

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 nine months ended September 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 nine months ended September 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 September 30, 2019 – 64.4156 (as of September 30, 2018 – 65.5906);
- 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 September 30, 2019 – 70.3161 (as of September 30, 2018 – 76.2294);
- as of December 31, 2018 – 79.4605 (as of December 31, 2017 – 68.8668).

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

- to US Dollar – 65.0789 and 61.4358, respectively;
- to Euro – 73.1629 and 73.2921, respectively.

RESULTS OF OPERATION

(in RUB million)

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2019	2018	2019	2018
Sales	1,621,588	1,930,036	5,698,339	5,901,591
Net (loss) gain from trading activity	12,224	9,342	(20,391)	7,048
Operating expenses	(1,421,299)	(1,414,385)	(4,617,986)	(4,450,034)
Impairment loss on financial assets	<u>(20,760)</u>	<u>(19,315)</u>	<u>(87,331)</u>	<u>(73,654)</u>
Operating profit	191,753	505,678	972,631	1,384,951
Finance income	181,215	156,954	534,853	416,893
Finance expense	(163,471)	(240,290)	(287,964)	(635,122)
Share of profit of associates and joint ventures	<u>64,679</u>	<u>57,597</u>	<u>179,934</u>	<u>149,180</u>
Profit before profit tax	274,176	479,939	1,399,454	1,315,902
Current profit tax expense	(44,932)	(78,169)	(242,426)	(181,390)
Deferred profit tax expense	<u>(940)</u>	<u>(1,235)</u>	<u>(50,080)</u>	<u>(70,426)</u>
Profit tax	(45,872)	(79,404)	(292,506)	(251,816)
Profit for the period	228,304	400,535	1,106,948	1,064,086
Other comprehensive income (loss):				
Items that will not be reclassified to profit or loss:				
Gain (loss) arising from changes in fair value of financial assets measured at fair value through other comprehensive income, net of tax	(9,901)	83,309	37,598	154,315
Remeasurement of provision for post-employment benefits	<u>(6,743)</u>	<u>68,973</u>	<u>(84,595)</u>	<u>84,316</u>
Total other comprehensive (loss) income that will not be reclassified to profit or loss	(16,644)	152,282	(46,997)	238,631
Items that may be reclassified subsequently to profit or loss:				
Share of other comprehensive (loss) income of associates and joint ventures	(691)	1,657	(5,020)	3,315
Translation differences	2,883	57,733	(137,745)	148,670
Gain (loss) from hedging operations, net of tax	<u>(5,370)</u>	<u>8,341</u>	<u>4,654</u>	<u>35,292</u>
Total other comprehensive (loss) income that may be reclassified subsequently to profit or loss	(3,178)	67,731	(138,111)	187,277
Other comprehensive (loss) income for the period, net of tax	<u>(19,822)</u>	<u>220,013</u>	<u>(185,108)</u>	<u>425,908</u>
Comprehensive income for the period	208,482	620,548	921,840	1,489,994
Profit for the period attributable to:				
Owners of PJSC Gazprom	211,789	386,446	1,048,286	1,017,250
Non-controlling interest	<u>16,515</u>	<u>14,089</u>	<u>58,662</u>	<u>46,836</u>
	228,304	400,535	1,106,948	1,064,086
Comprehensive income for the period attributable to:				
Owners of PJSC Gazprom	192,778	603,019	872,366	1,434,403
Non-controlling interest	<u>15,704</u>	<u>17,529</u>	<u>49,474</u>	<u>55,591</u>
	208,482	620,548	921,840	1,489,994

Sales

The following table sets out volumes and sales prices:

(in RUB million unless indicated otherwise)

	Three months ended		Nine months ended	
	September 30, 2019	2018	September 30, 2019	2018
Sales of gas				
<i>Europe and other countries</i>				
Gross sales ⁽¹⁾	586,778	934,774	2,393,535	2,715,098
Customs duties	(121,802)	(193,773)	(462,427)	(536,682)
Excise tax	(14,587)	(11,781)	(47,128)	(37,891)
Net sales	450,389	729,220	1,883,980	2,140,525
Volumes in bcm	53.5	56.9	171.4	185.4
Average price, US Dollar per mcm ⁽²⁾ (including excise tax and customs duties) ⁽³⁾	169.8	250.8	215.0	237.7
Average price, RUB per mcm ⁽²⁾ (including excise tax and customs duties)	10,961.6	16,427.1	13,966.2	14,647.3
<i>Former Soviet Union countries</i>				
Gross sales ⁽¹⁾	76,959	77,447	279,596	261,226
Customs duties	(6,085)	(8,863)	(28,984)	(25,618)
Net sales	70,874	68,584	250,612	235,608
Volumes in bcm	7.9	6.5	27.0	27.1
Average price, US Dollar per mcm ⁽²⁾ (including customs duties) ⁽³⁾	150.2	180.7	159.5	156.4
Average price, RUB per mcm ⁽²⁾ (including customs duties)	9,698.7	11,836.7	10,361.2	9,635.4
<i>Russian Federation</i>				
Gross sales (net of VAT)	147,869	128,108	666,125	636,873
Net sales	147,869	128,108	666,125	636,873
Volumes in bcm	36.5	33.4	162.9	163.0
Average price, RUB per mcm ⁽²⁾ (net of VAT)	4,050.7	3,831.4	4,089.5	3,906.5
<i>Total gas sales</i>				
Gross sales (net of VAT)	811,606	1,140,329	3,339,256	3,613,197
Customs duties	(127,887)	(202,636)	(491,411)	(562,300)
Excise tax	(14,587)	(11,781)	(47,128)	(37,891)
Retroactive gas price adjustments	-	(109)	8,009	37,686
Net sales	669,132	925,803	2,808,726	3,050,692
Volumes in bcm	97.9	96.8	361.3	375.5
Net sales of refined products (net of excise tax, VAT and customs duties)	548,555	594,652	1,591,926	1,586,225
Net sales of crude oil and gas condensate (net of VAT and customs duties)	190,434	205,055	573,381	550,711
Electric and heat energy net sales (net of VAT)	95,300	87,596	373,195	361,769
Gas transportation net sales (net of VAT)	49,866	54,538	160,020	168,292
Other sales (net of VAT)	<u>68,301</u>	<u>62,392</u>	<u>191,091</u>	<u>183,902</u>
Total sales (net of excise tax, VAT and customs duties)	1,621,588	1,930,036	5,698,339	5,901,591

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) decreased by RUB 203,252 million, or 3 %, to RUB 5,698,339 million for the nine months ended September 30, 2019 compared to the same period of the prior year. The decrease in sales was mainly due to a change in volumes sold and average prices..

Net sales of gas accounted for 49 % of total net sales for the nine months ended September 30, 2019 (52 % for the same period of the prior year).

Net sales of gas decreased by RUB 241,966 million, or 8 %, from RUB 3,050,692 million for the nine months ended September 30, 2018 to RUB 2,808,726 million for the nine months ended September 30, 2019.

Net sales of gas to Europe and other countries decreased by RUB 256,545 million, or 12 %, to RUB 1,883,980 million for the nine months ended September 30, 2019 compared to the same period of the prior year. The change was due to the decrease in volumes of gas sold by 8 % and the decrease in average prices (including excise tax and customs duties) denominated in the Russian Ruble by 5 % for the nine months ended September 30, 2019 compared to the same period of the prior year. At the same time average prices denominated in US Dollar decreased by 10 % compared to the same period of the prior year.

Net sales of gas to Former Soviet Union countries increased by RUB 15,004 million or 6 %, to RUB 250,612 million for the nine months ended September 30, 2019 compared to the same period of the prior year. The change was mainly due to the increase in average prices (including customs duties) denominated in the Russian Ruble by 8 % for the nine months ended September 30, 2019 compared to the same period of the prior year. At the same time average prices denominated in US Dollar increased by 2 % compared to the same period of the prior year.

Net sales of gas in the Russian Federation increased by RUB 29,252 million, or 5 %, to RUB 666,125 million for the nine months ended September 30, 2019 compared to the same period of the prior year. This change is explained by the increase in average prices (net of VAT) in the Russian Ruble by 5 % for the nine months ended September 30, 2019 compared to the same period of the prior year.

Operating expenses

Operating expenses increased by RUB 167,952 million, or 4 %, to RUB 4,617,986 million for the nine months ended September 30, 2019 compared to RUB 4,450,034 million for the same period of the prior year. Operating expenses as a percentage of sales increased from 75 % for the nine months ended September 30, 2018 to 81 % for the nine months ended September 30, 2019. The table below presents a breakdown of operating expenses in each period:

(in RUB million)	Three months ended September 30,		Nine months ended September 30,	
	2019	2018	2019	2018
Taxes other than on profit	329,674	386,480	1,063,183	1,054,965
Purchased gas and oil	321,773	368,419	1,051,552	1,112,961
Staff costs	189,634	183,560	570,768	562,331
Depreciation	177,169	157,589	525,044	476,136
Transit of gas, oil and refined products	161,144	169,509	497,197	472,992
Cost of goods for resale, including refined products	69,078	63,585	194,924	187,334
Materials	45,430	57,076	192,823	185,621
Repairs and maintenance	46,400	41,249	99,761	93,925
Electricity and heating expenses	31,079	23,797	88,223	81,405
Foreign exchange differences on operating items	16,623	(11,782)	68,013	(20,573)
Social expenses	11,074	8,717	27,389	25,157
Insurance expenses	8,098	8,312	23,575	23,904
Transportation expenses	11,684	6,010	21,398	22,971
Rental expenses	6,851	10,535	19,735	30,001
Processing services	5,498	4,958	15,994	14,079
Research and development expenses	1,896	1,294	11,263	8,823
Impairment loss (reversal of impairment loss) on non-financial assets	3,076	(153)	4,878	5,005
Derivatives gain	(17,415)	(22,227)	(7,364)	(6,072)
Other	<u>72,950</u>	<u>67,940</u>	<u>292,167</u>	<u>244,663</u>
	1,491,716	1,524,868	4,760,523	4,575,628
Change in balances of finished goods, work in progress and other effects	<u>(70,417)</u>	<u>(110,483)</u>	<u>(142,537)</u>	<u>(125,594)</u>
Total operating expenses	1,421,299	1,414,385	4,617,986	4,450,034

Taxes other than on profit

Taxes other than on profit consist of:

(in RUB million)	Three months ended September 30,		Nine months ended September 30,	
	2019	2018	2019	2018
Mineral extraction tax	253,951	305,299	843,418	798,047
Property tax	37,307	40,911	112,056	124,573
Excise tax	27,619	35,982	81,469	121,108
Other taxes	<u>10,797</u>	<u>4,288</u>	<u>26,240</u>	<u>11,237</u>
Total taxes other than on profit	329,674	386,480	1,063,183	1,054,965

Mineral extraction tax (MET) increased by RUB 45,371 million, or 6 % to RUB 843,418 million for the nine months ended September 30, 2019 compared to RUB 798,047 million for the same period of the prior year. MET for the nine months ended September 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 39,639 million, or 33 %, to RUB 81,469 million for the nine months ended September 30, 2019 compared to RUB 121,108 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 partially trimmed by motor oil excise rates increase.

Purchased gas and oil

Cost of purchased gas and oil decreased by RUB 61,409 million, or 6 %, to RUB 1,051,552 million for the nine months ended September 30, 2019 compared to RUB 1,112,961 million for the same period of the prior year. The change was mainly due to a decrease in cost of purchased gas.

Cost of purchased gas included in the purchased gas and oil decreased by RUB 67,120 million, or 9 %, to RUB 680,661 million for the nine months ended September 30, 2019 compared to RUB 747,781 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.

Depreciation

Depreciation increased by RUB 48,908 million, or 10 %, to RUB 525,044 million for the nine months ended September 30, 2019 compared to RUB 476,136 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.

Foreign exchange differences on operating items

Foreign exchange loss on operating items amounted to RUB 68,013 million for the nine months ended September 30, 2019 compared to the foreign exchange gain in the amount of RUB 20,573 million for the same period of the prior year. This change was mainly due to the revaluation of accounts receivable from foreign customers, which was caused by the depreciation of US Dollar and Euro against the Russian Ruble by 7 % and 12 %, respectively, for the nine months ended September 30, 2019 compared to the appreciation of US Dollar and Euro against the Russian Ruble by 14 % and 11 %, respectively, for the same period of the prior year.

Other operating expenses

Other operating expenses increased by RUB 47,504 million, or 19 %, to RUB 292,167 million for the nine months ended September 30, 2019 compared to RUB 244,663 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 changed by RUB 16,943 million, or 13 %, to the negative amount of RUB 142,537 million for the nine months ended September 30, 2019 compared to the negative amount of RUB 125,594 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 nine months ended September 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 13,677 million, or 19 %, to RUB 87,331 million for the nine months ended September 30, 2019 compared to RUB 73,654 million for the same period of the prior year. The change was 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, JSV Moldovagaz and NJSC Naftogaz of Ukraine, as well as from certain customers from the Republic of Turkey for the nine months ended September 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 412,320 million, or 30 %, to RUB 972,631 million for the nine months ended September 30, 2019 compared to RUB 1,384,951 million for the same period of the prior year. The operating profit margin decreased from 23 % for the nine months ended September 30, 2018 to 17 % for the nine months ended September 30, 2019.

Net finance income (expense)

(in RUB million)	Three months ended		Nine months ended	
	September 30, 2019	2018	September 30, 2019	2018
Foreign exchange gain	157,642	140,237	463,093	363,328
Foreign exchange loss	<u>(145,313)</u>	<u>(228,549)</u>	<u>(232,277)</u>	<u>(597,702)</u>
Net foreign exchange gain (loss)	12,329	(88,312)	230,816	(234,374)
Interest income	23,573	16,717	71,760	53,565
Interest expense	<u>(18,158)</u>	<u>(11,741)</u>	<u>(55,687)</u>	<u>(37,420)</u>
Net finance income (expense)	17,744	(83,336)	246,889	(218,229)

The net foreign exchange gain of RUB 230,816 million for the nine months ended September 30, 2019 compared to the net foreign exchange loss of RUB 234,374 million for the same period of the prior year were explained by the depreciation of US Dollar and Euro against the Russian Ruble by 7 % and 12 %, respectively, for the nine months ended September 30, 2019 compared to the appreciation of US Dollar and Euro against the Russian Ruble by 14 % and 11 %, respectively, for the same period of the prior year.

Interest income increased by RUB 18,195 million, or 34 %, to RUB 71,760 million for the nine months ended September 30, 2019 compared to RUB 53,565 million for the same period of the prior year.

Interest expense increased by RUB 18,267 million, or 49 %, to RUB 55,687 million for the nine months ended September 30, 2019 compared to RUB 37,420 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 30,754 million, or 21 %, to RUB 179,934 million for the nine months ended September 30, 2019 compared to RUB 149,180 million for the same period of the prior year. This change was mainly caused by an increase in the share of profit of Gazprombank (Joint-stock Company) and its subsidiaries, Sakhalin Energy Investment Company Ltd. and JSC Achimgaz.

Profit tax

Total profit tax increased by RUB 40,690 million, or 16 %, to RUB 292,506 million for the nine months ended September 30, 2019 compared to RUB 251,816 million for the same period of the prior year. The effective profit tax rate was 20.9 % and 19.1 % for the nine months ended September 30, 2019 and for the nine months ended September 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 31,036 million, or 3 %, to RUB 1,048,286 million for the nine months ended September 30, 2019 compared to RUB 1,017,250 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 11,826 million, or 25 %, to RUB 58,662 million for the nine months ended September 30, 2019 compared to RUB 46,836 million for the same period of the prior year.

Liquidity and capital resources

The following table summarises the cash flows for the nine months ended September 30, 2019 and for the nine months ended September 30, 2018:

(in RUB million)	Nine months ended September 30,	
	2019	2018
Net cash from operating activities	1,622,574	1,426,348
Net cash used in investing activities	(1,380,479)	(1,184,448)
Net cash used in financing activities	(66,130)	(284,824)

Net cash from operating activities

Net cash from operating activities increased by RUB 196,226 million, or 14 %, to RUB 1,622,574 million for the nine months ended September 30, 2019 compared to RUB 1,426,348 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 nine months ended September 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 196,031 million, or 17 %, to RUB 1,380,479 million for the nine months ended September 30, 2019 compared to RUB 1,184,448 million for the same period of the prior year. The change was mainly due to an increase in loans issued for the nine months ended September 30, 2019 compared to the same period of the prior year.

Net cash used in financing activities

Net cash used in financing activities decreased by RUB 218,694 million, or 77 %, to RUB 66,130 million for the nine months ended September 30, 2019 compared to RUB 284,824 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 and proceeds from sale of treasury shares, that was partially compensated by an increase in dividends paid compared to the same period of the prior year.

Capital expenditures

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

(in RUB million)	Nine months ended	
	September 30,	
	2019	2018
Transportation	329,864	405,293
Refining	263,581	208,141
Production of crude oil and gas condensate	198,537	172,259
Production of gas	177,314	168,426
Electric and heat energy generation and sales	47,434	35,950
Distribution of gas	10,554	27,582
Gas storage	8,047	6,396
All other segments	<u>82,599</u>	<u>84,449</u>
Total	1,117,930	1,108,496

Total capital expenditures increased by RUB 9,434 million, or 1 %, from RUB 1,108,496 million for the nine months ended September 30, 2018 to RUB 1,117,930 million for the nine months ended September 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 156,648 million, or 5 %, from RUB 3,014,403 million as of December 31, 2018 to RUB 2,857,755 million as of September 30, 2019. This change was mainly due to an increase in cash and cash equivalents balances.