

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, 2015. This consolidated interim condensed financial information is prepared in accordance with International Accounting Standard 34 Interim Financial Reporting. The consolidated interim condensed financial information should be read in conjunction with the consolidated financial statements for the year ended December 31, 2014 prepared in accordance with International Financial Reporting Standards ("IFRS").

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, Russia and other former Soviet Union countries.

We divide our operations into the following principal businesses:

- Production of gas – exploration and production of gas;
- Transport – transportation of gas;
- Distribution – 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; and
- Electric and heat energy generation and sales.

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

Our main business segments are mutually dependent, with a significant portion of the revenues of one segment comprising a part of the costs of another segment. In particular, our Distribution segment purchases natural gas from our Production of gas segment and transportation services from our Transport segment. Our Refining segment purchases gas from our Production of gas segment and crude oil and gas condensate from the Production of crude oil and gas condensate segment. We establish internal transfer prices with reference to the specific funding requirements of the individual subsidiaries within each segment. Accordingly, the results of operations of these segments on a stand-alone basis do not necessarily represent each segment's underlying financial position and results of operations as if it were a stand-alone business. For this reason, we do not analyze any of our main segments separately in the discussion that follows.

RESULTS OF OPERATION

(RUB million)

	Three months ended March 31,	
	2015	2014
Sales	1,648,253	1,558,737
Net (loss) gain from trading activity	(18,013)	3,802
Operating expenses	<u>(1,171,585)</u>	<u>(1,089,749)</u>
Operating profit	458,655	472,790
Finance income	683,675	27,310
Finance expense	(683,588)	(203,087)
Share of net income of associated undertakings and joint ventures	37,314	20,907
Gains on disposal of available-for-sale financial assets	<u>38</u>	<u>30</u>
Profit before profit tax	496,094	317,950
Current profit tax expense	(74,584)	(62,599)
Deferred profit tax expense	<u>(31,892)</u>	<u>(23,687)</u>
Profit tax expense	(106,476)	(86,286)
Profit for the period	389,618	231,664
Other comprehensive income (loss):		
Loss that will not be reclassified to profit or loss:		
Remeasurements of post-employment benefit obligations	<u>(54,348)</u>	<u>(6,159)</u>
Total loss that will not be reclassified to profit or loss	(54,348)	(6,159)
Income (loss) that will be reclassified to profit or loss:		
Gains (losses) arising from change in fair value of available-for-sale financial assets, net of tax	598	(18,604)
Share of other comprehensive income (loss) of associated undertakings and joint ventures	4,117	(2,373)
Translation differences	(10,826)	73,684
Gains (losses) from cash flow hedges, net of tax	<u>2,770</u>	<u>(10,387)</u>
Total (loss) income that will be reclassified to profit or loss	(3,341)	42,320
Other comprehensive (loss) income for the period, net of tax	(57,689)	36,161
Total comprehensive income for the period	331,929	267,825
Profit attributable to:		
Owners of PJSC Gazprom	382,112	223,007
Non-controlling interest	<u>7,506</u>	<u>8,657</u>
	389,618	231,664
Total comprehensive income attributable to:		
Owners of PJSC Gazprom	328,199	255,860
Non-controlling interest	<u>3,730</u>	<u>11,965</u>
	331,929	267,825

Sales

The following table sets out volumes and realized prices:

(RUB million unless indicated otherwise)	Three months ended	
	March 31,	
	2015	2014
Sales of gas		
<i>Europe and Other countries</i>		
Gross sales ⁽¹⁾	702,703	611,257
Customs duties	(131,498)	(126,878)
Excise tax	(28,212)	-
Net sales	542,993	484,379
Volumes in bcm	39.1	46.7
Gross average price, US Dollar per mcm ⁽²⁾ (including excise tax and customs duties) ⁽³⁾	284.2	372.4
Gross average price, RUB per mcm ⁽²⁾ (including excise tax and customs duties)	17,959.1	13,087.3
<i>Former Soviet Union countries</i>		
Gross sales ⁽¹⁾	173,808	138,021
Customs duties	(18,170)	(11,262)
Net sales	155,638	126,759
Volumes in bcm	12.9	16.3
Gross average price, US Dollar per mcm ⁽²⁾ (including customs duties) ⁽³⁾	212.5	241.3
Gross average price, RUB per mcm ⁽²⁾ (including customs duties)	13,427.7	8,479.0
<i>Russian Federation</i>		
Gross sales (net of VAT)	286,553	298,814
Net sales	286,553	298,814
Volumes in bcm	80.3	84.5
Gross average price, RUB per mcm ⁽²⁾ (net of VAT)	3,567.7	3,534.8
<i>Total sales of gas</i>		
Gross sales (net of VAT)	1,163,064	1,048,092
Customs duties	(149,668)	(138,140)
Excise tax	(28,212)	-
Retroactive gas price adjustments	16,425	-
Net sales	1,001,609	909,952
Volumes in bcm	132.3	147.5
Net sales of refined products (net of excise tax, VAT and customs duties)	364,681	380,658
Net sales of electric and heat energy (net of VAT)	133,204	134,614
Net sales of crude oil and gas condensate (net of VAT and customs duties)	59,511	49,339
Gas transportation net sales (net of VAT)	44,507	40,301
Other revenues (net of VAT)	<u>44,741</u>	<u>43,873</u>
Total sales (net of excise tax, VAT and customs duties)	1,648,253	1,558,737

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 89,516 million, or 6 %, to RUB 1,648,253 million for the three months ended March 31, 2015 compared to the same period of the prior year. The increase in sales is mainly driven by the increase in gas sales to Europe and Other countries and Former Soviet Union (excluding the Russian Federation).

Net sales of gas accounted for 61 % and 58 % of total net sales for the three months ended March 31, 2015 and 2014, respectively.

Net sales of gas increased by RUB 91,657 million, or 10 %, from RUB 909,952 million for the three months ended March 31, 2014 to RUB 1,001,609 million for the three months ended March 31, 2015.

For the three months ended March 31, 2015 net sales of gas to Europe and Other countries increased by RUB 58,614 million, or 12 %, to RUB 542,993 million compared to the three months ended March 31, 2014. Overall increase in sales of gas to Europe and Other countries was mainly driven by the increase in gross average Rouble price (including excise tax and customs duties) by 37 % compared to the same period of the prior year. Volume of gas sold for the three months ended March 31, 2015 decreased by 16 % compared to the same period of the prior year. At the same time gross average US Dollar price decreased by 24 %.

Net sales of gas to Former Soviet Union countries increased by RUB 28,879 million, or 23 %, to RUB 155,638 million for the three months ended March 31, 2015 compared to the same period of the prior year. The change was due to 58 % increase in the gross average Rouble price (including customs duties) compared to the same period of the prior year. Volumes of gas sold decreased by 21 % for the three months ended March 31, 2015 compared to the same period of the prior year. At the same time gross average US Dollar price decreased by 12 %.

Net sales of gas in the Russian Federation decreased by RUB 12,261 million, or 4 %, to RUB 286,553 million for the three months ended March 31, 2015 compared to the same period of the prior year. This is primarily explained by the decrease in volumes of gas sold by 5 % for the three months ended March 31, 2015 compared to the same period of the prior year.

Operating expenses

Operating expenses increased by 8 % for the three months ended March 31, 2015 to RUB 1,171,585 million from RUB 1,089,749 million for the same period of the prior year. Operating expenses as a percentage of sales increased from 70 % for the three months ended March 31, 2014 to 71 % for the three months ended March 31, 2015. The table below presents a breakdown of operating expenses in each period:

(RUB million)	Three months ended March 31,	
	2015	2014
Taxes other than on income	234,139	205,713
Purchased gas and oil	207,136	180,471
Staff costs	145,097	129,000
Transit of gas, oil and refined products	124,604	95,517
Depreciation	124,271	114,748
Materials	57,743	60,186
Cost of goods for resale, including refined products	41,839	61,201
Charge for impairment provisions	29,713	74,705
Electricity and heating expenses	25,511	23,946
Repairs and maintenance	20,026	25,847
Rental expenses	9,163	8,427
Transportation services	8,244	8,858
Insurance expenses	7,265	6,312
Research and development expenses	5,610	4,734
Social expenses	5,463	5,983
Processing services	4,703	4,357
Foreign exchange rate differences on operating items	17,444	(45,088)
Derivatives (gains) losses	(14,290)	4,973
Other	90,333	76,772
	<u>1,144,014</u>	<u>1,046,662</u>
Changes in inventories of finished goods, work in progress and other effects	<u>27,571</u>	<u>43,087</u>
Total operating expenses	1,171,585	1,089,749

Taxes other than on income

Taxes other than on income consist of:

(RUB million)	Three months ended	
	March 31,	
	2015	2014
Mineral extraction tax	180,798	154,127
Property tax	29,868	21,846
Other taxes	23,473	29,740
Taxes other than on income	234,139	205,713

Mineral extraction tax increased by 17 % to RUB 180,798 million for the three months ended March 31, 2015 compared to RUB 154,127 million for the three months ended March 31, 2014. The increase is mainly due to dynamics of mineral extraction tax rate for natural gas and oil.

Purchased gas and oil

Cost of purchased gas and oil increased by RUB 26,665 million to RUB 207,136 million for the three months ended March 31, 2015 compared to RUB 180,471 million for the same period of the prior year. Cost of purchased gas increased by RUB 41,100 million, or 34 %. The change is mainly related to an increase in cost of gas purchased from third parties abroad.

Cost of purchased oil included in the purchased gas and oil decreased by RUB 14,435 million, or 24 %, to RUB 45,749 million for the three months ended March 31, 2015 compared to RUB 60,184 million for the same period of the prior year. The change relates to decrease in volumes of oil purchased on international markets.

Staff costs

Staff costs increased by 12 % to RUB 145,097 million for the three months ended March 31, 2015 compared to RUB 129,000 million for the same period of the prior year. The increase was mainly driven by average salary indexation and increase in average number of personnel.

Transit of gas, oil and refined products

Transit of gas, oil and refined products increased by 30 % to RUB 124,604 million for the three months ended March 31, 2015 compared to RUB 95,517 million for the same period of the prior year. This increase was mainly driven by increase in volumes transported through the Nord Stream pipeline and through the territory of Germany.

Depreciation

Depreciation increased by 8 %, or RUB 9,523 million, to RUB 124,271 million for the three months ended March 31, 2015 compared to RUB 114,748 million for the same period of the prior year. The increase is primarily due to the growth in the fixed assets base.

Materials

Cost of materials decreased by 4 % to RUB 57,743 million for the three months ended March 31, 2015 compared to RUB 60,186 million for the same period of the prior year. The decrease mainly relates to decrease in purchases of materials from third parties.

Charge for impairment provisions

Charge for impairment provisions decreased by RUB 44,992 million for the three months ended March 31, 2015 compared to the same period of the prior year. The change was mainly driven by change of provision for doubtful trade accounts receivable of NJSC Naftogaz Ukraine.

Cost of goods for resale, including refined products

Cost of goods for resale, including refined products, decreased from RUB 61,201 million for the three months ended March 31, 2014 to RUB 41,839 million for the three months ended March 31, 2015. The decrease is mainly explained by the decrease in volumes of refined products purchased from third parties.

Exchange rate differences on operating items

Exchange rate differences on operating items for the three months ended March 31, 2015 amounted to a net loss of RUB 17,444 million compared to a net gain of RUB 45,088 million for the same period of the prior year. The change is explained by the appreciation of US Dollar against the Russian Rouble by 4 % and the depreciation of Euro against the Russian Rouble by 7 % for the three months ended March 31, 2015 compared to the appreciation of US Dollar and Euro against the Russian Rouble by 9 % for the same period of the prior year.

Other operating expenses

Other operating expenses increased by 18 % to RUB 90,333 million for the three months ended March 31, 2015 compared to RUB 76,772 million for the same period of the prior year. Other expenses include gas and gas condensate production expense, services from gas distribution companies, bank charges, security services, legal and consulting services, charity and financial aid, and advertising.

Changes in inventories of finished goods, work in progress and other effects

Change in inventories of finished goods, work in progress and other effects decreased by RUB 15,516 million to RUB 27,571 million for the three months ended March 31, 2015 compared to RUB 43,087 million for the same period of the prior year. The change in this line item is mainly due to a decrease in the balances of finished goods as of March 31, 2015 compared with the balances as of December 31, 2014.

Operating profit

As a result of the factors discussed above, operating profit decreased by RUB 14,135 million, or 3 %, to RUB 458,655 million for the three months ended March 31, 2015 from RUB 472,790 million for the same period of the prior year. The operating profit margin decreased from 30 % for the three months ended March 31, 2014 to 28 % for the three months ended March 31, 2015.

Net finance gain (loss)

(RUB million)	Three months ended March 31,	
	2015	2014
Exchange gains	654,715	19,634
Exchange losses	(669,808)	(191,610)
Net exchange loss	(15,093)	(171,976)
Interest income	28,960	7,676
Interest expense	(13,780)	(11,477)
Net finance gain (loss)	87	(175,777)

The net exchange loss of RUB 15,093 million for the three months ended March 31, 2015 compared to net exchange loss of RUB 171,976 million for the same period of the prior year is mainly explained by the appreciation of US Dollar against the Russian Rouble by 4 % and the depreciation of Euro against the Russian Rouble by 7 % for the three months ended March 31, 2015 compared to the appreciation of US Dollar and Euro against the Russian Rouble by 9 % for the same period of the prior year.

Interest income increased by 277 % to RUB 28,960 million for the three months ended March 31, 2015 from RUB 7,676 million for the same period of the prior year.

Interest expense increased by 20 % to RUB 13,780 million for the three months ended March 31, 2015 compared to RUB 11,477 million for the same period of the prior year.

Share of net income of associated undertakings and joint ventures

Share of net income of associated undertakings and joint ventures increased by RUB 16,407 million to RUB 37,314 million for the three months ended March 31, 2015 compared to RUB 20,907 million for the same period of the prior year. The change is mainly caused by an increase of net income of Sakhalin Energy Investment Company Ltd. by RUB 7,739 million due to the appreciation of US Dollar, an increase of net income of LLC Yamal razvitie and its subsidiaries by RUB 3,833 and of the Gazprom Germania Group by RUB 3,607 million due to increase in profit of these companies.

Profit tax

Total profit tax expense increased by RUB 20,190 million, or 23 %, to RUB 106,476 million for the three months ended March 31, 2015 compared to RUB 86,286 million for the same period of the prior year. The effective profit tax rate was 21.5 % and 27.1 % for the three months ended March 31, 2015 and 2014 respectively.

The change in effective profit tax rate was mainly driven by decrease in non-deductible expenses for tax purposes, which were primarily related to accrual of provision for doubtful trade accounts receivable.

Profit for the period attributable to owners of PJSC Gazprom

As a result of the factors discussed above, profit for the period attributable to owners of PJSC Gazprom increased by RUB 159,105 million, or 71 %, from RUB 223,007 million for the three months ended March 31, 2014 to RUB 382,112 million for the three months ended March 31, 2015.

Profit for the period attributable to non-controlling interest

Profit for the period attributable to non-controlling interest decreased by RUB 1,151 million, or 13 %, to RUB 7,506 million for the three months ended March 31, 2015 compared to RUB 8,657 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, 2015 and 2014:

(RUB million)	Three months ended March 31,	
	2015	2014
Net cash from operating activities	696,196	688,422
Net cash used in investing activities	(487,594)	(411,286)
Net cash used in financing activities	(26,230)	(22,148)

Net cash from operating activities

Net cash from operating activities increased by RUB 7,774 million, or 1 %, and amounted to RUB 696,196 million for the three months ended March 31, 2015 compared to RUB 688,422 million for the same period of the prior year.

Net cash used in investing activities

Net cash used in investing activities increased by RUB 76,308 million, or 19 %, to RUB 487,594 million for the three months ended March 31, 2015 compared to RUB 411,286 million for the same period of the prior year. The change was primarily due to an increase in cash used for capital expenditures for the three months ended March 31, 2015 compared to the same period of the prior year.

Net cash used in financing activities

Net cash used in financing activities amounted to RUB 26,230 million for the three months ended March 31, 2015 compared to RUB 22,148 million for the same period of the prior year. This change was primarily due to a change of loan portfolio of the Group.

Capital expenditures

Total capital expenditures (excluding the effect of acquisitions of subsidiaries) by segment for the three months ended March 31, 2015 and 2014 in nominal RUB terms, amounted to the following:

(RUB million)	Three months ended March 31,	
	2015 ⁽¹⁾	2014 ⁽¹⁾
Transport	88,940	77,560
Production of crude oil and gas condensate	67,243	55,489
Production of gas	33,695	57,626
Refining	30,858	20,518
Electric and heat energy generation and sales	14,351	10,883
Distribution	4,151	3,720
Gas storage	3,176	1,964
All other segments	9,678	8,226
Total	252,092	235,986

Note:

⁽¹⁾The capital expenditures in the present analysis differ from the capital additions disclosed within the Group's business segments in IFRS consolidated interim condensed financial information of PJSC Gazprom primarily due to VAT.

Total capital expenditures (excluding the effect of acquisitions of subsidiaries) increased by RUB 16,106 million, or 7 %, from RUB 235,986 million for the three months ended March 31, 2014 to RUB 252,092 million for the three months ended March 31, 2015.

Debt obligations

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) decreased by RUB 202,367 million, or 12 %, from RUB 1,650,633 million as of December 31, 2014 to RUB 1,448,266 million as of March 31, 2015. This decrease resulted from an increase in cash and cash equivalents.