,069	22,346
Interest expense	<u>(13,014)</u>	<u>(15,107)</u>
Net finance (expense) income	(16,043)	130,444

The net foreign exchange loss of RUB 21,098 million for the three months ended March 31, 2018 compared to the net foreign exchange gain of RUB 123,205 million for the same period of the prior year were explained by the depreciation of US Dollar against the Russian Ruble by 1 % and by the appreciation of Euro against the Russian Ruble by 2 % for the three months ended March 31, 2018 compared to the depreciation of US Dollar and Euro against the Russian Ruble by 7 % and 5 %, respectively, for the same period of the prior year.

Interest income decreased by RUB 4,277 million, or 19 %, to RUB 18,069 million for the three months ended March 31, 2018 compared to RUB 22,346 million for the same period of the prior year.

Interest expense decreased by RUB 2,093 million, or 14 %, to RUB 13,014 million for the three months ended March 31, 2018 compared to RUB 15,107 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 14,125 million, or 48 %, to RUB 43,680 million for the three months ended March 31, 2018 compared to RUB 29,555 million for the same period of the prior year. This change was mainly caused by an increase in the share of net income of Gazprombank (Joint-stock Company) and its subsidiaries and Sakhalin Energy Investment Company Ltd.

Profit tax

Total profit tax decreased by RUB 612 million, or 1 %, to RUB 103,049 million for the three months ended March 31, 2018 compared to RUB 103,661 million for the same period of the prior year. The effective profit tax rate was 20.8 % and 22.8 % for the three months ended March 31, 2018 and March 31, 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 38,170 million, or 11 %, to RUB 371,623 million for the three months ended March 31, 2018 compared to RUB 333,453 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 3,612 million, or 21 %, to RUB 20,546 million for the three months ended March 31, 2018 compared to RUB 16,934 million for the same period of the prior year.

Liquidity and capital resources

The following table summarises the cash flows for the three months ended March 31, 2018 and March 31, 2017:

(RUB million)	Three months ended 31 March	
	2018	2017
Net cash from operating activities	461,940	105,402
Net cash used in investing activities	(432,142)	(327,038)
Net cash from financing activities	47,527	34,503

Net cash from operating activities

Net cash from operating activities increased by RUB 356,538 million to RUB 461,940 million for the three months ended March 31, 2018 compared to RUB 105,402 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 105,104 million, or 32 %, to RUB 432,142 million for the three months ended March 31, 2018 compared to RUB 327,038 million for the same period of the prior year. The change was mainly due to an increase of capital expenditures for the three months ended March 31, 2018 compared to the same period of the prior year.

Net cash from financing activities

Net cash from financing activities increased by RUB 13,024 million, or 38 %, to RUB 47,527 million for the three months ended March 31, 2018 compared to RUB 34,503 million for the same period of the prior year. This change was mainly due to an increase in proceeds from long-term borrowings.

Capital expenditures

Total capital expenditures (excluding the effect of acquisitions of subsidiaries) by segments for the three months ended March 31, 2018 and 2017 in Russian Ruble terms, amounted to the following:

(RUB million)	Three months ended 31 March	
	2018	2017
Transportation	132,322	59,210
Production of crude oil and gas condensate	46,689	83,242
Refining	45,428	37,056
Production of gas	31,646	27,153
Electric and heat energy generation and sales	8,838	7,665
Distribution of gas	2,018	5,539
Gas storage	988	2,547
All other segments	<u>21,523</u>	<u>4,057</u>
Total	289,452	226,469

Total capital expenditures increased by RUB 62,983 million, or 28 %, from RUB 226,469 million for the three months ended March 31, 2017 to RUB 289,452 million for the three months ended March 31, 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 and balances of cash and cash equivalents restricted as to withdrawal under the terms of certain borrowings and other contractual obligations) increased by RUB 12,190 million, or 1 %, from RUB 2,397,511 million as of December 31, 2017 to RUB 2,409,701 million as of March 31, 2018. The change was mainly due to an increase in the amount of long-term borrowings that was partially compensated by an increase in cash and cash equivalents balances.