

**TRANSNEFT**

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

**FOR THE SIX MONTHS ENDED 30 JUNE 2016**





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**(in millions of Russian roubles, if not stated otherwise)**

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1.	General information and overview of the Group's activities .....	4
1.1.	Key investment projects of the Group .....	5
1.2.	Environmental policy .....	5
2.	Tariffs and key macroeconomic factors affecting the Group's performance .....	6
2.1.	Oil and oil products transportation tariffs .....	6
2.2.	Oil production and refining volumes.....	7
2.3.	The rouble's exchange rate against foreign currencies .....	8
2.4.	Inflation rates.....	8
2.5.	Taxation.....	8
3.	Analysis of the Group's performance .....	9
3.1.	Revenue .....	9
3.1.1.	Oil and oil products transportation services .....	10
3.1.2.	Revenue from sales of crude oil and oil products .....	10
3.1.3.	Revenue from oil compounding services .....	10
3.1.4.	Other revenue .....	10
3.2.	Operating expenses.....	11
3.2.1.	Salaries, social funds contributions and social expenses .....	13
3.2.2.	Pension expense .....	13
3.2.3.	Energy.....	14
3.2.4.	Materials .....	14
3.2.5.	Repair services and maintenance of relevant technical condition of pipeline.....	14
3.2.6.	Cost of crude oil and oil products sold .....	14
3.2.7.	Taxes (other than income tax) .....	14
3.2.8.	Other operating expenses .....	14
3.3.	Share of results from associates and jointly controlled entities.....	14
3.4.	Finance income and costs .....	15
3.5.	Reconciliation of profit and EBITDA.....	17
4.	Cash flow analysis .....	17
4.1.	Operating activities.....	18
4.2.	Investing activities .....	18
4.3.	Financing activities .....	18
4.4.	Disclosure of cash flows from operating activities using indirect method.....	19
5.	Liquidity analysis .....	20



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The following analysis provides an overview of the financial position of Transneft and its subsidiaries (hereinafter – the “Group”) as at 30 June 2016 and results of operations for the six months ended 30 June 2016, compared to the six months ended 30 June 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 six months ended 30 June 2016.

**Key financial and operating results**

	Six months ended 30 June 2016	Six months ended 30 June 2015	Change, %
Revenue	417,406	407,044	2.5
Net profit	134,521	119,775	12.3
EBITDA*	207,793	196,494	5.8
EBITDA margin, %*	58.4	59.0	x
Oil delivered to consignees, mln. tons	238.8	239.5	(0.3)
including:			
Russian oil refineries, mln. tons	118.2	124.0	(4.7)
transshipment into the CPC-R system, mln. tons	0.35	0.75	(53.3)
exports to neighboring countries, mln. tons	11.7	11.0	6.4
exports to other countries, mln. tons	108.6	103.7	4.7
Oil products delivered to consignees, mln. tons	17.2	16.1	6.8
including:			
Russia's domestic market, mln. tons	4.2	3.8	10.5
exports to the Customs Union member countries, mln.tons	0.43	0.26	65.4
exports to other countries, mln. tons	12.6	12.1	4.1

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

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

	Six months ended 30 June 2016	Six months ended 30 June 2015	Absolute change	Change, %
<b>Profit for the period</b>	<b>134,521</b>	<b>119,775</b>	<b>14,746</b>	<b>12,3</b>
Net (gain) / loss from foreign exchange differences	(29,769)	5,443	(35,212)	x
Net interest expense	17,099	5,151	11,948	3,3 times
Gain from operations with financial instruments	(4,165)	(16,860)	12,695	(75,3)
Share of profit from associates and jointly controlled entities	(11,265)	(3,359)	(7,906)	3,4 times
Gain on disposal of subsidiaries	(998)	-	(998)	x
<b>Adjusted net profit for the period</b>	<b>105,423</b>	<b>110,150</b>	<b>(4,727)</b>	<b>(4,3)</b>



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

Public joint stock company Transneft was established and incorporated by the Russian Government Resolution No. 810 dated 14 August 1993.

According to its Charter, Transneft was established for the purpose of generating profit.

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

- providing services of transporting oil and oil products via trunk pipelines in the Russian Federation as well as outside of Russia including interstate and intergovernmental agreements;
- raising of and making investments in development of the oil trunk pipeline and oil products trunk pipeline network;
- performing of scientific, technical, production, financial and foreign economic activities including mediating activity in the territory of the Russian Federation and outside of Russia;
- operating of oil and oil products trunk pipeline transport, sale of and storage of oil and oil products;
- organizing environmental work in areas where pipeline transport facilities are located.

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

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 30 June 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 16.1 thousand km.

During the six months ended 30 June 2016 the Group transported more than 85% of oil produced in Russia and more than 28% of light oil products produced in Russia, as well as significant volumes of hydrocarbons and oil products from CIS countries.

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

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. 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 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”, 1<sup>st</sup> stage, reconstruction of the trunk pipelines Tikhoretsk-Novorossiysk;
- Project “Yug”, 2<sup>nd</sup> stage, construction of MNPP Volgograd-Tikhoretsk;
- Project “Yug”, 3<sup>rd</sup> 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 Transneft's ecological policy, the principles of which underlie 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. 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 Transneft to meet the strictest Russian and international environmental standards.

As at today all subsidiaries of 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

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 six months ended 30 June 2016 and year ended 31 December 2015 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)<sup>1</sup>, 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 Shesharis 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 NNN-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;
  - Order of the FAS of Russian of 26.05.2016 No. 666/16 Concerning the setting of tariff for the services of OAO AK Transneft for delivery of oil via Uhta – Yaroslavl trunk pipeline through Uhta – OOO Lukoil – UNP route provided to PAO LUKOIL;

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<sup>1</sup> 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)

- Order of the FAS of Russian of 26.05.2016 No. 667/16 Concerning the setting of tariff for the services of OAO AK Transneft for delivery of oil via Uhta – Yaroslavl trunk pipeline through Synya – Pechora route provided to OOO SK Rusvietpetro.
- b) of transporting oil products, by charging fees for its services in accordance with fee rates approved by 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 of 07.10.2014 No.223-e/1 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 of 24.12.2014 No.307-e/1 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 of 10.02.2015 No.19-e/2 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.

	Six months ended 30 June 2016	Six months ended 30 June 2015	Change, %
Oil production volume in the Russian Federation, mln tons	269.9	263.8	2.3
Light oil refining volume in the Russian Federation, mln tons	60.8	62.3	(2.4)

Oil production volume increased for the six months ended 30 June 2016 compared to the similar period of the previous year by 6.1 mln tons or by 2.3%.

Light oil refining during the six months ended 30 June 2016 in the Russian Federation declined by 1.5 mln tons or by 2.4% 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 Bank of Russia 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 Bank of Russia at the date of payment, in the total revenue is relatively small.

	Six months ended 30 June 2016	Six months ended 30 June 2015	Change, %
Change in the rouble's exchange rate against the US dollar, %	(11.83)	(1.31)	x
Average exchange rate for the period (roubles per US dollar)	70.2583	57.3968	22.4
Exchange rate at the end of the period (roubles per US dollar)	64.2575	55.5240	15.7

### 2.4. Inflation rates

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

	Six months ended 30 June 2016	Six months ended 30 June 2015	Change, pp
Rouble inflation (CPI), %	3.3	8.5	(5.2)

### 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:

	Six months ended 30 June 2016	Six months ended 30 June 2015	Change, %
Current income tax	39,217	40,776	(3.8)
Property tax	10,602	8,422	25.9
Other taxes and levies	465	444	4.7

#### Income tax

The federal income tax rate is 2.0%, while the regional tax 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 2,180 or by 25.9%. 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 cannot 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.





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### 3. Analysis of the Group's performance

The table below presents consolidated statement of profit or loss and other comprehensive income for the six months ended 30 June 2016 and the relative period of 2015.

	Six months ended 30 June 2016	Six months ended 30 June 2015	Absolute change	Change, %
<b>Revenue</b>	<b>417,406</b>	<b>407,044</b>	<b>10,362</b>	<b>2.5</b>
revenue from oil transportation services	303,774	275,235	28,539	10.4
revenue from oil products transportation services	34,140	28,818	5,322	18.5
revenue from crude oil sales	67,775	88,183	(20,408)	(23.1)
other revenue	11,717	14,808	(3,091)	(20.9)
Operating expenses	(278,677)	(269,302)	(9,375)	3.5
<b>Operating profit</b>	<b>138,729</b>	<b>137,742</b>	<b>987</b>	<b>0.7</b>
<b>Net financial income</b>	<b>16,835</b>	<b>6,266</b>	<b>10,569</b>	<b>2.7 times</b>
Gain on disposal of subsidiaries	998	-	998	x
Share of profit from associates and jointly controlled entities	11,265	3,359	7,906	3.4 times
<b>Profit before income tax</b>	<b>167,827</b>	<b>147,367</b>	<b>20,460</b>	<b>13.9</b>
Current income tax	(39,256)	(40,912)	1,656	(4.0)
Deferred income tax	5,950	13,320	(7,370)	(55.3)
<b>Income tax expense</b>	<b>(33,306)</b>	<b>(27,592)</b>	<b>(5,714)</b>	<b>20.7</b>
<b>Profit for the reporting period</b>	<b>134,521</b>	<b>119,775</b>	<b>14,746</b>	<b>12.3</b>
Other comprehensive loss, net of income tax	(1,058)	(2,599)	1,541	(59.3)
<b>Total comprehensive income, net of income tax</b>	<b>133,463</b>	<b>117,176</b>	<b>16,287</b>	<b>13.9</b>

#### 3.1. Revenue

Revenue by type of operations	Six months ended 30 June 2016	Share of total revenue, %	Six months ended 30 June 2015	Share of total revenue, %	Absolute change	Change, %
<b>Revenue from crude oil transportation services</b>	<b>303,774</b>	<b>72.7</b>	<b>275,235</b>	<b>67.7</b>	<b>28,539</b>	<b>10.4</b>
exports, except the CIS	174,625	41.8	154,606	38.0	20,019	12.9
exports in the CIS	8,340	2.0	7,200	1.8	1,140	15.8
domestic sales	120,809	28.9	113,429	27.9	7,380	6.5
Revenue from oil products transportation services	34,140	8.2	28,818	7.1	5,322	18.5
Revenue from oil compounding services	2,874	0.7	2,594	0.6	280	10.8
Other revenue	8,012	2.0	11,312	2.8	(3,300)	(29.2)
<b>Total revenue (without revenue from sales of crude oil and oil products)</b>	<b>348,800</b>	<b>83.6</b>	<b>317,959</b>	<b>78.2</b>	<b>30,841</b>	<b>9.7</b>
Revenue from export sales of crude oil	61,776	14.8	74,255	18.2	(12,479)	(16.8)
Revenue from sales of crude oil in the domestic market	5,999	1.4	13,928	3.4	(7,929)	(56.9)
Revenue from sales of oil products	831	0.2	902	0.2	(71)	(7.9)
<b>Total revenue</b>	<b>417,406</b>	<b>100.0</b>	<b>407,044</b>	<b>100.0</b>	<b>10,362</b>	<b>2.5</b>



### **3.1. Revenue (continued)**

For the six months ended 30 June 2016, the Group's revenue increased by RUB 10,362 or by 2.5%, 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 six months ended 30 June 2016 increased by RUB 30,841 or 9.7% compared to the six months ended 30 June 2015 and accounted for 83.6% 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 28,539 or by 10.4% for the six months ended 30 June 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 5,322 or by 18.5% for the six months ended 30 June 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 PAO NK Rosneft.

Decrease in revenue from export sales of crude oil as for the six months ended 30 June 2016 compared to the six months ended 30 June 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 six months ended 30 June 2016 by RUB 7,929 or by 56.9% 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 six months ended 30 June 2016 by RUB 71 or by 7.9%.

#### **3.1.3. Revenue from oil compounding services**

Growth in revenue from oil compounding services by RUB 280 or by 10.8% as for the six months ended 30 June 2016 compared to the six months ended 30 June 2015 was a result of increase in oil compounding volumes by 11.8% (20,471.2 thousand tons for the six months ended 30 June 2016; 18,309.7 thousand tons for the six months ended 30 June 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.

Decrease of other revenue as for the six months ended 30 June 2016 compared to the relative period of the previous year was mainly caused by recognition of revenue from connection of facilities to the trunk pipeline system and revenue from trunk pipeline expansion services during the six months ended 30 June 2015.



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### 3.2. Operating expenses

Operating expenses for the six months ended 30 June 2016, and the six months ended 30 June 2015, are detailed in the table below:

Operating expense line items	Six months ended 30 June 2016	Share of total expenses, %	Six months ended 30 June 2015	Share of total expenses, %	Absolute change	Change, %
Salaries, social funds contributions and social expenses	69,506	24.9	63,177	23.5	6,329	10.0
Energy	18,907	6.8	17,300	6.4	1,607	9.3
Materials	11,361	4.1	9,097	3.4	2,264	24.9
Repairs services and maintenance of relevant technical condition of pipeline	4,878	1.8	4,941	1.8	(63)	(1.3)
Insurance expenses	3,148	1.1	3,009	1.1	139	4.6
Taxes (other than income tax)	10,352	3.7	8,485	3.2	1,867	22.0
Pension expense	2,541	0.9	3,005	1.1	(464)	(15.4)
Other operating expenses	20,525	7.4	15,494	5.7	5,031	32.5
Depreciation and amortization	67,600	24.2	59,153	22.1	8,447	14.3
Cost of export crude oil sales (including export custom duties)	62,118	22.3	73,854	27.4	(11,736)	(15.9)
Cost of crude oil sold in the domestic market	5,498	2.0	10,684	3.9	(5,186)	(48.5)
Cost of oil products sold	946	0.3	846	0.3	100	11.8
Cost of other goods sold	175	0.1	257	0.1	(82)	(31.9)
One-off expenses	1,122	0.4	-	-	1,122	x
<b>Total operating expenses</b>	<b>278,677</b>	<b>100.0</b>	<b>269,302</b>	<b>100.0</b>	<b>9,375</b>	<b>3.5</b>

For the six months ended 30 June 2016, compared to the six months ended 30 June 2015, the amount of operating expenses increased by RUB 9,375 or by 3.5%.

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).



**TRANSNEFT**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS OF THE GROUP'S FINANCIAL POSITION**  
**AND RESULTS OF ITS OPERATIONS FOR THE SIX MONTHS ENDED 30 JUNE 2016**  
(in millions of Russian roubles, if not stated otherwise)

**3.2 Operating expenses (continued)**

After applying inflation rates\*, operating expenses for the six months ended 30 June 2016, and for the six months ended 30 June 2015, were as follows:

Operating expense line items	Six months ended 30 June 2016	Share of total expenses, %	Inflation rates (2016 to 2015), %*	Six months ended 30 June 2015 (inflated to 2016)	Share of total expenses, %	Absolute change	Change, %
Salaries, social funds contributions and social expenses	69,506	24.9	7.5	67,915	24.7	1,591	2.3
Energy	18,907	6.8	8.2	18,719	6.8	188	1.0
Materials	11,361	4.1	3.7	9,434	3.4	1,927	20.4
Repairs services and maintenance of relevant technical condition of pipeline	4,878	1.8	4.0	5,139	1.9	(261)	(5.1)
Insurance expenses	3,148	1.1	3.7	3,120	1.1	28	0.9
Taxes (other than income tax)	10,352	3.7	3.7	8,799	3.2	1,553	17.6
Pension expense	2,541	0.9	7.5	3,230	1.2	(689)	(21.3)
Other operating expenses	20,525	7.3	3.7	16,067	5.8	4,458	27.7
Depreciation and amortization	67,600	24.2	X	59,153	21.5	8,447	14.3
Cost of export crude oil sales (including export custom duties)	62,118	22.3	(2.6)	71,934	26.2	(9,816)	(13.6)
Cost of crude oil sold in the domestic market	5,498	2.0	(2.6)	10,406	3.8	(4,908)	(47.2)
Cost of oil products sold	946	0.3	(4.0)	812	0.3	134	16.5
Cost of other goods sold	175	0.1	3.7	267	0.1	(92)	(34.5)
One-off expenses	1,122	0.4	(2.6)	-	-	1,122	x
<b>Total operating expenses</b>	<b>278,677</b>	<b>100.0</b>	<b>X</b>	<b>274,995</b>	<b>100.0</b>	<b>3,682</b>	<b>1.3</b>

\*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 are calculated using operating expenses indicator based on aggregated RAS data which considers the previous year data adjusted for conditions of the reporting period. 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.



**TRANSNEFT**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS OF THE GROUP'S FINANCIAL POSITION**  
**AND RESULTS OF ITS OPERATIONS FOR THE SIX MONTHS ENDED 30 JUNE 2016**  
(in millions of Russian roubles, if not stated otherwise)

### 3.2 Operating expenses (continued)

Unit costs for transportation of oil as per 100 tons-kilometers as for the six months ended 30 June 2016 and for the six months ended 30 June 2015 were as follows:

	Six months ended 30 June 2016	Six months ended 30 June 2015	Absolute change	Change, %
<b>Oil transportation services</b>				
Turnover, mln. tons x km	603,486	588,497	14,989	2.5
Unit costs per 100 tons x km, RUB	16.81	15.68	1.14	7.3
Inflated unit costs per 100 tons x km, RUB (inflated to 2016)		16.48	0.34	2.1

Unit costs for oil products transportation per ton as for the six months ended 30 June 2016 and as for the six months ended 30 June 2015 were as follows:

	Six months ended 30 June 2016	Six months ended 30 June 2015	Absolute change	Change, %
<b>Oil products transportation services</b>				
Volume turnover, mln. of tons	17.2	16.1	1.1	6.8
Unit costs per ton, RUB		572.71	33.42	5.84
Inflated unit costs per ton, RUB (inflated to 2016)	606.13	601.92	4.21	0.70

#### 3.2.1. Salaries, social funds contributions and social expenses

Salaries comprise wages, accrual of provision for annual bonus, provision for unused vacation and other remuneration in accordance with IAS 19 Employee benefits.

The increase in salaries, social funds contributions and social expenses for the six months ended 30 June 2016 compared to the six months ended 30 June 2015 in the amount of RUB 6,329 or 10.0% was mainly influenced by an increase of social funds contributions caused by increase of the limit for their accrual, indexation of wages held in 2016.

#### 3.2.2. Pension expense

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 pension plans.

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 Employee benefits and related expenses accrued.

	Six months ended 30 June 2016	Six months ended 30 June 2015	Absolute change	Change, %
Employers' contributions to AO NPF Transneft in favor of employees	2,435	2,897	(462)	(15.9)



### 3.2.3. Energy

Energy expenses for the six months ended 30 June 2016 increased by RUB 1,607 or 9.3% 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 of energy purchased because of increase in turnover.

The movement of power and energy consumption of oil transporting and oil products transporting subsidiaries of the Group is presented in the table below:

	Six months ended 30 June 2016	Six months ended 30 June 2015	Absolute change	Change, %
Average annual capacity, thsd. kW	1,576	1,511	65	4.3
Consumption of energy, mln. kW*h	7,193	6,894	299	4.3

### 3.2.4. Materials

Expenses on materials for the six months ended 30 June 2016 as compared to the same period of 2015, increased by RUB 2,264 or 24.9%.

### 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 63 or by 1.3% 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 six months ended 30 June 2016 amounted to RUB 62,118 includes cost of sales in the amount of RUB 48,884 of cruied oil purchased from PAO NK Rosneft under a contract signed in April 2009 and custom duties in the amount of RUB 13,234. This figure is a result of oil supplies to the People's Republic of China (ref. to 3.1.2.).

Decrease in cost of marketable oil sold in the domestic market as for the six months ended 30 June 2016 amounted to RUB 5,186 or 48.5% as compared to the relative period of 2015 and was caused by decrease in sale volumes of marketable oil by the Group's subsidiaries.

The cost of marketable oil products sold as for the six months ended 30 June 2016 increased by RUB 100 or 11.8% as compared to the relative period of 2015.

### 3.2.7. Taxes (other than income tax)

The amount of the Group's other taxes recognised 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.

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 the amount of profit recognised by the Group in "Share of profit from associates and jointly controlled entities" by RUB 7,906 was mainly caused by improved performance of the Group PAO NCSP and foreign exchange gains arising due the strengthening of Russian rouble to the US Dollar during the six month ended 30 June 2016.



**TRANSNEFT**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS OF THE GROUP'S FINANCIAL POSITION**  
**AND RESULTS OF ITS OPERATIONS FOR THE SIX MONTHS ENDED 30 JUNE 2016**  
(in millions of Russian roubles, if not stated otherwise)

**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	Six months ended 30 June 2016	Six months ended 30 June 2015	Absolute change	Change, %
Interest income from cash and equivalents	953	4,760	(3,807)	(80.0)
Interest income from other financial assets	9,385	14,511	(5,126)	(35.3)
Other interest income	374	268	106	39.6
<b>Total interest receivable</b>	<b>10,712</b>	<b>19,539</b>	<b>(8,827)</b>	<b>(45.2)</b>
Less interest income on the temporary investment of borrowings	(789)	(161)	(628)	4.9 times
<b>Total interest income recognised in the statement of profit or loss and other comprehensive income</b>	<b>9,923</b>	<b>19,378</b>	<b>(9,455)</b>	<b>(48.8)</b>

Decrease in interest income for the six months ended 30 June 2016 by RUB 9,455 or by 48.8% 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	Six months ended 30 June 2016	Six months ended 30 June 2015	Absolute change	Change, %
Interest expenses on loans and borrowings	23,174	20,568	2,606	12.7
Distribution of investment income to pension liabilities	3,407	3,162	245	7.7
Other interest expenses	2,060	1,841	219	11.9
<b>Total interest expenses</b>	<b>28,641</b>	<b>25,571</b>	<b>3,070</b>	<b>12.0</b>
Less finance costs to be capitalised	(1,619)	(1,042)	(577)	55.4
<b>Total interest expense recognised in the statement of profit or loss and other comprehensive income</b>	<b>27,022</b>	<b>24,529</b>	<b>2,493</b>	<b>10.2</b>

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 six months ended 30 June 2016 and for the relevant period of 2015;
- interest payable on series 01-03 of non-convertible interest-bearing documentary bonds amounting to RUB 93,688 for the six months ended 30 June 2016 and for the amount of RUB 110,427 for the relevant period of 2015;
- interest payable of non-convertible interest-bearing documentary bonds for the amount RUB 47,195 for the six months ended 30 June 2016 and for the amount RUB 15,000 for the relevant period of 2015.

Increase of interest expense as for the six months ended 30 June 2016 as compared to the similar period of 2015 was mainly driven by higher growth of US Dollar rate during the six months ended 30 June 2016 compared to the six months ended 30 June 2015.



### 3.4. Finance income and costs (continued)

During the six months ended 30 June 2016, interest in the amount of RUB 830 was capitalised as part of cost of assets under construction (for the six months ended 30 June 2015 – RUB 881) including:

- interest expenses to be capitalised in the amount of RUB 1,619 (for the six months ended 30 June 2015 – RUB 1,042);
- interest income to be excluded from interest expenses to be capitalised in the amount of RUB 789 (for the six months ended 30 June 2015 – RUB 161).

#### Foreign currency exchange gains and losses

The amount of foreign currency exchange gains and losses for the six months ended 30 June 2016, compared to the six months ended 30 June 2015, was a result of changes in the exchange rate 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 consolidated interim condensed financial statements on gross base.

Foreign exchange differences by sources are disclosed in the table below:

	Six months ended 30 June 2016	Six months ended 30 June 2015	Absolute change	Change, %
Foreign exchange gains on financial investments	24,331	114,457	(90,126)	(78.7)
Foreign exchange gains on loans and borrowings	124,544	182,328	(57,784)	(31.7)
Other foreign exchange gains	16,711	34,068	(17,357)	(50.9)
<b>Total foreign exchange gains recognised in the statement of profit or loss and other comprehensive income</b>	<b>165,586</b>	<b>330,853</b>	<b>(165,267)</b>	<b>(50.0)</b>
Foreign exchange loss on financial investments	(63,577)	(127,254)	63,677	(50.0)
Foreign exchange loss on loans and borrowings	(40,485)	(175,141)	134,656	(76.9)
Other foreign exchange loss	(31,755)	(33,900)	2,145	(6.3)
<b>Total foreign exchange loss recognised in the statement of profit or loss and other comprehensive income</b>	<b>(135,817)</b>	<b>(336,296)</b>	<b>200,479</b>	<b>(59.6)</b>
<b>Net foreign exchange gain/ (loss)</b>	<b>29,769</b>	<b>(5,443)</b>	<b>35,212</b>	<b>x</b>

Dynamics of exchange differences presented in the table was driven by strengthening of RUB to USD during the six months ended 30 June 2016 which is more significant then the strengthening of RUB to USD as for the six months ended 30 June 2015 (ref. to 2.3).

#### Derivatives

As for the six months ended 30 June 2016 net gain recognized by the Group from operations with derivatives amounted to RUB 3,388 which was less than the figure for the six months ended 30 June 2015 for the amount of RUB 12,778 or 79.0%. The dynamics was driven by significant volatility of exchange rate of RUB to US Dollar during the six months ended 30 June 2015 and settlement of obligation under barrier options in the year 2015.





**TRANSNEFT**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS OF THE GROUP'S FINANCIAL POSITION**  
**AND RESULTS OF ITS OPERATIONS FOR THE SIX MONTHS ENDED 30 JUNE 2016**  
(in millions of Russian roubles, if not stated otherwise)

### 3.5. Reconciliation of profit and EBITDA

	Six months ended 30 June 2016	Six months ended 30 June 2015	Change, %
<b>Profit for the period</b>	<b>134,521</b>	<b>119,775</b>	<b>12.3</b>
Adjustments for:			
income tax expense	33,306	27,592	20.7
depreciation and amortization	67,600	59,153	14.3
result of crued oil sales to China	342	(401)	x
net finance income	(16,835)	(6,266)	2.7 times
share of profit from associates and jointly controlled entities	(11,265)	(3,359)	3.4 times
gain on disposal of subsidiaries	(998)	-	x
one-off expenses	1,122	-	x
<b>EBITDA*</b>	<b>207,793</b>	<b>196,494</b>	<b>5.8</b>
<b>EBITDA margin*, %</b>	<b>58.4</b>	<b>59.0</b>	<b>x</b>

\* Less crude oil sale and purchase operations under contracts with PAO 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

	Six months ended 30 June 2016	Six months ended 30 June 2015	Absolute change	Change, %
Cash flows from operating activities	117,882	142,122	(24,240)	(17.1)
Cash flows used in investing activities	(90,797)	(72,894)	(17,903)	24.6
<b>Free cash inflow*</b>	<b>27,085</b>	<b>69,228</b>	<b>(42,143)</b>	<b>(60.9)</b>
Cash flows used in financing activities	(21,074)	(52,393)	31,319	(59.8)
<b>Net cash inflow</b>	<b>6,011</b>	<b>16,835</b>	<b>(10,824)</b>	<b>(64.3)</b>
Change in cash and cash equivalents due to deviation of currency exchange rate	(11,850)	(532)	(11,318)	22.3 times
<b>Net (decrease) / increase in cash and cash equivalents</b>	<b>(5,839)</b>	<b>16,303</b>	<b>(22,142)</b>	<b>x</b>

\*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 six months ended 30 June 2016 amounted to RUB 37,336 (positive free cash flow as for the six months ended 30 June 2015 amounted to RUB 27,909).



#### **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 117,882 for the six months ended 30 June 2016, which is RUB 24,240 or 17.1% lower than for the six months ended 30 June 2015.

The main factors which influenced on decrease of cash generated from operating activities for the six months ended 30 June 2016 as compared to the similar period in 2015 were as follows:

- increase in cash receipts from customers by RUB 9,274;
- increase in cash paid to suppliers by RUB 14,290;
- decrease in cash received from the refund of VAT and other taxes from the budget by RUB 17,825;
- increase in amount of interest paid by RUB 1,089.

#### **4.2. Investing activities**

The primary factors resulting in an increase in cash used in investment activities by RUB 17,903 or 24.6% for the six months ended 30 June 2016 compared to the same period of the previous year were:

- increase in the amount of purchase of property, plant and equipment by RUB 23,208;
- net cash inflow as for the six months ended 30 June 2016 from purchase-and-sale transactions of debt securities and allocation/closure of deposits in the amount of RUB 64,421 compared to net cash outflow for the relative period of 2015 amounting to RUB 41,319;
- decrease in interest and dividends received by RUB 5,518;
- 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 six months ended 30 June 2016 as compared to the relative period of 2015 by RUB 31,319 or 59.8% were:

- decrease of cash used for repayment of bonds and loans and borrowings in the amount of RUB 10,529:  
for the six months ended 30 June 2016 monthly repayments of the loan to China Development Bank in the total amount of USD 333.3 mln (RUB 23,594 at the rate of Central Bank of the Russian Federation on the dates of operations), RUB denominated bonds were repaid (repurchased) in the amount of RUB 10,414;  
during the six months ended 30 June 2015 monthly repayments of loan to China Development Bank were made in the amount of USD 333.3 mln (RUB 18,881 at the rate of Central Bank of the Russian Federation on the date of operation), RUB denominated bonds were repaid (repurchased) in the amount of RUB 24,573 and loan from LatRosTrans was repaid in the amount of RUB 1,083;
- payments for acquisition of non-controlling interests: 36% in AO Transneft Prikamye (former OAO SZMN) and 25% in OOO Transneft-Terminal amounting to RUB 7,856 during the six months ended 30 June 2015;
- cash received from placement of rouble denominated bonds in the amount of RUB 22,184 during the six months ended 30 June 2016;
- settlement of derivatives liability included in Other cash used in financing activities.



**TRANSNEFT**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS OF THE GROUP'S FINANCIAL POSITION**  
**AND RESULTS OF ITS OPERATIONS FOR THE SIX MONTHS ENDED 30 JUNE 2016**  
(in millions of Russian roubles, if not stated otherwise)

**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 six months ended 30 June 2016.

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

- (a) changes during the reporting 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 profit from associates and jointly controlled entities;
- (c) all other items for which the cash effects are investing or financing cash flows.

	Six months ended 30 June 2016	Six months ended 30 June 2015
<b>OPERATING ACTIVITIES</b>		
<b>Profit before tax</b>	<b>167,827</b>	<b>147,367</b>
<b>Adjustments for:</b>		
Depreciation and amortization	67,600	59,153
Loss from disposal of property, plant and equipment	507	474
Finance income	(180,538)	(367,091)
Finance costs	163,703	360,825
Gain on disposal of subsidiaries	(998)	-
Share of profit from associates and jointly controlled entities	(11,265)	(3,359)
Others	(5,011)	(8,501)
<b>Operating profit before changes in working capital and reserves</b>	<b>201,825</b>	<b>188,868</b>
Changes in operating assets and liabilities:		
Changes in inventories	(1,829)	(715)
Changes in trade and other receivables relating to operating activity and VAT assets	(39,598)	(3,478)
Changes in trade and other payables, and accruals relating to operating activity	1,310	(1,336)
<b>Cash flows from operating activities before payment of income tax expense and interest</b>	<b>161,708</b>	<b>183,339</b>
Income tax paid	(25,438)	(24,109)
Income tax refund	300	491
Interest paid	(18,688)	(17,599)
<b>Net cash flows received from operating activities</b>	<b>117,882</b>	<b>142,122</b>



## 5. Liquidity analysis

	30 June 2016	31 December 2015	Change, %
Current assets	595,472	640,914	(7.1)
including:			
cash and cash equivalents	86,874	92,713	(6.3)
short-term bank promissory notes, deposits and bonds*	354,509	427,192	(17.0)
Current liabilities	257,957	240,451	7.3
Net working capital	337,515	400,463	(15.7)
Current ratio	2.3	2.7	x
Quick ratio**	1.9	2.3	x
Debt / EBITDA	2.1	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 and other companies 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