

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

The following discussion and analysis should be read in conjunction with our unaudited consolidated interim condensed financial information as of and for the six months ended June 30, 2014. The consolidated interim condensed financial information has been prepared in accordance with International Accounting Standard 34 "Interim financial reporting" ("IAS 34"). This financial information should be read together with the consolidated financial statements for the year ended December 31, 2013, prepared in accordance with International Financial Reporting Standards ("IFRS").

OVERVIEW

We are one of the world's largest gas and oil companies in terms of reserves, production and market capitalization. Our revenues are primarily derived from sales of natural gas, crude oil and other hydrocarbon products to Western and Central Europe, Russia and other former Soviet Union countries.

We divide our operations into the following principal businesses:

- Production of gas – exploration and production of gas;
- Transport – transportation of gas;
- Distribution – sales of gas within Russian Federation and abroad;
- Gas storage – storage of extracted and purchased gas in underground gas storages;
- Production of crude oil and gas condensate – exploration and production of oil and gas condensate, sales of crude oil and gas condensate;
- Refining – processing of oil, gas condensate and other hydrocarbons, and sales of refined products; and
- Electric and heat energy generation and sales.

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

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

RESULTS OF OPERATIONS

(RUB million)

	Six-month period ended June 30,	
	2014	2013
Sales	2,873,932	2,568,122
Net gain from trading activity	14,377	3,764
Operating expenses	<u>(2,248,659)</u>	<u>(1,718,884)</u>
Operating profit	639,650	853,002
Finance income	165,596	38,501
Finance expense	(218,540)	(162,479)
Share of net income of associated undertakings and joint ventures	47,884	12,804
(Losses) gains on disposal of available-for-sale financial assets	<u>(26)</u>	<u>16</u>
Profit before profit tax	634,564	741,844
Current profit tax expense	(124,525)	(42,992)
Deferred profit tax expense	<u>(44,813)</u>	<u>(105,447)</u>
Profit tax expense	(169,338)	(148,439)
Profit for the period	465,226	593,405
Other comprehensive (loss) income:		
Items that will not be reclassified to profit or loss:		
Remeasurements of post-employment benefit obligations	<u>(6,463)</u>	<u>75,623</u>
Total items that will not be reclassified to profit or loss	(6,463)	75,623
Items that will be reclassified to profit or loss:		
Losses arising from change in fair value of available-for-sale financial assets, net of tax	(8,850)	(2,588)
Share of other comprehensive (loss) income of associated undertakings and joint ventures	(3,403)	4,138
Translation differences	13,667	49,247
Losses from cash flow hedges, net of tax	<u>(6,971)</u>	<u>(3,981)</u>
Total items that will be reclassified to profit or loss	(5,557)	46,816
Other comprehensive (loss) income for the period, net of tax	(12,020)	122,439
Total comprehensive income for the period	453,206	715,844
Profit attributable to:		
Owners of OAO Gazprom	450,578	582,683
Non-controlling interest	<u>14,648</u>	<u>10,722</u>
	465,226	593,405
Total comprehensive income attributable to:		
Owners of OAO Gazprom	438,470	702,329
Non-controlling interest	<u>14,736</u>	<u>13,515</u>
	453,206	715,844

Sales

The following table sets out our volumes and realized prices:

(RUB million unless indicated otherwise)	Six-month period ended June 30,	
	2014	2013
Sales of gas		
<i>Europe and Other Countries</i>		
Gross sales ⁽¹⁾	1,104,040	1,022,453
Customs duties	(220,844)	(198,034)
Net sales	883,196	824,419
Volumes in billion cubic meters (bcm)	86.0	85.5
Gross average price, U.S.\$ per mcm ⁽²⁾ (including customs duties) ⁽³⁾	366.1	385.1
Gross average price, RUB per mcm ⁽²⁾ (including customs duties)	12,843.4	11,953.6
<i>FSU (Former Soviet Union)</i>		
Gross sales ⁽¹⁾	320,337	216,409
Customs duties	(57,390)	(36,854)
Net sales	262,947	179,555
Volumes in bcm	30.7	27.4
Gross average price, U.S.\$ per mcm ⁽²⁾ (including customs duties, net of VAT) ⁽³⁾	297.7	254.4
Gross average price, RUB per mcm ⁽²⁾ (including customs duties, net of VAT)	10,445.7	7,897.6
<i>Russian Federation</i>		
Gross sales (net of VAT)	440,528	411,013
Net sales	440,528	411,013
Volumes in bcm	125.4	133.6
Gross average price, RUB per mcm ⁽²⁾ (net of VAT)	3,513.5	3,075.5
<i>Total sales of gas</i>		
Gross sales (net of VAT)	1,864,905	1,649,875
Customs duties	(278,234)	(234,888)
Effect of retroactive gas price adjustments	-	73,430
Net sales	1,586,671	1,488,417
Volumes in bcm	242.1	246.5
Net sales of refined products (net of excise tax, VAT and customs duties)	793,632	639,643
Net sales of electric and heat energy (net of VAT)	218,683	179,566
Net sales of crude oil and gas condensate (net of VAT and customs duties)	104,798	99,789
Gas transportation net sales (net of VAT)	82,721	80,495
Other revenues (net of VAT)	<u>87,427</u>	<u>80,212</u>
Total sales (net of excise tax, VAT and customs duties)	<u>2,873,932</u>	<u>2,568,122</u>

Notes:

⁽¹⁾ VAT is not charged on sales to Europe and Other Countries as well as FSU countries.

⁽²⁾ One mcm is equivalent to 35,316 cubic feet.

⁽³⁾ Calculated on the basis of average exchange rate between RUB and U.S.\$.

Total sales (net of excise tax, VAT and customs duties) increased by RUB 305,810 million, or 12%, to RUB 2,873,932 million in the six-month period ended June 30, 2014 compared to the same period of the prior year.

Net sales of gas accounted for 55% and 58% of total net sales in the six-month period ended June 30, 2014 and 2013, respectively.

Net sales of gas increased by RUB 98,254 million, or 7%, from RUB 1,488,417 million in the six-month period ended June 30, 2013 to RUB 1,586,671 million in the six-month period ended June 30, 2014.

Net sales of gas to Europe and Other Countries increased by RUB 58,777 million, or 7%, to RUB 883,196 million in the six-month period ended June 30, 2014 as compared to the six-month period ended June 30, 2013. Overall increase in net sales of gas to Europe and Other Countries was mainly driven by a 7% increase in the gross average

Rouble price (including customs duties) as compared to the same period of the prior year. Volumes of gas sold in the six-month period ended June 30, 2014 increased insignificantly.

Retroactive gas price adjustments were recognized in the unaudited consolidated interim condensed financial information for the six-month period ended June 30, 2013 as RUB 73,430 million increase in sales reflecting a decrease in a previously recognized accrual.

Net sales of gas to FSU countries increased by RUB 83,392 million, or 46%, to RUB 262,947 million in the six-month period ended June 30, 2014 compared to the same period in 2013. The change was due to a 32% increase in the gross average Rouble price (including customs duties) as compared to the six-month period ended June 30, 2013. Volumes of gas sold also increased by 12% in the six-month period ended June 30, 2014 compared to the same period of the prior year.

Net sales of gas in the Russian Federation increased by RUB 29,515 million, or 7%, to RUB 440,528 million in the six-month period ended June 30, 2014 compared to the same period of the prior year due to a 14% increase in the gross average domestic gas prices. Volumes of gas sold decreased by 6% in the six-month period ended June 30, 2014 compared to the same period of the prior year.

Net sales of refined products (net of excise tax, VAT and customs duties) increased by RUB 153,989 million, or 24%, to RUB 793,632 million in the six-month period ended June 30, 2014 in comparison with the same period of the prior year. The increase was primarily driven by an increase in volumes sold by Gazprom Neft Group to customers in the Russian Federation, as well as by an increase in prices. In the six-month period ended June 30, 2014 and 2013 Gazprom Neft Group's sales comprised 71% and 75% of the total amount of net sales of refined products, respectively.

Net sales of electric and heat energy (net of VAT) increased by RUB 39,117 million, or 22%, to 218,683 in the six-month period ended June 30, 2014 compared to the same period of the prior year. The increase was mainly driven by inclusion of OAO Moscow Integrated Power Company (OAO MIPC) in the consolidated financial statements from September 2013.

Net sales of crude oil and gas condensate (net of VAT and customs duties) increased by RUB 5,009 million, or 5%, to RUB 104,798 million in the six-month period ended June 30, 2014 compared to RUB 99,789 million in the same period of the prior year. Sales of crude oil, included in net sales of crude oil and gas condensate (net of VAT and customs duties), amounted to RUB 86,844 million and RUB 80,675 million in the six-month period ended June 30, 2014 and 2013, respectively.

Operating expenses

Operating expenses increased by 31% in the six-month period ended June 30, 2014 to RUB 2,248,659 million from RUB 1,718,884 million in the same period of the prior year. Operating expenses as a percentage of sales increased from 67% in the six-month period ended June 30, 2013 to 78% in the six-month period ended June 30, 2014. The table below presents a breakdown of operating expenses in each period:

(RUB million)	Six-month period ended June 30,	
	2014	2013
Taxes other than on income	394,392	343,192
Purchased gas and oil	382,928	369,866
Staff costs	259,288	235,238
Depreciation	228,784	210,810
Charge for impairment provisions	219,449	30,181
Transit of gas, oil and refined products	191,409	171,302
Materials	133,393	107,881
Cost of goods for resale, including refined products	123,311	65,065
Repairs and maintenance	72,208	77,649
Electricity and heating expenses	44,461	39,286
Rental expenses	17,580	12,295
Social expenses	16,215	18,221
Transportation services	16,034	15,409
Insurance expenses	12,410	10,961
Derivatives losses (gains)	9,454	(28)
Processing services	8,717	8,106
Research and development expenses	8,558	7,491
Heat transmission	61	4,817
Foreign exchange rate differences on operating items	(3,566)	(43,038)
Other	<u>132,382</u>	<u>99,516</u>
	<u>2,267,468</u>	<u>1,784,220</u>
Changes in inventories of finished goods, work in progress and other effects	<u>(18,809)</u>	<u>(65,336)</u>
Total operating expenses	<u>2,248,659</u>	<u>1,718,884</u>

Taxes other than on income

Taxes other than income tax consist of:

(RUB million)	Six-month period ended June 30,	
	2014	2013
Natural resources production tax	290,423	245,062
Property tax	45,408	38,712
Other taxes	<u>58,561</u>	<u>59,418</u>
Taxes other than on income	<u>394,392</u>	<u>343,192</u>

The natural resources production tax increased by 19% to RUB 290,423 million in the six-month period ended June 30, 2014 as compared to RUB 245,062 million in the six-month period ended June 30, 2013. The increase is mainly due to an increase in the tax rate for natural gas from RUB 582 per thousand cubic meters during six-month period ended June 30, 2013 to RUB 700 per thousand cubic meters since January 1, 2014. The increase in natural resources production tax on oil extraction resulted mainly from growth in the base tax rate from RUB 470 to RUB 493 per ton and increase of U.S. dollar exchange rate, included in calculation of oil production tax in accordance with the Tax Code of the Russian Federation.

Purchased gas and oil

Cost of purchased gas and oil increased by RUB 13,062 million to RUB 382,928 million in the six-month period ended June 30, 2014 as compared to RUB 369,866 million in the same period of the prior year. Cost of purchased gas decreased by RUB 7,681 million, or 3%. This decrease mainly relates to decline in prices for the gas purchased from third parties in Russia and abroad.

Cost of purchased oil included in the cost of purchased gas and oil increased by RUB 20,743 million, or 21%, and amounted to RUB 120,338 million in the six-month period ended June 30, 2014 as compared with RUB 99,595 million in the same period of the prior year. The change is mainly related to activity of Gazprom Neft Group, included in scope of Gazprom Group's consolidation, and increase in market oil prices.

Staff costs

Staff costs increased by 10% to RUB 259,288 million for the six-month period ended June 30, 2014 from RUB 235,238 million in the same period of the prior year. The increase was mainly driven by average salary indexation and increase in average number of personnel.

Depreciation

Depreciation increased by 9%, or RUB 17,974 million, to RUB 228,784 million in the six-month period ended June 30, 2014 from RUB 210,810 million in the same period of the prior year. The increase is primarily due to the growth in the fixed assets base and consolidation of OAO MIPC from September 2013.

Charge for impairment provisions

Charge for impairment provisions increased by RUB 189,268 million as compared to the same period of the prior year and included RUB 215,832 million and RUB 28,908 million of bad debt provision for accounts receivable in the six-month period ended June 30, 2014 and 2013, respectively. Such an increase was mainly driven by accrual of provision for doubtful trade accounts receivable from NAK Naftogaz Ukraine.

Transit of gas, oil and refined products

Transit of gas, oil and refined products increased by 12% to RUB 191,409 million in the six-month period ended June 30, 2014 from RUB 171,302 million in the same period of the prior year. This increase was mainly driven by growth of gas volumes transported through the Nord Stream pipeline.

Materials

Cost of materials increased by 24% to RUB 133,393 million in the six-month period ended June 30, 2014 from RUB 107,881 million in the same period of the prior year. The increase mainly relates to consolidation of OAO MIPC from September 2013, as well as to an increase in purchases of materials from third parties and increase in prices.

Cost of goods for resale, including refined products

Cost of goods for resale, including refined products, increased from RUB 65,065 million in the six-month period ended June 30, 2013 to RUB 123,311 million in the six-month period ended June 30, 2014. The increase is mainly explained by an increase in volumes of refined products purchased from third parties.

Exchange rate differences on operating items

Exchange rate differences on operating items amounted to a net gain of RUB 3,566 million in the six-month period ended June 30, 2014 as compared with a net gain of RUB 43,038 million in the same period of the prior year. The change is explained by appreciation of Euro against Rouble by 2% and appreciation of U.S. dollar against Rouble by 3% in the six-month period ended June 30, 2014, compared to appreciation of Euro against Rouble by 6% and appreciation of U.S. dollar against Rouble by 8% in the same period of the prior year.

Other operating expenses

Other operating expenses increased by 33% to RUB 132,382 million in the six-month period ended June 30, 2014 from RUB 99,516 million in the same period of the prior year. Other expenses include gas and gas condensate production expense, services from gas distribution companies, bank charges, security services, legal and consulting services, charity and financial aid, and advertising.

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

Change in inventories of finished goods, work in progress and other effects decreased by RUB 46,527 million to RUB 18,809 million in the six-month period ended June 30, 2014 as compared with RUB 65,336 million in the same period of the prior year. The negative amount of the line item in the six-month period ended June 30, 2014 is mainly due to an increase in the balances of inventories and finished goods as of June 30, 2014 as compared with the balances as of December 31, 2013.

Operating profit

As a result of the factors discussed above, our operating profit decreased by RUB 213,352 million, or 25%, to RUB 639,650 million in the six-month period ended June 30, 2014 from RUB 853,002 million in the six-month period ended June 30, 2013. The operating profit margin decreased from 33% in the six-month period ended June 30, 2013 to 22% in the six-month period ended June 30, 2014.

Net finance loss

(RUB million)	Six-month period ended June 30,	
	2014	2013
Exchange gains	149,754	21,968
Exchange losses	<u>(197,741)</u>	<u>(141,374)</u>
Net exchange loss	(47,987)	(119,406)
Interest income	15,842	16,533
Interest expense	<u>(20,799)</u>	<u>(21,105)</u>
Net finance loss	(52,944)	(123,978)

The net exchange loss of RUB 47,987 million in the six-month period ended June 30, 2014 in comparison with net exchange loss of RUB 119,406 million in the same period of the prior year is explained by appreciation of U.S. dollar against Rouble by 3% and Euro against Rouble by 2% in the six-month period ended June 30, 2014, compared to appreciation of U.S. dollar against Rouble by 8% and Euro by 6% in the same period of the prior year.

Interest income decreased by 4% to RUB 15,842 million in the six-month period ended June 30, 2014 from RUB 16,533 million in the same period of the prior year.

Interest expense decreased by 1% to RUB 20,799 million in the six-month period ended June 30, 2014 from RUB 21,105 million in the same period of the prior year.

Share of net income of associated undertakings and joint ventures

Share of net income of associated undertakings and joint ventures increased by RUB 35,080 million to RUB 47,884 million in the six-month period ended June 30, 2014 as compared to RUB 12,804 million in the same period of the prior year. The change is mainly due to recognition of an additional expense of RUB 25,961 million in the six-month period ended June 30, 2014 for OAO NGK Slavneft and its subsidiaries as a result of a one-time adjustment to correct the prior understatement of depreciation on the basis difference for property, plant and equipment since the Group's acquisition of interests in OAO NGK Slavneft. Without this effect the measure increased by RUB 9,119 million, which was mainly caused by an increase in net income of Sakhalin Energy Investment Company Ltd due to an increase in revenue from liquefied natural gas as a result of market prices increase and an increase in revenue from crude oil sales due to production output growth, an increase in net income of Nord Stream AG due to an increase in revenue from gas transportation sales, which was partially offset by a decrease in profit from Gazprombank Group.

Profit tax

Total profit tax expense increased by RUB 20,899 million, or 14%, to RUB 169,338 million in the six-month period ended June 30, 2014 as compared with RUB 148,439 million in the six-month period ended June 30, 2013. The effective profit tax rate was 26.7% and 20.0% in the six-month period ended June 30, 2014 and 2013, respectively.

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

Profit for the period attributable to owners of OAO Gazprom

As a result of the factors discussed above, our profit for the period attributable to owners of OAO Gazprom decreased by RUB 132,105 million, or 23%, from RUB 582,683 million in the six-month period ended June 30, 2013 to RUB 450,578 million in the six-month period ended June 30, 2014.

Profit for the period attributable to non-controlling interest

Profit for the period attributable to non-controlling interest increased by RUB 3,926 million, or 37%, to RUB 14,648 million in the six-month period ended June 30, 2014 compared to RUB 10,722 million in the same period of the prior year.

Liquidity and capital resources

The following table summarizes our statement of cash flows for the six-month period ended June 30, 2014 and 2013:

(RUB million)	Six-month period ended June 30,	
	2014	2013
Net cash from operating activities	986,143	955,542
Net cash used in investing activities	(698,150)	(693,959)
Net cash (used in) from financing activities	(27,390)	8,277

Net cash from operating activities

Net cash from operating activities increased by RUB 30,601 million, or 3%, and amounted to RUB 986,143 million in the six-month period ended June 30, 2014 as compared with RUB 955,542 million in the same period of the prior year. The increase was primarily due to positive dynamics in working capital changes.

Net cash used in investing activities

Net cash used in investing activities increased by RUB 4,191 million, or 1%, to RUB 698,150 million in the six-month period ended June 30, 2014 as compared with RUB 693,959 million in the same period of the prior year. The change was primarily due to an increase in investments in associated undertakings and increase in long-term loans issued in the six-month period ended June 30, 2014 as compared with the same period of the prior year. This effect was offset by a decrease in cash used for capital expenditure in the six-month period ended June 30, 2014 as compared with the same period of the prior year.

Net cash (used in) from financing activities

Net cash used in financing activities amounted to RUB 27,390 million in the six-month period ended June 30, 2014 as compared with net cash from financing activities in the amount of RUB 8,277 million in the same period of the prior year. This change was primarily due to increase in dividends and interest paid in the six-month period ended June 30, 2014 as compared with the same period of the prior year.

Capital expenditures

Total capital expenditures (excluding the effect of acquisitions of subsidiaries) by segment for the six-month period ended June 30, 2014 and 2013 in nominal RUB terms, amounted to the following:

(RUB million)	Six-month period ended June 30,	
	2014 ⁽¹⁾	2013 ⁽¹⁾
Transport	176,389	157,479
Production of gas	112,897	107,075
Production of crude oil and gas condensate	110,510	136,627
Refining	45,143	53,081
Electric and heat energy generation and sales	30,023	39,400
Distribution	8,500	12,151
Gas storage	2,926	9,845
All other segments	<u>14,584</u>	<u>30,746</u>
Total	500,972	546,404

Note:

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

Total capital expenditures (excluding the effect of acquisitions of subsidiaries) decreased by RUB 45,432 million, or 8%, from RUB 546,404 million in the six-month period ended June 30, 2013 to RUB 500,972 million in the six-month period ended June 30, 2014.

The increase of capital expenditures in Transport segment was due to construction of Bovanenkovo-Ukhta gas pipeline system and extension of the unified gas supply system to ensure gas supply to South Stream pipeline. The decrease in capital expenditures in Production of crude oil and gas condensate segment was mainly due to the decrease of capital expenditures of Gazprom нефт Group.

Debt obligations

Net debt balance (defined as the sum of short-term borrowings, current portion of long-term borrowings, short-term promissory notes payable, long-term borrowings and long-term promissory notes payable, net of cash and cash equivalents and balances of cash and cash equivalents restricted as to withdrawal under the terms of certain borrowings and other contractual obligations) decreased by RUB 218,251 million, or 20%, from RUB 1,112,798 million as of December 31, 2013 to RUB 894,547 million as of June 30, 2014. This decrease resulted from the increase in cash and cash equivalents, which was partially offset by appreciation of U.S. dollar and Euro against Rouble.