

ОАО АК ТРАНСНЕФТ

**MANAGEMENT'S DISCUSSION AND ANALYSIS
OF THE GROUP'S FINANCIAL POSITION
AND RESULTS OF ITS OPERATIONS**

FOR THE THREE MONTHS ENDED 31 MARCH 2016





OAO AK TRANSNEFT
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(in millions of Russian roubles, if not stated otherwise)

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The following analysis provides an overview of the financial position of OAO AK Transneft and its subsidiaries (hereinafter – the “Group”) as at 31 March 2016 and results of operations for the three months ended 31 March 2016, compared to the three months ended 31 March 2015, as well as other important factors which could affect the future results of the Group. This analysis should be read in conjunction with the consolidated interim condensed financial statements prepared in accordance with International financial reporting standards (hereinafter – “IFRS”) for the three months ended 31 March 2016.

Key financial and operating results

	Three months ended 31 March 2016	Three months ended 31 March 2015	Change, %
Revenue	204,005	201,477	1.3
Net profit	75,568	63,388	19.2
EBITDA*	107,326	101,339	5.9
EBITDA margin, %*	61.2	61.9	x
Oil delivered to consignees, mln. tons	119.4	120.1	(0.6)
including:			
Russian oil refineries, mln. tons	59.8	61.8	(3.2)
transshipment into the CPC-R system, mln. tons	0.3	0.5	(40.0)
exports to neighboring countries, mln. tons	5.9	5.6	5.4
exports to other countries, mln. tons	53.4	52.3	2.1
Oil products delivered to consignees, mln. tons	8.4	8.1	3.7
including:			
Russia's domestic market, mln. tons	1.6	1.3	23.1
exports to the Customs Union member countries, mln.tons	0.22	0.07	3.1 times
exports to other countries, mln. tons	6.6	6.8	(2.9)

* Less crude oil sale and purchase operations under contracts with OAO NK Rosneft and the China National United Oil Corporation.

The Group's profit was mainly affected by the following non-production factors:

	Three months ended 31 March 2016	Three months ended 31 March 2016	Absolute change	Change, %
Profit for the period	75,568	63,388	12,180	19.2
Net (gain) / loss from foreign exchange differences	(17,266)	4,279	(21,545)	x
Net interest expense	8,522	2,531	5,991	3.4 times
Net gain from operations with financial instruments	(4,921)	(10,274)	5,353	(52.1)
Share of profit from associates and jointly controlled entities	(6,805)	(1,443)	(5,362)	4.7 times
Gain on disposal of subsidiaries	(998)	-	(998)	x
Adjusted net profit for the period	54,100	58,481	(4,381)	(7.5)



1. General information and overview of the Group's activities

The oil transporting joint stock company Transneft was established and incorporated by the Russian Government Resolution No. 810 dated 14 August 1993 under Presidential Decree No. 1403 dated 17 November 1992.

According to its Charter, OAO AK Transneft was established for the purposes of:

- promoting the technical and socio-economic interests of its shareholders, while unconditionally ensuring the Russian Federation's interests in the area of transporting oil, gas, and the products of oil & gas refining via trunk pipelines;
- generating profit.

The main areas of OAO AK Transneft and its subsidiaries' operations are as follows:

- providing services in the area of transporting oil and oil products via trunk pipelines in the Russian Federation and outside of its territory;
- carrying out prevention, diagnostic, and emergency & recovery work on trunk pipelines;
- coordinating activities aimed at comprehensive development of the trunk pipeline network and other pipeline transport facilities;
- interacting with pipeline transport companies in other countries on matters of oil and oil products transportation in accordance with intergovernmental agreements;
- participating in scientific, technical, and innovative development of the pipeline transport, and implementing new equipment, technology, and materials;
- raising investment capital for the development of the production base, as well as the expansion and reconstruction of facilities of the Transneft system's entities;
- organizing environmental work in areas where pipeline transport facilities are located.

The Group also provides services of oil storage, oil compounding, crude oil sales.

OAO AK Transneft is also responsible for oil transportation planning and management on foreign territory, for exercising control of oil storage at and delivery to foreign oil receipt-and-delivery facilities, and for data collection and summarizing.

The Group as at 31 March 2016 possesses an extensive network of trunk oil pipelines with a total length of approximately 51.6 thousand km and trunk oil products pipelines with a total length of some 16.9 thousand km.

During the three months ended 31 March 2016 the Group transported more than 85% of oil produced in Russia and more than 27% of oil products produced in Russia, as well as significant volumes of hydrocarbons and oil products from CIS countries.

OAO AK Transneft's key competitive advantages include:

- a monopoly position in the oil pipeline transport market;
- a low ratio of operating costs to total oil transportation volume compared to railway or water transport;
- average level of oil transportation tariffs, compared to those in the CIS, Europe, USA and Canada.



1.1. Key investment projects of the Group

OAO AK Transneft pays considerable attention to comprehensive development of its trunk pipeline network, promotion of scientific and technical progress, and implementation of new equipment and technology. OAO AK Transneft's capital investment policy is aimed at achieving system-wide targets for production base development, as well as expansion, reconstruction, and technical upgrades of pipeline transport facilities.

Fulfillment by OAO AK Transneft of investment projects provides development of the system of trunk pipelines that allows to redistribute operationally export flows to both the Western and Eastern directions depending on the market situation.

The largest investment projects for construction and expansion of pipeline systems under realization are:

- Construction of Zapolyarie–Purpe oil trunk pipeline;
- Construction of Kuyumba – Tayshet oil trunk pipeline;
- Expansion of the ESPO pipeline system in the GNPS Taishet – NPS Skovorodino section to 80 mln tons annually;
- Expansion of the ESPO pipeline system in the NPS Skovorodino – SMNP Kozmino to 50 mln. tons annually;
- Oil pipeline TS VSTO – Komsomolskiy NPZ;
- Project “Sever”. Development of the trunk pipeline system for increase of deliveries of oil products to Primorsk Sea Port to 15 mln tons;
- Project “Sever”. Development of the trunk pipeline system for increase of deliveries of oil products to Primorsk Sea Port to 25 mln tons;
- Reconstruction of the trunk pipeline system for increase of transportation volumes of oil products to the Moscow area;
- Project “Yug”, 1st stage, reconstruction of the trunk pipelines Tikhoretsk-Novorossiysk;
- Project “Yug”, 2nd stage, construction of MNPP Volgograd-Tikhoretsk;
- Project “Yug”, 3rd stage.

1.2. Environmental policy

The Group's management is fully aware of potential danger of a possible negative impact of technologically complex production activities on the environment. The main areas of the Group's environmental activities have been set out in OAO AK Transneft's ecological policy, the principles of which underlie OAO AK Transneft's ecological policy for 2010–2017, which spells out specific environmental measures.

The Group's management is fully informed of the conditions of all fixed assets and the pace of their wear and tear, and uses these data to plan reconstruction or building of new facilities. OAO AK Transneft's ecological strategy contains specific seven-year programs for each of its subsidiaries.

The amount of funding of the ecological safety program, building and reconstruction of environmental facilities, and acquisition of environmental protection equipment enable OAO AK Transneft to meet the strictest Russian and international environmental standards.

As at today all subsidiaries of OAO AK Transneft have developed, introduced and certified the environmental management System. All subsidiaries of the Company has received the international certificate DQS and IQNet conformity to the standard ISO 14001.



2. Tariffs and key macroeconomic factors affecting the Group's performance

2.1. Oil and oil products transportation tariffs

OAO AK Transneft has been providing tariff-based oil transportation services to consignors since 1992.

Tariff rates are currently calculated in accordance with the Rules of state regulation of fees or their maximum limits for services of natural monopolies with respect to transportation of oil and oil products via trunk pipelines, approved by a Decree of the Government of the Russian Federation of 29.12.2007 No. 980, as well as in accordance with the Regulations on setting fees for services of transportation of oil via trunk pipelines, approved by an Order of the Federal Tariff Service of Russia of 17.08.2005 No. 380-e/2 and the Methodology of setting tariffs on oil products transportation via trunk pipelines of the Russian Federation approved by Federal Energy Commission of Russia of 16.10.2002 No. 70-e/5.

During the three months ended 31 March 2016 and year ended 31 December 2015 OAO AK Transneft was performing its core operations:

- a) of transporting oil, by charging fees for its services in accordance with oil transportation tariff rates approved by orders of the state regulatory body for natural monopolies – the Federal Tariff Service of Russia (FTS of Russia), Federal Antimonopoly Service (FAS of Russia)¹, as well as by intergovernmental agreements:
 - Order of the FTS of Russia of 22.12.2009 No. 455-t/1 Concerning the setting of fees for sea port services provided to OOO Specialized Oil Loading Sea Port Kozmino;
 - Order of the FTS of Russia of 03.12.2013 No. 225-e/6 Concerning the setting of fees for the services of OAO AK Transneft for transportation of oil via the Purpe – Samotlor trunk pipeline system rendered to OAO NK Rosneft;
 - Order of the FTS of Russia of 26.11.2013 No. 219-e/1 Concerning the setting of fees for the services of OAO AK Transneft for transportation of oil via the Tikhoretsk – Tuapse-2 trunk pipeline section for OAO NK Rosneft;
 - Order of the FTS of Russia of 03.12.2013 No. 224-e/5 Concerning the setting of fees for the services of ZAO Morskoy portoviy servis for filling of railway wagons with oil in the territory of Grushevaya industrial site of the transshipment complex Sheshkharis;
 - Order of the FTS of Russia of 31.10.2014 No. 240-e/2 Concerning the setting of fee for the service of OAO AK Transneft for transportation of oil via the Ephimoffka – OOO LUKOIL-Volgogradneftepererabotka route rendering for OAO LUKOIL;
 - Order of the FTS of Russia of 27.11.2014 No. 275-e/1 Concerning the setting of fee for the service of OAO AK Transneft for transportation of oil via the trunk pipeline system;
 - Order of the FTS of Russia of 10.02.2015 No. 18-e/1 Concerning the setting of fee for the service of OAO AK Transneft for transportation of oil via Tikhoretsk – Tuapse-2 rendering for OAO NK Rosneft;
 - Order of the FTS of Russia of 07.04.2015 №71-e/1 Concerning the setting of fee for the service of OAO AK Transneft for transportation of oil via Frontier of Azerbaijan republic/ Russian Federation (Shirvanovka) – PK Sheshkharis route and concerning amendments to the order of FTS of Russia of 27.11.2014 №275-e/1»;
 - Order of the FAS of Russia of 07.09.2015 No. 814/15 Concerning the setting of tariff for the service of AO Transneft-Terminal for filling oil from trunk pipelines of OAO AK Transneft into railway tank cars on the territory of Grushevaya industrial site of the transshipment complex Sheshkharis;
 - Order of the FAS of Russia of 15.10.2015 No. 964/15 Concerning the setting of tariff for the service of OAO AK Transneft for delivery of oil to AO NNK-Khabarovskiy NPZ;
 - Order of the FAS of Russia of 22.10.2015 No. 991/15 Concerning the setting of tariff for the service of OAO AK Transneft for delivery of oil by oil trunk pipeline system;
 - Order of the FAS of Russia of 30.12.2015 No. 1359/15 Concerning the setting of tariff for the service of OAO AK Transneft for delivery of oil to OOO Ilinskiy NPZ;
 - Order of the FAS of Russia of 30.12.2015 No. 1360/15 Concerning the setting of tariff for the service of OAO AK Transneft for delivery of oil through Tikhoretsk – Tuapse-2 route provided to OAO NK Rosneft.

¹ the FAS of Russia is a successor of the FTS of Russia. Degree of the President of the Russian Federation of 21.07.2015 No.373 Concerning different issues on state administration and control in antimonopoly and tariff regulation.



2.1. Oil and oil products transportation tariffs (continued)

- b) of transporting oil products, by charging fees for its services in accordance with fee rates approved by OAO AK Transneft in accordance with orders of the FTS of Russia, the FAS of Russia:
- Order of the FTS of Russia of 30.04.2013 No. 90-e/2 Concerning the setting of maximum tariff rates for services of OAO AK Transneft for execution of orders and scheduling deliveries of oil products which are in transit to LPDS Sokur and are further exported outside the customs territory of the Russian Federation and the states - members of the Customs Union;
 - Order of the FTS of Russia of 30.05.2014 No. 132-e/2 Concerning the setting of tariff for services rendered by OAO AK Transneft for transportation of oil products through the route "LUKOIL - Nizhegorodnefteorgsynthez" - MP "Primorsk" for OAO NK LUKOIL;
 - Order of the FTS of Russia of 02.09.2014 No. 211-e/1 Concerning the setting of tariff for the services rendered by OAO AK Transneft for transportation of oil products through OOO KINEF - MP "Primorsk" route for OAO Surgutneftegaz;
 - Order of the FTS of Russia No.223-e/1 of 07.10.2014 Concerning the setting of tariff for the services of OAO AK Transneft and its affiliated parties for transportation of oil products by trunk pipelines;
 - Order of the FTS of Russia No.307-e/1 of 24.12.2014 Concerning the setting of maximum rates of tariff for the services of OAO AK Transneft and its affiliated entities for loading of oil products from trunk pipeline system and making amendments to the Order of the FTS of Russia No.223-e/1 of 07.10.2014;
 - Order of the FTS of Russia No.19-e/2 of 10.02.2015 Concerning the setting of maximum rate of tariff for the services of OAO AK Transneft and making amendments to appendix 1 of the Order of the FTS of Russia No.223-e/1 of 07.10.2014;
 - Order of the FTS of Russia of 11.06.2015 No. 234-e/4 Concerning the setting of tariff for the services rendered by OAO AK Transneft for transportation of oil products through OOO KINEF - MP "Primorsk" route for OAO Surgutneftegaz (acting from 17.07.2015);
 - Order of the FAS of Russia of 15.10.2015 No. 965/15 Concerning the setting limit for maximum tariff rates for the services of OAO AK Transneft for filling of oil products from trunk pipeline network.

2.2. Oil production and refining volumes

The level of oil production and refining volumes in the Russian Federation determine the level of transportation turnover via the Group's oil and oil products pipelines and therefore the Group's revenue from the relevant services.

	Three months ended 31 March 2016	Three months ended 31 March 2015	Change, %
Oil production volume in the Russian Federation, mln tons	135.4	131.0	3.4
Oil refining volume in the Russian Federation, mln tons	31.1	31.8	(2.2)

Oil production volume increased for the three months ended 31 March 2016 compared to the similar period of the previous year by 4.4 mln tons or by 3.4%.

Light oil refining during the three months ended 31 March 2016 in the Russian Federation declined by 0.7 mln tons or by 2.2% compared to the relative period of the previous year.



2.3. The rouble's exchange rate against foreign currencies

Services for transportation of oil through trunk oil pipelines which are located in the territory of the Russian Federation are paid for in Russian roubles.

Oil products transportation services are paid for in the following main currencies:

- in the Russian Federation - Russian roubles;
- in the Republic of Belarus - US dollars;
- in the Republic of Kazakhstan - the rouble equivalent calculated at the exchange rate of the Kazakhstan tenge established by the Central Bank of the Russian Federation on the payment date.

Fluctuations of US Dollar and Kazakhstan tenge do not significantly affect the Group's operating results as the portion of revenue which is paid for in US Dollars or rouble equivalent, calculated at the Kazakhstan tenge exchange rate, established by Central Bank of Russian Federation at the date of payment, in the total revenue is relatively small.

	Three months ended 31 March 2016	Three months ended 31 March 2015	Change, %
Change in the rouble's exchange rate against the US dollar, %	(7.2)	3.9	x
Average exchange rate for the period (roubles per US dollar)	74.6283	62.1838	20.0
Exchange rate at the end of the period (roubles per US dollar)	67.6076	58.4643	15.6

2.4. Inflation rates

Russia's inflation rates as per Federal state statistics service during the period in question were as follows:

	Three months ended 31 March 2016	Three months ended 31 March 2015	Change, pp
Rouble inflation (CPI), %	2.1	7.4	(5.3)

2.5. Taxation

Most of the Group's companies are incorporated in the Russian Federation and subject to taxation under the Tax Code of the Russian Federation.

The amount of taxes accrued by the Group was as follows:

	Three months ended 31 March 2016	Three months ended 31 March 2015	Change, %
Current income tax	21,057	21,954	(4.1)
Property tax	5,363	4,218	27.1
Other taxes and levies	244	210	16.2

Income tax

The federal income tax rate is 2.0%, while the regional rates range from 13.5% to 18.0%. The Group's international operations are taxable at rates established by the laws of countries where they take place.

Property tax

The amount of property tax increased by RUB 1,145 or by 27.1%. The increase was a result of putting into use of fixed assets, revaluation held at 31.12.2015 as well as increase in a tax rate applied to trunk pipelines as well as constructions which are integral technological part of these pipelines. These properties are taxed at the rates set locally by regions of the Russian Federation and can not be more than 1.0% during 2015, 1.3% during 2016.

Other taxes and levies

Other taxes mainly include the transport tax, the land tax and other taxes and levies.



3. Analysis of the Group's performance

The table below presents consolidated statement of profit or loss and other comprehensive income for the three months ended 31 March 2016 and the relative period of 2015.

	Three months ended 31 March 2016	Three months ended 31 March 2015	Absolute change	Change, %
Revenue	204,005	201,477	2,528	1.3
revenue from oil transportation services	149,608	137,443	12,165	8.9
revenue from oil products transportation services	18,122	15,169	2,953	19.5
revenue from crude oil sales	30,392	43,097	(12,705)	(29.5)
other revenue	5,883	5,768	115	2.0
Operating expenses	(131,882)	(129,818)	(2,064)	1.6
Operating profit	72,123	71,659	464	0.6
Net financial income	13,665	3,464	10,201	3.9 times
Gain on disposal of subsidiaries	998	-	998	x
Share of profit from associates and jointly controlled entities	6,805	1,443	5,362	4.7 times
Profit before income tax	93,591	76,566	17,025	22.2
Current income tax	(21,062)	(22,012)	950	(4.3)
Deferred income tax	3,039	8,834	(5,795)	(65.6)
Income tax expense	(18,023)	(13,178)	(4,845)	36.8
Profit for the reporting period	75,568	63,388	12,180	19.2
Other comprehensive loss, net of income tax	(562)	(774)	212	(27.4)
Total comprehensive income, net of income tax	75,006	62,614	12,392	19.8

3.1. Revenue

Revenue by type of operations	Three months ended 31 March 2016	Share of total revenue, %	Three months ended 31 March 2015	Share of total revenue, %	Absolute change	Change, %
Revenue from crude oil transportation services	149,608	73.4	137,443	68.2	12,165	8.9
exports, except the CIS	85,097	41.7	76,799	38.1	8,298	10.8
exports in the CIS	4,429	2.2	4,273	2.1	156	3.7
domestic sales	60,082	29.5	56,371	28.0	3,711	6.6
Revenue from oil products transportation services	18,122	8.9	15,169	7.5	2,953	19.5
Revenue from oil compounding services	1,389	0.7	1,112	0.6	277	24.9
Other revenue	4,011	1.9	4,140	2.0	(129)	(3.1)
Total revenue (without revenue from sales of crude oil and oil products)	173,130	84.9	157,864	78.3	15,266	9.7
Revenue from export sales of crude oil	28,652	14.0	37,822	18.8	(9,170)	(24.2)
Revenue from sales of crude oil in the domestic market	1,740	0.9	5,275	2.6	(3,535)	(67.0)
Revenue from sales of oil products	483	0.2	516	0.3	(33)	(6.4)
Total revenue	204,005	100.0	201,477	100.0	2,528	1.3



3.1. Revenue (continued)

For the three months ended 31 March 2016, the Group's revenue increased by RUB 2,528 or by 1.3%, attributable mainly to an increase in revenue from crude oil transportation and oil products transportation services. Without taking into account revenue from crude oil sales and oil products sales, revenue for the three months ended 31 March 2016 increased by RUB 15,266 or 9.7% compared to the three months ended 31 March 2015 and accounted for 84.9% of total revenue as for the reporting period.

3.1.1. Oil and oil products transportation services

Increase in revenue from oil transportation services amounted to RUB 12,165 or by 8.9% for the three months ended 31 March 2016 comparable to the same period of 2015 and was attributable to change in tariffs and to change in oil transportation turnover and turnover volumes as well as to setting of new tariffs.

Increase in revenue from oil products transportation services by RUB 2,953 or by 19.5% for the three months ended 31 March 2016 compared to the same period of 2015 was driven by changes in oil products transportation tariffs as well as changes in turnover volumes and turnover.

3.1.2. Revenue from sales of crude oil and oil products

Revenue from export sales of crude oil was driven by the start of oil supplies to the People's Republic of China under a 20-year contract to supply 6 mln. tons of crude oil annually effective January 1, 2011. This contract was signed as collateral for a loan obtained from the China Development Bank. The respective oil volumes are being purchased from OAO NK Rosneft.

Decrease in revenue from export sales of crude oil as for the three months ended 31 March 2016 compared to the three months ended 31 March 2015 was mainly a result of decline in oil market price per barrel set in USD as well as increase of USD/RUB exchange rate during the reporting period to the same period of previous year.

Decrease in revenue from domestic sales of crude oil as for the three months ended 31 March 2016 by 3,535 or by 67.0% compared to the relative period of the previous year was a result of decline of sale volumes of crude oil by the companies of the Group.

Decrease in revenue from sales of oil products as for the three months ended 31 March 2016 by RUB 33 or by 6.4% was driven by decline of oil products volume sold.

3.1.3. Revenue from oil compounding services

Growth in revenue from oil compounding services by RUB 277 or by 24.9% as for the three months ended 31 March 2016 compared to the three months ended 31 March 2015 was a result of increase in oil compounding volumes by 27.9% (10,027.5 thousand tons for the three months ended 31 March 2016; 7,840.0 thousand tons for the three months ended 31 March 2015).

3.1.4. Other revenue

Other revenue includes revenue from connection of companies to the trunk pipeline system and revenue from trunk pipeline expansion services, information services related to oil transportation, oil and oil products storage services, communication services, diagnostic services, construction services, rent services, organization of transporting services, as well as other services.



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3.2. Operating expenses

Operating expenses for the three months ended 31 March 2016, and the three months ended 31 March 2015, are detailed in the table below:

Operating expense line items	Three months ended 31 March 2016	Share of total expenses, %	Three months ended 31 March 2015	Share of total expenses, %	Absolute change	Change, %
Salaries, social funds contributions and social expenses	32,681	24.8	29,791	22.9	2,890	9.7
Energy	9,694	7.4	8,911	6.9	783	8.8
Materials	5,139	3.9	4,235	3.3	904	21.3
Repairs services and maintenance of relevant technical condition of pipeline	1,547	1.2	1,915	1.5	(368)	(19.2)
Insurance expenses	1,597	1.2	1,551	1.2	46	3.0
Taxes (other than income tax)	5,290	4.0	4,287	3.3	1,003	23.4
Pension expense	1,311	1.0	1,240	1.0	71	5.7
Other operating expenses	8,173	6.1	5,848	4.4	2,325	39.8
Total operating expenses (net of D&A, one-time expenses and cost of goods sold)	65,432	49.6	57,778	44.5	7,654	13.2
Depreciation and amortization	33,944	25.7	30,096	23.3	3,848	12.8
Cost of export crude oil sales (including export custom duties)	28,789	21.8	37,406	28.8	(8,617)	(23.0)
Cost of crude oil sold in the domestic market	1,868	1.4	3,939	3.0	(2,071)	(52.6)
Cost of oil products sold	651	0.5	432	0.3	219	50.7
Cost of other goods sold	76	0.1	167	0.1	(91)	(54.5)
One-time expenses (non-production activities)	1,122	0.9	-	-	1,122	x
Total operating expenses	131,882	100.0	129,818	100.0	2,064	1.6

For the three months ended 31 March 2016, compared to the three months ended 31 March 2015, the amount of operating expenses increased by RUB 2,064 or by 1.6%, while total operating expenses net of depreciation and amortization, one-time expenses and cost of goods sold increased by RUB 7,654 or by 13.2%.

Increase in the Group's total operating expenses was driven by the following factors:

- growth in depreciation and amortization. The growth of depreciation was mainly associated with putting into operation of new items of PPE, reconstruction and modernization of fixed assets during 2015-2016;
- growth of salaries, social funds contributions and social expenses (ref. to 3.2.1);
- growth in the amount of other taxes recognised in operating expenses (ref. to 3.2.7);
- growth in the amount of other operating expenses (ref. to 3.2.8).



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3.2 Operating expenses (continued)

After applying inflation rates*, operating expenses for the three months ended 31 March 2016, and for the three months ended 31 March 2015, were as follows:

Operating expense line items	Three months ended 31 March 2016	Share of total expenses, %	Inflation rates (2015 to 2014), %*	Three months ended 31 March 2015 (inflated to 2015)	Share of total expenses, %	Absolute change	Change, %
Salaries, social funds contributions and social expenses	32,681	24.8	7.5	32,025	24.2	656	2.0
Energy	9,694	7.4	8.2	9,642	7.3	52	0.5
Materials	5,139	3.9	3.7	4,392	3.3	747	17.0
Repairs services and maintenance of relevant technical condition of pipeline	1,547	1.2	4.0	1,992	1.5	(445)	(22.3)
Insurance expenses	1,597	1.2	3.7	1,608	1.2	(11)	(0.7)
Taxes (other than income tax)	5,290	4.0	3.7	4,446	3.4	844	19.0
Pension expense	1,311	1.0	7.5	1,333	1.0	(22)	(1.7)
Other operating expenses	8,173	6.1	3.7	6,064	4.6	2,109	34.8
Total operating expenses (net of D&A, one-time expenses and cost of goods sold)	65,432	49.6	6.4	61,502	46.5	3,930	6.4
Depreciation and amortization	33,944	25.7	X	30,096	22.7	3,848	12.8
Cost of export crude oil sales (including export custom duties)	28,789	21.8	(2.6)	36,433	27.5	(7,644)	(21.0)
Cost of crude oil sold in the domestic market	1,868	1.4	(2.6)	3,837	2.9	(1,969)	(51.3)
Cost of oil products sold	651	0.5	(4.0)	415	0.3	236	56.9
Cost of other goods sold	76	0.1	3.7	173	0.1	(97)	(56.1)
One-time expenses (non-production activities)	1,122	0.9	(2.6)	-	-	1,122	x
Total operating expenses	131,882	100.0	X	132,456	100.0	(574)	(0.4)

*The inflation rates used are based on scenarios prepared by the Ministry of Economic Development for devising socio-economic development scenarios to 2019, as well as on 2015-2016 inflation rates.

Unit costs are analysed by Oil transportation and Oil products transportation activities based on indicators developed under the Russian Accounting Standards

Unit costs km are calculated using operating expenses indicator formed under aggregated RAS data with previous year indicator adjusted for change in oil turnover / volume turnover of oil products transportation and turnover for each of the above-mentioned activities. For calculation of inflated unit costs the index of inflation for "Transportation (including pipelines)" activity is used which is based on key macroeconomic assumptions of social and economic development of Russia till 2019 prepared by Ministry of Economic Development of the Russian Federation, as well as inflation rate for 2015-2016.



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3.2 Operating expenses (continued)

Unit costs for transportation of oil as per 100 tons-kilometers as for the three months ended 31 March 2016 and for the three months ended 31 March 2015 were as follows:

	Three months ended 31 March 2016	Three months ended 31 March 2015	Absolute change	Change, %
Oil transportation services				
Turnover, mln. tons x km	297,678	294,523	3,155	1.1
Unit costs per 100 tons x km, RUB	16.03	14.90	1.14	7.6
Inflated unit costs per 100 tons x km, RUB (inflated to 2016)		15.76	0.27	1.7

Unit costs for oil products transportation per ton as for the three months ended 31 March 2016 and as for the three months ended 31 March 2015 were as follows:

	Three months ended 31 March 2016	Three months ended 31 March 2015	Absolute change	Change, %
Oil products transportation services				
Volume turnover, mln. of tons	8.4	8.1	0.3	3.7
Unit costs per ton, RUB		554.97	34.99	6.3
Inflated unit costs per ton, RUB (inflated to 2016)	589.96	587.16	2.8	0.5

3.2.1. Salaries, social funds contributions and social expenses

Salaries comprise wages, accrual of provision for annual bonus, provision for unused vacation, staff training and other remuneration.

The increase in salaries, social funds contributions and social expenses for the three months ended 31 March 2016 compared to the three months ended 31 March 2015 in the amount of RUB 2,890 or 9.7% was mainly influenced by an increase of social funds contributions caused by increase of the limit for their accrual, decrease of expenses included in construction in progress, indexation of wages held in 2016.

3.2.2. Pension expense

OAO AK Transneft has set the protection of the life and health of its employees as well as the creation of safe working conditions for them as its highest priority. One of the key tasks of social policy is to create conditions for effective work and social protection of workers.

An important area of social protection of employees of the industry is a non-state pension system providing various options for corporate programs.

Pension expense includes accruals to the non-state pension fund as well as other accruals in conjunction with IAS 19 Employee benefits.

Pension expenses changed under following factors which influence expenses:

- inclusion of pension liabilities of NPF Transneft in the consolidated financial statements of the Group;
- recognition of obligations of the Group under defined benefit plan in accordance with IAS 19 and related expenses accrued.

	Three months ended 31 March 2016	Three months ended 31 March 2015	Absolute change	Change, %
Employers' contributions to NPF Transneft in favor of employees	1,228	1,470	(242)	(16.5)



3.2.3. Energy

Energy expenses for the three months ended 31 March 2016 increased by RUB 783 or 8.8% compared to the same period of the previous year. The increase was caused by growth of tariffs of natural monopolies for energy and by growth energy purchased because of increase in turnover.

The dynamics of power and energy consumption for the group of oil transporting entities is presented in the table below:

	Three months ended 31 March 2016	Three months ended 31 March 2015	Absolute change	Change, %
Average annual capacity, thsd. kW	1,536	1,539	(3)	(0.2)
Consumption of energy, (mln. kW*h)	3,627	3,490	137	3.9

3.2.4. Materials

Expenses on materials for the three months ended 31 March 2016 as compared to the same period of 2015, increased by RUB 904 or 21.3%.

3.2.5. Repair services and maintenance of relevant technical condition of pipeline

The amount of expense for repair services and maintenance of relevant technical condition of pipeline decreased as for the reporting period by RUB 368 or by 19.2% as compared to the relative period of the previous year.

3.2.6. Cost of crude oil and oil products sold

The cost of crude oil sold for export for the three months ended 31 March 2016 amounted to RUB 28,789 including custom duties in the amount of RUB 6,330, which was a result of oil supplies to the People's Republic of China (ref. to 3.1.2.). These expenses are related to the cost of oil purchased from OAO NK Rosneft under a contract signed in April 2009.

Decrease in cost of marketable oil sold in the domestic market as for the three months ended 31 March 2016 amounted to RUB 2,071 or 52.6% as compared to the relative period of 2015 and was caused by decrease in sale volumes of marketable oil.

The cost of marketable oil products sold as for the three months ended 31 March 2016 increased by RUB 219 or 50.7% as compared to the relative period of 2015.

3.2.7. Taxes (other than income tax)

The amount of the Group's other taxes included in operating expenses primarily contains property tax, tax on land and transport tax. The increase of these items was mainly caused by the increase of the property tax expenses (ref. to 2.5).

3.2.8. Other operating expenses

Other expenses include the results related to fixed assets and other assets disposals, income from posting oil surpluses, charity spending, fines and penalties received and paid, as well as other operating income and expenses.

OAO AK Transneft implements a policy of transparency with regard to its charity spending by disclosing information on its official website.

3.3. Share of results from associates and jointly controlled entities

The Group holds a number of financial investments in associated and jointly controlled entities reported on an equity method basis. The main activities of those entities are stevedoring operations, towing services, ship repair and the provision of additional port services, cargo handling, transport of oil products, wholesale of electric and heat power.

The increase of profit shown in "Share of profit from associates and jointly controlled entities" by RUB 5,362 was mainly caused by improved performance of Group PAO NCSP and foreign exchange gains arising due the strengthening of Russian rouble to the US Dollar during the 1st quarter of 2016 as compared to foreign exchange loss arising because of the weakening Russian rouble to the US Dollar during the 1st quarter of 2015.



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3.4. Finance income and costs

Interest income and expenses

Interest income is generated from depositing available cash in bank accounts as well as investing in fixed-income securities.

Interest income	Three months ended 31 March 2016	Three months ended 31 March 2015	Absolute change	Change, %
Interest income from cash and equivalents	499	2,732	(2,233)	(81.7)
Interest income from other financial assets	4,912	7,603	(2,691)	(35.4)
Other interest income	205	144	61	42.4
Total interest receivable	5,616	10,479	(4,863)	(46.4)
Less interest income on the temporary investment of borrowings	(335)	(50)	(285)	6.7 times
Total interest income recognised in the statement of profit or loss and other comprehensive income	5,281	10,429	(5,148)	(49.4)

Decrease in interest income for the three months ended 31 March 2016 by RUB 5,148 or by 49.4% compared to the relative period of 2015 was driven mainly by significant fall of interest rates for temporarily free cash placed with banks.

Accrued interest expenses and amounts of capitalized interest expenses for the relevant periods were as follows:

Interest expenses	Three months ended 31 March 2016	Three months ended 31 March 2015	Absolute change	Change, %
Interest expenses on loans and borrowings	11,849	11,078	771	7.0
Distribution of investment income to pension liabilities	1,733	1,432	301	21.0
Other interest expenses	1,056	944	112	11.9
Total interest expenses	14,638	13,454	1,184	8.8
Less finance costs to be capitalised	(835)	(494)	(341)	69.0
Total interest expense recognised in the statement of profit or loss and other comprehensive income	13,803	12,960	843	6.5

The amount of interest expenses was composed of:

- interest payable on loan obtained in 2009 from the China Development Bank with a 20-year maturity repayable in equal installments after five years from the moment of issue;
- interest payable on Eurobonds issued by the Group in 2008 for a total of USD 1,050 mln for the three months ended 31 March 2016 and for the relevant period of 2015;
- interest payable on series 01-03 of non-convertible interest-bearing documentary bonds amounting to RUB 104,102 for the three months ended 31 March 2016 and for the amount of RUB 135,000 for the relevant period of 2015;
- interest payable of non-convertible interest-bearing documentary bonds on series BO-04 for the amount RUB 10,000 and on series BO-03 for the amount RUB 15,000 for the three months ended 31 March 2016 and for the amount RUB 15,000 on series BO-03 for the relevant period of 2015.



3.4. Finance income and costs (continued)

Increase of interest expense as for the three months ended 31 March 2016 as compared to the similar period of 2015 was mainly driven by higher growth of US Dollar rate during the three months ended 31 March 2016 compared to the three months ended 31 March 2015.

During the three months ended 31 March 2016, interest in the amount of RUB 500 was capitalised as part of cost of assets under construction (for the three months ended 31 March 2015 – RUB 444) including:

- interest expenses to be capitalised in the amount of RUB 835 (for the three months ended 31 March 2015 – RUB 494);
- interest income to be excluded from interest expenses to be capitalised in the amount of RUB 335 (for the three months ended 31 March 2015 – RUB 50).

Foreign currency exchange gains and losses

The amount of foreign currency exchange gains and losses and for the three months ended 31 March 2016, compared to the three months ended 31 March 2015, was a result of changes in the exchange rates of the US dollar to the Russian rouble.

Due to a restatement of assets and liabilities denominated in foreign currencies at the end of every month, positive and negative currency-translation changes results, which are presented in the reporting on gross base.

Disclosure of foreign exchange differences by sources is presented in the tables below:

	Three months ended 31 March 2016	Three months ended 31 March 2015	Absolute change	Change, %
Foreign exchange gains on financial investments	15,523	90,056	(74,533)	(82.8)
Foreign exchange gains on loans and borrowings	74,697	112,220	(37,523)	(33.4)
Other foreign exchange gains	11,119	23,138	(12,019)	(51.9)
Total foreign exchange gains recognised in the statement of profit or loss and other comprehensive income	101,339	225,414	(124,075)	(55.0)
Foreign exchange loss on financial investments	(38,490)	(75,316)	36,826	(48.9)
Foreign exchange loss on loans and borrowings	(23,328)	(136,185)	112,858	(82.9)
Other foreign exchange loss	(22,255)	(18,192)	(4,064)	22.3
Total foreign exchange loss recognised in the statement of profit or loss and other comprehensive income	(84,073)	(229,693)	145,620	(63.4)
Net exchange differences	17,266	(4,279)	21,545	x

Dynamics of exchange differences presented in the table was driven by strengthening of RUB to USD during the three months ended 31 March 2016 and weakening of RUB to USD as for the three months ended 31 March 2015.

Derivatives

As for the three months ended 31 March 2016 gain recognized by the Group from operations with derivatives amounted to RUB 4,252 which was RUB 5,353 or 52.1% less than for the three months ended 31 March 2015. The dynamics was driven by settlement of obligation under barrier options during 2015 in full.



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3.5. Reconciliation of profit and EBITDA

	Three months ended 31 March 2016	Three months ended 31 March 2015	Change, %
Profit for the period	75,568	63,388	19.2
Adjustments for:			
income tax expense	18,023	13,178	36.8
depreciation and amortization	33,944	30,096	12.8
result of oil sales to China	137	(416)	x
net finance income	(13,665)	(3,464)	3.9 times
share of profit from associates and jointly controlled entities	(6,805)	(1,443)	4.7 times
gain on disposal of subsidiaries	(998)	-	x
one-time expenses (non-production activities)	1,122	-	x
EBITDA*	107,326	101,339	5.9
EBITDA margin*, %	61.2	61.9	x

* Less crude oil sale and purchase operations under contracts with OAO NK Rosneft and the China National United Oil Corporation.

EBITDA is a useful indicator for investors, as it reflects the Group's operating performance, including its ability to finance capital expenditures, company acquisitions, and other investments, as well as its ability to raise and service borrowings and loans. Some investors, analysts, and rating agencies tend to use EBITDA as a basis for estimating and projecting the efficiency and value of oil & gas companies. This indicator should not be considered separately, as an alternative to net income, operating income, or any other of Group's performance indicators reported in its consolidated financial statements.

4. Cash flow analysis

	Three months ended 31 March 2016	Three months ended 31 March 2015	Absolute change	Change, %
Cash flows from operating activities	71,620	100,567	(28,947)	(28.8)
Cash flows used in investing activities	(33,057)	(69,145)	36,088	(52.2)
Free cash inflow*	38,563	31,422	7,141	22.7
Cash flows used in financing activities	(12,486)	(18,026)	5,540	(30.7)
Net cash inflow	26,077	13,396	12,681	94.7
Change in cash and cash equivalents due to deviation of currency exchange rate	(8,644)	2,296	(10,940)	x
Net increase in cash and cash equivalents	17,433	15,692	1,741	11.1

*Including purchase and sale of promissory notes and net effect from placement of funds on deposits.

Negative free cash flow excluding investments in promissory notes of banks and deposits for the three months ended 31 March 2016 amounted to RUB 12,677 (positive free cash flow as for the three months ended 31 March 2015 amounted to RUB 46,099).



4.1. Operating activities

Cash received from operating activities is the Group's main source of cash. The net cash generated from operating activities amounted to RUB 71,620 for the three months ended 31 March 2016, which is RUB 28,947 or 28.8% lower than for the three months ended 31 March 2015.

The main factors which influenced on decrease of cash generated from operating activities for the three months ended 31 March 2016 as compared to the similar period in 2015 were as follows:

- increase in cash paid to suppliers by RUB 7,885;
- decrease in cash received from the refund of VAT and other taxes from the budget by RUB 16,742;
- increase in amount of interest paid by RUB 2,017.

4.2. Investing activities

The primary factors resulting in a decrease in cash used in investment activities by RUB 36,088 or 52.2% for the three months ended 31 March 2016 compared to the same period for the previous year, were:

- increase in the amount of purchase of property, plant and equipment by RUB 14,740;
- net cash inflow as for the three months ended 31 March 2016 from purchase-and-sale transactions of debt securities and allocation/closure of deposits in the amount of RUB 51,240 compared to net cash outflow for 2015 amounting to RUB 14,677;
- decrease in interest received by RUB 3,137;
- consideration paid for acquisition of 50% share capital of OOO NMT in the amount of USD 159 mln (RUB 12,497 at the exchange rate of Bank of Russia on the date of payment).

4.3. Financing activities

The main factors which influenced on decrease of cash flows used in financing activities for the three months ended 31 March 2016 as compared to the relative period of 2015 by RUB 5,540 or 30.7% were:

- increase of cash used for repayment of bonds and loans and borrowings in the amount of RUB 2,235:
for the three months ended 31 March 2016 monthly repayment of the loan to China Development Bank in the total amount of USD 166.7 mln (RUB 12,550 at the rate of Central Bank of the Russian Federation on the dates of operations);
during the three months ended 31 March 2015 repayment of loan to China Development Bank was made in the amount of USD 166.7 mln (RUB 10,315 at the rate of Central Bank of the Russian Federation on the date of operation);
- payments for acquisition of non-controlling interests: 36% in AO Transneft Prikamye (previously OAO SZMN) and 25% in OOO Transneft-Terminal amounting to RUB 7,856 during the three months ended 31 March 2015.



4.4. Disclosure of cash flows from operating activities using indirect method

Cash flows received from operating activities using the indirect method are disclosed in the table below in addition to the consolidated interim condensed statement of cash flows prepared using the direct method and disclosed in the consolidated interim condensed financial statements prepared in accordance with IFRS for the year ended 31 December 2015.

Under the indirect method, the net cash flow from operating activities is determined by adjusting profit or loss before tax for the effects of:

- (a) changes during the period in inventories and operating receivables and payables;
- (b) non-cash items such as depreciation and amortization, provisions, unrealized foreign currency gains and losses, interest income and expenses, share of loss from associates and jointly controlled entities;
- (c) all other items for which the cash effects are investing or financing cash flows.

	Three months ended 31 March 2016	Three months ended 31 March 2015
OPERATING ACTIVITIES		
Profit before tax	93,591	76,566
Adjustments for:		
Depreciation and amortization	33,944	30,096
Loss from disposal of property, plant and equipment	119	22
Finance income	(111,541)	(246,117)
Finance costs	97,876	242,653
Gain on disposal of subsidiaries	(998)	-
Share of profit from associates and jointly controlled entities	(6,805)	(1,443)
Others	(2,816)	(2,584)
Operating profit before changes in working capital and reserves	103,370	99,193
Changes in operating assets and liabilities:		
Changes in inventories	(140)	1,274
Changes in trade and other receivables relating to operating activity and VAT assets	(23,538)	(3,154)
Changes in trade and other payables, and accruals relating to operating activity	5,533	14,027
Cash flows from operating activities before payment of income tax expense and interest	85,225	111,340
Income tax paid	(3,264)	(2,717)
Income tax refund	39	307
Interest paid	(10,380)	(8,363)
Net cash flows received from operating activities	71,620	100,567



5. Liquidity analysis

	31 March 2016	31 December 2015	Change, %
Current assets	627,134	640,914	(2.2)
including:			
cash and cash equivalents	110,146	92,713	18.8
short-term bank promissory notes, deposits and bonds*	378,287	427,192	(11.4)
Current liabilities	260,148	240,451	8.2
Net working capital	366,986	400,463	(8.4)
Current ratio	2.4	2.7	x
Quick ratio**	2.0	2.3	x
Debt / EBITDA	2.3	2.3	x
Debt / Equity	0.5	0.6	x

* The main part of short-term bank promissory-notes, deposits and bonds consist of promissory notes, deposits and bonds issued by banks with credit ratings at Ba1 – Ba3 at the Moody's adjusted scale. Thus, short-term bank promissory notes, deposits and bonds consist of highly reliable or reliable financial instruments issued by credit organisations and companies.

** Quick ratio = (Cash and cash equivalents + Current financial assets + Short-term receivables) / Current liabilities