**PAO NOVATEK**

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

**FOR THE THREE MONTHS ENDED 30 SEPTEMBER 2018**

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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 2018 together with our unaudited consolidated interim condensed financial statements as of and for the three and nine months ended 30 September 2018. 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 2017 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 one of the Russia's largest natural gas producers and leaders in terms of proved natural gas reserves in the Russian Federation under the Petroleum Resources Management System ("PRMS") and the Securities 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.

The natural gas assets of our subsidiaries and joint ventures include projects where we sell natural gas through the Unified Gas Supply System in the Russian domestic market and liquefied natural gas ("LNG") delivered to international markets. In the fourth quarter of 2017, OAO Yamal LNG, a Group's joint venture, commenced producing LNG at the first train of its liquefaction plant, and in the third quarter of 2018, the second LNG train was launched.

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 natural gas liquids ("NGL"). 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 (by rail and from the port of Ust-Luga on the Baltic Sea by tankers).

A significant part of our NGL produced at the Purovsky Plant is dispatched via pipeline for refining by OOO SIBUR Tobolsk at its refining facilities (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 liquefied petroleum gas ("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. NGL sold directly from the Purovsky Plant and sales of LPG received from the processing at the Tobolsk Refining Facilities are presented within LPG sales in this report.

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

## RECENT DEVELOPMENTS

### Implementing our Yamal LNG project

In the fourth quarter of 2017, Yamal LNG started producing LNG at the first LNG train of 5.5 million tons annual capacity, and, in December 2017, commenced shipping of LNG from the port of Sabetta by Arc7 ice-class LNG tankers.

In July 2018, natural gas was introduced into the process pipelines of the second LNG train. In the same month the production of LNG commenced and, in August, Yamal LNG shipped the first LNG cargo produced from the second LNG train. The commencement of LNG production at the second train six months ahead of schedule is another important step in realizing the Yamal LNG project and substantiating the company's ambition of becoming one of the largest suppliers of LNG to the international LNG market.

In July 2018, three Arc7 ice-class LNG tankers with LNG produced at the Yamal LNG project have successfully completed the Northern Sea Route passage from the port of Sabetta via the Eastern direction to the Chinese ports of Jiangsu Rudong and Tangshan. The net voyage time from the port of Sabetta to the destination point was 19 days as compared to 35 days for the traditional route via the Suez Canal and the Strait of Malacca. These shipments represent the first voyages with Russian LNG via the Northern Sea Route without escort of an icebreaker and mark the start of seasonal LNG shipments via the Northern Sea Route.

In total, during the nine months of 2018, five million tons of LNG and 473 thousand tons of stable gas condensate were shipped from the port of Sabetta. LNG was delivered under both short-term and long-term contracts.

Currently, commissioning works at the third LNG train, which is expected to be launched by year-end, and the design of the fourth LNG train are in progress.

### Signing an agreement with TOTAL on the terms to enter the Arctic LNG 2 project

In May 2018, NOVATEK and TOTAL S.A. signed a binding agreement on the terms to enter the Arctic LNG 2 project. The agreement provides for the acquisition by TOTAL of a 10% participation interest in the project, as well as the right to additionally acquire up to 5% in case the Group decides to decrease its participation interest in the project below 60%. The agreement stipulates that final transaction documents on the sale of a 10% participation interest in OOO Arctic LNG 2 to TOTAL will be signed in 2018 and the transaction will be closed no later than 31 March 2019. Signing the agreement with TOTAL is an important step in implementing the Arctic LNG 2 project and evidences outstanding economic attractiveness and perspectives of the Group's future LNG projects on the Yamal and Gydan peninsulas.

### Obtaining a patent for natural gas liquefaction technology

In March 2018, the Group obtained a patent for its proprietary natural gas liquefaction technology called "Arctic Cascade". The patented LNG technology is based on a two-stage liquefaction process ensuring high energy efficiency due to the maximum use of the colder ambient temperature in the arctic climate. Our proprietary technology intends to use mainly Russian-made equipment and achieve a decrease in the overall cost of liquefaction, as well as develop a domestic technological base for the Group's future LNG projects.

### Logistics improvement and transportation costs optimization

In line with our long-term strategy to effectively manage logistics and to optimize shipping costs of our Arctic projects, in 2018, the Group established two wholly owned subsidiaries:

- In May 2018, the Group established a subsidiary OOO Maritime Arctic Transport to manage and optimize transportation costs, build up the unique competencies of Arctic navigation and ensure centralized management of the Arctic fleet.

- In April 2018, we established a subsidiary OOO NOVATEK-Kamchatka to build an LNG transshipment terminal on the Kamchatka Peninsula with throughput of 20 million tons of LNG per annum. In September 2018, the Group signed an agreement of intent with the Ministry of the Russian Federation for the Development of the Far East and the Government of the Kamchatka Territory on supporting and providing assistance in the implementation of this project. Construction of the transshipment complex will contribute to the logistics optimization of LNG deliveries from the Arctic region to the customers in the Asian Pacific Region ("APR"), promoting the Northern Sea Route, as well as boil-off gas deliveries potential to supplement the peninsula's needs in natural gas.

In September 2018, the Group and the State Corporation Rosatom signed an agreement of intent to establish a joint venture for the purpose of joint developing, financing and implementing a project to create an LNG-fueled icebreaker fleet to support the Group's Arctic projects in frozen water areas along the Northern Sea Route as well as building port fleet and supply vessels.

In October 2018, the Group and Fluxys Germany Holding GmbH arranged a joint venture, Rostock LNG GmbH, with 49% and 51% participation interests, respectively, to undertake a project for the construction and operation of a medium-scale LNG transshipment terminal with capacity of approximately 300 thousand tons per annum located in the port of Rostock in Germany. The terminal will receive LNG carriers with further LNG deliveries made via trucks to consumers. Additionally, the terminal will conduct vessels bunkering and LNG transshipment onto bunkering barges. In October 2018, Rostock LNG GmbH signed a land lease agreement with the administration of the port of Rostock for construction of an LNG transshipment terminal. The LNG transshipment terminal project in Germany is an important marketing channel for our LNG deliveries and will allow us to develop medium-scale LNG production, including the LNG plant in the port of Vysotsk.

**Increasing our resource base and production facilities**

In February 2018, based on the results of an auction held by AK ALROSA (PAO), the Group acquired 100% participation interests in companies Maretiom Investments Limited and Velarion Investments Limited, the owners of 100% participation interests in AO Geotransgas and OOO Urengoyskaya gasovaya companiya, respectively, for RR 30.3 billion. Geotransgas holds the license for exploration and production of hydrocarbons within the Beregovoy license area, which is currently producing hydrocarbons. As of 31 December 2017, the license area's reserves under the category A+B of the Russian reserve classification totaled 73 bcm of natural gas and five million tons of liquid hydrocarbons. Urengoyskaya gasovaya companiya holds the license for exploration and production of hydrocarbons within the Ust-Yamsoveyskiy license area. As of 31 December 2017, the license area's reserves under the category B of the Russian reserve classification totaled 89 bcm of natural gas and 14 million tons of liquid hydrocarbons.

During the nine months of 2018, the Group also obtained rights for the usage of four more license areas located in close proximity to other Group's assets:

- In April 2018, we obtained the right for geological research works at the Palkurtoiskiy license area. The license area is located in the YNAO and borders with other license areas of the Group (the North-Tanamskiy, the Nyavuyahskiy, the West-Solpatinskiy and the Centralno-Nadoyakhskiy). As of 31 December 2017, the license area's recoverable resources under the category D of the Russian reserve classification totaled 278 bcm of natural gas and approximately 49 million tons of liquid hydrocarbons.

- In April 2018, we obtained the right for geological research works at the Centralno-Nadoyakhskiy license area. The license area is located in the YNAO and borders with the West-Solpatinskiy and the Tanamskiy license areas of the Group. As of 31 December 2017, the license area's recoverable resources under the category D of the Russian reserve classification totaled 258 bcm of natural gas and 144 million tons of liquid hydrocarbons.

- In March 2018, the Group won an auction held by the Federal Agency for the Use of Natural Resources of the Russian Federation for the right for geological research works, exploration and production of hydrocarbons at the Payutskiy license area. The license area is located in the Krasnoyarsk Region in close proximity to the Group's license areas on the Gydan peninsula, the West-Solpatinskiy, the North-Tanamskiy, the Nyavuyahskiy and Tanamskiy license areas. As of 31 December 2017, the license area's reserves and recoverable resources under the category C+D of the Russian reserve classification totaled 54 bcm of natural gas. The payment for the license was set at RR 66 million.

- In January 2018, the Group acquired a 100% participation interest in OOO Chernichnoye for RR 616 million. OOO Chernichnoye is a holder of the license for geological research works, exploration and production of hydrocarbons within the Chernichniy license area located in the YNAO in close proximity to the Termokarstovoye field of our joint venture ZAO Terneftegas. As of 31 December 2017, the license area's reserves under the category B of the Russian reserve classification totaled 17.7 bcm of natural gas and 7.8 million tons of liquid hydrocarbons.

In addition, based on the results of drilling and wells testing we discovered a new North-Obskoye field and new hydrocarbon deposits at the Salmanovskoye (Utrenneye) field:

- At the North-Obskiy license area we discovered a new natural gas and gas condensate field bearing the same name with estimated reserves under the category C1+C2 of the Russian reserve classification of not less than 320 bcm of natural gas. The reserves estimates will be submitted to the Russian State Reserves commission for confirmation in November 2018. The discovery of this new field is an important starting point for one of our future LNG projects.

- At the Salmanovskoye (Utrenneye) field two new hydrocarbon deposits were discovered and commercial viability of the mid-Jurassic deposits was confirmed. The reserves of the two new deposits within the Salmanovskoye (Utrenneye) license area, owned by OOO Arctic LNG 2, under the category C1+C2 of the Russian reserve classification totaled 405 bcm of natural gas and 40 million tons of gas condensate. The new deposits expand the reserve potential of the field and open additional opportunities for implementing the Arctic LNG 2 project.

**The change in the participation interest in AO Arcticgas**

In the first quarter of 2018, the Group and PAO Gazprom Neft completed the final stage of the previously commenced restructuring procedures to achieve parity shareholdings in our joint venture AO Arcticgas:

- In January 2018, Yamal Development and SeverEnergia were merged with Arcticgas. As a result, the Group and Gazprom Neft obtained direct participation interests in Arcticgas of 53.3% and 46.7%, respectively.

- In March 2018, Gazprom Neft subscribed to an additional share emission of Arcticgas for a total cash consideration of RR 32.1 billion.

As a result of the aforementioned transactions, the Group's participation interest in Arcticgas decreased from 53.3% to 50.0%. The Group continues to recognize the entity as a joint venture and accounts for this investment under the equity method.

**International oil and gas projects**

In January 2018, the Group, TOTAL S.A. and Eni S.p.A., through their subsidiaries NOVATEK Lebanon SAL, Total E&P Liban SAL and Eni Lebanon B.V. (hereinafter referred to as the "Right holders"), entered into Exploration and Production Agreements for Petroleum Activities with the Lebanese Republic for the exploration and production of hydrocarbons on offshore blocks 4 and 9 located in the Eastern Mediterranean (hereinafter referred to as the "Exploration and Production Agreements"). The Exploration and Production Agreements stipulate that the Right holders are committed to undertake specified joint upstream activities during the exploration phase within five years. The Group is assigned a 20% participating interest, and Total E&P Liban SAL was appointed as the operator.

## BASIS OF PRESENTATION

Certain changes have been made to the presentation of production volumes, as well as average realized prices and revenue streams in this report to conform to the reporting practices of the Group's domestic and international peers in the oil and gas industry. The comparative data for 2017 have been recalculated in accordance with this approach.

Oil and gas production is calculated based on 100% of our subsidiaries production and our proportionate share in the production of our joint ventures including volumes of natural gas consumed in oil and gas producing and development activities (previously, such own use volumes were excluded). Production of the South-Tambeyskoye field developed by the Group's joint venture Yamal LNG is reported at 60% including an additional 9.9% interest not owned by the Group, since the Group assumes certain economic and operational risks related to this interest. The comparative figures for 2017 were recalculated accordingly.

Our oil and gas revenues and average realized prices are presented for each product category without split by geographic destination reflecting the prevailing industry practice of presenting upstream revenue and prices based on product origination rather than its final destination, and taking into account that the Group's production activities are currently concentrated in the Russian Federation.

## SELECTED DATA

| *millions of Russian roubles except as stated* | Three months ended 30 September: 2018 | 2017 | Change % |
|---|---|---|---|
| **Financial results** | | | |
| Total revenues [(1)] | 219,366 | 130,703 | 67.8% |
| Operating expenses | (156,903) | (94,385) | 66.2% |
| EBITDA [(2)] | 118,091 | 59,270 | 99.2% |
| Profit attributable to shareholders of PAO NOVATEK | 45,900 | 37,737 | 21.6% |
| Profit attributable to shareholders of PAO NOVATEK, excluding the effect of foreign exchange gains (losses) [(3)] | 65,522 | 34,905 | 87.7% |
| Earnings per share (in Russian roubles) | 15.23 | 12.51 | 21.7% |
| Earnings per share, excluding the effect of foreign exchange gains (losses) [(3)] (in Russian roubles) | 21.75 | 11.57 | 87.9% |
| Net debt [(4)] | 77,638 | 92,044 | (15.7%) |
| **Production volumes [(5)]** | | | |
| Hydrocarbons production (million barrels of oil equivalent) | 138.0 | 125.3 | 10.1% |
| Daily production (million barrels of oil equivalent per day) | 1.50 | 1.36 | 10.1% |
| **Operating results** | | | |
| Natural gas sales volumes (million cubic meters) | 15,589 | 13,888 | 12.2% |
| Crude oil sales volumes (thousand tons) | 1,134 | 1,108 | 2.3% |
| Naphtha sales volumes (thousand tons) | 970 | 873 | 11.1% |
| Liquefied petroleum gas sales volumes (thousand tons) | 679 | 656 | 3.5% |
| Other stable gas condensate refined products (thousand tons) | 582 | 604 | (3.6%) |
| Stable gas condensate sales volumes (thousand tons) | 566 | 475 | 19.2% |
| **Cash flow results** | | | |
| Net cash provided by operating activities | 50,371 | 35,122 | 43.4% |
| Cash used for capital expenditures [(6)] | 24,783 | 5,678 | 336.5% |
| Free cash flow [(7)] | 25,588 | 29,444 | (13.1%) |

(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 of foreign exchange gains (losses) of subsidiaries and our proportionate share in foreign exchange gains (losses) of our joint ventures (see "Profit attributable to shareholders and earnings per share" below).

(4) Net Debt represents our total debt net of cash, cash equivalents and bank deposits with original maturity more than three months.

(5) Oil and gas production is calculated based on 100% of production of our subsidiaries and our proportionate share in the production of our joint ventures including fuel gas. Production of the South-Tambeyskoye field of Yamal LNG is reported at 60% (see "Basis of presentation" above). Figures for the third quarter of 2017 were recalculated accordingly.

(6) 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.

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

Reconciliation of EBITDA is as follows:

| *millions of Russian roubles* | Three months ended 30 September: 2018 | 2017 | Change % |
|---|---|---|---|
| **Profit** | **51,397** | **40,166** | **28.0%** |
| Depreciation, depletion and amortization | 8,511 | 8,997 | (5.4%) |
| Net impairment reversals (expenses) | 30 | 9 | 233.3% |
| Loss (income) from changes in fair value of commodity derivative instruments | 225 | (8) | n/a |
| Total finance expense (income) | (14,560) | (5,061) | 187.7% |
| Total income tax expense | 13,199 | 7,866 | 67.8% |
| Share of loss (profit) of joint ventures, net of income tax | 11,942 | (6,875) | n/a |
| **EBITDA from subsidiaries** | **70,744** | **45,094** | **56.9%** |
| **Share in EBITDA of joint ventures** | **47,347** | **14,176** | **234.0%** |
| **EBITDA** | **118,091** | **59,270** | **99.2%** |

## SELECTED MACRO-ECONOMIC DATA

| *Exchange rate, Russian roubles for one foreign currency unit* [(1)] | Three months ended 30 September: 2018 | 2017 | Change % |
|---|---|---|---|
| **US dollar (USD)** | | | |
| Average for the period | 65.53 | 59.02 | 11.0% |
| At the beginning of the period | 62.76 | 59.09 | 6.2% |
| At the end of the period | 65.59 | 58.02 | 13.0% |
| Depreciation (appreciation) of Russian rouble to US dollar | 4.5% | (1.8%) | n/a |
| **Euro** | | | |
| Average for the period | 76.18 | 69.29 | 9.9% |
| At the beginning of the period | 72.99 | 67.50 | 8.1% |
| At the end of the period | 76.23 | 68.45 | 11.4% |
| Depreciation (appreciation) of Russian rouble to Euro | 4.4% | 1.4% | 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: 2018 | 2017 | Change % |
|---|---|---|---|
| **Benchmark natural gas prices** [(2)] | | | |
| NBP, USD per mmbtu | 8.4 | 5.5 | 52.7% |
| **Benchmark crude oil prices** [(3)] | | | |
| Brent, USD per barrel | 75.2 | 52.1 | 44.3% |
| Urals, USD per barrel | 74.2 | 50.9 | 45.8% |
| Urals, Russian roubles per barrel | 4,862 | 3,004 | 61.9% |
| **Benchmark crude oil prices excluding export duties** [(4)] | | | |
| Urals, USD per barrel | 55.7 | 40.0 | 39.3% |
| Urals, Russian roubles per barrel | 3,650 | 2,361 | 54.6% |
| **Benchmark oil products** [(5)] **and liquefied petroleum gas** [(6)] **prices, USD per ton** | | | |
| Naphtha Japan | 666 | 468 | 42.3% |
| Naphtha CIF NWE | 652 | 463 | 40.8% |
| Jet fuel | 710 | 520 | 36.5% |
| Gasoil | 661 | 476 | 38.9% |
| Fuel oil | 436 | 305 | 43.0% |
| Liquefied petroleum gas | 541 | 391 | 38.4% |
| **Export duties, USD per ton** [(7)] | | | |
| Crude oil, stable gas condensate | 134.8 | 79.8 | 68.9% |
| Naphtha | 74.1 | 43.8 | 69.2% |
| Jet fuel, gasoil | 40.4 | 23.9 | 69.0% |
| Fuel oil | 134.8 | 79.8 | 68.9% |
| Liquefied petroleum gas | 8.9 | 0.0 | n/a |

(2) Based on natural gas prices at the National Balancing Point (NBP), the natural gas hub in the United Kingdom.

(3) Based on Brent (dtd) and Russian Urals CIF Rotterdam spot assessments prices.

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

(5) 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.

(6) Based on spot prices for propane-butane mix at the Belarusian-Polish border (DAF, Brest).

(7) 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

Commodity price volatility continues to exert significant influence on financial and operational results in the global oil and gas industry. 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. In each reporting period, the Group achieved strong operating results and remained free cash flow positive.

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 also closely monitor the present commodity price environment and its impact on our business operations. We do not expect any asset impairments or write-offs resulting from a lower commodity price environment.

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.

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 60 days (prior to 28 November 2017, the aforementioned restrictions related to new credit facilities with maturity of more 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 debt, and does not have a material effect on the Group's financial position.

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

### Natural gas prices

We sell our natural gas to customers in the Russian domestic market, mainly through trunk pipelines and regional distribution networks, and deliver LNG purchased from our joint venture OAO Yamal LNG to international markets (starting from December 2017). In addition, we perform LNG regasification activities in Poland by purchasing LNG in Poland, regasifying it at our own regasification stations and selling natural gas to customers in Poland.

The Group's natural gas prices in Russia are strongly influenced by the prices set by the Federal Anti-Monopoly Service, 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 2017, wholesale natural gas prices for sales to all customer categories (excluding residential customers) on the domestic market remained unchanged. Effective 1 July 2017, the Regulator increased wholesale prices by 3.9%, and from 21 August 2018 – by 3.4%.

In October 2018, the Ministry of Economic Development of the Russian Federation published the "Forecast of Socio-economic Development of the Russian Federation for the period till 2024" stating that wholesale natural gas prices for sales to all customer categories (excluding residential customers) will be increased from July 2019 by an average of 1.4% and from July 2020-2024 by 3.0%. 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.

The Group's natural gas prices on international markets are influenced by many factors, such as the balance between supply and demand fundamentals, weather, the geography of sales, the delivery terms to name a few. The Group sells LNG on international markets under short-term contracts and, since April 2018, under long-term contracts with prices based on the prices for natural gas at major natural gas hubs and on the benchmark crude oil prices. The Group's prices for regasified LNG sold as natural gas on the Polish market are based on the prices regulated by the Energy Regulatory Office of Poland.

The following table shows our aggregate average realized natural gas sales prices on the domestic and international markets (excluding VAT, where applicable):

| | Three months ended 30 September: | | Change |
|---|---|---|---|
| | 2018 | 2017 | % |
| Average natural gas price, RR per mcm | 5,869 | 3,924 | 49.6% |
| Average natural gas price, USD per mcm [(1)] | 89.3 | 66.5 | 34.3% |

[(1)] Operations initially priced in Russian roubles were translated into US dollars using the average exchange rate for the period.

In the three months ended 30 September 2018, our aggregate average price for natural gas sold in the Russian Federation and on the international markets increased by 49.6% mainly due to the commencement of LNG sales to international markets from December 2017, as well as an increase in the regulated Russian domestic price by 3.4% effective 21 August 2018.

### 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. We export SILCO (low-sulfur "Siberian Light Crude Oil") and ESPO ("East Siberia – Pacific Ocean") grades of crude oil to international markets with a premium or a discount to the benchmark Brent and Dubai crude oil depending on current market situation.

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

| *Russian roubles or US dollars per ton* (1) | Three months ended 30 September: 2018 | 2017 | Change % |
|---|---|---|---|
| **Stable gas condensate** | | | |
| Average net price, RR per ton | 29,334 | 16,430 | 78.5% |
| Average net price, USD per ton | 450 | 279 | 61.3% |
| **Naphtha** | | | |
| Average net price, RR per ton | 40,747 | 27,486 | 48.2% |
| Average net price, USD per ton | 621 | 468 | 32.7% |
| **Other stable gas condensate refined products** | | | |
| Average net price, RR per ton | 38,938 | 25,888 | 50.4% |
| Average net price, USD per ton | 597 | 439 | 36.0% |
| **Crude oil** | | | |
| Average net price, RR per ton | 25,996 | 16,245 | 60.0% |
| Average net price, USD per ton | 396 | 275 | 44.0% |
| **LPG** | | | |
| Average net price, RR per ton | 26,564 | 14,947 | 77.7% |
| Average net price, USD per ton | 405 | 253 | 60.1% |

(1) Operations initially priced in Russian roubles were translated into US dollars using the average exchange rate for the period.

In the three months ended 30 September 2018, our weighted-average realized net prices for our liquid hydrocarbons increased compared to the corresponding period in 2017 due to an increase in the underlying benchmark prices for these products excluding export duties (see "Selected macro-economic data" above). Our weighted-average realized net prices in Russian roubles terms increased to a greater extent compared to US dollar prices as a result of 11.0% Russian rouble depreciation relative to the US dollar in the three months ended 30 September 2018 compared to the corresponding period in 2017.

The dynamics of our weighted-average realized net prices for each product category also reflects changes in volumes sold within periods and changes in the geography of shipments which may significantly impact our average prices in periods of high benchmark prices volatility on international markets. In addition, specifics of pricing mechanism for each particular product (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 other factors) also have an impact on the dynamics of our weighted-average realized net prices.

**Transportation tariffs**

*Natural gas by pipelines*

We transport our natural gas within the Russian Federation territory 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.

In 2017 and during the nine months of 2018, the average tariff for natural gas transportation through the trunk pipeline did not change. The transportation rate amounted to RR 13.04 per mcm per 100 km (excluding VAT), and the rate for utilization of the trunk pipeline was set in the range from RR 62.57 to RR 2,014.16 per mcm (excluding VAT).

According to the Forecast of the Ministry of Economic Development of the Russian Federation published in October 2018, the increase in tariffs for natural gas transportation through the trunk pipeline in 2019-2024 will not exceed the growth rate for wholesale natural gas prices (see "Natural gas prices" above). 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*

Substantially all of our stable gas condensate and LPG (excluding volumes sold ex-works from the Purovsky Plant and the Tobolsk Refining Facilities) we transport 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 January 2018, railroad freight transportation tariffs for all types of hydrocarbons were increased by 5.4% relative to the 2017 tariffs.

In 2017 and in the nine months of 2018, 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 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, refined products and liquefied natural gas by tankers*

We deliver part of our stable gas condensate and substantially all stable gas condensate refined products, as well as liquefied natural gas (excluding volumes purchased and sold to customers in the same location) to international markets by chartered tankers. In addition to time chartering expenses, we also may incur transshipment, bunkering, port charges and other expenses depending on the delivery terms, which are included in the transportation by tankers expense category. Our tanker transportation expenses are also influenced by the distance to the final port of destination, tanker availability, seasonality of deliveries and other factors.

*Crude oil*

We transport nearly all of our crude oil through the pipeline network owned by PAO 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 2018, crude oil transportation tariffs through the pipeline network within the Russian Federation territory were increased by an average of 3.9% relative to the 2017 tariffs.

**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.

Information regarding UPT, export duties and excise taxes described below is based on the Tax Code of the Russian Federation and the law "On Customs Tariff" effective as at this report date. Amendments to the taxation that will become effective 1 January 2019 are described below in the section *"Completion of the tax maneuver in the oil and gas industry"*.

*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 (set at 6.5 in both reporting periods), and the UPT rate for natural gas also takes into account a parameter characterizing natural gas transportation costs (set at zero in both reporting periods 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.

Effective January 2018, in accordance with the Tax Code of the Russian Federation, the Group began to apply a tax deduction on gas condensate produced for processing into NGL. The amount of the tax deduction is calculated monthly by multiplying a coefficient of NGL recovery from gas condensate processing, the quantity of gas condensate produced and processed, and the tax deduction rate in Russian roubles per ton of NGL derived. The tax deduction rate is determined as a serial number of the respective month starting from January 2018 multiplied by RR 147 per ton, and, from January 2021, the tax deduction rate will be fixed at RR 5,280 per ton of produced NGL.

*UPT – crude oil*

In both reporting periods, the UPT rate for crude oil was calculated as a product of a coefficient characterizing the dynamics of world crude oil prices and the base UPT rate adjusted for parameters characterizing crude oil production peculiarities at the particular area. The result was then additionally increased by RR 306 per ton in 2017 and by RR 357 per ton in 2018.

In 2017 and 2018, the base crude oil UPT rate is 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. Therefore, the adjusted base UPT rate for crude oil produced at these fields for the Group amounted to 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 ("monitoring period"). In both reporting periods, 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 30% of the difference between the average Urals crude oil price and USD 182.5 per ton.

The export duty rates for oil products are 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 stable gas condensate refined products as a percentage of the crude oil export duty rate are presented below:

| | **% from the crude oil export duty rate** |
|---|---|
| Naphtha | 55% |
| Jet fuel | 30% |
| Gasoil | 30% |
| Fuel oil | 100% |

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) |

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 of own production on the domestic market.

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 tax rate in both reporting periods amounted to 670 Polish zloty per ton, and the fuel tax rate was increased from 159.71 Polish zloty per ton in 2017 to 162.27 Polish zloty per ton in 2018).

*Completion of the tax maneuver in the oil and gas industry*

In August 2018, as part of the completion of the tax maneuver in the oil and gas industry, federal laws introducing changes to the Law of the Russian Federation "On Customs Tariff" and to the Tax Code of the Russian Federation were adopted. The amendments envisage a phased decrease in crude oil and stable gas condensate export duty rate from 1 January 2019 with a respective increase in UPT rates for crude oil and gas condensate, introduction of excise tax deductions for processors of raw oil, as well as other amendments to tax and customs legislation.

Starting from January 2019, export duty rate for stable gas condensate and crude oil will gradually decrease during the six years by 1/6 annually from 30% of crude oil price to 0% in 2024. At the same time, the UPT rate for crude oil will increase by the same amount in Russian rouble terms. The UPT rate for gas condensate will increase by 75% of the amount of a decrease in the export duty rate (since the share of NGL received from processing of extracted gas condensate is subject to a UPT deduction).

Where Urals crude oil price in Russian rouble terms in the current monitoring period (from the 15th calendar day in the previous month to the 14th calendar day of the current month) exceeds its average for the previous three monitoring periods, the export duty rate for stable gas condensate and crude oil may be increased by the Russian Federation government from 30% to 45% of crude oil price, and the export duty rates for oil products – to 60% of the export duty rate for crude oil. In this case, the UPT rate for crude oil will decrease by the amount of the corresponding increase in the export duty rate, and the UPT rate for gas condensate – by 75% of this amount.

The export duty rates for oil products will continue to be based on the export duty rate for crude oil adjusted by a coefficient set for each category of oil products. Thus, in case extracted crude oil and gas condensate are further sent for processing, the amount of an increase in UPT rate for crude oil and gas condensate will exceed the amount of a decrease in export duty rates for oil products received from processing. To compensate for this difference, effective January 2019, the so called "negative excise" is introduced: organizations that process raw oil (crude oil, stable gas condensate, vacuum gasoil, tar, fuel oil) are subject to excise tax payments and simultaneously become entitled to an excise tax deduction at a double rate. Effective 1 January 2019, the Group will apply a tax deduction on excise tax for stable gas condensate sent to processing at our Ust-Luga Complex.

*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 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 2018 and 2017:

| | 2018 | | 2017 | |
|---|---|---|---|---|
| | **Base, RR thousand** | **Rate, %** | **Base, RR thousand** | **Rate, %** |
| Pension Fund of the Russian Federation | less 1,021<br>above 1,021 | 22.0%<br>10.0% | less 876<br>above 876 | 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 815<br>above 815 | 2.9%<br>0.0% | less 755<br>above 755 | 2.9%<br>0.0% |

## OPERATIONAL HIGHLIGHTS

### Hydrocarbon production and sales volumes

In the current reporting period, our operational results were significantly impacted by the production launch at the first and second LNG trains at Yamal LNG at the end of 2017 and in July 2018, respectively, as well as the acquisitions of new production assets at the end of 2017 and during the first quarter of 2018. As a result, our total natural gas production increased by 12.6% and our total liquids production decreased slightly by 0.3%.

In the three months ended 30 September 2018, our total natural gas sales volumes increased by 1,701 mmcm, or 12.2%, primarily due to sales of LNG purchased from our joint venture Yamal LNG to international markets.

In the three months ended 30 September 2018, our liquids sales volumes increased by 214 thousand tons, or 5.8%, mainly due to changes in inventory balances that vary period-to-period depending on shipping schedules and final destinations of our liquid hydrocarbons shipments.

*Natural gas production volumes*

The following table presents natural gas production of the Group's subsidiaries by major production fields and our proportionate share in natural gas production of joint ventures by entities:

| *millions of cubic meters if not stated otherwise* | **Three months ended 30 September: 2018** | **2017** | **Change %** |
|---|---|---|---|
| **Production by subsidiaries from:** | | | |
| Yurkharovskoye field | 6,867 | 7,395 | (7.1%) |
| East-Tarkosalinskoye field | 1,665 | 1,828 | (8.9%) |
| Khancheyskoye field | 475 | 538 | (11.7%) |
| Other fields | 1,517 | 734 | 106.7% |
| **Total natural gas production by subsidiaries [1]** | **10,524** | **10,495** | **0.3%** |
| **Group's proportionate share in the production of joint ventures:** | | | |
| Arcticgas | 3,258 | 3,498 | (6.9%) |
| Yamal LNG [2] | 2,331 | 39 | n/a |
| Nortgas | 972 | 1,096 | (11.3%) |
| Terneftegas | 301 | 306 | (1.6%) |
| **Total Group's proportionate share in the natural gas production of joint ventures [1]** | **6,862** | **4,939** | **38.9%** |
| **Total natural gas production including proportionate share in the production of joint ventures** | **17,386** | **15,434** | **12.6%** |
| *The Group's proportionate share in LNG production of joint ventures (thousands of tons) [2]* | *1,462* | - | *n/a* |

[1] Natural gas production includes natural gas volumes consumed in oil and gas production and development activities (primarily, as fuel gas):

| | | | |
|---|---|---|---|
| in subsidiaries | 354 | 342 | 3.5% |
| in joint ventures (Group's proportionate share) | 80 | 104 | (23.1%) |

Production for 2017 was recalculated accordingly.

[2] Natural gas and LNG production at Yamal LNG are reported at 60% (see "Basis of presentation" above).

In the three months ended 30 September 2018, our total natural gas production (including our proportionate share in the production of joint ventures) increased by 1,952 mmcm, or 12.6%, to 17,386 mmcm from 15,434 mmcm in the corresponding period in 2017. The main factors positively impacting our production growth were the commencement of natural gas production at Yamal LNG resulting from the start of LNG production at the first and second LNG trains of the LNG liquefaction plant at the end of 2017 and in July 2018, respectively, as well as the acquisition by the Group of new production fields at the end of 2017 and during the first quarter of 2018 (the Beregovoye, the West-Yaroyakhinskoye and the Syskonsyninskoye). These factors allowed us to fully compensate for the decrease in production at mature fields of our subsidiaries (the Yurkharovskoye, the East-Tarkosalinskoye and the Khancheyskoye) and our joint venture Nortgas, which resulted mainly from natural declines in the reservoir pressure at the current gas producing horizons.

Our proportionate share in the production of Arcticgas decreased by 6.9%, of which 6.2% related to a decrease in the Group's effective participation interest in Arcticgas from 53.3% to 50.0% in March 2018 (see "Recent Developments" above).

*Natural gas sales volumes*

In the three months ended 30 September 2018, our total natural gas sales volumes increased by 1,701 mmcm, or 12.2%, to 15,589 mmcm from 13,888 mmcm in the corresponding period in 2017.

| *millions of cubic meters* | **Three months ended 30 September: 2018** | **2017** | **Change %** |
|---|---|---|---|
| Production by subsidiaries | 10,524 | 10,495 | 0.3% |
| Purchases from the Group's joint ventures | 4,133 | 2,165 | 90.9% |
| Other purchases | 2,439 | 2,407 | 1.3% |
| **Total production and purchases** | **17,096** | **15,067** | **13.5%** |
| Own usage [(1)] | (396) | (371) | 6.7% |
| Decrease (increase) in natural gas inventory balance | (1,111) | (808) | 37.5% |
| **Total natural gas sales volumes** | **15,589** | **13,888** | **12.2%** |
| *Sold to end-customers* | *12,917* | *13,388* | *(3.5%)* |
| *Sold ex-field* | *849* | *500* | *69.8%* |
| ***Subtotal sold in the Russian Federation*** | ***13,766*** | ***13,888*** | ***(0.9%)*** |
| ***Sold on international markets*** | ***1,823*** | ***-*** | ***n/a*** |

(1) Own usage associated primarily with volumes of natural gas consumed in oil and gas producing and development activities (primarily, as fuel gas), the maintaining of refining process at the Purovsky Plant, and methanol production.

In the three months ended 30 September 2018, natural gas purchases from our joint ventures increased by 1,968 mmcm, or 90.9%, to 4,133 mmcm from 2,165 mmcm in the corresponding period in 2017 primarily due to the commencement of purchases of LNG produced at Yamal LNG for subsequent sale on international markets from December 2017, and an increase in purchases of natural gas from Arcticgas in order to fulfill our Russian domestic contractual sales obligations.

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. In the three months ended 30 September 2018, we purchased from third parties 2,021 mmcm of natural gas on the Russian domestic market, and 418 mmcm of natural gas on international markets. In the corresponding period in 2017, we purchased 2,407 mmcm of natural gas on the Russian domestic market.

As of 30 September 2018, our cumulative natural gas inventory balance, mainly representing our inventory balances of natural gas in the UGSF and LNG in transit, aggregated 2,363 mmcm and increased by 1,111 mmcm during the quarter as compared to an increase by 808 mmcm in the corresponding period in 2017.

*Liquids production volumes*

The following table presents liquids production of the Group's subsidiaries by major production fields and our proportionate share in the liquids production of joint ventures by entities:

| *thousands of tons* | Three months ended 30 September: 2018 | 2017 | Change % |
|---|---|---|---|
| **Production by subsidiaries from:** | | | |
| Yarudeyskoye field | 850 | 907 | (6.3%) |
| East-Tarkosalinskoye field | 344 | 326 | 5.5% |
| Yurkharovskoye field | 305 | 361 | (15.5%) |
| Khancheyskoye field | 56 | 66 | (15.2%) |
| Other fields | 76 | 23 | 230.4% |
| **Total liquids production by subsidiaries** | **1,631** | **1,683** | **(3.1%)** |
| *including crude oil* | *1,174* | *1,208* | *(2.8%)* |
| *including gas condensate* | *457* | *475* | *(3.8%)* |
| **Group's proportionate share in the production of joint ventures:** | | | |
| Arcticgas | 952 | 1,041 | (8.5%) |
| Yamal LNG [(1)] | 155 | - | n/a |
| Terneftegas | 97 | 103 | (5.8%) |
| Nortgas | 76 | 94 | (19.1%) |
| **Total Group's proportionate share in the liquids production of joint ventures** | **1,280** | **1,238** | **3.4%** |
| **Total liquids production including proportionate share in the production of joint ventures** | **2,911** | **2,921** | **(0.3%)** |

[(1)] Production at South-Tambeyskoye field of Yamal LNG is reported at 60% (see "Basis of presentation" above).

The commencement of gas condensate production at Yamal LNG at the end of 2017, as well as the acquisition by the Group of new production fields almost compensated for the effect of a decrease in the Group's effective participation interest in Arcticgas from 53.3% to 50.0% in March 2018 (see "Recent Developments" above) and a decrease in gas condensate production at mature fields of our subsidiaries and joint ventures mainly due to natural declines in the concentration of gas condensate as a result of decreasing reservoir pressure at the current gas condensate producing horizons. As a result, in the three months ended 30 September 2018, our total liquids production (including our proportionate share in the production of joint ventures) decreased slightly by 10 thousand tons, or 0.3%, to 2,911 thousand tons from 2,921 thousand tons in the corresponding period in 2017.

*Liquids sales volumes*

In the three months ended 30 September 2018, our total liquids sales volumes increased by 214 thousand tons, or 5.8%, to 3,934 thousand tons from 3,720 thousand tons in the corresponding period in 2017.

| *thousands of tons* | **Three months ended 30 September: 2018** | **2017** | **Change %** |
|---|---|---|---|
| Production by subsidiaries | 1,631 | 1,683 | (3.1%) |
| Purchases from the Group's joint ventures | 2,220 | 2,312 | (4.0%) |
| Other purchases | 178 | 53 | 235.8% |
| **Total production and purchases** | **4,029** | **4,048** | **(0.5%)** |
| Losses (1) and own usage (2) | (51) | (58) | (12.1%) |
| Decreases (increases) in liquids inventory balances | (44) | (270) | (83.7%) |
| **Total liquids sales volumes** | **3,934** | **3,720** | **5.8%** |
| *Naphtha export* | *970* | *873* | *11.1%* |
| *Other stable gas condensate refined products export (3)* | *546* | *583* | *(6.3%)* |
| *Other stable gas condensate refined products domestic (3)* | *36* | *21* | *71.4%* |
| ***Subtotal stable gas condensate refined products*** | ***1,552*** | ***1,477*** | ***5.1%*** |
| *Crude oil export* | *385* | *337* | *14.2%* |
| *Crude oil domestic* | *749* | *771* | *(2.9%)* |
| ***Subtotal crude oil*** | ***1,134*** | ***1,108*** | ***2.3%*** |
| *LPG export* | *152* | *133* | *14.3%* |
| *LPG domestic* | *527* | *523* | *0.8%* |
| ***Subtotal LPG*** | ***679*** | ***656*** | ***3.5%*** |
| *Stable gas condensate export* | *158* | *69* | *129.0%* |
| *Stable gas condensate domestic* | *408* | *406* | *0.5%* |
| ***Subtotal stable gas condensate*** | ***566*** | ***475*** | ***19.2%*** |
| ***Other oil products*** | ***3*** | ***4*** | ***(25.0%)*** |

(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 chartered tankers.

(3) Other stable gas condensate refined products include jet fuel, gasoil and fuel oil received from the processing of stable gas condensate at the Ust-Luga Complex.

Our sales volumes of naphtha and other stable gas condensate refined products fluctuate from period-to-period depending on changes in inventory balances, with volumes of the products received from processing at the Ust-Luga Complex staying relatively flat. Our sales volumes of stable gas condensate represent the volumes remaining after we deliver most of our stable gas condensate for further processing to our Ust-Luga Complex, as well as volumes purchased by the Group for subsequent sale on international markets, including purchases from our joint venture Yamal LNG.

In the 2018 reporting period, our liquids inventory balances increased by 44 thousand tons to 850 thousand tons as of 30 September 2018 as compared to an increase in inventory balances by 270 thousand tons to 969 thousand tons in the corresponding period in 2017. Our liquids inventory balances may vary period-to-period depending on shipping schedules and final destinations (see "Changes in natural gas, liquid hydrocarbons and work-in-progress" below).

## RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED 30 SEPTEMBER 2018 COMPARED TO THE CORRESPONDING PERIOD IN 2017

The following table and discussion is a summary of our consolidated results of operations for the three months ended 30 September 2018 and 2017. Each line item is also shown as a percentage of our total revenues.

| | Three months ended 30 September: | | | |
|---|---|---|---|---|
| *millions of Russian roubles* | **2018** | **% of total revenues** | **2017** | **% of total revenues** |
| **Total revenues [1]** | **219,366** | ***100.0%*** | **130,703** | ***100.0%*** |
| *including:* | | | | |
| natural gas sales | 91,488 | *41.7%* | 54,504 | *41.7%* |
| liquids' sales | 126,446 | *57.6%* | 75,466 | *57.7%* |
| Operating expenses | (156,903) | *(71.5%)* | (94,385) | *(72.2%)* |
| Other operating income (loss) | (485) | *(0.2%)* | (222) | *(0.2%)* |
| **Profit from operations** | **61,978** | ***28.3%*** | **36,096** | ***27.6%*** |
| Finance income (expense) | 14,560 | *6.5%* | 5,061 | *3.8%* |
| Share of profit (loss) of joint ventures, net of income tax | (11,942) | *(5.4%)* | 6,875 | *5.3%* |
| **Profit before income tax** | **64,596** | ***29.4%*** | **48,032** | ***36.7%*** |
| Total income tax expense | (13,199) | *(6.0%)* | (7,866) | *(6.0%)* |
| **Profit** | **51,397** | ***23.4%*** | **40,166** | ***30.7%*** |
| Less: profit (loss) attributable to non-controlling interest | (5,497) | *(2.5%)* | (2,429) | *(1.8%)* |
| **Profit attributable to shareholders of PAO NOVATEK** | **45,900** | ***20.9%*** | **37,737** | ***28.9%*** |
| **Profit attributable to shareholders of PAO NOVATEK, excluding the effect of foreign exchange gains (losses)** | **65,522** | ***29.9%*** | **34,905** | ***26.7%*** |

[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 2018 and 2017:

| | Three months ended 30 September: | | Change | Change [1] | | |
|---|---|---|---|---|---|---|
| *millions of Russian roubles* | **2018** | **2017** | **%** | **Total** | **Due to volume [2]** | **Due to price [3]** |
| Natural gas sales | 91,488 | 54,504 | 67.9% | 36,984 | 6,675 | 30,309 |
| Stable gas condensate refined products sales | 62,185 | 39,616 | 57.0% | 22,569 | 2,112 | 20,457 |
| *Naphtha* | *39,513* | *23,984* | *64.7%* | *15,529* | *2,670* | *12,859* |
| *Other refined products* | *22,672* | *15,632* | *45.0%* | *7,040* | *(558)* | *7,598* |
| Crude oil sales | 29,479 | 18,004 | 63.7% | 11,475 | 417 | 11,058 |
| Liquefied petroleum gas sales | 18,036 | 9,815 | 83.8% | 8,221 | 334 | 7,887 |
| Stable gas condensate sales | 16,601 | 7,807 | 112.6% | 8,794 | 1,490 | 7,304 |
| Other products sales | 145 | 224 | (35.3%) | (79) | n/a | n/a |
| **Total oil and gas sales** | **217,934** | **129,970** | **67.7%** | **87,964** | **n/a** | **n/a** |
| Other revenues | 1,432 | 733 | 95.4% | 699 | n/a | n/a |
| **Total revenues** | **219,366** | **130,703** | **67.8%** | **88,663** | **n/a** | **n/a** |

(1) The figures reflect the impact of sales volumes and average realized net 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 category as a product of the average realized net price for the previous reporting period and the change in sales volumes.

(3) The amount of the change in total revenues due to average realized net prices is calculated for each product category as a product of the volume sold in the current reporting period and the change in average realized net prices.

*Natural gas sales*

Revenues from natural gas sales represent our revenues from natural gas sales in the Russian Federation (to end-customers and wholesale traders), revenues from LNG sales to international markets, as well as revenues from sales of regasified LNG to customers in Poland.

The commencement of sales of LNG purchased primarily from our joint venture Yamal LNG to international markets from December 2017, as well as an increase in sales prices in the Russian domestic market resulted in an increase in our aggregate average price by 49.6% and sales volumes by 12.2% (see "Natural gas prices" and "Natural gas sales volumes" above). As a result, in the three months ended 30 September 2018, our total revenues from natural gas sales increased by RR 36,984 million, or 67.9%, compared to the corresponding period in 2017.

*Stable gas condensate refined products sales*

Stable 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 2018, our revenues from sales of stable gas condensate refined products increased by RR 22,569 million, or 57.0%, to RR 62,185 million from RR 39,616 million in the corresponding period in 2017 primarily due to an increase in average realized prices and, to a lesser extent, an increase in naphtha sales volumes (see "Liquids sales volumes" above).

In the three months ended 30 September 2018, our revenues from sales of naphtha increased by RR 15,529 million, or 64.7%, as compared to the corresponding period in 2017. In the three months ended 30 September 2018 and 2017, we exported 970 thousand and 873 thousand tons of naphtha, respectively, mainly to the APR, and the European and North America markets. We sold naphtha at different delivery terms: CFR, CIF, DES, DAP and FOB (only in the third quarter of 2017). Our average realized net price, excluding export duties, where applicable, increased by RR 13,261 per ton, or 48.2%, to RR 40,747 per ton from RR 27,486 per ton in the corresponding period in 2017 (see "Stable gas condensate and refined products, liquefied petroleum gas and crude oil prices" above).

In the three months ended 30 September 2018, our total revenues from sales of jet fuel, gasoil and fuel oil on the domestic and export markets increased by RR 7,040 million, or 45.0%, as compared to the corresponding period in 2017. In the three months ended 30 September 2018 and 2017, we exported in aggregate 546 thousand and 583 thousand tons of these products mainly to the European markets, or 93.8% and 96.5% of total sales volumes (on the domestic and export markets), respectively. The export delivery terms were CIF, DAP, FOB, CFR (only in the third quarter of 2018) and DES (only in the third quarter of 2017). Our average realized net price, excluding export duties, where applicable, increased by RR 13,050 per ton, or 50.4%, to RR 38,938 per ton from RR 25,888 per ton in the corresponding period in 2017 (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 2018, our revenues from crude oil sales increased by RR 11,475 million, or 63.7%, compared to the corresponding period in 2017 primarily due to an increase in average realized prices.

In the three months ended 30 September 2018, we sold 749 thousand tons, or 66.0% of our total crude oil sales volumes, domestically as compared to sales of 771 thousand tons, or 69.6%, in the corresponding period in 2017. The remaining 385 thousand tons of crude oil, or 34.0% of our total crude oil sales volumes, in the current reporting period and 337 thousand tons, or 30.4%, in the corresponding period in 2017 were sold to the European and the APR markets under FOB delivery terms.

Our average realized net price, excluding export duties, where applicable, increased by RR 9,751 per ton, or 60.0%, to RR 25,996 per ton from RR 16,245 per ton in the corresponding period in 2017 (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 2018, our revenues from sales of LPG increased by RR 8,221 million, or 83.8%, compared to the corresponding period in 2017 primarily due to an increase in average realized prices.

In the three months ended 30 September 2018, we sold 527 thousand tons of LPG, or 77.6% of our total LPG sales volumes, on the domestic market compared to sales of 523 thousand tons, or 79.7%, in the corresponding period in 2017. The remaining 152 thousand tons of LPG, or 22.4% of our total LPG sales volumes, in the current reporting period and 133 thousand tons, or 20.3%, in the corresponding period in 2017 were sold to the European markets (primarily to the Polish market) under free carrier FCA (at terminal points in Poland) delivery terms and also under DAP (at the border of the customer's country) delivery terms in the third quarter of 2017.

Our average realized LPG net price, excluding export and import duties, excise and fuel taxes expense, where applicable, in the three months ended 30 September 2018 increased by RR 11,617 per ton, or 77.7%, to RR 26,564 per ton from RR 14,947 per ton in the corresponding period in 2017 (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 2018, our revenues from sales of stable gas condensate increased by RR 8,794 million, or 112.6%, compared to the corresponding period in 2017 due to an increase in average realized prices, as well as export sales volumes (see "Liquids sales volumes" above).

In the three months ended 30 September 2018, we sold 408 thousand tons of stable gas condensate, or 72.1% of our total stable gas condensate sales volumes, on the domestic market compared to sales of 406 thousand tons, or 85.5%, in the corresponding period in 2017. The remaining 158 thousand tons of stable gas condensate, or 27.9% of our total stable gas condensate sales volumes, in the current reporting period were sold to the APR, the Middle East and European markets under CFR and DAF delivery terms compared to sales of 69 thousand tons, or 14.5%, in the corresponding period in 2017 to the European markets under DAP delivery terms.

Our average realized net price, excluding export duties, where applicable, increased by RR 12,904 per ton, or 78.5%, to RR 29,334 per ton from RR 16,430 per ton in the corresponding period in 2017 (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 produced methanol. In the three months ended 30 September 2018, our revenues from other products sales decreased by RR 79 million, or 35.3%, to RR 145 million from RR 224 million in the corresponding period in 2017.

*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 2018, other revenues increased by RR 699 million, or 95.4%, to RR 1,432 million from RR 733 million in the corresponding period in 2017 primarily due to an increase in revenues from tankers transporting third party goods by RR 681 million.

## Operating expenses

In the three months ended 30 September 2018, our total operating expenses increased by RR 62,518 million, or 66.2%, to RR 156,903 million compared to RR 94,385 million in the corresponding period in 2017 mainly due to an increase in purchases of natural gas and liquid hydrocarbons as a result of an increase in volumes of natural gas purchased from our joint ventures, in particular, with the commencement of LNG production at the first and second LNG trains at Yamal LNG at the end of 2017 and in July 2018, respectively, as well as an increase in the average purchase prices for hydrocarbons (see "Purchases of natural gas and liquid hydrocarbons" below), which in turn allowed us to earn higher revenues from hydrocarbons sales.

| | **Three months ended 30 September:** | | | |
|---|---|---|---|---|
| *millions of Russian roubles* | **2018** | **% of total revenues** | **2017** | **% of total revenues** |
| Purchases of natural gas and liquid hydrocarbons | 94,158 | *42.9%* | 37,282 | *28.5%* |
| Transportation expenses | 33,672 | *15.3%* | 30,246 | *23.1%* |
| Taxes other than income tax | 15,440 | *7.0%* | 12,024 | *9.2%* |
| Depreciation, depletion and amortization | 8,511 | *3.9%* | 8,997 | *6.9%* |
| General and administrative expenses | 5,940 | *2.7%* | 3,872 | *3.0%* |
| Materials, services and other | 5,474 | *2.5%* | 5,208 | *4.0%* |
| Exploration expenses | 838 | *0.4%* | 297 | *0.2%* |
| Impairment expenses (reversals), net | 30 | *n/a* | 9 | *n/a* |
| Changes in natural gas, liquid hydrocarbons and work-in-progress | (7,160) | *n/a* | (3,550) | *n/a* |
| **Total operating expenses** | **156,903** | ***71.5%*** | **94,385** | ***72.2%*** |

*Purchases of natural gas and liquid hydrocarbons*

In the three months ended 30 September 2018, our purchases of natural gas and liquid hydrocarbons increased significantly by RR 56,876 million, or 152.6%, to RR 94,158 million from RR 37,282 million in the corresponding period in 2017.

| | **Three months ended 30 September:** | | **Change** |
|---|---|---|---|
| *millions of Russian roubles* | **2018** | **2017** | **%** |
| Unstable gas condensate | 44,755 | 26,050 | 71.8% |
| Natural gas | 42,408 | 10,150 | 317.8% |
| Other hydrocarbons | 6,995 | 1,082 | n/a |
| **Total purchases of natural gas and liquid hydrocarbons** | **94,158** | **37,282** | **152.6%** |

In the three months ended 30 September 2018, our purchases of unstable gas condensate from our joint ventures increased by RR 18,705 million, or 71.8%, as compared to the corresponding period in 2017 due to an increase in purchase prices, which are impacted by international crude oil prices excluding export duties (see "Selected macro-economic data" above).

In the three months ended 30 September 2018, our purchases of natural gas increased by RR 32,258 million, or 317.8%, as compared to the corresponding period in 2017 mainly due to the commencement of purchases of LNG produced at Yamal LNG for subsequent sale on international markets from December 2017, as well as an increase in volumes of natural gas purchased from Arcticgas in order to fulfill our contractual sales obligations on the domestic market. In addition, our purchases of natural gas increased due to an increase in purchase prices on the domestic market that are influenced by the regulated natural gas prices (see "Natural gas prices" above).

Other hydrocarbons purchases represent our purchases of oil products, LPG and stable gas condensate for subsequent resale depending on the demand for these types of products. In the three months ended 30 September 2018, our purchases of other hydrocarbons increased by RR 5,913 million, or 546.5%, as compared to the corresponding period in 2017 mainly due to purchases of stable gas condensate from Yamal LNG for subsequent sale on international markets.

*Transportation expenses*

In the three months ended 30 September 2018, our total transportation expenses increased by RR 3,426 million, or 11.3%, to RR 33,672 million as compared to RR 30,246 million in the corresponding period in 2017.

| *millions of Russian roubles* | **Three months ended 30 September:** **2018** | **2017** | **Change %** |
|---|---|---|---|
| Natural gas transportation by trunk and low-pressure pipelines | 20,955 | 20,523 | 2.1% |
| Stable gas condensate and liquefied petroleum gas transportation by rail | 7,503 | 6,782 | 10.6% |
| Stable gas condensate and refined products, crude oil and liquefied natural gas transportation by tankers | 2,997 | 1,121 | 167.4% |
| Crude oil transportation by trunk pipelines | 2,170 | 1,806 | 20.2% |
| Other | 47 | 14 | n/a |
| **Total transportation expenses** | **33,672** | **30,246** | **11.3%** |

In the three months ended 30 September 2018, our expenses for natural gas transportation by trunk and low-pressure pipelines increased by RR 432 million, or 2.1%, to RR 20,955 million from RR 20,523 million in the corresponding period in 2017 mainly due to an increase in the proportion of sales to our end-customers located at more distant regions from our production fields in the current period as compared to the reporting period in the previous year.

In the three months ended 30 September 2018, our total expenses for stable gas condensate and LPG transportation by rail increased by RR 721 million, or 10.6%, to RR 7,503 million from RR 6,782 million in the corresponding period in 2017. The increase was due to a 7.2% increase in weighted average transportation cost per unit mainly resulted from a 5.4% increase in the regulated railroad transportation tariffs effective January 2018 (see "Transportation tariffs" above), as well as a 3.2% increase in volumes of liquids sold and transported via rail.

In the three months ended 30 September 2018, our total transportation expenses for hydrocarbons delivered by tankers to international markets increased by RR 1,876 million, or 167.4%, to RR 2,997 million from RR 1,121 million in the corresponding period in 2017 primarily due to the commencement of sales of LNG purchased mainly from Yamal LNG to international markets from December 2017. In addition, the increase was also due to a 20.3% increase in volumes of stable gas condensate and its refined products sold and transported via tankers, as well as a 11.0% depreciation of the average exchange rate of the Russian rouble relative to the US dollar (since all our tankers transportation expenses are US dollar denominated).

In the three months ended 30 September 2018, our expenses for crude oil transportation to customers by trunk pipeline increased by RR 364 million, or 20.2%, to RR 2,170 million from RR 1,806 million in the corresponding period in 2017. The increase was due to an increase in the proportion of crude oil sales to more distant regions from our production fields, a 3.9% increase in the regulated transportation tariffs effective 1 January 2018 (see "Transportation tariffs" above), as well as a 2.3% increase in sales volumes compared to the corresponding period of the prior year.

*Taxes other than income tax*

In the three months ended 30 September 2018, taxes other than income tax increased by RR 3,416 million, or 28.4%, to RR 15,440 million from RR 12,024 million in the corresponding period in 2017.

| *millions of Russian roubles* | **Three months ended 30 September:** **2018** | **2017** | **Change %** |
|---|---|---|---|
| Unified natural resources production tax (UPT) | 14,471 | 11,160 | 29.7% |
| Property tax | 909 | 765 | 18.8% |
| Other taxes | 60 | 99 | (39.4%) |
| **Total taxes other than income tax** | **15,440** | **12,024** | **28.4%** |

In the three months ended 30 September 2018, our unified natural resources production tax expense increased by RR 3,311 million, or 29.7%, to RR 14,471 million from RR 11,160 million in the corresponding period in 2017 mainly due to an increase in UPT rates for crude oil and natural gas as a result of an increase in benchmark crude oil prices, as well as due to changes in the formula for crude oil UPT rate calculation effective 1 January 2018 (see "Our tax burden and obligatory payments" above).

In the three months ended 30 September 2018, our property tax expense increased by RR 144 million, or 18.8%, to RR 909 million from RR 765 million in the corresponding period in 2017 due to acquisitions of new production assets at the end of 2017 and in the first quarter of 2018, as well as additions to property, plant and equipment at our other production subsidiaries.

*Depreciation, depletion and amortization*

In the three months ended 30 September 2018, our depreciation, depletion and amortization ("DDA") expense decreased by RR 486 million, or 5.4%, to RR 8,511 million from RR 8,997 million in the corresponding period in 2017 mainly due to an increase in total proved reserves (excluding acquisitions) in our subsidiaries as at the end of 2017 compared to the previous period. This effect was partially offset as a result of consolidating new production assets at the end of 2017 and in the first quarter of 2018. 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.

*General and administrative expenses*

In the three months ended 30 September 2018, our general and administrative expenses increased by RR 2,068 million, or 53.4%, to RR 5,940 million compared to RR 3,872 million in the corresponding period in 2017. The main components of these expenses were employee compensation and social expenses and compensatory payments, which, on aggregate, comprised 83.6% and 80.1% of total general and administrative expenses in the three months ended 30 September 2018 and 2017, respectively.

| | **Three months ended 30 September:** | | **Change** |
|---|---|---|---|
| *millions of Russian roubles* | **2018** | **2017** | **%** |
| Employee compensation | 3,722 | 2,423 | 53.6% |
| Social expenses and compensatory payments | 1,245 | 678 | 83.6% |
| Legal, audit and consulting services | 252 | 237 | 6.3% |
| Business travel expense | 192 | 149 | 28.9% |
| Fire safety and security expenses | 119 | 108 | 10.2% |
| Advertising expenses | 115 | 27 | 325.9% |
| Rent expense | 75 | 27 | 177.8% |
| Repair and maintenance expenses | 57 | 55 | 3.6% |
| Other | 163 | 168 | (3.0%) |
| **Total general and administrative expenses** | **5,940** | **3,872** | **53.4%** |

Employee compensation relating to administrative personnel increased by RR 1,299 million, or 53.6%, to RR 3,722 million in the three months ended 30 September 2018 from RR 2,423 million in the corresponding period in 2017 due to an indexation of base salaries effective from 1 July 2018, an increase in accrued provision for bonuses to key management and the related increase in social contributions for medical and social insurance and to the Pension Fund, as well as the acquisition of new assets at the end of 2017 and in the first quarter of 2018.

In the three months ended 30 September 2018, our social expenses and compensatory payments increased by RR 567 million, or 83.6%, to RR 1,245 million compared to RR 678 million in the corresponding period in 2017. The increase was largely due to increased social expenses related mainly to continued support of charities and social programs in the regions where we operate. In addition, in both reporting periods, we made compensatory payments in the amount of RR 231 million and RR 360 million, respectively, which mainly related to the development of the Yarudeyskoye field. Social expenses and compensatory payments fluctuate period-on-period depending on the implementation schedules of specific programs we support.

Advertising expenses increased by RR 88 million, or 325.9%, to RR 115 million compared to RR 27 million in the corresponding period in 2017 and related to advertising during sporting events, exhibitions and conferences. Advertising expenses fluctuate period-on-period depending on events schedules.

Other items of our general and administrative expenses changed marginally.

*Materials, services and other*

In the three months ended 30 September 2018, our materials, services and other expenses increased by RR 266 million, or 5.1%, to RR 5,474 million compared to RR 5,208 million in the corresponding period in 2017.

| | Three months ended 30 September: | | Change |
|---|---|---|---|
| *millions of Russian roubles* | **2018** | **2017** | **%** |
| Employee compensation | 2,300 | 2,114 | 8.8% |
| Repair and maintenance | 772 | 813 | (5.0%) |
| Materials and supplies | 487 | 554 | (12.1%) |
| Complex of services for preparation, transportation and processing of hydrocarbons | 486 | 473 | 2.7% |
| Electricity and fuel | 295 | 291 | 1.4% |
| Liquefied petroleum gas volumes reservation expenses | 289 | 216 | 33.8% |
| Fire safety and security expenses | 256 | 191 | 34.0% |
| Transportation services | 223 | 185 | 20.5% |
| Rent expenses | 95 | 79 | 20.3% |
| Insurance expense | 91 | 115 | (20.9%) |
| Other | 180 | 177 | 1.7% |
| **Total materials, services and other** | **5,474** | **5,208** | **5.1%** |

Employee compensation relating to operating personnel increased by RR 186 million, or 8.8%, to RR 2,300 million compared to RR 2,114 million in the corresponding period in 2017 due to the acquisition of new production assets at the end of 2017 and in the first quarter of 2018, an indexation of base salaries effective from 1 July 2018 and the related increase in social contributions for medical and social insurance and to the Pension Fund.

Other items of our materials, services and other expenses changed marginally.

*Exploration expenses*

In the three months ended 30 September 2018, our exploration expenses increased by RR 541 million, or 182.2%, to RR 838 million from RR 297 million in the corresponding period in 2017 mainly due to an increase in exploration works performed at the North-Obskiy license area, as well as expenses related to purchase and interpretation of seismic data on offshore blocks in Lebanon located in the Eastern Mediterranean. The increase in exploration works will ensure timely preparation of reserves at our promising fields for development and further progress of the Group's hydrocarbons production projects in line with our long-term strategy. Exploration expenses include geological and geophysical research services expenditures, expenditures associated with the maintenance of license areas with non-proven reserves and other expenditures relating to exploration activity, as well as expenses of our science and technology center associated with the exploration activities at our fields. 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 2018 and 2017, we recorded reversals of RR 7,160 million and RR 3,550 million, respectively, to changes in inventory expense due to increases in our natural gas (including LNG) and liquid hydrocarbons inventory balances in both reporting periods.

In the three months ended 30 September 2018 and 2017, our cumulative natural gas inventory balance representing mainly our inventory balances of natural gas in the Underground Gas Storage Facilities ("UGSF") and LNG in transit increased by 1,111 mmcm and 808 mmcm, respectively. Increases in inventory balances in both reporting periods were mainly due to seasonal injection of natural gas into the UGSF for the subsequent sale in the period of higher seasonal demand, as well as due to the recognition of waterborne LNG inventory balances in transit not realized at the end of the third quarter of 2018. Natural gas inventory balances tend to fluctuate period-to-period depending on the Group's demand for natural gas withdrawal from the UGSF for the sale in the subsequent periods in the Russian Federation, as well as depending on shipment schedules and final destination of our LNG shipments via tankers.

In the three months ended 30 September 2018, our cumulative liquid hydrocarbons inventory balances, recognized as inventory in transit or in storage, increased by 44 thousand tons mainly due to an increase in inventory balance of stable gas condensate in tankers in transit not realized at the reporting date. In the corresponding period in 2017, our cumulative liquid hydrocarbons inventory balances increased by 270 thousand tons due to an increase in inventory balance of naphtha in tankers in transit not realized at the reporting date, as well as an increase in crude oil inventory balances. 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:

| | **2018** | | | **2017** | | |
|---|---|---|---|---|---|---|
| *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)** | **2,363** | **1,252** | **1,111** | **1,419** | **611** | **808** |
| *incl. Gazprom's UGSF* | *2,119* | *1,170* | *949* | *1,365* | *550* | *815* |
| *tankers in transit (LNG)* | *209* | *-* | *209* | *-* | *-* | *-* |
| **Liquid hydrocarbons (thousand tons)** | **850** | **806** | **44** | **969** | **699** | **270** |
| *incl. stable gas condensate* | | | | | | |
| *refined products* | *346* | *334* | *12* | *449* | *264* | *185* |
| *stable gas condensate* | *298* | *259* | *39* | *254* | *227* | *27* |
| *crude oil* | *103* | *107* | *(4)* | *158* | *108* | *50* |

## 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 2018, we recognized other operating loss of RR 485 million compared to other operating loss of RR 222 million in the corresponding period in 2017.

In the three months ended 30 September 2018, within our trading activities we purchased and sold approximately 1.8 bcm of natural gas, as well as various derivative commodity instruments, and recognized the aggregate realized loss from trading activities of RR 466 million as compared to RR 212 million of loss in the corresponding period in 2017. At the same time, we recognized non-cash loss of RR 225 million in the three months ended 30 September 2018 as a result of a decrease in the fair value of aforementioned contracts as compared to RR 8 million of non-cash gain in the corresponding period in 2017. The effect of the change in fair value of the commodity contracts fluctuate from period to period depending on the forecast prices for hydrocarbons on international markets and other macroeconomic parameters and may or may not reflect actual future cash flows from trading activities.

**Profit from operations and EBITDA**

In the three months ended 30 September 2018, our profit from operations and EBITDA including our proportionate share of joint ventures increased due to the production launch at the first and second LNG trains at Yamal LNG in the end of 2017 and in July 2018, respectively, and an increase in average realized liquid hydrocarbons and natural gas prices.

Our aggregate EBITDA including our proportionate share of joint ventures increased to RR 118,091 million from RR 59,270 million in the corresponding period in 2017. Our cumulative profit from operations including our proportionate share of joint ventures amounted to RR 100,913 million as compared to RR 45,696 million in the corresponding period in 2017, including profit from operations of our subsidiaries in the amount of RR 61,978 million and RR 36,096 million, respectively.

**Finance income (expense)**

In the three months ended 30 September 2018, we recorded net finance income of RR 14,560 million compared to RR 5,061 million in the corresponding period in 2017.

| *millions of Russian roubles* | **Three months ended 30 September: 2018** | **2017** | **Change %** |
|---|---|---|---|
| Accrued interest expense on loans received | (2,164) | (2,498) | (13.4%) |
| Less: capitalized interest | 1,330 | 809 | 64.4% |
| Provisions for asset retirement obligations: | | | |
| effect of the present value discount unwinding | (153) | (189) | (19.0%) |
| Interest expense on lease liabilities | (126) | (36) | 250.0% |
| **Interest expense** | **(1,113)** | **(1,914)** | **(41.8%)** |
| Interest income | 3,666 | 3,857 | (5.0%) |
| Change in fair value of non-commodity financial instruments | 2,384 | 57 | n/a |
| Foreign exchange gain (loss), net | 9,623 | 3,061 | 214.4% |
| **Total finance income (expense)** | **14,560** | **5,061** | **187.7%** |

In the three months ended 30 September 2018, our interest expense decreased by RR 801 million, or 41.8%, to RR 1,113 million primarily due to repayments of the Group's borrowings.

Interest income decreased by RR 191 million, or 5.0%, to RR 3,666 million in the three months ended 30 September 2018 from RR 3,857 million in the corresponding period in 2017. In both reporting periods, interest income primarily related to loans provided to our joint ventures for the development and expansion of their activities. According to IFRS 9 "*Financial instruments*", the Group accounts for the most of these loans as at fair value through profit or loss with a portion of changes in fair value relating to interest income (calculated based on the amortised cost of the loans using the effective interest method) presented separately from other factors of changes in fair value (such as changes in interest rates and expected maturities).

In the three months ended 30 September 2018, we recognized a non-cash gain of RR 2,384 million compared to RR 57 million in the corresponding period in 2017 due to the remeasurement of the shareholders' loans issued by the Group to our joint ventures in accordance with IFRS 9 *"Financial instruments"*. 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 2018, we recorded a net foreign exchange gain of RR 9,623 million compared to RR 3,061 million in the corresponding period in 2017 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 2018, the Group's proportionate share of loss of joint ventures amounted to RR 11,942 million as compared to the share of profit of joint ventures in the amount of RR 6,875 million in the corresponding period in 2017.

| *millions of Russian roubles* | Three months ended 30 September: 2018 | 2017 | Change % |
|---|---|---|---|
| **Share in profit from operations** | **38,935** | **9,600** | **305.6%** |
| **Share in finance income (expense)** | | | |
| Share in interest income (expense), net | (11,760) | (2,687) | 337.7% |
| Share in foreign exchange gain (loss), net | (32,733) | 456 | n/a |
| Share in change in fair value of non-commodity financial instruments | (6,367) | 1,223 | n/a |
| **Total share in finance income (expense)** | **(50,860)** | **(1,008)** | **n/a** |
| Share in total income tax benefit (expense) | (17) | (1,717) | (99.0%) |
| **Total share of profit (loss) of joint ventures, net of income tax** | **(11,942)** | **6,875** | **n/a** |

Our proportionate share in the profit from operations of our joint ventures significantly increased by RR 29,335 million, or by approximately four-fold, mainly due to the production launch at the first and second LNG trains at Yamal LNG in the end of 2017 and in July 2018, respectively, as well as an increase in revenues from liquid hydrocarbons sales in our joint ventures as a result of higher average realized prices.

In the three months ended 30 September 2018, our proportionate share in the finance expense of our joint ventures significantly increased by RR 49,852 million, compared to the corresponding period in 2017. The main factor impacting the increase in our share in finance expense was the recognition of a significant non-cash foreign exchange loss in the current reporting period (our share amounted to RR 32.7 billion). The non-cash loss primarily related to the revaluation of foreign currency denominated loans in our joint venture Yamal LNG as compared to the recognition of an insignificant foreign exchange gain in the corresponding prior year period. In addition, our share in interest expense increased by RR 9.1 billion mainly due to the commencement of LNG production at Yamal LNG and the cessation of the respective interest expense capitalization. The remaining change related to the recognition of a non-cash loss from the remeasurement of the fair value of shareholders' loans in Yamal LNG and Terneftegas (our share amounted to RR 6.4 billion) in the current reporting period as compared to the recognition of a non-cash gain (our share amounted to RR 1.2 billion) in the third quarter of 2017.

### 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 2018 and 2017, was 17.8% and 19.3%, respectively.

### Profit attributable to shareholders and earnings per share

As a result of the factors discussed in the respective sections above, profit attributable to shareholders of PAO NOVATEK increased by RR 8,163 million, or 21.6%, to RR 45,900 million in the three months ended 30 September 2018 compared to RR 37,737 million in the corresponding period in 2017.

In each reporting period, as a result of currency exchange rates fluctuations, the Group records non-cash foreign exchange gains and/or losses primarily related to the revaluation of foreign currency denominated borrowings and loans provided in the Group and the joint ventures. Excluding the effect of foreign exchange gains and losses, our profit attributable to shareholders of PAO NOVATEK increased by RR 30,617 million, or 87.7%, and amounted to RR 65,522 million in the three months ended 30 September 2018 compared to RR 34,905 million in the corresponding period in 2017 (see the table below):

| *millions of Russian roubles* | **Three months ended 30 September: 2018** | **2017** | **Change %** |
|---|---|---|---|
| **Profit attributable to shareholders of PAO NOVATEK** | **45,900** | **37,737** | **21.6%** |
| Foreign exchange (gains) losses | (9,623) | (3,061) | 214.4% |
| Income tax expense (benefit) relating to foreign exchange (gains) losses | 1,925 | 612 | 214.5% |
| Share of foreign exchange (gains) losses of joint ventures | 32,733 | (456) | n/a |
| Share of income tax expense (benefit) relating to foreign exchange (gains) losses of joint ventures | (5,413) | 73 | n/a |
| **Profit attributable to shareholders of PAO NOVATEK, excluding the effect of foreign exchange gains (losses)** | **65,522** | **34,905** | **87.7%** |

Our weighted average basic and diluted earnings per share, calculated from the profit attributable to shareholders of PAO NOVATEK increased by RR 2.72 per share, or 21.7%, to RR 15.23 per share in the three months ended 30 September 2018 from RR 12.51 per share in the corresponding period in 2017. Excluding the effects of foreign exchange gains and losses, our weighted average basic and diluted earnings per share increased by RR 10.18, or 87.9%, to RR 21.75 per share in the three months ended 30 September 2018 from RR 11.57 per share in the corresponding period in 2017.

## 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 2018 and 2017:

| | Three months ended 30 September: | | Change |
|---|---|---|---|
| *millions of Russian roubles* | **2018** | **2017** | **%** |
| Net cash provided by **operating** activities | 50,371 | 35,122 | 43.4% |
| Net cash used for **investing** activities | (25,328) | (12,506) | 102.5% |
| Net cash used for **financing** activities | (7,041) | (11,397) | (38.2%) |

*Net cash provided by operating activities*

Our net cash provided by operating activities increased by RR 15,249 million, or 43.4%, to RR 50,371 million compared to RR 35,122 million in the corresponding period in 2017 primarily due to an increase in profit from operations adjusted for non-cash items, net of related income tax, as well as an increase in dividends received from our joint ventures. These effects were partially offset by changes in working capital, which vary period-to-period depending on various factors.

| | Three months ended 30 September: | | Change |
|---|---|---|---|
| *millions of Russian roubles* | **2018** | **2017** | **%** |
| Profit from operations | 61,978 | 36,096 | 71.7% |
| Non-cash adjustments [(1)] | 8,995 | 9,150 | (1.7%) |
| Changes in working capital and long-term advances given | (11,358) | (281) | n/a |
| Dividends received from joint ventures | 3,625 | 771 | 370.2% |
| Interest received | 179 | 353 | (49.3%) |
| Income taxes paid | (13,048) | (10,967) | 19.0% |
| **Total net cash provided by operating activities** | **50,371** | **35,122** | **43.4%** |

[(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.

Profit from operations adjusted for non-cash items increased due to the production launch at the first and second LNG trains at Yamal LNG in the end of 2017 and in July 2018, respectively, and an increase in average realized liquid hydrocarbons and natural gas prices (see "Profit from operations and EBITDA" above).

In the reporting periods of 2018 and 2017, we received RR 3,625 million and RR 771 million, respectively, of dividends from our joint venture Nortgas.

*Net cash used for investing activities*

In the three months ended 30 September 2018, our net cash used for investing activities increased by RR 12,822 million, or 102.5%, to RR 25,328 million compared to RR 12,506 million in the corresponding period in 2017.

| *millions of Russian roubles* | Three months ended 30 September: 2018 | 2017 | Change % |
|---|---|---|---|
| Cash used for capital expenditures | (24,783) | (5,678) | 336.5% |
| Loans provided to joint ventures | (2,567) | - | n/a |
| Repayments of loans provided to joint ventures | 433 | 2,189 | (80.2%) |
| Proceeds from disposals of property, plant and equipment and materials for construction | 2,117 | - | n/a |
| Payments for mineral licenses | - | (6,991) | n/a |
| Acquisition of joint ventures | - | (1,583) | n/a |
| Other | (528) | (443) | 19.2% |
| **Net cash used for investing activities** | **(25,328)** | **(12,506)** | **102.5%** |

Cash used for capital expenditures increased by RR 19,105 million, or 4.4 times, as compared to the 2017 reporting period primarily due to investments in our future LNG projects, the ongoing development at the North-Russkiy and East-Tazovskiy fields, as well as exploration drilling at the North-Obskiy license area (see "Capital expenditures" below).

In the current reporting period, we provided loans to our joint venture Yamal LNG in the aggregate amount of RR 2,567 million for financing the construction of the fourth LNG train. In addition, in the three months ended 30 September 2018 and 2017, we received RR 433 million and RR 2,189 million, respectively, due to partial repayments of the loans provided to Terneftegas and Yamal Development (only in the third quarter of 2017).

In the current quarter, we received RR 2,117 million from disposals of property, plant and equipment and materials for construction, which primarily related to the assignment of rights to our joint venture Yamal LNG under concluded contracts for design and equipment production for the fourth LNG train, as well as materials purchased for this purpose.

In the three months ended 30 September 2017, we made payments in the amount of RR 6,786 million for participation in auctions for the right for geological research works, exploration and production of hydrocarbons at license areas, which include the Shtormovoye, the Verhnetiuteyskoye and the West-Seyakhinskoye fields (according to the results of the auctions, the license fee payments were set in total at RR 7,465 million). In the third quarter of 2017, we also made a final payment in the amount of RR 205 million for the right for the usage of the Gydanskiy license area (an advance payment of RR 2,057 million was made in the second quarter of 2017).

In July 2017, the Group acquired a 51% ownership interest in OOO Cryogas-Vysotsk for RR 1,583 million.

*Net cash used for financing activities*

In the three months ended 30 September 2018, our net cash used for financing activities decreased by RR 4,356 million, or 38.2%, to RR 7,041 million as compared to RR 11,397 million in the corresponding period in 2017.

| *millions of Russian roubles* | **Three months ended 30 September: 2018** | **2017** | **Change %** |
|---|---|---|---|
| Repayments of long-term debt | (1,141) | (10,110) | (88.7%) |
| Proceeds from (repayments of) short-term debt with original maturity three months or less | - | (13) | n/a |
| Dividends paid to non-controlling interest | (5,254) | - | n/a |
| Interest paid | (77) | (974) | (92.1%) |
| Purchase of treasury shares | - | (169) | n/a |
| Payments of lease liabilities | (569) | (131) | 334.4% |
| **Net cash used for financing activities** | **(7,041)** | **(11,397)** | **(38.2%)** |

In both reporting periods, we did not obtain any new long-term loans. In the three months ended 30 September 2018, the Group fully repaid a loan obtained by a Group subsidiary from its non-controlling shareholder. In the third quarter of 2017, the Group partially repaid a loan obtained under our syndicated credit line facility in the amount of RR 6,577 million (USD 115 million) according to the loan's maturity schedule, as well as partially repaid a loan obtained by a Group subsidiary from its non-controlling shareholder.

The remaining change related primarily to dividends paid, the repayment of interest on borrowings and loans and shares buy-back.

## Liquidity and working capital

The following table shows the Group's liquidity and credit measures as of 30 September 2018 and 31 December 2017:

| | **30 September 2018** | **31 December 2017** | **Change, %** |
|---|---|---|---|
| **Absolute amounts, RR million** | | | |
| Net debt [(1)] | 77,638 | 89,807 | (13.6%) |
| Net working capital position [(2)] | 125,911 | 69,478 | 81.2% |
| **Liquidity and credit ratios** | | | |
| Current ratio [(3)] | 1.90 | 1.83 | 3.8% |
| Total debt to total equity | 0.19 | 0.20 | (5.0%) |
| Long-term debt to long-term debt and total equity | 0.16 | 0.15 | 6.7% |
| Net debt to total capitalization [(4)] | 0.07 | 0.09 | (22.2%) |
| Net debt to normalized EBITDA from subsidiaries [(5)] | 0.31 | 0.45 | (31.1%) |

(1) Net debt represents total debt less cash, cash equivalents and bank deposits with original maturity more than three months.

(2) Net working capital position represents current assets less current liabilities.

(3) Current ratio is calculated as current assets 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.

In each quarter of 2017 and 2018, the Group demonstrated high operating results and achieved 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, processing facilities and other assets:

| | Three months ended 30 September: | |
|---|---|---|
| *millions of Russian roubles* | **2018** | **2017** |
| Infrastructure for future LNG projects [(1)] | 4,816 | 580 |
| Arctic LNG 2 project | 4,624 | 910 |
| North-Russkiy and East-Tazovskiy license areas | 3,267 | 1,264 |
| North-Obskiy license area | 1,658 | 405 |
| East-Tarkosalinskoye field | 1,505 | 1,181 |
| Ust-Luga Complex | 1,134 | 63 |
| Yarudeyskoye field | 997 | 1,682 |
| Gydanskiy license area | 687 | 2 |
| West-Yurkharovskoye field | 654 | 71 |
| Other | 4,950 | 774 |
| **Capital expenditures** | **24,292** | **6,932** |

[(1)] Includes, among others, the project for the construction of a center to build and fabricate large-scale marine facilities located in the Murmansk region.

Total capital expenditures on property, plant and equipment in the three months ended 30 September 2018 significantly increased by RR 17,360 million, or 250.4%, to RR 24,292 million from RR 6,932 million. In both reporting periods, a significant part of our capital expenditures related to the development of our future LNG projects: the Arctic LNG 2 project and the project for the construction of a center to build and fabricate large-scale marine facilities located in the Murmansk region. In this regard, we continued to invest in the development of the Salmanovskoye (Utrenneye) field and the development of the front-end engineering design (FEED) for the Arctic LNG 2 plant, as well as continued constructing our center in the Murmansk region (constructing buildings and facilities foundations for gravity-based platforms construction site and concrete plant, building berths and other works).

In both reporting periods, we also continued ongoing development of the Yarudeyskoye and East-Tarkosalinskoye field's crude oil deposits. In the current reporting period, we significantly increased our capital expenditures related to the ongoing development activities at the North-Russkiy and East-Tazovskiy fields, as well as exploration drilling at the North-Obskiy license area. In addition, in the third quarter of 2018, we invested in the project for construction of a hydrocracker unit at our Ust-Luga Complex, which will allow us to increase the depth of processing of stable gas condensate and output of light oil products.

The "Other" line in the table above represents our capital expenditures related to other fields and processing facilities of the Group, as well as unallocated capital expenditures as of the reporting date. The allocation of capital expenditures by fields or processing facilities 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, and cash used for capital expenditures:

| *millions of Russian roubles* | **Three months ended 30 September: 2018** | **2017** | **Change %** |
|---|---|---|---|
| **Total additions to property, plant and equipment per Note "Property, plant and equipment" in the Group's IFRS Consolidated Financial Statements** | **24,292** | **16,222** | **49.7%** |
| Less: acquisition of mineral licenses | - | (6,991) | n/a |
| Less: right-of-use assets [(1)] additions | - | (2,299) | n/a |
| **Capital expenditures** | **24,292** | **6,932** | **250.4%** |
| Add (less): change in accounts payable, capitalized foreign exchange losses and other non-cash adjustments | 491 | (1,254) | n/a |
| **Cash used for capital expenditures [(2)]** | **24,783** | **5,678** | **336.5%** |

(1) In 2017, related mainly to long-term agreements on time chartering of marine tankers.

(2) 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 and joint ventures.

In the third quarter of 2017, we paid RR 6,786 million for the auctions won in August 2017 for the right for geological research works, exploration and hydrocarbons production at license areas, which include the Shtormovoye, the Verhnetiuteyskoye and the West-Seyakhinskoye fields. In addition, in the third quarter of 2017, the Group made a final payment in the amount of RR 205 million for the right for the usage of the Gydanskiy license area won at the auction held in June 2017.

## 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 2018, the total amount of our debt denominated in US dollars was RR 153,866 million, or 94.7% 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, 55.0% in the three months ended 30 September 2018, was denominated in foreign currencies.

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 foreign currency risk relating to the debt portfolio of Yamal LNG will be mitigated by the fact that all of its products will be delivered to international markets and its revenues will be denominated in foreign currencies.

As of 30 September 2018, the Russian rouble depreciated by 13.9% and 10.7% against the US dollar and the Euro, respectively, compared to 31 December 2017.

### Commodity risk

Our export prices for natural gas, stable gas condensate and refined products, LPG and crude oil are primarily linked to international natural gas, crude oil and oil products prices and/or a combination thereof. 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 stable 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.

Within our trading activities, 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 within the Russian Federation territory 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 the domestic market. 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.

**Forward-looking statements**

This report includes forward-looking statements concerning future possible events that can impact operational and financial results of the Group. Forward-looking statements can be identified by words such as “believes”, “anticipates”, “expects”, “estimates”, “intends”, “plans” and similar expressions. Forward-looking statements are made based on the current situation with definite and indefinite risks and uncertainties. Actual future results could differ materially from those discussed in the forward-looking statements as they are dependent on various factors beyond and under the control of management.

**Off balance sheet activities**

As of 30 September 2018, 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" |
| **DAP** | "Delivery at point of destination" |
| **DDA** | depreciation, depletion and amortization |
| **DES** | "Delivery to the port of destination ex-ship" |
| **FCA** | "Free carrier" |
| **FEED** | Front-End Engineering Design |
| **FOB** | "Free on board" |
| **Forecast of the Ministry of Economic Development** | The document *"Forecast of Socio-economic Development of the Russian Federation for the period till 2024"* prepared by the Ministry of Economic Development of the Russian Federation or the similar document prepared for another period |
| **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 |
| **NGL** | natural gas liquids |
| **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. Effective July 2015, Federal Anti-Monopoly Service fulfills the Regulator's role. |
| **RR** | Russian rouble(s) |
| **RZD** | OAO Russian Railways, Russia's state-owned monopoly railway operator |
| **SEC** | Securities and Exchange Commission |
| **Tobolsk Refining Facilities** | Refining facilities of OOO SIBUR Tobolsk |
| **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 |