**PAO NOVATEK**

**MANAGEMENT'S DISCUSSION AND ANALYSIS**
**OF FINANCIAL CONDITION**
**AND RESULTS OF OPERATIONS**

**FOR THE THREE MONTHS ENDED**
**30 SEPTEMBER 2016 AND 2015**

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## GENERAL PROVISIONS

You should read the following discussion and analysis of our financial condition and results of operations for the three months ended 30 September 2016 and 2015 together with our unaudited consolidated interim condensed financial statements as of and for the three and nine months ended 30 September 2016. The unaudited consolidated interim condensed financial statements have been prepared in accordance with International Accounting Standard ("IAS") 34 "Interim Financial Reporting". These consolidated interim condensed financial statements should be read together with the audited consolidated financial statements for the year ended 31 December 2015 prepared in accordance with International Financial Reporting Standards (IFRS).

The financial and operating information contained in this "Management's Discussion and Analysis of Financial Condition and Results of Operations" comprises information of PAO NOVATEK, its consolidated subsidiaries and joint ventures (hereinafter jointly referred to as "we" or the "Group").

## OVERVIEW

We are Russia's largest independent natural gas producer and one of the leaders in terms of proved natural gas reserves in the Russian Federation under the Petroleum Resources Management System ("PRMS") and the Security and Exchange Commission ("SEC") reserve reporting methodologies.

Our exploration and development, production and processing of natural gas, gas condensate and crude oil are conducted mainly within the Russian Federation.

In accordance with Russian law, we currently sell all of our produced natural gas volumes exclusively in the Russian domestic market.

Several wholly owned subsidiaries of the Group (OOO Arctic LNG 1, OOO Arctic LNG 2, and OOO Arctic LNG 3) and the Group's joint venture OAO Yamal LNG are the holders of liquefied natural gas ("LNG") export licenses. The aforementioned subsidiaries hold licenses for exploration and production on the Salmanovskoye (Utrenneye) and Geofizicheskoye fields, and the North-Obskiy and Trekhbugorniy license areas located on the Gydan peninsula and the Gulf of Ob. Yamal LNG holds the exploration and production license for the South-Tambeyskoye field located in the north-eastern part of the Yamal peninsula in the Yamal-Nenets Autonomous Region ("YNAO").

We deliver our extracted unstable gas condensate through our own pipelines to our Purovsky Gas Condensate Plant (the "Purovsky Plant") for processing into stable gas condensate and liquefied petroleum gas ("LPG"). The Purovsky Plant allows us to process more than 12 million tons of unstable gas condensate per annum.

Most of our stable gas condensate is sent for further processing to our Gas Condensate Fractionation and Transshipment Complex located at the port of Ust-Luga on the Baltic Sea (the "Ust-Luga Complex"). The Ust-Luga Complex processes our stable gas condensate into light and heavy naphtha, jet fuel, gasoil and fuel oil, nearly all of which we sell to the international markets allowing us to increase the added value of our liquid hydrocarbons sales. The Ust-Luga Complex allows us to process about seven million tons of stable gas condensate annually.

The excess volumes of stable gas condensate received from the processing at the Purovsky Plant over volumes sent for further processing to the Ust-Luga Complex are sold on both the domestic and international markets (from the port of Ust-Luga on the Baltic Sea by tankers and to European markets by rail).

A significant part of our LPG produced at the Purovsky Plant is dispatched via pipeline for refining by OOO SIBUR Tobolsk (formerly OOO Tobolsk-Neftekhim) at its refining facility (the "Tobolsk Refining Facilities"). The remaining volumes are sold directly from the Purovsky Plant without incurring additional transportation expenses. After processing at the Tobolsk Refining Facilities we receive LPG with higher added value, the majority of which are transported by rail to our end-customers in the domestic and international markets with the remaining portion sold directly from the Tobolsk Refining Facilities without incurring additional transportation expenses.

We deliver our crude oil to both domestic and international markets.

The Group, jointly with our international partners TOTAL S.A., China National Petroleum Corporation and China's Silk Road Fund Co. Ltd., through our joint venture OAO Yamal LNG, undertakes a large-scale project on constructing a liquefied natural gas plant with an annual capacity of 16.5 million tons based on the feedstock resources of the South-Tambeyskoye field (the "Yamal LNG project"). The Yamal LNG project also requires the construction of transportation infrastructure, including the seaport and the international airport. The launch of the first train of the LNG plant and start of liquefied natural gas shipments is planned in 2017. It is expected that the produced LNG will be sold mainly to the Asian-Pacific Region ("APR") and to the European market. The Yamal LNG project has now concluded the sale of more than 95% of LNG volumes produced under long-term contractual agreements.

## RECENT DEVELOPMENTS

### Increasing our production and utilization of refining capacity

At the end of 2014 and in the first half of 2015, OOO SeverEnergia, the Group's joint venture with PAO Gazprom Neft, and ZAO Terneftegas, the Group's joint venture with TOTAL S.A., launched additional production facilities. As a result, the Group's gas condensate production has increased significantly enabling us to fully utilize the processing facilities of our Ust-Luga Complex (effective January 2015) and our Purovsky Plant (effective May 2015).

In December 2015, we commenced commercial production at the Yarudeyskoye oil field and at the end of the month we reached the nameplate production capacity of approximately 3.5 million tons of crude oil per annum. The successful launch and production ramp-up of the Yarudeyskoye field allows us to significantly increase our production of crude oil and represents the majority of liquids production growth in 2016.

### Increasing our resource base

During the nine months of 2016, as part of our long-term development strategy, the Group expanded the resource base and obtained the rights for the usage of several license areas, located in the YNAO.

In April 2016, based on auction results held by the Federal Agency for the Use of Natural Resources of the Russian Federation, the Group won the right for geological research works, exploration and production of hydrocarbons at the Nyakhartinskiy license area. The license area is located in the YNAO in close proximity to our Yurkharovskoye field, which will allow us to develop the new area using the existing well-developed infrastructure of one of our core production assets. As of 31 December 2015, the field's recoverable resources according to the Russian reserve classification C3+D totaled 215 billion cubic meters ("bcm") of natural gas and more than 70 million tons of liquid hydrocarbons. The payment for the license amounted to RR 1,057 million.

In April 2016, the Group acquired a 100% equity stake in OOO Evrotek-Yuh for RR six million. Evrotek-Yuh is a holder of the license for geological research works, exploration and production of hydrocarbons within Ladertoyskiy license area located on the Gydan peninsula in YNAO. As of 31 December 2015, the license area's reserves and recoverable resources according to the Russian reserve classification ABC1+C2+C3 totaled approximately 39 bcm of natural gas and approximately six million tons of liquid hydrocarbons.

In June 2016, the Group obtained mineral licenses for exploration works at the West-Solpatinskiy and Nyavuyahskiy license areas adjacent to the Ladertoyskiy license area, and the North-Tanamskiy license area located in the central part of the Gydan peninsula. As of 31 December 2015, the aggregate recoverable resources of these three new license areas according to the Russian reserve classification C3+D totaled approximately 560 bcm of natural gas and approximately 57 million tons of liquid hydrocarbons.

We continue to expand our resource base in the Gydan peninsula and are actively exploring the region's geological potential for future commercial projects. The acquisition of the four new license areas located in close proximity to each other will allow us to use common infrastructure for the most efficient development of these license areas. We are currently developing an exploration work program for these license areas.

In September 2016, based on auction results held by the Federal Agency for the Use of Natural Resources of the Russian Federation, the Group won the right for geological research works, exploration and production of hydrocarbons at the Syadorskiy license area. The acquisition of the new license area located in the northern part of the Yamal peninsula in YNAO allows to expand the Group's resource base for implementation of our future projects. As of 31 December 2015, the field's recoverable resources according to the Russian reserve classification C3+D totaled approximately 63 bcm of natural gas and approximately 19 million tons of liquid hydrocarbons. The payment for the license was set at RR 404 million.

**Implementing our Yamal LNG project**

In December 2015, NOVATEK and China's Silk Road Fund Co. Ltd. signed an agreement on the acquisition of a 9.9% equity stake in Yamal LNG by the fund. In March 2016, the transaction was closed upon the completion of the conditions precedent. As a result of this transaction, the Group's interest in Yamal LNG was reduced from 60% to 50.1%. The Group continues to exercise joint control over Yamal LNG and, accordingly, recognizes the project as a joint venture. The entrance of Silk Road Fund Co. Ltd. to the Yamal LNG project is an important step in the execution of our long-term development strategy for this project.

In the second quarter of 2016, Yamal LNG signed 15-year credit line facility agreements with a number of Russian and foreign banks to raise project financing for the total amount of EUR 12.9 billion and CNY 9.8 billion. The signing of these credit agreements contributes to the planned financing of the project and its further successful realization.

**LNG market development**

In July 2016, NOVATEK through its wholly owned subsidiary Novatek Gas and Power GmbH performed its first trading operation for the purchase and sale of liquefied natural gas on the spot market. The first LNG cargo was purchased in Trinidad and Tobago and supplied to Chili. This operation allowed the Group to gain experience in LNG trading and will contribute to our successful entry to the global LNG market. The financial result from the LNG trading activity was recorded in "Other operating income (loss)".

**International projects**

In September 2016, the Group and the Italian oil and gas company Eni (the "Concessionaries") through their wholly owned subsidiaries entered into a concession contract with the State of Montenegro for the exploration and production of hydrocarbons on four offshore blocks located in the Adriatic Sea (the "Concession Contract"). The participation interest of each Concessioner is 50%, and Eni was appointed as the operator.

According to the Concession Contract, the Concessionaries are committed to perform 3D-seismic exploratory works and to drill several exploration wells during the exploration phase of up to seven years. The Concessionaries are currently preparing for performing exploration works that are planned to commence in the beginning of 2017.

The participation in the Concession Contract contributes to the Group's ability to realize future international joint projects, as well as enables the Group to gain experience working in offshore projects.

## SELECTED DATA

| *millions of Russian roubles except as stated* | Three months ended 30 September: 2016 | 2015 | Change % |
|---|---|---|---|
| **Financial results** | | | |
| Total revenues (1) | 126,483 | 117,367 | 7.8% |
| Operating expenses | (93,458) | (85,096) | 9.8% |
| Normalized EBITDA (2),(3) | 57,726 | 52,579 | 9.8% |
| Normalized profit (loss) attributable to shareholders of PAO NOVATEK (3) | 36,494 | (13,405) | n/a |
| Normalized profit attributable to shareholders of PAO NOVATEK (3), excluding the effect of foreign exchange gains (losses) | 31,236 | 31,904 | (2.1%) |
| Normalized earnings (loss) per share (3) (in Russian roubles) | 12.09 | (4.44) | n/a |
| Normalized earnings per share (3), excluding the effect of foreign exchange gains (losses) (in Russian roubles) | 10.35 | 10.56 | (2.0%) |
| Net debt (4) | 200,412 | 258,212 | (22.4%) |
| **Production volumes (5)** | | | |
| Hydrocarbons production (million barrels of oil equivalent) | 131.5 | 131.8 | (0.2%) |
| Daily production (million barrels of oil equivalent per day) | 1.43 | 1.43 | n/a |
| **Operating results** | | | |
| Natural gas sales volumes (million cubic meters) | 14,456 | 14,272 | 1.3% |
| Crude oil sales volumes (thousand tons) | 1,157 | 251 | 361.0% |
| Naphtha sales volumes (thousand tons) | 994 | 979 | 1.5% |
| Stable gas condensate sales volumes (thousand tons) | 715 | 975 | (26.7%) |
| Liquefied petroleum gas sales volumes (thousand tons) | 660 | 632 | 4.4% |
| Other gas condensate refined products (thousand tons) (6) | 653 | 634 | 3.0% |
| **Cash flow results** | | | |
| Net cash provided by operating activities (7) | 42,795 | 16,772 | 155.2% |
| Cash used for capital expenditures (8) | 7,716 | 12,198 | (36.7%) |
| Free cash flow (7),(9) | 35,079 | 4,574 | n/a |

(1) Net of VAT, export duties, excise and fuel taxes.

(2) EBITDA represents profit (loss) adjusted for the add-back of depreciation, depletion and amortization, net impairment expenses (reversals), finance income (expense), income tax expense, as well as income (loss) from changes in fair value of derivative financial instruments. EBITDA includes EBITDA from subsidiaries and our proportionate share in the EBITDA of our joint ventures.

(3) Excluding the effect from the disposal of interests in joint ventures.

(4) Net Debt represents our total debt net of cash and cash equivalents.

(5) Hydrocarbons production and daily production are calculated based on 100% of net production of our subsidiaries and our proportionate share in the production of our joint ventures.

(6) Other gas condensate refined products include jet fuel, gasoil and fuel oil.

(7) The results of the third quarter of 2016 were positively impacted by lower income tax payments as a result of a significant advance payments for income tax made in the second quarter of 2016 based on the gain on the disposal of the 9.9% equity stake in Yamal LNG (see "Cash flows" below). Excluding this effect, our net cash provided by operating activities and free cash flow increased by RR 21.1 billion, or 126%, and by RR 25.6 billion, or 6.6 times, respectively.

(8) Cash used for capital expenditures represents purchases of property, plant and equipment, materials for construction and capitalized interest paid per Consolidated Statement of Cash Flows net of payments for mineral licenses and acquisition of subsidiaries.

(9) Free cash flow represents the difference between Net cash provided by operating activities and Cash used for capital expenditures.

From time to time our financial results are significantly impacted by a recognition of non-cash foreign exchange gains (losses) as a result of the Russian rouble appreciation/depreciation relative to the foreign currencies.

In the third quarter of 2015, as a result of the Russian rouble depreciation relative to the US dollar and Euro by 19% and 21%, respectively, we recognized significant non-cash foreign exchange losses. These losses primarily related to the US dollar- and Euro-denominated borrowings of Yamal LNG, our joint venture. We believe the effects of currency movements arising in relation to the debt portfolio of Yamal LNG will be fully mitigated by its foreign currency denominated revenues as all liquefied natural gas volumes will be delivered to and sold in international markets once commercial production commences. In the 2016 reporting period, the effect from non-cash foreign exchange gains and losses was less significant.

Excluding the one-off effect from the disposal of interests in joint ventures and the effect of foreign exchange gains and losses, the Group's profit attributable to shareholders of PAO NOVATEK was relatively flat and amounted to RR 31,236 million compared to 31,904 million in the corresponding period of the prior year.

Reconciliation of EBITDA and normalized EBITDA is as follows:

| | **Three months ended 30 September:** | | **Change** |
|---|---|---|---|
| *millions of Russian roubles* | **2016** | **2015** | **%** |
| **Profit (loss)** | **37,950** | **(12,411)** | **n/a** |
| Depreciation, depletion and amortization | 10,233 | 4,883 | 109.6% |
| Net impairment reversals (expenses) | (6) | (16) | (62.5%) |
| Loss (income) from changes in fair value of commodity derivative instruments | (126) | (176) | (28.4%) |
| Total finance expense (income) | (1,101) | 6,174 | n/a |
| Total income tax expense | 6,284 | 4,942 | 27.2% |
| Share of loss (profit) of joint ventures, net of income tax | (9,401) | 34,713 | n/a |
| **EBITDA from subsidiaries** | **43,833** | **38,109** | **15.0%** |
| Share in EBITDA of joint ventures | 13,893 | 15,459 | (10.1%) |
| **EBITDA** | **57,726** | **53,568** | **7.8%** |
| Net gain on disposal of interests in joint ventures | - | (989) | n/a |
| **Normalized EBITDA** | **57,726** | **52,579** | **9.8%** |
| **Normalized EBITDA from subsidiaries** | **43,833** | **37,120** | **18.1%** |

## SELECTED MACRO-ECONOMIC DATA

| *Exchange rate, Russian roubles for one foreign currency unit* [1] | Three months ended 30 September: 2016 | 2015 | Change % |
|---|---|---|---|
| **US dollar (USD)** | | | |
| Average for the period | 64.62 | 62.98 | 2.6% |
| At the beginning of the period | 64.26 | 55.52 | 15.7% |
| At the end of the period | 63.16 | 66.24 | (4.6%) |
| Depreciation (appreciation) of Russian rouble to US dollar | (1.7%) | 19.3% | n/a |
| **Euro** | | | |
| Average for the period | 72.15 | 70.11 | 2.9% |
| At the beginning of the period | 71.21 | 61.52 | 15.8% |
| At the end of the period | 70.88 | 74.58 | (5.0%) |
| Depreciation (appreciation) of Russian rouble to Euro | (0.5%) | 21.2% | n/a |

(1) Based on the data from the Central Bank of Russian Federation (CBR). The average rates for the period are calculated as the average of the daily exchange rates on each business day (rate is announced by the CBR) and on each non-business day (rate is equal to the exchange rate on the previous business day).

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| *Average for the period* | Three months ended 30 September: 2016 | 2015 | Change % |
|---|---|---|---|
| **Benchmark crude oil prices** [2] | | | |
| Brent, USD per barrel | 45.9 | 50.5 | (9.1%) |
| Urals, USD per barrel | 44.0 | 49.6 | (11.3%) |
| Urals, Russian roubles per barrel | 2,843 | 3,124 | (9.0%) |
| **Benchmark crude oil prices excluding export duties** [3] | | | |
| Urals, USD per barrel | 31.8 | 32.0 | (0.6%) |
| Urals, Russian roubles per barrel | 2,055 | 2,015 | 2.0% |
| **World market prices for oil products** [4] **and liquefied petroleum gas** [5]**, USD per ton** | | | |
| Naphtha Japan | 389 | 462 | (15.8%) |
| Naphtha CIF NWE | 382 | 431 | (11.4%) |
| Jet fuel | 437 | 503 | (13.1%) |
| Gasoil | 409 | 480 | (14.8%) |
| Fuel oil | 249 | 253 | (1.6%) |
| Liquefied petroleum gas | 326 | 352 | (7.4%) |
| **Export duties, USD per ton** [6] | | | |
| Crude oil, stable gas condensate | 88.7 | 128.5 | (31.0%) |
| Naphtha | 62.9 | 109.2 | (42.4%) |
| Jet fuel, gasoil | 35.4 | 61.6 | (42.5%) |
| Fuel oil | 72.7 | 97.6 | (25.5%) |
| Liquefied petroleum gas | 0.0 | 0.0 | n/a |

(2) Based on Brent (dtd) and Russian Urals CIF Rotterdam spot assessments prices as provided by Platts.

(3) Export duties per barrel were calculated based on export duties per ton divided by the coefficient 7.3.

(4) Based on Naphtha C+F (cost plus freight) Japan, Naphtha CIF NWE, Jet CIF NWE, Gasoil 0.1% CIF NWE, Fuel Oil 1.0% CIF NWE prices provided by Platts.

(5) Based on spot prices for propane-butane mix at the Belarusian-Polish border (DAF, Brest) as provided by Argus.

(6) Export duties are determined by the Russian Federation government in US dollars and are paid in Russian roubles (see "Our tax burden and obligatory payments" below).

## CERTAIN FACTORS AFFECTING OUR RESULTS OF OPERATIONS

### Current economic conditions

Political events in Ukraine in the beginning of 2014 have prompted a negative reaction by the world community, including economic sanctions levied by the United States of America, Canada and the European Union against certain Russian individuals and legal entities. In July 2014, NOVATEK was included on the OFAC's Sectoral Sanctions Identification List (the "List"), which imposed sanctions that prohibit individuals or legal entities registered or working on the territory of the United States from providing new credit facilities to the Group for longer than 90 days. Despite the inclusion on the List, the Group may conduct any other activities, including financial transactions, with U.S. investors and partners. NOVATEK was included on the List even though the Group does not conduct any business activities in Ukraine, nor does it have any impact on the political and economic processes taking place in this country. Management has assessed the impact of the sanctions described above on the Group's activities taking into consideration the current state of the world economy, the condition of domestic and international capital markets, the Group's business, and long-term projects with foreign partners. We have concluded that the inclusion on the List does not significantly impede the Group's operations and business activities in any jurisdiction, nor does it affect the Group's assets and exchange listed shares and debt, and does not have a material effect on the Group's financial position.

Simultaneously, during 2014, the Russian economy has experienced signs of weakness which became especially apparent during the fourth quarter of 2014 with the severe devaluation of the Russian rouble, the contraction of the Country's gross domestic product, a significant increase in the Central Bank's lending rates, increased inflation and other factors. The domestic economic situation was further exasperated by the rapid commodity price decline in global oil markets. As a result, in January and February 2015, both Standard & Poor's (S&P) and Moody's downgraded the Russian sovereign rating to below investment rating status as well as made the corresponding downward adjustments to Russian issuers, including NOVATEK. We strongly disagree with the position taken by both S&P and Moody's regarding our credit rating because our operating results and cash flow generating capabilities to support our liquidity position remain strong.

In 2015 and during the nine months of 2016, the Central Bank's lending rates gradually decreased, whereas the Russian rouble exchange rates relative to world currencies and benchmark commodity prices in international markets remained volatile. Commodity price volatility continues to exert significant influence on financial and operations results in the global oil and gas industry, and this present macro situation is expected to remain volatile throughout 2016 as present crude oil supplies exceed world demand. Our financial results are obviously impacted by these global developments as our export sales are linked to the specific underlying benchmark commodity prices but we believe our business model, representing one of the lowest cost producers in the world, insulates us from severe financial and operational stress. We do not expect any asset impairments or write-offs resulting from a lower commodity price environment.

In June 2016, the United Kingdom through a referendum voted to exit the European Union, commonly referred to as "Brexit", which caused further economic and political uncertainties as well as significant volatility in the global financial markets.

Management continues to closely monitor the economic and political environment in Russia and abroad, including the domestic and international capital markets, to determine if any further corrective and/or preventive measures are required to sustain and grow our business. We are also closely monitoring the present commodity price environment and its impact on our business operations.

We conduct regular reviews of our capital expenditure program and existing debt obligations. In our opinion, the Group's financial position is stable and expected operating cash flows are sufficient to service and repay our debt, as well as to execute our planned capital expenditure programs.

We together with our international partners are undertaking all necessary actions to implement the joint investment projects on time as planned, including, but not limited to, attraction of financing from domestic and non-US capital markets.

### Natural gas prices

The Group's natural gas prices on the domestic market are strongly influenced by the prices set by a federal executive agency of the Russian Federation that carries out governmental regulation of prices and tariffs for products and services of natural monopolies in energy, utilities and transportation (the "Regulator"), as well as present market conditions. During the first half of 2015, the Federal Tariffs Service ("FTS") fulfilled the Regulator's role. In July 2015, a Decree of the President of the Russian Federation became effective abolishing the FTS and transferring its functions to the Federal Anti-Monopoly Service.

Effective 1 July 2015, wholesale natural gas prices for sales to all customer categories (excluding residential customers) on the domestic market were increased by the Regulator by 7.5% and remained unchanged through the end of the third quarter of 2016.

In May 2016, the Ministry of Economic Development of the Russian Federation published "Scenario conditions, basic parameters of the Forecast of Socio-economic Development of the Russian Federation and overall price (tariff) level for services provided by the companies of infrastructure sector for 2017 and planned period 2018 and 2019" ("Parameters of the Forecast of Socio-economic Development for 2017-2019") providing for increases of wholesale natural gas prices for sales to all customer categories (excluding residential customers) in 2016-2019 on average by 2.0% on an annual basis effective 1 July of each respective year. As of our report date no information regarding the actual effective date and the size of wholesale natural gas price adjustments for sales to all customer categories (excluding residential customers) in 2016 was available. The Russian Federation government continues to discuss various concepts relating to the natural gas industry development, including natural gas prices and transportation tariffs growth rates on the domestic market.

The specific terms for delivery of natural gas affect our average realized prices. The majority of our natural gas volumes are sold directly to end-customers in the regions of natural gas consumption, so transportation tariff to the end customer's location is included in the contract sales price. The remaining volumes of natural gas are sold "ex-field" to wholesale gas traders, in which case the buyer is responsible for the payment of further gas transportation tariff. Sales to wholesale gas traders allow us to diversify our natural gas sales without incurring additional commercial expenses.

We deliver natural gas to residential customers in the Chelyabinsk and Kostroma regions of the Russian Federation at regulated prices through our subsidiaries OOO NOVATEK-Chelyabinsk and OOO NOVATEK-Kostroma, respectively. We disclose such residential sales within our end-customers category.

In addition, we periodically sell natural gas at the Saint-Petersburg International Mercantile Exchange based on market conditions. We disclose such sales within our sales to end-customers category.

In the three months ended 30 September 2016, our average natural gas price on end-customers sales decreased by 4.1% due to an increase in the proportion of sales to our end-customers located closer to our production fields in the current reporting period as compared to the respective period in 2015. The change in the sales geography also reduced our average transportation expense per mcm by 5.3%. As a result, the average natural gas price on end-customers sales excluding transportation expenses decreased to a lesser extent by 3.2%.

The following table shows our average realized natural gas sales prices (excluding VAT):

| *Russian roubles per mcm* | **Three months ended 30 September: 2016** | **2015** | **Change %** |
|---|---|---|---|
| Average natural gas price to end-customers [(1)] | 3,693 | 3,849 | (4.1%) |
| Average natural gas transportation expense for sales to end-customers | (1,438) | (1,519) | (5.3%) |
| Average natural gas price on end-customer sales excluding transportation expense | 2,256 | 2,331 | (3.2%) |
| Average natural gas price ex-field (wholesale traders) | 2,051 | 2,051 | 0.0% |
| **Total average natural gas price excluding transportation expense** | **2,241** | **2,314** | **(3.2%)** |

[(1)] Includes cost of transportation.

**Stable gas condensate and refined products, crude oil and liquefied petroleum gas prices**

Crude oil, stable gas condensate, LPG and oil products prices on international markets have historically been volatile depending on, among other things, the balance between supply and demand fundamentals, the ability and willingness of oil producing countries to sustain or change production levels to meet changes in global demand and potential disruptions in global crude oil supplies due to war, geopolitical developments, terrorist activities or natural disasters.

The actual prices we receive for our liquid hydrocarbons on both the domestic and international markets are dependent on many external factors beyond the control of management. Among many other factors volatile movements in benchmark crude oil and oil products prices can have a positive and/or negative impact on the contract prices we receive for our liquids sales volumes.

In addition, our actual realized net export prices for crude oil, stable gas condensate and its refined products are affected by the so-called "export duty lag effect". This effect is due to the differences between actual crude oil prices for a certain period and crude oil prices based on which export duty rate is calculated for the same period (see "Our tax burden and obligatory payments" below). In periods when crude oil prices are rising, the duty lag effect normally has a positive impact on the Group's financial results, as the export duty rates are set on the basis of lower crude oil prices compared to the actual prices. Conversely, in periods of crude oil prices decline, the export duty rate is calculated based on higher prices compared to the actual prices, which results in a negative financial impact.

Most of our liquid hydrocarbons sales prices on both the international and domestic markets include transportation expenses in accordance with the specific terms of delivery. The remaining portion of our liquids volumes is sold without additional transportation expenses (ex-works sales of liquefied petroleum gas from the Purovsky Plant and the Tobolsk Refining Facilities, as well as certain other types of sales).

We commonly sell our stable gas condensate and refined products, as well as liquefied petroleum gas to the international markets with a premium to the respective international benchmark reference products prices. Our crude oil sold to the international markets is commonly traded with a discount to the benchmark Brent crude oil in case of SILCO grade sales (low-sulfur "Siberian Light Crude Oil") and with a premium to the benchmark Dubai crude oil in case of ESPO grade sales (crude oil delivered by the pipeline "East Siberia – Pacific ocean").

The following table shows our average realized stable gas condensate and refined products, crude oil and LPG sales prices. Average realized net prices are shown net of VAT, export duties, excise and fuel taxes expense, where applicable:

| *Russian roubles or US dollars per ton* | **Three months ended 30 September: 2016** | **2015** | **Change %** |
|---|---|---|---|
| **Stable gas condensate** | | | |
| Export contract price, USD per ton | 401 | 388 | 3.4% |
| Net export price, USD per ton | 314 | 267 | 17.6% |
| Net export price, RR per ton | 20,346 | 16,547 | 23.0% |
| Domestic price, RR per ton | 15,105 | 14,063 | 7.4% |
| **Naphtha** | | | |
| Export contract price, USD per ton | 406 | 454 | (10.6%) |
| Net export price, USD per ton | 345 | 342 | 0.9% |
| Net export price, RR per ton | 22,302 | 20,429 | 9.2% |
| **Other gas condensate refined products** | | | |
| Export contract price, USD per ton | 402 | 458 | (12.2%) |
| Net export price, USD per ton | 352 | 380 | (7.4%) |
| Net export price, RR per ton | 22,738 | 23,247 | (2.2%) |
| Domestic price, RR per ton | 18,656 | 18,930 | (1.4%) |
| **Crude oil** | | | |
| Export contract price, USD per ton | 316 | 342 | (7.6%) |
| Net export price, USD per ton | 228 | 225 | 1.3% |
| Net export price, RR per ton | 14,768 | 14,229 | 3.8% |
| Domestic price, RR per ton | 13,558 | 13,557 | 0.0% |
| **LPG** | | | |
| Export contract price, USD per ton (1) | 547 | 515 | 6.2% |
| Net export price, USD per ton (1) | 392 | 396 | (1.0%) |
| Net export price, RR per ton | 25,346 | 24,912 | 1.7% |
| Domestic price, RR per ton | 9,522 | 11,932 | (20.2%) |

(1) For operations in Polish zloty price in US dollars was translated from Russian roubles using the average exchange rate for the period.

*Crude oil, stable gas condensate and its refined products*

In the three months ended 30 September 2016, compared to the corresponding period in 2015 our average realized export contract prices for stable gas condensate refined products and crude oil decreased primarily due to decreases in the underlying respective product prices on the international markets (see "Selected macro-economic data" above). The dynamics of our stable gas condensate prices during each reporting period was also in line with the benchmark crude oil prices movements. However, as a result of uneven distribution of sales volumes within periods and significant volatility of benchmark crude oil prices on international markets, our weighted-average stable gas condensate export contract price in the third quarter of 2016 slightly increased compared to the corresponding period in 2015.

A significant decrease in average export duties for liquid hydrocarbons sales (see "Selected macro-economic data" above), as well as a 2.6% increase in the average exchange rate of the US dollar to the Russian rouble in the three months ended 30 September 2016 compared to the corresponding period in 2015 had a positive impact on our average realized net export prices. As a result, our average realized net export prices in Russian roubles terms for all liquid products either increased or remained relatively unchanged.

In the three months ended 30 September 2016, our average realized domestic prices for crude oil, stable gas condensate and its refined products changed marginally compared to the corresponding period in 2015 as a result of the respective changes in benchmark crude oil prices excluding export duties in Russian roubles terms, and specifics of pricing mechanism for each particular product on the domestic market (such as time lag of international benchmark crude oil prices and export duty rates used in price calculation, price setting on an individual transaction basis for some deliveries and others).

*Liquefied petroleum gas*

In the three months ended 30 September 2016, compared to the corresponding period in 2015, our average realized LPG export contract price increased due to changes in the sales geography (increase in the share of sales to Poland where the contract price is higher than prices for sales to other countries according to the delivery terms), as well as uneven distribution of sales volumes within reporting periods. As a result of an increase in the share of LPG sales subject to excise and fuel taxes in Poland (see "Our tax burden" below), our average realized LPG net export price remained relatively flat.

In the three months ended 30 September 2016, our average realized LPG domestic price decreased compared to the corresponding period in 2015. A decrease in our average realized price was mainly due to a decrease in the underlying benchmark prices for LPG on international markets and increased transportation tariffs as these figures form the basis for the price setting of some LPG deliveries.

**Transportation tariffs**

*Natural gas*

We transport our natural gas through our own pipelines into the Unified Gas Supply System ("UGSS"), which is owned and operated by PAO Gazprom, a Russian Federation government controlled monopoly. Transportation tariffs charged to independent producers for the use of the Gas Transmission System ("GTS"), as part of the UGSS, are set by the Regulator (see "Terms and abbreviations" below).

In accordance with the existing methodology of calculating transportation tariffs for natural gas produced in the Russian Federation for shipments to consumers located within the customs territory of the Russian Federation and the member states of the Customs Union Agreement (Belarus, Kazakhstan, Kyrgyzstan and Tajikistan), the transportation tariff consists of two parts: a rate for the utilization of the trunk pipeline and a transportation rate per mcm per 100 kilometers (km). The rate for utilization of the trunk pipeline is based on an "input/output" function, which is determined by where natural gas enters and exits the trunk pipeline and includes a constant rate for end-customers using Gazprom's gas distribution systems. The constant rate is deducted from the utilization rate for end-customers using non-Gazprom gas distribution systems.

Effective 1 July 2015, the average tariff for natural gas transportation through the trunk pipeline was increased by 2.0% and remained unchanged through the end of the third quarter of 2016. The transportation rate amounts to RR 13.04 per mcm per 100 km (excluding VAT), and the rate for utilization of the trunk pipeline is set between RR 62.57 to RR 2,014.16 per mcm (excluding VAT).

According to the "Parameters of the Forecast of Socio-economic Development for 2017 to 2019" prepared by the Ministry of Economic Development of the Russian Federation and published in May 2016, the increase in transportation tariffs for natural gas produced by independent producers in 2016 to 2019 should be in line with the increase in wholesale natural gas prices – in average by 2.0% effective 1 July of each respective year (see "Natural gas prices" above). There was no indexation of transportation tariffs effective 1 July 2016, and, as of our report date no information regarding the actual effective date and the size of the next adjustment of transportation tariffs was available. The Russian Federation government continues to discuss various concepts relating to the natural gas industry development, including natural gas prices and transportation tariffs growth on the domestic market.

*Stable gas condensate and LPG by rail*

We transport stable gas condensate and LPG (excluding volumes sold ex-works from the Purovsky Plant and the Tobolsk Refining Facilities) by rail owned by Russia's state-owned monopoly railway operator – OAO Russian Railways ("RZD").

The railroad transportation tariffs are set by the Regulator and vary depending on the type of a product, direction and the length of the transport route. In addition, the Regulator sets the range of railroad tariffs as a percentage of the regulated tariff within which RZD may vary railroad transportation tariffs within the Russian Federation territory based on the type of product, direction and length of the transportation route taking into account current railroad transportation and market conditions.

Effective 1 January 2015, the Regulator increased railroad freight transportation tariffs for all types of hydrocarbons by 10%, and until the end of 2015 transportation tariffs did not change. Effective 3 January 2016, the Regulator increased railroad freight transportation tariffs for all types of hydrocarbons by an additional 9%.

In 2015 and during the nine months of 2016, we applied the discount coefficient of 0.94 to the existing railroad transportation tariffs for stable gas condensate deliveries from the Limbey rail station to the port of Ust-Luga and to end-customers on the domestic and export (only in 2016) markets. The discount coefficient is set by the decision of the Management Board of RZD as part of the Strategic Partnership Agreement between the Group and RZD.

*Stable gas condensate and refined products by tankers*

We deliver part of our stable gas condensate and substantially all stable gas condensate refined products to international markets by chartered tankers via the port of Ust-Luga on the Baltic Sea. The tanker transportation cost is determined by standard shipping terms, the distance to the final port of destination, tanker availability and seasonality of deliveries.

*Crude oil*

We transport nearly all of our crude oil through the pipeline network owned by OAO AK Transneft, Russia's state-owned monopoly crude oil pipeline operator. The Regulator sets tariffs for transportation of crude oil through Transneft's pipeline network, which includes transport, dispatch, pumping, loading, charge-discharge, transshipment and other related services. The Regulator sets tariffs for each separate route of the pipeline network, so the overall expense for the transport of crude oil depends on the length of the transport route from the producing fields to the ultimate destination, transportation direction and other factors.

Effective 1 January 2015, crude oil transportation tariffs within the Russian Federation territory through the pipeline network were increased by an average of 6.75% and did not change until the end of 2015. Effective 1 January 2016, crude oil transportation tariffs were increased by an average of 5.76% relative to the 2015 tariffs and remained unchanged until the end of the third quarter of 2016.

## Our tax burden and obligatory payments

We are subject to a wide range of taxes imposed at the federal, regional, and local levels, many of which are based on revenue or volumetric measures. In addition to income tax, significant taxes and obligatory payments to which we are subject include VAT, unified natural resources production tax ("UPT", commonly referred as "MET" – mineral extraction tax), export duties, property tax and social contributions to non-budget funds.

In practice, Russian tax authorities often have their own interpretation of tax laws that rarely favors taxpayers, who have to resort to court proceedings to defend their position against the tax authorities. Differing interpretations of tax regulations exist both among and within government ministries and organizations at the federal, regional and local levels, creating uncertainties and inconsistent enforcement. Tax declarations, together with related documentation such as customs declarations, are subject to review and investigation by a number of authorities, each of which may impose fines, penalties and interest charges. Generally, taxpayers are subject to an inspection of their activities for a period of three calendar years immediately preceding the year in which the audit is conducted. Previous audits do not completely exclude subsequent claims relating to the audited period. In addition, in some instances, new tax regulations may have a retroactive effect.

We have not employed any tax minimization schemes using offshore or domestic tax zones in the Russian Federation.

*The tax maneuver in the oil and gas industry*

In November 2014, as part of the tax maneuver in the oil and gas industry, a federal law №366-FZ "Concerning introducing changes to the second part of the Tax Code of the Russian Federation and certain legislative acts of the Russian Federation" was adopted which envisages the increase in national budgetary income as a result of the phased (during three years) increases in UPT rates with a simultaneous decrease in excise taxes and export duties (see below).

*UPT – natural gas and gas condensate*

In accordance with the Tax Code of the Russian Federation, the UPT rates for natural gas and gas condensate are calculated monthly according to a formula based on which the set base UPT rate is multiplied by the base value of a standard fuel equivalent and a coefficient characterizing the difficulty of extracting natural gas and gas condensate from each particular field. In addition, the formula for gas condensate UPT rate is multiplied by an adjusting coefficient, and the UPT rate for natural gas also takes into account a parameter characterizing natural gas transportation costs (the latter was set at zero for 2015 and 2016 and did not affect the UPT rate).

The base UPT rate is set at RR 35 per one thousand cubic meters of extracted natural gas and at RR 42 per one ton of extracted gas condensate. The base value of a standard fuel equivalent is calculated monthly and depends primarily on natural gas prices, Urals crude oil prices and crude oil export duty rate.

A coefficient characterizing the difficulty of extracting natural gas and gas condensate is defined as a minimum value from the coefficients characterizing either the reserves' depletion, the field's geographical location, the deposit's (or reservoir's) depth, assignment of the field to the regional gas supply chain or particular features of certain field deposits development.

The adjusting coefficient for gas condensate UPT rate calculation is set at 4.4, 5.5 and 6.5 for 2015, 2016 and 2017, respectively. Therefore, the adjusting coefficient was increased by 25.0% from 1 January 2016 (effective 1 January 2017, the coefficient will be further increased by 18.2% in relation to 2016).

*UPT – crude oil*

The UPT rate for crude oil is calculated as the base UPT rate multiplied by a coefficient characterizing the dynamics of world crude oil prices, and the resulting product is further decreased by a parameter characterizing crude oil production peculiarities. The base crude oil UPT rate in 2015 was set at RR 766 per ton and was increased to RR 857 per ton effective 1 January 2016. Effective 1 January 2017, the base UPT rate will be set at RR 919 per ton.

In both reporting periods, in accordance with the Tax Code of the Russian Federation, we applied a reduced UPT rate for crude oil produced at our Yurkharovskoye, East-Tarkosalinskoye, Khancheyskoye and Yarudeyskoye fields since these fields are located fully or partially to the north of the 65th degree of the northern latitude fully or partially in the YNAO. In 2016, the UPT rate for crude oil produced at the aforementioned fields was calculated using an effective rate of RR 298 per ton (increased by 26.3% compared to 2015) multiplied by a coefficient characterizing the dynamics of world crude oil prices. From 1 January 2017, the effective rate will be set at RR 360 per ton.

*Export duties and excise taxes*

According to the Law of the Russian Federation "On Customs Tariff" we are subject to export duties on our exports of liquid hydrocarbons (stable gas condensate and refined products, LPG and crude oil). Formulas for export duty rates calculation are set by the Russian Federation government. Based on the set formulas the Ministry of Economic Development calculates and publishes export duty rates on a monthly basis (see "Selected macro-economic data" above).

The export duty rate for stable gas condensate and crude oil for the next calendar month is calculated based on the average Urals crude oil price for the period from the 15th calendar day in the previous month to the 14th calendar day of the current month. In 2015, the calculation of the export duty rate in US dollars per ton when the average Urals crude oil price is more than USD 182.5 per ton (or USD 25 per barrel) was set as follows: USD 29.2 plus 42% of the difference between the average Urals crude oil price and USD 182.5 per ton. As part of the tax maneuver in the oil and gas industry (see above), effective 1 January 2016 and 2017, the set percentage should have been decreased to 36% and 30%, respectively. However, in order to increase state budget income in 2016 in the anticipation of a lower crude oil price environment, in November 2015, the Russian Federation government made a decision not to adjust the formula for crude oil export duty rate calculation in 2016 and to keep a set percentage at the 2015 level of 42%.

The export duty rates for oil products is calculated based on the export duty rate for crude oil which is adjusted by a coefficient set for each category of oil products. The export duty rates for our exported gas condensate refined products as a percentage of the crude oil export duty rate are presented below:

| *% from the crude oil export duty rate* | **2015** | **2016** | **2017 and further** |
|---|---|---|---|
| Naphtha | 85% | 71% | 55% |
| Jet fuel | 48% | 40% | 30% |
| Gasoil | 48% | 40% | 30% |
| Fuel oil | 76% | 82% | 100% |

The phased decrease in export duty rates for oil products (except fuel oil) is also implemented as part of the tax maneuver in the oil industry with a simultaneous increase in the UPT rates for gas condensate and crude oil (see above).

The export duty rate for LPG for the next calendar month is calculated based on the average LPG price at the Polish border (DAF, Brest) for the period from the 15th calendar day in the previous month to the 14th calendar day of the current month. The formula for LPG export duty rate calculation is presented in the table below:

| *Average LPG price, USD per ton (P)* | **Formula for export duty rate calculation** |
|---|---|
| less 490 (inclusive) | Zero rate |
| between 490 and 640 (inclusive) | 0.5 × (P – 490) |
| between 640 and 740 (inclusive) | 75 + 0.6 × (P – 640) |
| above 740 | 135 + 0.7 × (P – 740) |

As the average LPG price for the export duty rate calculation was below USD 490 per ton in both reporting periods, we applied a zero export duty rate in respect of our LPG export sales.

In accordance with the Tax Code of the Russian Federation, producers of excisable goods (petrol, diesel fuel, medium distillates and others) that sell those goods on the domestic market are subject to excise tax payments. The Group does not sell excisable goods on the domestic market and, therefore, does not pay excise taxes in Russia.

Most of our LPG sales in Poland are subject to excise and fuel taxes in accordance with the local legislation. The amount of excise and fuel tax payments depends on the volume of excisable goods sold and the respective tax rates (the excise and fuel tax rates in 2015 and 2016 did not change and amounted to 670 and 159.71 Polish zloty per ton, respectively).

*Social contributions*

In both reporting periods the rates for social contributions to the Pension Fund of the Russian Federation, the Federal Compulsory Medical Insurance Fund and the Social Insurance Fund of the Russian Federation paid by the employer on behalf of employees did not change and were set at 22.0%, 5.1% and 2.9%, respectively (cumulatively 30.0%).

The employer applies the aforementioned rates for social contributions to the Pension Fund of the Russian Federation and the Social Insurance Fund of the Russian Federation until the annual income of an employee exceeds the maximum taxable base set by the Russian Federation government. For the portion of the annual income exceeding the maximum base the reduced rates are applied: 10.0% for the Pension Fund of the Russian Federation and nil for the Social Insurance Fund of the Russian Federation.

The rate for social contributions to the Federal Compulsory Medical Insurance Fund does not vary with the employee's annual income.

The table below provides for the rates and maximum taxable bases set by the Russian Federation government for social contributions in 2015 and 2016:

| | 2015 | | 2016 | |
|---|---|---|---|---|
| | **Base, RR thousand** | **Rate, %** | **Base, RR thousand** | **Rate, %** |
| Pension Fund of the Russian Federation | less 711<br>above 711 | 22.0%<br>10.0% | less 796<br>above 796 | 22.0%<br>10.0% |
| Federal Compulsory Medical Insurance Fund | No limit | 5.1% | No limit | 5.1% |
| Social Insurance Fund of the Russian Federation | less 670<br>above 670 | 2.9%<br>0.0% | less 718<br>above 718 | 2.9%<br>0.0% |

## OPERATIONAL HIGHLIGHTS

### Hydrocarbon production and sales volumes

In the three months ended 30 September 2016, our natural gas sales volumes increased by 184 mmcm, or 1.3%, mainly due to additional volumes sold to traders and the respective decrease in natural gas inventory balance as compared to the corresponding period in 2015. Natural gas volumes produced by our subsidiaries and joint ventures at mature fields decreased mainly due to natural declines in the reservoir pressure at the current gas producing horizons that was partially offset by the launch of the Yarudeyskoye field and additional facilities to improve the efficiency of associated petroleum gas utilization at our Khancheyskoye field.

In the three months ended 30 September 2016, our liquids sales volumes increased significantly by 709 thousand tons, or 20.4%, primarily due to the commencement of crude oil commercial production at the Yarudeyskoye field in December 2015.

*Natural gas production volumes*

In the three months ended 30 September 2016, our total natural gas production (including our proportionate share in the production of joint ventures) decreased by 866 mmcm, or 5.1%, to 16,195 mmcm from 17,061 mmcm in the corresponding period in 2015.

| *millions of cubic meters* | **Three months ended 30 September: 2016** | **2015** | **Change %** |
|---|---|---|---|
| **Production by subsidiaries from:** | | | |
| Yurkharovskoye field | 8,092 | 8,743 | (7.4%) |
| East-Tarkosalinskoye field | 1,987 | 2,136 | (7.0%) |
| Khancheyskoye field | 645 | 597 | 8.0% |
| Other fields | 580 | 392 | 48.0% |
| **Total natural gas production by subsidiaries** | **11,304** | **11,868** | **(4.8%)** |
| **Group's proportionate share in the production of joint ventures:** | | | |
| SeverEnergia (Arcticgas) | 3,370 | 3,613 | (6.7%) |
| Nortgas | 1,219 | 1,297 | (6.0%) |
| Terneftegas | 302 | 283 | 6.7% |
| **Total Group's proportionate share in the natural gas production of joint ventures** | **4,891** | **5,193** | **(5.8%)** |
| **Total natural gas production including proportionate share in the production of joint ventures** | **16,195** | **17,061** | **(5.1%)** |

In the three months ended 30 September 2016, natural gas volumes produced by our subsidiaries at mature fields (Yurkharovskoye and East-Tarkosalinskoye), as well as volumes produced by Nortgas and at Samburgskoye field of SeverEnergia decreased mainly due to natural declines in the reservoir pressure at the current gas producing horizons. The decrease was partially offset by the launch of the Yarudeyskoye field in December 2015 and the launch of additional facilities to improve the efficiency of associated petroleum gas utilization at our Khancheyskoye field in August 2015.

*Natural gas sales volumes*

In the three months ended 30 September 2016, our total natural gas sales volumes increased by 184 mmcm, or 1.3%, to 14,456 mmcm from 14,272 mmcm in the corresponding period in 2015.

| *millions of cubic meters* | **Three months ended 30 September: 2016** | **2015** | **Change %** |
|---|---|---|---|
| Production by subsidiaries | 11,304 | 11,868 | (4.8%) |
| Purchases from the Group's joint ventures | 1,812 | 1,851 | (2.1%) |
| Other purchases | 2,174 | 1,699 | 28.0% |
| **Total production and purchases** | **15,290** | **15,418** | **(0.8%)** |
| Own usage [(1)] | (33) | (50) | (34.0%) |
| Decrease (increase) in GTS, UGSF and own pipeline infrastructure | (801) | (1,096) | (26.9%) |
| **Total natural gas sales volumes** | **14,456** | **14,272** | **1.3%** |
| *Sold to end-customers* | *13,445* | *13,435* | *0.1%* |
| *Sold ex-field* | *1,011* | *837* | *20.8%* |

[(1)] Own usage associated primarily with the maintaining of refining process at the Purovsky Plant, as well as heat and electric energy generation in some of our subsidiaries.

In the three months ended 30 September 2016, natural gas purchases from our joint ventures remained relatively unchanged and amounted to 1,812 mmcm as compared to 1,851 mmcm in the corresponding period in 2015.

Other natural gas purchases increased by 475 mmcm, or 28.0%, to 2,174 mmcm from 1,699 mmcm in the corresponding period in 2015. Other natural gas purchases are included in our natural gas volumes for sale, which allows us to coordinate sales across geographic regions as well as to optimize end-customers portfolios.

As of 30 September 2016, our natural gas inventory balance in the GTS, the UGSF and our own pipeline infrastructure aggregated 2,495 mmcm and increased by 801 mmcm during the quarter as compared to an increase by 1,096 mmcm in the corresponding period in 2015. In both reporting periods, an increase in inventory balances was due to the seasonal injection of natural gas into the UGSF for the subsequent sale in the period of high demand.

*Liquids production volumes*

In the three months ended 30 September 2016, our total liquids production (including our proportionate share in the production of joint ventures) increased by 714 thousand tons, or 30.4%, to 3,060 thousand tons from 2,346 thousand tons in the corresponding period in 2015.

| *thousands of tons* | **Three months ended 30 September: 2016** | **2015** | **Change %** |
|---|---|---|---|
| **Production by subsidiaries from:** | | | |
| Yarudeyskoye field | 896 | - | n/a |
| Yurkharovskoye field | 431 | 520 | (17.1%) |
| East-Tarkosalinskoye field | 336 | 325 | 3.4% |
| Khancheyskoye field | 93 | 91 | 2.2% |
| Other fields | 28 | 33 | (15.2%) |
| **Total liquids production by subsidiaries** | **1,784** | **969** | **84.1%** |
| *including crude oil* | *1,204* | *298* | *304.0%* |
| *including gas condensate* | *580* | *671* | *(13.6%)* |
| **Group's proportionate share in the production of joint ventures:** | | | |
| SeverEnergia (Arcticgas) | 1,046 | 1,127 | (7.2%) |
| Nortgas | 122 | 148 | (17.6%) |
| Terneftegas | 108 | 102 | 5.9% |
| **Total Group's proportionate share in the liquids production of joint ventures** | **1,276** | **1,377** | **(7.3%)** |
| **Total liquids production including proportionate share in the production of joint ventures** | **3,060** | **2,346** | **30.4%** |

In the three months ended 30 September 2016, we significantly increased crude oil production primarily due to the commencement of commercial production at the Yarudeyskoye field in December 2015 and reaching the nameplate production capacity by the end of the month (see "Recent developments" above). At the same time gas condensate production at mature fields of our subsidiaries (Yurkharovskoye and East-Tarkosalinskoye) and fields of SeverEnergia and Nortgas decreased due to the natural declines in the concentration of gas condensate as a result of decreasing reservoir pressure at the current gas condensate producing horizons.

*Liquids sales volumes*

In the three months ended 30 September 2016, our total liquids sales volumes increased by 709 thousand tons, or 20.4%, to 4,183 thousand tons from 3,474 thousand tons in the corresponding period in 2015 mainly due to an increase in the production of crude oil in our subsidiaries.

| *thousands of tons* | **Three months ended 30 September: 2016** | **2015** | **Change %** |
|---|---|---|---|
| Production by subsidiaries | 1,784 | 969 | 84.1% |
| Purchases from the Group's joint ventures | 2,382 | 2,555 | (6.8%) |
| Other purchases | 42 | 37 | 13.5% |
| **Total production and purchases** | **4,208** | **3,561** | **18.2%** |
| Losses [(1)] and own usage [(2)] | (69) | (67) | 3.0% |
| Decreases (increases) in liquids inventory balances | 44 | (20) | n/a |
| **Total liquids sales volumes** | **4,183** | **3,474** | **20.4%** |
| *Naphtha export* | *994* | *979* | *1.5%* |
| *Other gas condensate refined products export* | *627* | *616* | *1.8%* |
| *Other gas condensate refined products domestic* | *26* | *18* | *44.4%* |
| ***Subtotal gas condensate refined products*** | ***1,647*** | ***1,613*** | ***2.1%*** |
| *Crude oil export* | *370* | *108* | *242.6%* |
| *Crude oil domestic* | *787* | *143* | *n/a* |
| ***Subtotal crude oil*** | ***1,157*** | ***251*** | ***361.0%*** |
| *Stable gas condensate export* | *340* | *607* | *(44.0%)* |
| *Stable gas condensate domestic* | *375* | *368* | *1.9%* |
| ***Subtotal stable gas condensate*** | ***715*** | ***975*** | ***(26.7%)*** |
| *LPG export* | *126* | *138* | *(8.7%)* |
| *LPG domestic* | *534* | *494* | *8.1%* |
| ***Subtotal LPG*** | ***660*** | ***632*** | ***4.4%*** |
| *Other oil products domestic* | *4* | *3* | *33.3%* |
| ***Subtotal other oil products*** | ***4*** | ***3*** | ***33.3%*** |

(1) Losses associated with processing at the Purovsky Plant, the Ust-Luga Complex and the Tobolsk Refining Facilities, as well as during railroad, trunk pipeline and tanker transportation.

(2) Own usage associated primarily with the maintaining of refining process at the Ust-Luga Complex, as well as bunkering of charted tankers.

In the three months ended 30 September 2016, our purchases of liquid hydrocarbons from joint ventures decreased by 173 thousand tons, or 6.8%, due to a decrease in purchases of gas condensate from SeverEnergia and Nortgas resulting from the natural declines in the concentration of gas condensate at some of their fields (see "Liquids production volumes" above).

Sales volumes of jet fuel, gasoil and fuel oil received from the processing of stable gas condensate are disclosed in lines "Other gas condensate refined products export" and "Other gas condensate refined products domestic".

In the 2016 reporting period, our liquids inventory balances decreased by 44 thousand tons to 626 thousand tons as of 30 September 2016 as compared to an increase in inventory balances by 20 thousand tons to 831 thousand tons in the corresponding period in 2015. Our liquids inventory balances may vary period-to-period depending on shipping schedules and final destinations of stable gas condensate and its refined products shipments (see "Changes in natural gas, liquid hydrocarbons and work-in-progress" below).

## RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED 30 SEPTEMBER 2016 COMPARED TO THE CORRESPONDING PERIOD IN 2015

The following table and discussion is a summary of our consolidated results of operations for the three months ended 30 September 2016 and 2015. Each line item is also shown as a percentage of our total revenues.

| | Three months ended 30 September: | | | |
|---|---|---|---|---|
| *millions of Russian roubles* | **2016** | **% of total revenues** | **2015** | **% of total revenues** |
| **Total revenues [1]** | **126,483** | ***100.0%*** | **117,367** | ***100.0%*** |
| *including:* | | | | |
| natural gas sales | 51,733 | *40.9%* | 53,425 | *45.5%* |
| liquids' sales | 74,034 | *58.5%* | 62,787 | *53.5%* |
| Operating expenses | (93,458) | *(73.9%)* | (85,096) | *(72.5%)* |
| Other operating income (loss) | 707 | *0.6%* | 158 | *0.1%* |
| **Profit from operations before disposals of interests in joint ventures** | **33,732** | ***26.7%*** | **32,429** | ***27.6%*** |
| Net gain on disposal of interests in joint ventures | - | *n/a* | 989 | *0.9%* |
| **Profit from operations** | **33,732** | ***26.7%*** | **33,418** | ***28.5%*** |
| Finance income (expense) | 1,101 | *0.9%* | (6,174) | *(5.3%)* |
| Share of profit (loss) of joint ventures, net of income tax | 9,401 | *7.4%* | (34,713) | *(29.6%)* |
| **Profit (loss) before income tax** | **44,234** | ***35.0%*** | **(7,469)** | ***(6.4%)*** |
| Total income tax expense | (6,284) | *(5.0%)* | (4,942) | *(4.2%)* |
| **Profit (loss)** | **37,950** | ***30.0%*** | **(12,411)** | ***(10.6%)*** |
| Less: profit (loss) attributable to non-controlling interest | (1,456) | *(1.1%)* | (5) | *(0.0%)* |
| **Profit (loss) attributable to shareholders of PAO NOVATEK** | **36,494** | ***28.9%*** | **(12,416)** | ***(10.6%)*** |
| **Normalized profit attributable to shareholders of PAO NOVATEK, excluding the effect of foreign exchange gains (losses)** | **31,236** | ***24.7%*** | **31,904** | ***27.2%*** |

**(1)** Net of VAT, export and import duties, excise and fuel taxes expense, where applicable.

## Total revenues

The following table sets forth our sales (excluding VAT, export duties, excise and fuel taxes expense, where applicable) for the three months ended 30 September 2016 and 2015:

| *millions of Russian roubles* | Three months ended 30 September: 2016 | 2015 | Change % | Change (1) Total | Due to volume (2) | Due to price (3) |
|---|---|---|---|---|---|---|
| **Natural gas sales** | **51,733** | **53,425** | **(3.2%)** | **(1,692)** | **396** | **(2,088)** |
| *End-customers* | *49,659* | *51,708* | *(4.0%)* | *(2,049)* | *39* | *(2,088)* |
| *Ex-field sales* | *2,074* | *1,717* | *20.8%* | *357* | *357* | *-* |
| **Gas condensate refined products sales** | **36,894** | **34,644** | **6.5%** | **2,250** | **731** | **1,519** |
| *Export – naphtha* | *22,164* | *19,993* | *10.9%* | *2,171* | *309* | *1,862* |
| *Export – other refined products* | *14,246* | *14,310* | *(0.4%)* | *(64)* | *272* | *(336)* |
| *Domestic – other refined products* | *484* | *341* | *41.9%* | *143* | *150* | *(7)* |
| **Crude oil sales** | **16,139** | **3,473** | **364.7%** | **12,666** | **12,467** | **199** |
| *Export* | *5,461* | *1,535* | *255.8%* | *3,926* | *3,727* | *199* |
| *Domestic* | *10,678* | *1,938* | *n/a* | *8,740* | *8,740* | *-* |
| **Stable gas condensate sales** | **12,588** | **15,213** | **(17.3%)** | **(2,625)** | **(4,305)** | **1,680** |
| *Export* | *6,905* | *10,041* | *(31.2%)* | *(3,136)* | *(4,424)* | *1,288* |
| *Domestic* | *5,683* | *5,172* | *9.9%* | *511* | *119* | *392* |
| **Liquefied petroleum gas sales** | **8,268** | **9,337** | **(11.4%)** | **(1,069)** | **165** | **(1,234)** |
| *Export* | *3,182* | *3,445* | *(7.6%)* | *(263)* | *(318)* | *55* |
| *Domestic* | *5,086* | *5,892* | *(13.7%)* | *(806)* | *483* | *(1,289)* |
| **Other products sales** | **145** | **120** | **20.8%** | **25** | **n/a** | **n/a** |
| *Domestic* | *145* | *120* | *20.8%* | *25* | *n/a* | *n/a* |
| **Total oil and gas sales** | **125,767** | **116,212** | **8.2%** | **9,555** | **n/a** | **n/a** |
| Other revenues | 716 | 1,155 | (38.0%) | (439) | n/a | n/a |
| **Total revenues** | **126,483** | **117,367** | **7.8%** | **9,116** | **n/a** | **n/a** |

(1) The figures reflect the impact of sales volumes and average realized prices factors on the change in total revenues from hydrocarbons sales in millions of Russian roubles for the respective periods.

(2) The amount of the change in total revenues due to sales volumes is calculated for each product and selling destination as a product of the volume sold in the reporting period of the previous year and the change in average realized prices.

(3) The amount of the change in total revenues due to average realized prices is calculated for each product and selling destination as a product of the average realized price for the current reporting period and the change in sales volumes.

*Natural gas sales*

Our revenues from natural gas sales decreased by RR 1,692 million, or 3.2%, compared to the corresponding period in 2015 due to a decrease in our average sales prices by 4.4% which was partially offset by an increase in sales volumes by 1.3%. The decrease in our natural gas average sales prices was due to an increase in the proportion of sales to our end-customers located closer to our production fields, as well as an increase from 5.9% to 7.0% in the proportion of natural gas sold to wholesale traders with lower average sales prices compared to end-customer sales (see "Natural gas prices" above). As a result of changes in the sales geography and the increase in the proportion of sales to wholesale traders, our expenses for natural gas transportation also decreased – in total by RR 1,063 million, or 5.2%, which compensated for the major part of the decrease in revenues.

*Gas condensate refined products sales*

Gas condensate refined products sales represent revenues from sales of naphtha, jet fuel, gasoil and fuel oil produced from our stable gas condensate at the Ust-Luga Complex.

In the three months ended 30 September 2016, our revenues from sales of gas condensate refined products increased by RR 2,250 million, or 6.5%, as compared to the corresponding period in 2015 due to an increase in average realized net export prices for naphtha in Russian roubles terms and, to a lesser extent, an increase in sales volumes.

In the three months ended 30 September 2016, our revenues from sales of naphtha increased by RR 2,171 million, or 10.9%, as compared to the corresponding period in 2015 due to an increase in average realized net export prices in Russian roubles terms, as well as an increase in sales volumes (by 1.5%). In the three months ended 30 September 2016 and 2015, we exported 994 thousand and 979 thousand tons of naphtha, respectively. Nearly all our naphtha volumes were sold to the APR, the European and North America markets. Our average realized net export price, excluding export duties, increased by RR 1,873 per ton, or 9.2%, to RR 22,302 per ton (CFR, CIF, DES and FOB) from RR 20,429 per ton (CFR, CIF, DES, DAP and FOB) in the corresponding period in 2015 (see "Stable gas condensate and refined products, liquefied petroleum gas and crude oil prices" above).

In the three months ended 30 September 2016, our revenues from sales of jet fuel, gasoil and fuel oil on the domestic and export markets remained relatively flat (decreased by RR 79 million, or 0.5%), as compared to the corresponding period in 2015. In the three months ended 30 September 2016 and 2015, we exported in aggregate 627 thousand and 616 thousand tons of these products to the European markets, or 96.0% and 97.2% of total sales volumes (on the domestic and export markets), respectively. Our average realized net export price, excluding export duties, decreased by RR 509 per ton, or 2.2%, to RR 22,738 per ton (CIF, DES and FOB) from RR 23,247 per ton (CIF, FOB and DES) in the corresponding period in 2015 (see "Stable gas condensate and refined products, liquefied petroleum gas and crude oil prices" above).

*Crude oil sales*

In the three months ended 30 September 2016, revenues from crude oil sales increased significantly by RR 12,666 million, or 4.6 times, compared to the corresponding period in 2015 due to a significant increase in sales volumes. Our crude oil sales volumes increased by 906 thousand tons, or 4.6 times, to 1,157 thousand tons from 251 thousand tons in the corresponding period in 2015 due to the commencement of crude oil commercial production at the Yarudeyskoye field in December 2015 and reaching the nameplate production capacity by the end of the month.

In the three months ended 30 September 2016, we sold 787 thousand tons, or 68.0% of our total crude oil sales volumes, domestically at an average price of RR 13,558 per ton (excluding VAT). Our average realized price stayed relatively flat compared to the third quarter of 2015.

The remaining 370 thousand tons, or 32.0% of our total sales volumes, were sold to the APR, the European and the North America markets at an average net export price of RR 14,768 per ton (FOB, excluding export duties) representing an increase of RR 539 per ton, or 3.8%, as compared to the corresponding period in 2015 (see "Stable gas condensate and refined products, liquefied petroleum gas and crude oil prices" above).

*Stable gas condensate sales*

In the three months ended 30 September 2016, our revenues from sales of stable gas condensate decreased by RR 2,625 million, or 17.3%, compared to the corresponding period in 2015 due to a decrease in volumes sold to export markets (see "Hydrocarbon production and sales volumes" above) which was partially offset by an increase in average realized prices.

In the three months ended 30 September 2016, we sold 340 thousand tons of stable gas condensate, or 47.6% of our total sales volumes, compared to 607 thousand tons, or 62.3%, in the corresponding period in 2015 to the APR and the European markets. Our average realized stable gas condensate net export price, excluding export duties, increased by RR 3,799 per ton, or 23.0%, to RR 20,346 per ton (CFR and DAP) from RR 16,547 per ton (CFR, DAP, CIF and DES) (see "Stable gas condensate and refined products, liquefied petroleum gas and crude oil prices" above).

In the three months ended 30 September 2016, we sold 375 thousand tons of stable gas condensate, or 52.4% of our total sales volumes, on the domestic market compared to 368 thousand tons, or 37.7%, in the corresponding period in 2015. Our average realized price for stable gas condensate sales on the domestic market in the three months ended 30 September 2016 amounted to RR 15,105 per ton (excluding VAT), representing an increase of RR 1,042 per ton, or 7.4%, as compared to the corresponding period in 2015 (see "Stable gas condensate and refined products, liquefied petroleum gas and crude oil prices" above).

*Liquefied petroleum gas sales*

In the three months ended 30 September 2016, our revenues from sales of LPG decreased by RR 1,069 million, or 11.4%, compared to the corresponding period in 2015 due to a decrease in average realized domestic prices (see "Stable gas condensate and refined products, liquefied petroleum gas and crude oil prices" above) which was partially offset by an increase in total sales volumes.

In the three months ended 30 September 2016, we sold 126 thousand tons of LPG, or 19.1% of our total LPG sales volumes, to export markets as compared to sales of 138 thousand tons, or 21.8%, in the corresponding period in 2015. Our average realized LPG net export price, excluding export duties, excise and fuel taxes expense, increased by RR 434 per ton, or 1.7%.

In both reporting periods our LPG export delivery terms were DAP at the border of the customer's country or free carrier (FCA) at terminal points in Poland. We sold most of our LPG export sales volumes to Poland in both reporting periods.

In the three months ended 30 September 2016, we sold 534 thousand tons of LPG, or 80.9% of our total LPG sales volumes, on the domestic market compared to sales of 494 thousand tons, or 78.2%, in the corresponding period in 2015. Our average realized LPG domestic price in the three months ended 30 September 2016, was RR 9,522 per ton representing a decrease of RR 2,410 per ton, or 20.2%, compared to the corresponding period in 2015 (see "Stable gas condensate and refined products, liquefied petroleum gas and crude oil prices" above).

*Other products sales*

Other products sales represent our revenues from the domestic sales of purchased oil products (diesel fuel and petrol) through our retail stations, sales of other purchased liquid hydrocarbons, and sales of our output methanol. In the three months ended 30 September 2016, our revenues from other products sales increased by RR 25 million, or 20.8%, to RR 145 million from RR 120 million in the corresponding period in 2015.

*Other revenues*

Other revenues include revenue from transportation, geological and geophysical research services, repair and maintenance of energy equipment services, and other services. In the three months ended 30 September 2016, other revenues decreased by RR 439 million, or 38.0%, to RR 716 million from RR 1,155 million in the corresponding period in 2015 primarily due to a decrease in revenues from tankers transporting third party goods by RR 562 million.

At the same time, in the three months ended 30 September 2016, other revenues increased by RR 43 million due to an increase in revenues from repair and maintenance of energy equipment services provided by our subsidiary NOVATEK-Energo, and by RR 63 million due to an increase in revenues from geological and geophysical research services provided by the Group (primarily to our joint ventures) and from services for preparation of third party hydrocarbons for transportation.

### Operating expenses

In the three months ended 30 September 2016, our total operating expenses increased by RR 8,362 million, or 9.8%, to RR 93,458 million compared to RR 85,096 million in the corresponding period in 2015 mainly due to the launch of the Yarudeyskoye field in December 2015 and the respective increase of certain items in transportation, taxes other than income tax expenses, depreciation, depletion and amortization, and materials, services and other expenses. Our total operating expenses as a percentage of total revenues changed insignificantly (increased to 73.9% from 72.5%).

| | **Three months ended 30 September:** | | | |
|---|---|---|---|---|
| *millions of Russian roubles* | **2016** | **% of total revenues** | **2015** | **% of total revenues** |
| Purchases of natural gas and liquid hydrocarbons | 32,229 | *25.5%* | 32,892 | *28.0%* |
| Transportation expenses | 30,929 | *24.5%* | 32,546 | *27.7%* |
| Taxes other than income tax | 10,872 | *8.6%* | 9,054 | *7.7%* |
| Depreciation, depletion and amortization | 10,233 | *8.1%* | 4,883 | *4.2%* |
| Materials, services and other | 5,010 | *4.0%* | 3,626 | *3.1%* |
| General and administrative expenses | 3,817 | *3.0%* | 2,930 | *2.5%* |
| Exploration expenses | 906 | *0.7%* | 439 | *0.4%* |
| Impairment expenses (reversals), net | (6) | *n/a* | (16) | *n/a* |
| Changes in natural gas, liquid hydrocarbons and work-in-progress | (532) | *n/a* | (1,258) | *n/a* |
| **Total operating expenses** | **93,458** | ***73.9%*** | **85,096** | ***72.5%*** |

*Purchases of natural gas and liquid hydrocarbons*

In the three months ended 30 September 2016, our purchases of natural gas and liquid hydrocarbons decreased by RR 663 million, or 2.0%, to RR 32,229 million from RR 32,892 million in the corresponding period in 2015.

| | **Three months ended 30 September:** | | **Change** |
|---|---|---|---|
| *millions of Russian roubles* | **2016** | **2015** | **%** |
| Unstable gas condensate | 23,117 | 24,856 | (7.0%) |
| Natural gas | 8,322 | 7,379 | 12.8% |
| Other liquid hydrocarbons | 790 | 657 | 20.2% |
| **Total purchases of natural gas and liquid hydrocarbons** | **32,229** | **32,892** | **(2.0%)** |

In the three months ended 30 September 2016, our purchases of unstable gas condensate from our joint ventures decreased by RR 1,739 million, or 7.0%, as compared to the corresponding period in 2015, mainly due to a decrease in purchases from SeverEnergia (through its wholly owned subsidiary, OAO Arcticgas) and Nortgas due to the natural declines in the concentration of gas condensate as a result of decreasing reservoir pressure at the current gas condensate producing horizons at some fields (see "Liquids production volumes" above).

In the three months ended 30 September 2016, our purchases of natural gas increased by RR 943 million, or 12.8%, as compared to the corresponding period in 2015 as a result of an increase in purchases from third parties.

Other liquid hydrocarbons purchases represent our purchases of oil products and LPG for subsequent resale depending on the demand for these types of products. In the three months ended 30 September 2016, our purchases of other liquid hydrocarbons increased by RR 133 million, or 20.2%, as compared to the corresponding period in 2015.

*Transportation expenses*

In the three months ended 30 September 2016, our total transportation expenses decreased by RR 1,617 million, or 5.0%, to RR 30,929 million as compared to RR 32,546 million in the corresponding period in 2015.

| *millions of Russian roubles* | Three months ended 30 September: 2016 | 2015 | Change % |
|---|---|---|---|
| Natural gas transportation by trunk and low-pressure pipelines | 19,332 | 20,395 | (5.2%) |
| Stable gas condensate and liquefied petroleum gas transportation by rail | 7,805 | 7,749 | 0.7% |
| Gas condensate refined products, stable gas condensate and crude oil transportation by tankers | 2,085 | 3,975 | (47.5%) |
| Crude oil transportation by trunk pipelines | 1,664 | 387 | 330.0% |
| Other | 43 | 40 | 7.5% |
| **Total transportation expenses** | **30,929** | **32,546** | **(5.0%)** |

In the three months ended 30 September 2016, our expenses for natural gas transportation decreased by RR 1,063 million, or 5.2%, to RR 19,332 million from RR 20,395 million in the corresponding period in 2015 due to an increase in the proportion of sales to our end-customers located closer to our production fields in the current reporting period as compared to the respective period in 2015.

In the three months ended 30 September 2016, our total expenses for stable gas condensate and LPG transportation by rail remained relatively flat compared to the corresponding period in the prior year (increased by RR 56 million, or 0.7%, to RR 7,805 million from RR 7,749 million). The 9.8% increase in our weighted average transportation cost per unit mainly resulted from an increase in the regulated railroad transportation tariffs effective January 2016 (see "Transportation tariffs" above) was almost completely offset by a 8.3% decrease in volumes of liquids sold and transported via rail.

In the three months ended 30 September 2016, our total transportation expenses for liquids delivered by tankers to international markets decreased by RR 1,890 million, or 47.5%, to RR 2,085 million from RR 3,975 million in the corresponding period in 2015 as a result of a decrease in average freight rates which fluctuate period-on-period depending on worldwide demand for tankers transportation, as well as a decrease in volumes of liquids sold and transported via tankers by 13.6%.

In the three months ended 30 September 2016, our expenses for crude oil transportation to customers by trunk pipeline significantly increased by RR 1,277 million, or 4.3 times, to RR 1,664 million from RR 387 million in the corresponding period in 2015 due to a significant 4.6 times increase in volumes transported as a result of the commencement of crude oil commercial production at the Yarudeyskoye field in December 2015.

*Taxes other than income tax*

In the three months ended 30 September 2016, taxes other than income tax increased by RR 1,818 million, or 20.1%, to RR 10,872 million from RR 9,054 million in the corresponding period in 2015 primarily due to an increase in the unified natural resources production tax expense.

| *millions of Russian roubles* | Three months ended 30 September: 2016 | 2015 | Change % |
|---|---|---|---|
| Unified natural resources production tax (UPT) | 10,115 | 8,148 | 24.1% |
| Property tax | 681 | 807 | (15.6%) |
| Other taxes | 76 | 99 | (23.2%) |
| **Total taxes other than income tax** | **10,872** | **9,054** | **20.1%** |

In the three months ended 30 September 2016, our unified natural resources production tax expense increased by RR 1,967 million, or 24.1%, to RR 10,115 million from RR 8,148 million in the corresponding period in 2015 primarily due to a significant increase in crude oil production as a result of the commercial production commencement at the Yarudeyskoye field in December 2015. In addition, as a part of the tax maneuver in the oil and gas industry (see "Our tax burden and obligatory payments" above), the adjusting coefficient that is applied in the calculation of the UPT rate for gas condensate was increased by 25.0% from 1 January 2016 in relation to 2015, thus also leading to an increase in our UPT expense.

In the three months ended 30 September 2016, our property tax expense decreased by RR 126 million, or 15.6%, to RR 681 million from RR 807 million in the corresponding period in 2015 primarily due to an additional property tax charge relating to prior periods recorded in the third quarter of 2015.

*Depreciation, depletion and amortization*

In the three months ended 30 September 2016, our depreciation, depletion and amortization ("DDA") expense increased significantly by RR 5,350 million, or 109.6%, to RR 10,233 million from RR 4,883 million in the corresponding period in 2015 mainly due to the launch of the Yarudeyskoye field in December 2015, as well as additions of property, plant and equipment at our production subsidiaries during the 12 months preceding the reporting period. We accrue depreciation and depletion using the "units-of-production" method for our oil and gas assets and using a straight-line method for other facilities.

*Materials, services and other*

In the three months ended 30 September 2016, our materials, services and other expenses increased by RR 1,384 million, or 38.2%, to RR 5,010 million compared to RR 3,626 million in the corresponding period in 2015 primarily due to the launch of the Yarudeyskoye field in December 2015. The main components of this expense category were expenses relating to repair and maintenance services, complex of services for preparation, transportation and processing of hydrocarbons, materials and supplies, as well as employee compensation, which on aggregate comprised 80.4% and 78.0% of total materials, services and other expenses in the three months ended 30 September 2016 and 2015, respectively.

| *millions of Russian roubles* | **Three months ended 30 September: 2016** | **2015** | **Change %** |
|---|---|---|---|
| Employee compensation | 1,986 | 1,441 | 37.8% |
| Repair and maintenance | 936 | 626 | 49.5% |
| Complex of services for preparation, transportation and processing of hydrocarbons | 613 | 406 | 51.0% |
| Materials and supplies | 491 | 356 | 37.9% |
| Electricity and fuel | 261 | 210 | 24.3% |
| Liquefied petroleum gas volumes reservation expenses | 235 | 217 | 8.3% |
| Security services | 170 | 110 | 54.5% |
| Transportation services | 155 | 115 | 34.8% |
| Rent expenses | 61 | 15 | n/a |
| Other | 102 | 130 | (21.5%) |
| **Total materials, services and other** | **5,010** | **3,626** | **38.2%** |

Operating employee compensation increased by RR 545 million, or 37.8%, to RR 1,986 million compared to RR 1,441 million in the corresponding period in 2015. The increase was due to an increase in the average number of employees as a result of launch of the Yarudeyskoye field in December 2015, an indexation of base salaries effective from 1 July 2016 and the related increase in social contributions for medical and social insurance and to the Pension Fund.

Repair and maintenance services expenses, materials and supplies, transportation, security services and rent expenses increased mainly due to the launch of the Yarudeyskoye field in December 2015.

Complex of services for preparation, transportation and processing of hydrocarbons expenses mainly relate to transportation of our LPG produced at the Purovsky Plant for further processing at the Tobolsk Refining Facilities. These expenses increased by RR 207 million, or 51.0%, to RR 613 million in the three months ended 30 September 2016 compared to RR 406 million in the corresponding period in 2015 primarily due to an increase in the tariff for complex of services for preparation, transportation and processing of our hydrocarbons at the Tobolsk Refining Facilities at the end of 2015, as well as additional expenses for preparation of crude oil for transportation by trunk pipeline resulted from the commencement of crude oil commercial production at the Yarudeyskoye field in December 2015.

In the three months ended 30 September 2016, liquefied petroleum gas volumes reservation costs increased by RR 18 million, or 8.3%, to RR 235 million from RR 217 million in the corresponding period in 2015 primarily due to an increase in LPG volumes sold through our subsidiary in Poland. The reservation of LPG is required in order to maintain the necessary strategic reserve in Poland in accordance with local regulation.

*General and administrative expenses*

In the three months ended 30 September 2016, our general and administrative expenses increased by RR 887 million, or 30.3%, to RR 3,817 million compared to RR 2,930 million in the corresponding period in 2015. The main components of these expenses were employee compensation, social expenses and compensatory payments, as well as legal, audit and consulting services, which, on aggregate, comprised 82.3% and 79.2% of total general and administrative expenses in the three months ended 30 September 2016 and 2015, respectively.

| | **Three months ended 30 September:** | | **Change** |
|---|---|---|---|
| *millions of Russian roubles* | **2016** | **2015** | **%** |
| Employee compensation | 2,524 | 1,790 | 41.0% |
| Social expenses and compensatory payments | 360 | 330 | 9.1% |
| Legal, audit and consulting services | 259 | 200 | 29.5% |
| Business travel expense | 127 | 174 | (27.0%) |
| Insurance expense | 119 | 79 | 50.6% |
| Fire safety and security expenses | 97 | 80 | 21.3% |
| Advertising expenses | 55 | 72 | (23.6%) |
| Rent expense | 52 | 44 | 18.2% |
| Repair and maintenance expenses | 47 | 74 | (36.5%) |
| Other | 177 | 87 | 103.4% |
| **Total general and administrative expenses** | **3,817** | **2,930** | **30.3%** |

Employee compensation relating to administrative personnel increased by RR 734 million, or 41.0%, to RR 2,524 million in the three months ended 30 September 2016 from RR 1,790 million in the corresponding period in 2015. The increase was due to an increase in bonuses accrued to key management, an increase in the average number of employees, an indexation of base personnel salaries effective 1 July 2016, and the related increase in social contributions for medical and social insurance and to the Pension Fund.

In the three months ended 30 September 2016, our social expenses and compensatory payments increased by RR 30 million, or 9.1%, to RR 360 million compared to RR 330 million in the corresponding period in 2015 mainly due to continued support of charities and social programs in the regions where we operate. Social expenses and compensatory payments fluctuate period-on-period depending on the implementation schedules of specific programs we support.

In the three months ended 30 September 2016, legal, audit, and consulting services expenses increased by RR 59 million, or 29.5%, to RR 259 million compared to RR 200 million in the corresponding period in 2015 primarily due to an increase in expenses relating to software support and renewals.

Insurance expenses increased by RR 40 million, or 50.6%, to RR 119 million in the three months ended 30 September 2016 from RR 79 million in the corresponding period in 2015 due to an increase in insurable property valuation and the number of items of insured property, plant and equipment in our major subsidiaries.

Other items of our general and administrative expenses changed marginally.

*Exploration expenses*

In the three months ended 30 September 2016, our exploration expenses significantly increased by RR 467 million, or 106.4%, to RR 906 million from RR 439 million in the corresponding period in 2015 and related primarily to exploration works performed at our North-Obskiy and Nyakhartinskiy license areas. The exploration expenses fluctuate period-to-period in accordance with the approved working schedule of exploration works at our production subsidiaries.

*Changes in natural gas, liquid hydrocarbons and work-in-progress*

In the three months ended 30 September 2016 and 2015, we recorded reversals of RR 532 million and RR 1,258 million, respectively, to changes in inventory expense mainly due to a significant increase in our natural gas inventory balances as of 30 September compared to 30 June in both reporting periods.

In the three months ended 30 September 2016 and 2015, our cumulative natural gas inventory balance in the Underground Gas Storage Facilities ("UGSF"), the GTS and own pipeline infrastructure increased by 801 mmcm and 1,096 mmcm, respectively, that was due to the seasonal injection of natural gas for the subsequent sale in the period of higher seasonal demand in both reporting periods.

In the three months ended 30 September 2016 and 2015, our cumulative liquid hydrocarbons inventory balances, recognized as inventory in transit or in storage, changed marginally (decreased by 44 thousand tons and increased by 20 thousand tons, respectively). Inventory balances of stable gas condensate and refined products tend to fluctuate period-to-period depending on shipment schedules and final destination of our shipments.

The following table highlights movements in our hydrocarbons inventory balances:

| | **2016** | | | **2015** | | |
|---|---|---|---|---|---|---|
| *Inventory balances in transit or in storage* | **At 30 September** | **At 30 June** | **Increase / (decrease)** | **At 30 September** | **At 30 June** | **Increase / (decrease)** |
| **Natural gas (millions of cubic meters)** | **2,495** | **1,694** | **801** | **2,692** | **1,596** | **1,096** |
| *including Gazprom's UGSF* | *2,231* | *1,603* | *628* | *2,468* | *1,563* | *905* |
| **Liquid hydrocarbons (thousand tons)** | **626** | **670** | **(44)** | **831** | **811** | **20** |
| *including naphtha* | *90* | *90* | *-* | *195* | *223* | *(28)* |
| *stable gas condensate* | *263* | *278* | *(15)* | *411* | *348* | *63* |
| *crude oil* | *105* | *106* | *(1)* | *29* | *32* | *(3)* |

### Other operating income (loss)

Other operating income (loss) includes realized income (loss) from hydrocarbons trading on the international markets, income (loss) from the change in the fair value of the aforementioned contracts, as well as other income (loss) relating to penalty charges, disposal of materials, fixed assets and other transactions. In the three months ended 30 September 2016, we recognized other operating income of RR 707 million compared to other operating income of RR 158 million in the corresponding period in 2015.

In the three months ended 30 September 2016, within our trading activities we purchased and sold approximately 0.9 bcm of natural gas, as well as various derivative commodity instruments, and recognized the aggregate realized income from trading activities of RR 525 million as compared to RR two million of income in the corresponding period in 2015. At the same time, in the three months ended 30 September 2016, we recognized a non-cash income of RR 126 million as a result of an increase in the fair value of aforementioned contracts as compared to RR 176 million of a non-cash income in the corresponding period in 2015.

### Net gain on disposal of interests in joint ventures

In August 2015, as part of the restructuring procedures intended to achieve parity shareholdings in SeverEnergia, we contributed a 6.4% ownership interest in joint venture Artic Russia B.V. to the capital of Yamal Development. As a result, taking into account the 50% participation interest of NOVATEK in joint venture Yamal Development, in the three months ended 30 September 2015, we recognized a gain on the disposal in the amount of RR 989 million.

### Profit from operations and EBITDA

Our profit from operations increased by RR 314 million, or 0.9%, to RR 33,732 million in the three months ended 30 September 2016, as compared to RR 33,418 million in the corresponding period in 2015. Our profit from operations before disposals of interests in joint ventures increased by RR 1,303 million, or 4.0%, to RR 33,732 million in the three months ended 30 September 2016, as compared to RR 32,429 million in the corresponding period in 2015 mainly due to a significant increase in crude oil sales volumes resulted from the commencement of commercial production at the Yarudeyskoye field in December 2015 and reaching the nameplate production capacity by the end of the month. At the same time our share in the profit from operations of our joint ventures decreased by RR 743 million, or 7.9%, to RR 8,645 million compared to RR 9,388 million in the three months ended 30 September 2016 (see "Share of profit (loss) of joint ventures, net of income tax" below).

Our EBITDA, normalized for the effect of the disposal of interests in joint ventures, increased by RR 5,147 million, or 9.8%, to RR 57,726 million in the three months ended 30 September 2016 from RR 52,579 million in the corresponding period in 2015 also due to a significant increase in crude oil sales volumes.

### Finance income (expense)

In the three months ended 30 September 2016, we recorded a net finance income of RR 1,101 million compared to net finance expense of RR 6,174 million in the corresponding period in 2015.

| *millions of Russian roubles* | **Three months ended 30 September: 2016** | **2015** | **Change %** |
|---|---|---|---|
| Accrued interest expense on loans received | (3,588) | (3,801) | (5.6%) |
| Less: capitalized interest | 1,054 | 1,839 | (42.7%) |
| Provisions for asset retirement obligations: effect of the present value discount unwinding | (150) | (85) | 76.5% |
| **Interest expense** | **(2,684)** | **(2,047)** | **31.1%** |
| Interest income | 4,489 | 3,182 | 41.1% |
| Change in fair value of non-commodity financial instruments | (267) | (5,018) | (94.7%) |
| Foreign exchange gain (loss), net | (437) | (2,291) | (80.9%) |
| **Total finance income (expense)** | **1,101** | **(6,174)** | **n/a** |

In the three months ended 30 September 2016, our interest expense increased by RR 637 million, or 31.1%, to RR 2,684 million primarily due to a decrease in a base used for interest capitalization as a result of additions to property, plant and equipment at Yarudeyskoye field after its launch in December 2015 that was partially offset by a decrease in the aggregate amount of the Group's borrowing obligations.

Interest income increased by RR 1,307 million, or 41.1%, to RR 4,489 million in the three months ended 30 September 2016 from RR 3,182 million in the corresponding period in 2015 due to an increase in loans provided to our joint ventures for the development and expansion of their activities, as well as a result of the average Russian rouble depreciation relative to the US dollar and Euro in the three months ended 30 September 2016 compared to the average exchange rate in the corresponding period in 2015.

In the three months ended 30 September 2016, we recognized non-cash loss of RR 267 million compared to a non-cash loss of RR 5,018 million in the corresponding period in 2015 due to the remeasurement of the shareholders' loans issued by the Group to our joint ventures in accordance with IAS 39 *"Financial instruments: recognition and measurement"*. The effect of the fair value remeasurement of shareholders' loans may change period-to-period due to the change in market interest rates and other macroeconomic parameters and does not affect real future cash flows of loans repayments.

The Group continues to record non-cash foreign exchange gains and losses each reporting period due to movements between currency exchange rates. In the three months ended 30 September 2016, we recorded a net foreign exchange loss of RR 437 million compared to a net loss of RR 2,291 million in the corresponding period in 2015 primarily due to the revaluation of our foreign currency denominated borrowings and loans provided, as well as cash balances in foreign currency.

### Share of profit (loss) of joint ventures, net of income tax

In the three months ended 30 September 2016, the Group's proportionate share of profit of joint ventures amounted to RR 9,401 million as compared to the share of loss of joint ventures in the amount of RR 34,713 million in the corresponding period in 2015.

| *millions of Russian roubles* | **Three months ended 30 September: 2016** | **2015** | **Change %** |
|---|---|---|---|
| Share in profit from operations | 8,645 | 9,388 | (7.9%) |
| Share in finance income (expense) | 2,555 | (50,109) | n/a |
| Share in total income tax benefit (expense) | (1,799) | 6,008 | n/a |
| **Total share of profit (loss) of joint ventures, net of income tax** | **9,401** | **(34,713)** | **n/a** |

Our proportionate share in the profit from operations of our joint ventures decreased by RR 743 million, or 7.9%, primarily due to lower operating results of SeverEnergia and Nortgas (natural decline in gas and gas condensate production at mature fields), as well as an increase in the unified natural resources production tax expense (see "Our tax burden and obligatory payments" above).

In the three months ended 30 September 2016, our proportionate share in the finance income of our joint ventures amounted to RR 2,555 million compared to the share in the finance expense of RR 50,109 million in the corresponding period in 2015. The change in our share in finance income (expense) was primarily due to a recognition of a non-cash foreign exchange gain on foreign currency denominated loans at our joint ventures Yamal LNG and Terneftegas (our share amounted to RR 6.6 billion) as compared to a significant non-cash loss (our share amounted to RR 51.4 billion) in the corresponding period in 2015. In addition, in the 2015 reporting period, we recognized a non-cash gain from the remeasurement of the fair value of shareholders' loans in Yamal LNG and Terneftegas (our share amounted to RR 7.0 billion) while in the current reporting period the fair value estimate of shareholders' loans changed insignificantly. The remaining changes in both reporting periods primarily related to our share in interest expense of our joint ventures.

### Income tax expense

The Russian statutory income tax rate for both reporting periods was 20%.

The Group recognizes in profit before income tax its share of net profit (loss) from joint ventures, which influences the consolidated profit of the Group but does not result in additional income tax expense (benefit) at the Group's level. Net profit (loss) of joint ventures was recorded in their financial statements on an after-tax basis. The Group's dividend income from its joint ventures is subject to a zero withholding tax rate according to the Russian tax legislation as the Group holds at least a 50% interest in each of its joint ventures, and also does not result in a tax charge.

Without the effect of net profit (loss) and dividends from joint ventures, the effective income tax rate (total income tax expense calculated as a percentage of profit before income tax) in the three months ended 30 September 2016 and 2015, was 18.0% and 18.1%, respectively.

### Profit (loss) attributable to shareholders and earnings (loss) per share

As a result of the factors discussed in the respective sections above, we recorded profit attributable to shareholders of PAO NOVATEK of RR 36,494 million in the three months ended 30 September 2016 compared to loss of RR 12,416 million in the corresponding period in 2015.

The major factor that had a negative effect on the Group's financial result in the third quarter of 2015 was the recognition of significant non-cash foreign exchange losses on foreign currency denominated loans of the Group and its joint ventures. Excluding the one-time effect from the disposal of interests in joint ventures and the effect of foreign exchange gains and losses, the Group's profit attributable to shareholders of PAO NOVATEK changed insignificantly and amounted to RR 31,236 million in the three months ended 30 September 2016 compared to RR 31,904 million in the corresponding period in 2015 (see the table below):

| | Three months ended 30 September: | | Change |
|---|---|---|---|
| *millions of Russian roubles* | **2016** | **2015** | **%** |
| Profit (loss), attributable to shareholders of PAO NOVATEK | 36,494 | (12,416) | n/a |
| Net (gain) loss on disposal of interests in joint ventures | - | (989) | n/a |
| Foreign exchange (gains) losses | 437 | 2,291 | (80.9%) |
| Income tax expense (benefit) relating to foreign exchange (gains) losses | (87) | (458) | (81.0%) |
| Share of foreign exchange (gains) losses of joint ventures | (6,618) | 51,451 | n/a |
| Share of income tax expense (benefit) relating to foreign exchange (gains) losses of joint ventures | 1,010 | (7,975) | n/a |
| **Normalized profit attributable to shareholders of PAO NOVATEK, excluding the effect of foreign exchange gains (losses)** | **31,236** | **31,904** | **(2.1%)** |

Our weighted average basic and diluted earnings per share, calculated from the profit attributable to shareholders of PAO NOVATEK amounted to RR 12.09 per share in the three months ended 30 September 2016 compared to a loss of RR 4.11 per share in the corresponding period in 2015. Excluding the effects of the disposals of interests in joint ventures and foreign exchange gains and losses, our weighted average basic and diluted earnings per share slightly decreased to RR 10.35 per share, or 2.0%, from RR 10.56 per share in the corresponding period in 2015.

## LIQUIDITY AND CAPITAL RESOURCES

### Cash flows

The following table shows our net cash flows from operating, investing and financing activities for the three months ended 30 September 2016 and 2015:

| *millions of Russian roubles* | **Three months ended 30 September:** **2016** | **2015** | **Change %** |
|---|---|---|---|
| Net cash provided by **operating** activities | 42,795 | 16,772 | 155.2% |
| Net cash used for **investing** activities | (27,928) | (32,116) | (13.0%) |
| Net cash provided by (used for) **financing** activities | (12,726) | 7,387 | n/a |

*Net cash provided by operating activities*

Our net cash provided by operating activities significantly increased by RR 26,023 million, or 155.2%, to RR 42,795 million compared to RR 16,772 million in the corresponding period in 2015. The increase was due to changes in working capital and long-term advances given, an increase in the profit from operations adjusted for non-cash items, as well as a decrease in income tax payments.

| *millions of Russian roubles* | **Three months ended 30 September:** **2016** | **2015** | **Change %** |
|---|---|---|---|
| Profit from operations before disposals of interests in joint ventures | 33,732 | 32,429 | 4.0% |
| Non-cash adjustments [(1)] | 10,328 | 4,747 | 117.6% |
| Changes in working capital and long-term advances given | (158) | (12,681) | (98.8%) |
| Interest received | 362 | 284 | 27.5% |
| Income taxes paid | (1,469) | (8,007) | (81.7%) |
| **Total net cash provided by operating activities** | **42,795** | **16,772** | **155.2%** |

[(1)] Include adjustments for depreciation, depletion and amortization, net impairment expenses (reversals), change in fair value of non-commodity financial instruments and some other adjustments.

The profit from operations adjusted for non-cash items increased mainly due to a significant increase in crude oil sales volumes as a result of the commencement of commercial production at the Yarudeyskoye field in December 2015 (see "Profit from operations and EBITDA" above).

Working capital balances fluctuate from period to period depending on various factors. The changes in long-term advances given were mainly due to a decrease in long-term advances payments to RZD in the current reporting period as compare to the corresponding period in 2015, which were provided in accordance with the Strategic Partnership Agreement's installment schedule (see "Transportation tariffs" above).

The decrease in income tax payments in the three months ended 30 September 2016 was mainly due to the offset of a portion of income tax advance payments made in the second quarter of 2016 based on the gain on the disposal of the 9.9% equity stake in Yamal LNG. Excluding this effect, our net cash provided by operating activities increased by RR 21.1 billion, or 126%.

*Net cash used for investing activities*

In the three months ended 30 September 2016, our net cash used for investing activities decreased by RR 4,188 million, or 13.0%, to RR 27,928 million compared to RR 32,116 million in the corresponding period in 2015.

| *millions of Russian roubles* | Three months ended 30 September: 2016 | 2015 | Change % |
|---|---|---|---|
| Cash used for capital expenditures | (7,716) | (12,198) | (36.7%) |
| Additional capital contributions to joint ventures | (19,565) | - | n/a |
| Payments for mineral licenses | (367) | - | n/a |
| Repayments of loans provided to joint ventures | 76 | 537 | (85.8%) |
| Loans provided to joint ventures | - | (16,825) | n/a |
| Payments for acquisition of subsidiaries net of cash acquired | - | (3,630) | n/a |
| Other | (356) | - | n/a |
| **Net cash used for investing activities** | **(27,928)** | **(32,116)** | **(13.0%)** |

Cash used for capital expenditures decreased by RR 4,482 million, or 36.7%, as compared to the 2015 reporting period. In the 2016 reporting period, cash was mainly used for the development of the Yarudeyskoye and East-Tarkosalinskoye field's crude oil deposits, maintenance of production at our Yurkharovskoye field, as well as the development of the Salmanovskoye (Utrenneye) field.

In September 2016, we made capital contributions to Yamal LNG in the amount of RR 19,565 million as part of the financing commitment by the Group as a result of the disposal of the 9.9% equity stake in Yamal LNG to China's Silk Road Fund Co. Ltd. on the same terms that were previously applied upon the entrance of TOTAL S.A. and China National Petroleum Corporation into the Yamal LNG project.

In the three months ended 30 September 2016, we made a payment in the amount of RR 367 million for the acquisition of exploration and production license for the Syadorskiy license area, located in the northern part of the Yamal peninsula in YNAO (see "Recent developments" above).

In the three months ended 30 September 2016, we received RR 76 million due to a partial repayment of the loans provided to Terneftegas and Yamal Development while in the 2015 reporting period we received RR 537 million due to a partial repayment of the loan provided to Terneftegas.

In the 2015 reporting period, we provided loans to our joint venture Yamal Development in the amount of RR 16,825 million. In the current reporting quarter we did not provide loans to our joint ventures.

In the 2015 reporting period, we paid RR 3,630 million (USD 62 million) in relation to the 100% equity stake in ZAO Office acquired in August 2014 for the total consideration of RR 4,895 million (USD 135 million).

*Net cash provided by (used for) financing activities*

In the three months ended 30 September 2016, our net cash used for financing activities amounted to RR 12,726 million as compared to RR 7,387 million provided by financing activities in the corresponding period in 2015.

| *millions of Russian roubles* | Three months ended 30 September: 2016 | 2015 | Change % |
|---|---|---|---|
| Proceeds from (repayments of) long-term debt, net | (7,835) | 8,327 | n/a |
| Proceeds from (repayments of) short-term debt, net | (681) | 808 | n/a |
| Other | (4,210) | (1,748) | 140.8% |
| **Net cash provided by (used for) financing activities** | **(12,726)** | **7,387** | **n/a** |

During the three months ended 30 September 2016, we did not obtain long-term loans whereas in the corresponding period in 2015 one of the Group's subsidiaries obtained long-term loans from its minority shareholder in the amount of RR 16,130 million. In both reporting periods, the Group partially repaid a loan obtained under our syndicated credit line facility in the amount of RR 7,403 million and RR 7,803 million (USD 115 million), respectively, according to the loan's maturity schedule. In addition, in the 2016 reporting period, the Group also partially repaid a loan obtained from the minority shareholder.

In the three months ended 30 September 2016, we repaid a short-term loan from our minority shareholder in the amount of RR 1,191 million. In addition, in both reporting periods, we obtained short-term loans to finance trade activities. In the third quarter of 2016, net proceeds from short-term loans amounted to RR 510 million as compared to RR 808 million in the corresponding period in 2015.

The main change in the line "Other" in the table above related to an increase in the repayments of interest on borrowings and loans.

## Liquidity and working capital

The following table shows our liquidity and credit measures as of 30 September 2016 and 31 December 2015:

| | 30 September 2016 | 31 December 2015 | Change, % |
|---|---|---|---|
| **Absolute amounts, RR million** | | | |
| Net debt [(1)] | 200,412 | 329,518 | (39.2%) |
| Net working capital position [(2)] | 8,697 | (41,203) | n/a |
| **Liquidity and credit ratios** | | | |
| Current ratio [(3)] | 1.08 | 0.76 | 42.1% |
| Total debt to total equity | 0.38 | 0.84 | (54.8%) |
| Long-term debt to long-term debt and total equity | 0.24 | 0.37 | (35.1%) |
| Net debt to total capitalization [(4)] | 0.24 | 0.41 | (41.5%) |
| Net debt to normalized EBITDA from subsidiaries [(5)] | 1.10 | 2.05 | (46.3%) |

(1) Net debt represents total debt less cash and cash equivalents.

(2) Net working capital position represents current assets plus assets held for sale less current liabilities.

(3) Current ratio is calculated as current assets plus assets held for sale divided by current liabilities.

(4) Total capitalization represents total debt, total equity and deferred income tax liability.

(5) Net debt to normalized EBITDA from subsidiaries ratio is calculated as Net debt divided by EBITDA from subsidiaries excluding the effect from the disposal of interests in joint ventures for the last twelve months.

During the nine months of 2016, we repaid short-term and long-term debt in aggregate of approximately RR 131 billion. As a result, the Group's net debt decreased significantly by 39.2% and net working capital position increased to RR 8.7 billion as of 30 September 2016.

In each quarter of 2015 and 2016, the Group achieved strong operating results and retained positive free cash flow. The Group's management believes that it presently has and will continue to have the ability to generate sufficient cash flows (from operating and financing activities) to repay all its current liabilities as they become due and to finance the Group's capital construction programs.

## Capital expenditures

In both reporting periods, our capital expenditures represent our investments primarily relating to developing our oil and gas properties. The following table shows capital expenditures at our main fields and processing facilities:

| *millions of Russian roubles* | Three months ended 30 September: 2016 | 2015 |
|---|---|---|
| Yarudeyskoye field | 1,273 | 6,603 |
| East-Tarkosalinskoye field | 1,161 | 2,165 |
| Salmanovskoye (Utrennee) field | 581 | 1,890 |
| Yurkharovskoye field | 496 | 1,449 |
| West-Yurkharovskoye field | 430 | 124 |
| Khancheyskoye field | 318 | 344 |
| Purovsky Plant | 199 | 163 |
| North-Russkoye field | 100 | 38 |
| Other | 1,376 | 1,833 |
| **Capital expenditures** | **5,934** | **14,609** |

Total capital expenditures on property, plant and equipment in the three months ended 30 September 2016 decreased by RR 8,675 million, or 59.4%, to RR 5,934 million from RR 14,609 million in the corresponding period in 2015. In both reporting periods, our main capital expenditures related to the development of the Yarudeyskoye and East-Tarkosalinskoye field's crude oil deposits, Yurkharovskoye field's production maintenance, as well as the development of the Salmanovskoye (Utrenneye) field.

The "Other" line in the table above represents our capital expenditures related to multiple field activities, as well as unallocated capital expenditures as of the reporting date. The allocation of capital expenditures by fields takes place upon the completion of the fixed assets construction stages and depends on the approved fixed assets launch schedule.

The following table presents the reconciliation of our capital expenditures and additions to property, plant and equipment per Note "Property, plant and equipment" in the Group's IFRS Consolidated Financial Statements, as well as cash used for capital investments:

| *millions of Russian roubles* | Three months ended 30 September: 2016 | 2015 | Change % |
|---|---|---|---|
| **Total additions to property, plant and equipment per Note "Property, plant and equipment" in the Group's IFRS Consolidated Financial Statements** | **6,338** | **14,609** | **(56.6%)** |
| Less: acquisition of mineral licenses | (404) | - | n/a |
| **Capital expenditures** | **5,934** | **14,609** | **(59.4%)** |
| Less: capitalized foreign exchange differences, change in accounts payable, change in asset retirement costs and other non-cash adjustments | 1,782 | (2,411) | n/a |
| **Cash used for capital expenditures (1)** | **7,716** | **12,198** | **(36.7%)** |

(1) Represents purchases of property, plant and equipment, materials for construction and capitalized interest paid per Consolidated Statement of Cash Flows net of payments for mineral licenses and acquisition of subsidiaries.

## QUALITATIVE AND QUANTITATIVE DISCLOSURES AND MARKET RISKS

We are exposed to market risk from changes in commodity prices, foreign currency exchange rates and interest rates. We are exposed to commodity price risk as our prices for crude oil, stable gas condensate and refined products destined for export sales are linked to international crude oil prices and other benchmark price references. We are exposed to foreign exchange risk to the extent that a portion of our sales, costs, receivables, loans and debt are denominated in currencies other than Russian roubles. We are subject to market risk from changes in interest rates that may affect the cost of our financing. From time to time we may use derivative instruments, such as commodity forward contracts, commodity price swaps, commodity options, foreign exchange forward contracts, foreign currency options, interest rate swaps and forward rate agreements, to manage these market risks, and we may hold or issue derivative or other financial instruments for trading purposes.

### Foreign currency risk

Our principal exchange rate risk involves changes in the value of the Russian rouble relative to the US dollar. As of 30 September 2016, the total amount of our long-term debt denominated in US dollars was RR 168,374 million, or 73.9% of our total borrowings at that date. Changes in the value of the Russian rouble relative to foreign currencies will impact our foreign currency-denominated costs and expenses, our debt service obligations for foreign currency-denominated borrowings, as well as receivables at our foreign subsidiaries in Russian rouble terms. We believe that the risks associated with our foreign currency exposure are partially mitigated by the fact that a portion of our total revenues, 37.6% in the three months ended 30 September 2016, was denominated in US dollars.

In addition, our share of profit (loss) of joint ventures is also exposed to foreign currency exchange rate movements due to the significant amount of foreign currency-denominated borrowings in our joint ventures, mostly in Yamal LNG. We expect that once commercial production commences, the effects of the foreign currency movements in relation to foreign currency-denominated debt portfolio of Yamal LNG will be mitigated by the fact that all of its products will be delivered to international markets and revenues will be denominated in foreign currencies.

As of 30 September 2016, the Russian rouble appreciated by 13.3% and 11.1% against the US dollar and the Euro, respectively, compared to 31 December 2015.

### Commodity risk

Substantially all of our stable gas condensate and refined products, LPG and crude oil export sales are sold under spot market contracts. Our export prices are primarily linked to international crude oil and oil products prices. External factors such as geopolitical developments, natural disasters and the actions of the Organization of Petroleum Exporting Countries affect crude oil prices and thus our export prices.

The weather is another factor affecting demand for natural gas. Changes in weather conditions from year to year can influence demand for natural gas and to some extent gas condensate and refined products.

From time to time we may employ derivative instruments to mitigate the price risk of our sales activities. In our consolidated financial statements all derivative instruments are recognized at their fair values. Unrealized gains or losses on derivative instruments are recognized within other operating income (loss), unless the underlying arrangement qualifies as a hedge.

The Group purchases and sells natural gas on the European market under long-term contracts based on formulas with reference to benchmark natural gas prices quoted for the North-Western European natural gas hubs, crude oil and oil products prices and/or a combination thereof. Therefore, the Group's financial results from natural gas foreign trading activities are subject to commodity price volatility based on fluctuations or changes in the respective benchmark reference prices.

**Pipeline access**

We transport substantially all of our natural gas through the Gas Transmission System ("GTS") owned and operated by PAO Gazprom, which is responsible for gathering, transporting, dispatching and delivering substantially all natural gas supplies in Russia. Under existing legislation, Gazprom must provide access to the GTS to all independent suppliers on a non-discriminatory basis provided there is capacity available that is not being used by Gazprom. In practice, Gazprom exercises considerable discretion over access to the GTS because it is the sole owner of information relating to capacity. There can be no assurance that Gazprom will continue to provide us with access to the GTS; however, we have not been denied access in prior periods.

**Ability to reinvest**

Our business requires significant ongoing capital expenditures in order to grow our production and meet our strategic plans. An extended period of reduced demand for our hydrocarbons available for sale and the corresponding revenues generated from these sales would limit our ability to maintain an adequate level of capital expenditures, which in turn could limit our ability to increase or maintain current levels of production and deliveries of natural gas, gas condensate, crude oil and other associated products; thereby, adversely affecting our financial and operating results.

**Off balance sheet activities**

As of 30 September 2016, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which are typically established for the purpose of facilitating off-balance sheet arrangements.

## TERMS AND ABBREVIATIONS

| | |
|---|---|
| **APR** | Asian-Pacific Region |
| **bbl** | Barrel |
| **bcm** | billion cubic meters |
| **boe** | barrels of oil equivalent |
| **CBR** | Central Bank of Russian Federation |
| **CFR** | "Cost and freight" |
| **CIF** | "Cost, insurance and freight" |
| **CNY** | Chinese Yuan |
| **DAP** | "Delivery at point of destination" |
| **DDA** | depreciation, depletion and amortization |
| **DES** | "Delivery to the port of destination ex-ship" |
| **FCA** | "Free carrier" |
| **FOB** | "Free on board" |
| **Forecast of the Ministry of Economic Development** | The document *"Forecast of Socio-economic Development of the Russian Federation for 2015 and planned period 2016 and 2017"* prepared by the Ministry of Economic Development of the Russian Federation or the similar document prepared for another period |
| **FTS** | Federal Tariffs Service |
| **GTS** | Gas Transmission System part of the UGSS |
| **IFRS** | International Financial Reporting Standards |
| **List** | the OFAC's Sectoral Sanctions Identification List |
| **LNG** | liquefied natural gas |
| **LPG** | liquefied petroleum gas |
| **mcm** | thousand cubic meters |
| **MET** | mineral extraction tax |
| **OFAC** | Office of Foreign Assets Control |
| **PRMS** | Petroleum Resources Management System |
| **Purovsky Plant** | Purovsky Gas Condensate Plant |
| **Regulator** | A federal executive agency of the Russian Federation that carries out governmental regulation of prices and tariffs for products and services of natural monopolies in energy, utilities and transportation. During the first half of 2015, the Federal Tariffs Service fulfilled the Regulator's role. In July 2015, a Decree of the President of the Russian Federation became effective abolishing the FTS and transferring its functions to the Federal Anti-Monopoly Service |
| **RR** | Russian rouble(s) |
| **RZD** | OAO Russian Railways, Russia's state-owned monopoly railway operator |
| **S&P** | Standard & Poor's |
| **SEC** | Securities and Exchange Commission |
| **Tobolsk Refining Facilities** | Refining facilities of OOO SIBUR Tobolsk (formerly OOO Tobolsk-Neftekhim) |
| **UGSF** | Underground Gas Storage Facilities |
| **UGSS** | Unified Gas Supply System owned and operated by PAO Gazprom |
| **UPT** | unified natural resources production tax |
| **USD, US dollar** | United States Dollar |
| **Ust-Luga Complex** | Gas Condensate Fractionation and Transshipment Complex located at the port of Ust-Luga on the Baltic Sea |
| **VAT** | Value added tax |
| **Yamal LNG project** | A large-scale project on constructing a liquefied natural gas plant with an annual capacity of 16.5 million tons based on the feedstock resources of the South-Tambeyskoye field located at the northeast of the Yamal Peninsula that Group undertakes jointly with TOTAL S.A., China National Petroleum Corporation and China's Silk Road Fund Co. Ltd., through its joint venture OAO Yamal LNG |
| **YNAO** | Yamal-Nenets Autonomous Region |