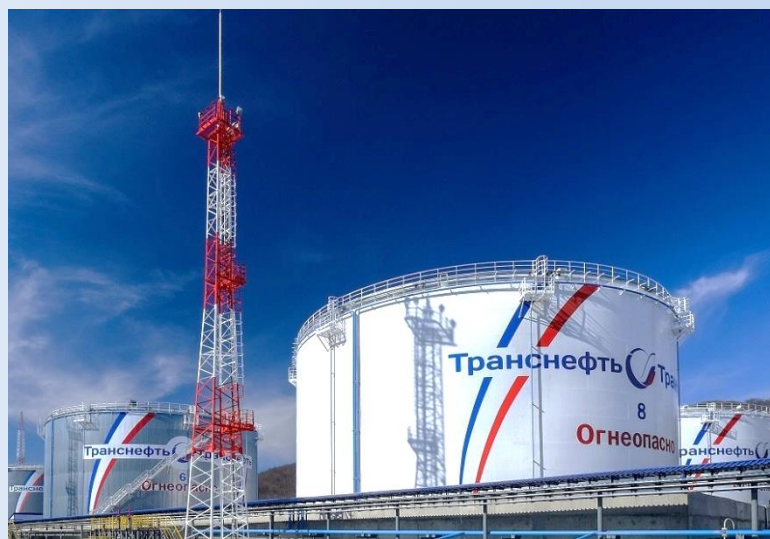


TRANSNEFT

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

FOR THE THREE MONTHS ENDED 31 MARCH 2017





**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 Transneft and its subsidiaries (hereinafter – the “Group”) as at 31 March 2017 and results of operations for the three months ended 31 March 2017, compared to the three months ended 31 March 2016, 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 2017.

**Key financial and operating results**

	Three months ended 31 March 2017	Three months ended 31 March 2016	Change, %
Revenue	219,071	204,005	7.4
Profit for the period	79,507	75,568	5.2
Earnings before interest, income tax, depreciation and amortisation (EBITDA*)	110,385	107,131	3.0
Oil delivered to consignees, mln tons	117.7	119.4	(1.4)
including:			
Russian oil refineries, mln tons	60.2	59.8	0.7
transshipment into the CPC-R system, mln tons	0.002	0.298	(99.3)
exports to neighboring countries, mln tons	4.1	5.9	(30.5)
exports to other countries, mln tons	53.4	53.4	-
Oil products delivered to consignees, mln tons	8.1	8.4	(3.6)
including:			
Russia's domestic market, mln tons	1.5	1.6	(6.3)
exports to the Customs Union member countries, mln tons	0.06	0.22	(72.7)
exports to other countries, mln tons	6.5	6.6	(1.5)

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

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

	Three months ended 31 March 2017	Three months ended 31 March 2016	Absolute change	Change, %
<b>Profit for the period</b>	<b>79,507</b>	<b>75,568</b>	<b>3,939</b>	<b>5.2</b>
Net gain from foreign exchange differences	(13,522)	(17,266)	3,744	(21.7)
Net interest expense	7,409	8,522	(1,113)	(13.1)
Net loss/ (gain) from operations with financial instruments	362	(4,921)	5,283	x
Share of profit from associates and jointly controlled entities	(17,265)	(6,805)	(10,460)	2.5 times
Gain from disposal of subsidiaries	-	(998)	998	(100.0)
<b>Adjusted profit for the period</b>	<b>56,491</b>	<b>54,100</b>	<b>2,391</b>	<b>4.4</b>



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

Public joint stock company Transneft was incorporated in accordance the Russian Government Resolution No. 810 dated 14 August 1993, hereinafter the Company.

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 including production of goods, works and services for servicing trunk oil pipeline and trunk oil products pipeline system to maintain its working condition, increase efficiency and safety of its operations;
- performing of scientific, technical, production, financial and foreign economic activities including mediating activity in the territory of the Russian Federation and outside of Russia;
- carrying out works relating to use of information constituting state secrets (protection of state secrets), provision of services for keeping state secrets safe;
- operating of oil and oil products trunk pipeline transport, sale of and storage of oil and oil products;
- carrying out activities to organize departmental protection of fuel and energy complex objects owned by the Company and (or) companies, more than 50 percent of voting shares (stakes in the authorized capital) of which are owned by the Company and (or) companies, whose decisions the Company has the ability to determine, and the products supplied under the state contract.

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 31 March 2017 possesses an extensive network of trunk oil pipelines with a total length of approximately 52.7 thousand km and trunk oil products pipelines with a total length of some 15.6 thousand km.

During the three months ended 31 March 2017 the Group transported more than 83% of oil produced in Russia and more than 26% of light oil products produced in Russia, as well as significant volume 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 and Europe.



### 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:

- 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 ESPO – Komsomolskiy NPZ;
- Development of the trunk pipeline system for increase of deliveries of oil products to Primorsk Sea Port to 25 mln tons (Project “Sever”);
- 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.

### 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 have 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 provides tariff-based oil and oil products transportation services to consignors.

Tariff rates are currently calculated in accordance with the Rules of state regulation of tariffs 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, 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, as well as, by the Decree of the Government of the Russian Federation of 14.03.2014 No. 377-r.

During the year ended 31 December 2016 and three months ended 31 March 2017 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) and Federal Antimonopoly Service (FAS of Russia)<sup>1</sup>:
  - 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 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 rendered for OAO LUKOIL;
  - 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 Sheskhari;
  - 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 Il'skiy 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;
  - Order of the FAS of Russia 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;
  - Order of the FAS of Russia of 01.07.2016 No. 876/16 Concerning the setting of tariff for the services of OAO AK Transneft for delivery of oil via Uhta – Yaroslavl trunk pipeline through Pechora – Chickshino provided to AO “NNK – Pechoraneft”;
  - Order of the FAS of Russia of 29.08.2016 No. 1216/16 Concerning the setting of tariff for the services of Transneft for delivery of oil via Uhta – Yaroslavl trunk pipeline through Urdoma – Privodino provided to AO “NK – Neftisa”;
  - Order of the FAS of Russia of 29.08.2016 No. 1217/16 Concerning the setting of tariff for the services of Transneft for delivery of oil via Uhta – Yaroslavl trunk pipeline through Uhta - Sindor provided to OOO “Nizhneomrinskaya neft”;
  - Order of FAS of Russia of 09.12.2016 No. 1742/16 Concerning the setting of tariff for the services of Transneft for delivery of oil through Chikshino-Zelenoborsk route via Usa – Uhta trunk pipeline provided to OOO ZARUBEZHNEFT – dobitcha Kharyaga;

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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 FAS of Russia of 23.12.2016 No. 1825/16 Concerning the setting of tariff for the services of Transneft for delivery of oil via trunk pipeline system;
- Order of FAS of Russia of 26.12.2016 No. 1863/16 Concerning the setting of tariff for the services of Transneft for delivery of oil through Tikhoretsk – Tuapse-2 route provided to PAO NK Rosneft;
- Order of FAS of Russia of 26.12.2016 No. 1842/16 Concerning the setting of tariff for the services of Transneft-Terminal for loading of oil into railway tank cars on the territory of Grushevaya industrial site of the transshipment complex Sheskharis from trunk pipeline system of Transneft.
- 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 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;
  - 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;
  - Order of the FAS of Russia of 01.07.2016 No. 875/16 Concerning the setting limit for maximum tariff rates for the services of OAO AK Transneft and its affiliated parties for filling of oil products from trunk pipeline network and making amendments to the order of 07.10.2014 of the FST of Russia 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 FAS of Russia of 26.12.2016 No. 1843/16 Concerning the setting limit for maximum tariff rates for the services of Transneft and its affiliated parties for filling of oil products from trunk pipeline network and making amendments to the order of 07.10.2014 of the FST of Russia 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 FAS of Russia of 26.12.2016 No. 1844/16 Concerning the setting limit for maximum tariff rates for the services of Transneft for filling of oil products from trunk pipeline network.



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## 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 2017	Three months ended 31 March 2016	Change, %
Oil production volume in the Russian Federation, mln tons	136.2	135.4	0.6
Light oil refining volume in the Russian Federation, mln tons	30.7	31.1	(1.3)

Oil production volume increased for the three months ended 31 March 2017 compared to the similar period of the previous year by 0.8 mln tons or by 0.6%.

Light oil refining during the three months ended 31 March 2017 in the Russian Federation decreased by 0.4 mln tons or by 1.3% 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.

	Three months ended 31 March 2017	Three months ended 31 March 2016	Change, %
Change in the rouble's exchange rate against the US dollar, %	(7.05)	(7.24)	x
Average exchange rate for the period (roubles per US dollar)	58.84	74.63	(21.2)
Exchange rate at the end of the period (roubles per US dollar)	56.38	67.61	(16.6)

## 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 2017	Three months ended 31 March 2016	Change, pp
Rouble inflation (CPI), %	1.0	2.1	(1.1)





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## 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 2017	Three months ended 31 March 2016	Change, %
Current income tax	16,619	21,057	(21.1)
Property tax	7,407	5,363	38.1
Other taxes and levies	7,275	7,532	(3.4)

### Income tax

The federal income tax rate is 3.0% (for the same period of 2016 – 2.0%), while the regional tax rates range from 12.5% to 17.0% (from 13.5% to 18% for the same period of 2016). 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 2,044 or by 38.1%. The increase was a result of putting into use of fixed assets, revaluation of property, plant and equipment at replacement cost in accounting under Russian accounting standards which was held at 31 December 2016, increase of 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 1.3% during 2016, 1.6% during 2017.

### Other taxes and levies

Other taxes, levies and insurance contributions mainly include insurance contributions (which are regulated by Tax Code of Russia from 1 January of 2017), as well as, transport tax, land tax and other levies. Comparative figures for the three months ended 31 March 2016 include the same insurance contributions which were paid to social funds before 1 January 2017.

## 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 2017 and the relative period of 2016.

	Three months ended 31 March 2017	Three months ended 31 March 2016	Absolute change	Change, %
<b>Revenue</b>	<b>219,071</b>	<b>204,005</b>	<b>15,066</b>	<b>7.4</b>
Revenue from oil transportation services	155,022	149,608	5,414	3.6
Revenue from oil products transportation services	18,704	18,122	582	3.2
Revenue from crude oil sales	38,590	30,392	8,198	27.0
Other revenue	6,755	5,883	872	14.8
Operating expenses net of amortisation and depreciation	(108,904)	(97,011)	(11,893)	12.3
<b>Operating profit net of amortisation and depreciation</b>	<b>110,167</b>	<b>106,994</b>	<b>3,173</b>	<b>3.0</b>
Amortisation and depreciation	(37,379)	(34,895)	(2,484)	7.1
<b>Operating profit</b>	<b>72,788</b>	<b>72,099</b>	<b>689</b>	<b>1.0</b>
Other expenses	4,024	1,022	3,002	3.9 times
Share of profit from associates and jointly controlled entities	17,265	6,805	10,460	2.5 times
<b>Profit before income tax and finance income</b>	<b>94,077</b>	<b>79,926</b>	<b>14,151</b>	<b>17.7</b>
Net finance income	5,751	13,665	(7,914)	(57.9)
<b>Profit before income tax</b>	<b>99,828</b>	<b>93,591</b>	<b>6,237</b>	<b>6.7</b>
<b>Income tax expense</b>	<b>(20,321)</b>	<b>(18,023)</b>	<b>(2,298)</b>	<b>12.8</b>
<b>Profit for the reporting period</b>	<b>79,507</b>	<b>75,568</b>	<b>3,939</b>	<b>5.2</b>
Other comprehensive loss, net of income tax	(669)	(562)	(107)	19.0
<b>Total comprehensive income, net of income tax</b>	<b>78,838</b>	<b>75,006</b>	<b>3,832</b>	<b>5.1</b>



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### 3.1. Revenue

Revenue by type of operations	Three months ended 31 March 2017	Share of total revenue, %	Three months ended 31 March 2016	Share of total revenue, %	Absolute change	Change, %
<b>Revenue from crude oil transportation services</b>	<b>155,022</b>	<b>70.8</b>	<b>149,608</b>	<b>73.3</b>	<b>5,414</b>	<b>3.6</b>
exports, except the CIS	84,531	38.6	85,097	41.7	(566)	(0.7)
exports in the CIS	4,241	1.9	4,429	2.2	(188)	(4.2)
domestic sales	66,250	30.3	60,082	29.4	6,168	10.3
Revenue from oil products transportation services	18,704	8.5	18,122	8.9	582	3.2
Revenue from oil compounding services	1,620	0.7	1,389	0.7	231	16.6
Revenue from sales of crude oil in the domestic market	2,946	1.4	1,740	0.9	1,206	69.3
Revenue from sales of oil products	900	0.4	483	0.2	417	86.3
Other revenue	4,235	1.9	4,011	2.0	224	5.6
<b>Total revenue (without revenue from export sales of crude oil)</b>	<b>183,427</b>	<b>83.7</b>	<b>175,353</b>	<b>86.0</b>	<b>8,074</b>	<b>4.6</b>
Revenue from export sales of crude oil	35,644	16.3	28,652	14.0	6,992	24.4
<b>Total revenue</b>	<b>219,071</b>	<b>100.0</b>	<b>204,005</b>	<b>100.0</b>	<b>15,066</b>	<b>7.4</b>

For the three months ended 31 March 2017, the Group's revenue increased by RUB 15,066 or by 7.4%, 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 2017 increased by RUB 8,074 or 4.6% compared to the three months ended 31 March 2016 and accounted for 83.7% 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 5,414 or by 3.6% for the three months ended 31 March 2017 comparable to the same period of 2016 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 582 or by 3.2% for the three months ended 31 March 2017 compared to the same period of 2016 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.

Increase in revenue from export sales of crude oil by RUB 6,992 or 24.4% as for the three months ended 31 March 2017 compared to the three months ended 31 March 2016 was mainly a result of growth in average oil market price per barrel set in USD as well as decrease of USD/RUB exchange rate during the reporting period as compared to the same period of the previous year which resulted in the growth of oil price per barrel set in RUB for the three months ended 31 March 2017 as compared to the three months ended 31 March 2016.

Increase in revenue from domestic sales of crude oil as for the three months ended 31 March 2017 by RUB 1,206 or by 69.3% compared to the relative period of the previous year was a result of increase of sale volumes of crude oil by the companies of the Group.

#### 3.1.3. Revenue from oil compounding services

Growth in revenue from oil compounding services by RUB 231 or by 16.6% as for the three months ended 31 March 2017 compared to the three months ended 31 March 2016 was a result of increase in oil compounding volumes by 13.8% (11,407.5 thousand tons for the three months ended 31 March 2017; 10,027.5 thousand tons for the three months ended 31 March 2016).



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**3.1.4. Other revenue**

Other revenue includes revenue oil and oil products storage services, communication services, diagnostic services, construction services, information services related to oil transportation, rent services, organization of transporting of cargos, as well as revenue from provision of other services.

**3.2. Operating expenses net of amortisation and depreciation**

Operating expenses net of amortisation and depreciation for the three months ended 31 March 2017, and the three months ended 31 March 2016, are detailed in the table below:

Operating expense line items	Three months ended 31 March 2017	Share of total expenses, %	Three months ended 31 March 2016	Share of total expenses, %	Absolute change	Change, %
Salaries, insurance contributions and social expenses	32,531	29.9	32,681	33.7	(150)	(0.5)
Energy	11,029	10.1	9,694	10.0	1,335	13.8
Materials	7,210	6.6	5,139	5.3	2,071	40.3
Repair and maintenance of relevant technical condition of pipeline	2,279	2.1	1,547	1.6	732	47.3
Insurance expenses	1,522	1.4	1,597	1.6	(75)	(4.7)
Taxes (other than income tax)	7,260	6.7	5,290	5.5	1,970	37.2
Pension expense	1,834	1.7	1,311	1.4	523	39.9
Cost of crude oil sold in the domestic market	2,585	2.4	1,868	1.9	717	38.4
Cost of oil products sold	813	0.7	651	0.7	162	24.9
Cost of other goods sold	420	0.4	610	0.6	(190)	(31.1)
Other operating expenses	5,559	5.1	7,834	8.0	(2,275)	(29.0)
<b>Operating expenses (net of export crude oil sales)</b>	<b>73,042</b>	<b>67.1</b>	<b>68,222</b>	<b>70.3</b>	<b>4,820</b>	<b>7.1</b>
Cost of export crude oil sales (including export custom duties)	35,862	32.9	28,789	29.7	7,073	24.6
<b>Operating expenses net of amortisation and depreciation</b>	<b>108,904</b>	<b>100.0</b>	<b>97,011</b>	<b>100.0</b>	<b>11,893</b>	<b>12.3</b>

For the three months ended 31 March 2017, compared to the three months ended 31 March 2016, the amount of operating expenses net of amortisation and depreciation increased by RUB 11,893 or by 12.3%.

Insignificant increase of the operating expenses net of amortisation and depreciation was driven by the following factors:

- increase in the cost of export crude oil sales and cost of crude oil sold in the domestic market (ref. to 3.2.6);
- increase of material expenses (ref. to 3.2.4);
- increase of other taxes (ref. to 3.2.7).



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### 3.2 Operating expenses net of amortisation and depreciation (continued)

After applying inflation rates\*, operating expenses net of amortisation and depreciation for the three months ended 31 March 2017, and for the three months ended 31 March 2016, were as follows:

Operating expense line items	Three months ended 31 March 2017	Share of total expenses, %	Inflation rates (2017 to 2016), %*	Three months ended 31 March 2016 (inflated to 2017)	Share of total expenses, %	Absolute change	Change, %
Salaries, insurance contributions and social expenses	32,531	29.9	4.7	34,217	33.9	(1,686)	(4.9)
Energy	11,029	10.1	10.3	10,692	10.6	337	3.2
Materials	7,210	6.6	4.5	5,370	5.3	1,840	34.3
Repair and maintenance of relevant technical condition of pipeline	2,279	2.1	5.4	1,631	1.6	648	39.7
Insurance expenses	1,522	1.4	4.5	1,669	1.7	(147)	(8.8)
Taxes (other than income tax)	7,260	6.7	4.5	5,528	5.5	1,732	31.3
Pension expense	1,834	1.7	4.7	1,373	1.4	461	33.6
Cost of crude oil sold in the domestic market	2,585	2.4	1.1	1,889	1.9	696	36.8
Cost of oil products sold	813	0.7	0.7	656	0.6	157	23.9
Cost of other goods sold	420	0.4	4.5	637	0.6	(217)	(34.1)
Other operating expenses	5,559	5.1	4.5	8,187	8.1	(2,628)	(32.1)
<b>Operating expenses (net of export crude oil sales)</b>	<b>73,042</b>	<b>67.1</b>	<b>X</b>	<b>71,849</b>	<b>71.2</b>	<b>1,193</b>	<b>1.7</b>
Cost of export crude oil sales (including export custom duties)	35,862	32.9	1.1	29,106	28.8	6,756	23.2
<b>Operating expenses net of amortisation and depreciation</b>	<b>108,904</b>	<b>100.0</b>	<b>X</b>	<b>100,955</b>	<b>100.0</b>	<b>7,949</b>	<b>7.9</b>

\*The inflation rates used are based on scenarios prepared by the Ministry of Economic Development for devising socio-economic development scenarios to 2017 and planning period of 2018 and 2019.

#### 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 is used which is based on key macroeconomic assumptions of social and economic development of Russia for 2017 and forecast for 2018 and 2019 prepared by the Ministry of Economic Development of the Russian Federation.

Unit costs for transportation of oil as per 100 tons-kilometers as for the three months ended 31 March 2017 and for the three months ended 31 March 2016 were as follows:

	Three months ended 31 March 2017	Three months ended 31 March 2016	Absolute change	Change, %
<b>Oil transportation services</b>				
Turnover, mln tons x km	296,666	297,678	(1,012)	(0.3)
Unit costs per 100 tons x km, RUB (2016 figures inflated to 2017)	17.13	16.95	0.18	1.1
Unit costs per 100 tons x km net of new objects expenditure, RUB (2016 figures inflated to 2017)	16.62	16.95	(0.33)	(2.0)



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### 3.2 Operating expenses net of amortisation and depreciation (continued)

Unit costs for oil products transportation per ton as for the three months ended 31 March 2017 and as for the three months ended 31 March 2016 were as follows:

	Three months ended 31 March 2017	Three months ended 31 March 2016	Absolute change	Change, %
<b>Oil products transportation services</b>				
Volume turnover, mln of tons	8.1	8.4	(0.3)	(3.6)
Unit costs per ton, RUB (2016 figures inflated to 2017)	652.29	619.11	33.18	5.4
Unit costs per ton net of new objects expenditure, RUB (2016 figures inflated to 2017)	643.72	619.11	24.61	4.0

#### 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.

As for the three months ended 31 March 2017 salaries, social funds contributions and social expenses have not changed significantly as compared to the three months ended 31 March 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 JSC "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.

	Three months ended 31 March 2017	Three months ended 31 March 2016	Absolute change	Change, %
Employers' contributions to JSC "NPF "Transneft" in favor of employees	1,683	1,228	455	37.1

#### 3.2.3. Energy

Energy expenses for the three months ended 31 March 2017 increased by RUB 1,335 or 13.8% compared to the same period of the previous year. The increase was caused by growth of tariffs of natural monopolies for power and consumed energy and by growth of power purchased because of putting into use Zapolyarie-Purpe, Kyumba-Taishet trunk oil pipelines.

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

	Three months ended 31 March 2017	Three months ended 31 March 2016	Absolute change	Change, %
Average annual capacity, thsd. kW	1,647	1,536	111	7.2
Consumption of energy, mln kW*h	3,632	3,624	8	0.2

#### 3.2.4. Materials

Expenses on materials for the three months ended 31 March 2017 as compared to the same period of 2016, increased by RUB 2,071 or 40.3%. Increase of material expenses was mainly caused by increase of anti-turbulent additives, capital and current repairs produced by the Group itself, as well as, preparation and putting into use of new pipeline objects.



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

The amount of expense for repair and maintenance of relevant technical condition of pipeline increased as for the reporting period by RUB 732 or by 47.3% as compared to the relative period of the previous year because of performing planned capital repairment works.

### 3.2.6. Cost of crude oil and oil products sold

The cost of export crude oil sales for the three months ended 31 March 2017 in the amount of RUB 35,862 includes cost of sales in the amount of RUB 28,160 of crude oil purchased from PAO NK Rosneft under a contract signed in April 2009 and custom duties in the amount of RUB 7,702. This figure is a result of oil supplies to the People's Republic of China (ref. to 3.1.2.).

Increase in cost of oil sold in the domestic market as for the three months ended 31 March 2017 amounted to RUB 717 or 38.4% as compared to the relative period of 2016 and was caused by increase in sale volumes of oil by the Group's subsidiaries.

### 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 by 37.2% was mainly caused by the increase of the property tax expenses (ref. to 2.5).

### 3.2.8. Other operating expenses

Other expenses include communication services, rent expenses, transportation services, business trip expenses, the summarized gains and losses relating to disposal of property, plant and equipment and other assets, fines and penalties received and paid, as well as other income and expenses.

Decrease of other operating expenses was mainly caused by decline from transportation of oil by railway and provision of services by third parties.

### 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" as for the three months ended 31 March 2017 as compared to the relative period of 2016 amounted to RUB 10,460.

### 3.4. Finance income and costs

#### Interest income and expenses

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

Interest income	Three months ended 31 March 2017	Three months ended 31 March 2016	Absolute change	Change, %
Interest income from cash and equivalents	955	499	456	91.4
Interest income from other financial assets	4,105	4,912	(807)	(16.4)
Other interest income	196	205	(9)	(4.4)
<b>Total interest receivable</b>	<b>5,256</b>	<b>5,616</b>	<b>(360)</b>	<b>(6.4)</b>
Less interest income on the temporary investment of borrowings	(148)	(335)	187	(55.8)
<b>Total interest income recognised in the statement of profit or loss and other comprehensive income</b>	<b>5,108</b>	<b>5,281</b>	<b>(173)</b>	<b>(3.3)</b>

Decrease in interest income for the three months ended 31 March 2017 by RUB 173 or by 3.3% compared to the relative period of 2016 was driven mainly by significant decline in interest rates for temporarily free cash deposited with banks.



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

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

Interest expenses	Three months ended 31 March 2017	Three months ended 31 March 2016	Absolute change	Change, %
Interest expenses on loans and borrowings	11,089	11,849	(760)	(6.4)
Distribution of investment income to pension liabilities	1,076	1,733	(657)	(37.9)
Other interest expenses	1,035	1,056	(21)	(2.0)
<b>Total interest expenses</b>	<b>13,200</b>	<b>14,638</b>	<b>(1,438)</b>	<b>(9.8)</b>
Less finance costs to be capitalised	(683)	(835)	152	(18.2)
<b>Total interest expense recognised in the statement of profit or loss and other comprehensive income</b>	<b>12,517</b>	<b>13,803</b>	<b>(1,286)</b>	<b>(9.3)</b>

The amount of interest expenses was composed of:

- interest payable on loan obtained in 2009 from the China Development Bank Corporation with a maturity of 5 years after five years from the moment of issue;
- interest payable on Eurobonds issued by the Group in 2008 for the three months ended 31 March 2017 and for the relevant period of 2016;
- interest payable on series 01-03 of non-convertible interest-bearing documentary bonds for the three months ended 31 March 2017 and for the relevant period of 2016;
- interest payable on non-convertible interest-bearing documentary marketable bonds for the three months ended 31 March 2017 and for the relevant period of 2016.

Decrease of interest expense as for the three months ended 31 March 2017 as compared to the similar period of 2016 was mainly driven by decline of USD/RUB average exchange rate during the three months ended 31 March 2017 compared to the three months ended 31 March 2016 (ref. to 2.3), as well as, decrease from distribution of investment income to pension liabilities.

During the three months ended 31 March 2017, interest in the amount of RUB 535 was capitalised as part of cost of assets under construction (for the three months ended 31 March 2016 – RUB 500) including:

- interest expenses to be capitalised in the amount of RUB 683 (for the three months ended 31 March 2016 – RUB 835);
- interest income to be excluded from interest expenses to be capitalised in the amount of RUB 148 (for the three months ended 31 March 2016 – RUB 335).

#### Foreign currency exchange gains and losses

The amount of foreign currency exchange gains and losses for the three months ended 31 March 2017, compared to the three months ended 31 March 2016, was a result of changes in the exchange rate of the US dollar to the Russian rouble.

Due to a remeasurement of assets and liabilities denominated in foreign currency at the end of every month, foreign currency gains and losses arise, which are presented in the consolidated financial statements on a gross basis.



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

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

	Three months ended 31 March 2017	Three months ended 31 March 2016	Absolute change	Change, %
Foreign exchange gains on financial assets	348	15,523	(15,175)	(97.8)
Foreign exchange gains on loans and borrowings	34,458	74,697	(40,239)	(53.9)
Other foreign exchange gains	1,977	11,119	(9,142)	(82.2)
<b>Total foreign exchange gains recognised in the statement of profit or loss and other comprehensive income</b>	<b>36,783</b>	<b>101,339</b>	<b>(64,556)</b>	<b>(63.7)</b>
Foreign exchange loss on financial assets	(19,676)	(38,490)	18,814	(48.9)
Foreign exchange loss on loans and borrowings	(47)	(23,328)	23,281	(99.8)
Other foreign exchange loss	(3,538)	(22,255)	18,717	(84.1)
<b>Total foreign exchange loss recognised in the statement of profit or loss and other comprehensive income</b>	<b>(23,261)</b>	<b>(84,073)</b>	<b>60,812</b>	<b>(72.3)</b>
<b>Net foreign exchange gain</b>	<b>13,522</b>	<b>17,266</b>	<b>(3,744)</b>	<b>(21.7)</b>

Dynamics of exchange differences presented in the table was driven by lesser strengthening of RUB to USD during the three months ended 31 March 2017 as compared to the strengthening of RUB to USD as for the three months ended 31 March 2016 (ref. to 2.3).

**3.5. Reconciliation of profit and earnings before interest, income tax, depreciation and amortisation (EBITDA)**

	Three months ended 31 March 2017	Three months ended 31 March 2016	Change, %
<b>Profit for the period</b>	<b>79,507</b>	<b>75,568</b>	<b>5.2</b>
Adjustments for:			
income tax expense	20,321	18,023	12.8
amortisation and depreciation	37,379	34,895	7.1
result of crude oil sales to China	218	137	59.1
net finance income	(5,751)	(13,665)	(57.9)
share of profit from associates and jointly controlled entities	(17,265)	(6,805)	2.5 times
other income	(4,024)	(1,022)	3.9 times
<b>EBITDA*</b>	<b>110,385</b>	<b>107,131</b>	<b>3.0</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 interim condensed financial statements.





## 4. Cash flow analysis

	Three months ended 31 March 2017	Three months ended 31 March 2016	Absolute change	Change, %
Cash flows from operating activities	95,973	71,620	24,353	34.0
Cash flows used for purchase of property, plant and equipment (net)	(74,368)	(76,807)	2,439	(3.2)
<b>Free cash inflow / (outflow)</b>	<b>21,605</b>	<b>(5,187)</b>	<b>26,792</b>	<b>x</b>
Cash flows from investing activities	5,199	43,750	(38,551)	(88.1)
Cash flows from / (used in) financing activities	1,343	(12,486)	13,829	x
<b>Net cash inflow</b>	<b>28,147</b>	<b>26,077</b>	<b>2,070</b>	<b>7.9</b>
Change in cash and cash equivalents due to deviation of currency exchange rate	(661)	(8,644)	7,983	(92.4)
<b>Net increase in cash and cash equivalents</b>	<b>27,486</b>	<b>17,433</b>	<b>10,053</b>	<b>57.7</b>

Positive free cash flow for the three months ended 31 March 2017 amounted to RUB 21,605 (negative free cash flow as for the three months ended 31 March 2016 amounted to RUB 5,187).

### 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 95,973 for the three months ended 31 March 2017, which is RUB 24,353 or 34.0% lower than for the three months ended 31 March 2016.

The main factors which influenced on increase of cash generated from operating activities for the three months ended 31 March 2017 as compared to the similar period in 2016 were as follows:

- increase in cash receipts from customers by RUB 25,302;
- decrease in cash paid to suppliers by RUB 19,752;
- increase in cash received from the refund of VAT and other taxes from the budget by RUB 24,477;
- increase in income tax paid amounting to RUB 7,669;
- decrease in the amount of interest paid by RUB 523.

### 4.2. Investing activities

The primary factors resulting in an increase in cash used in investment activities by RUB 36,112 or in 2.1 times as for the three months ended 31 March 2017 compared to the same period of the previous year were:

- increase in net cash inflow as for the three months ended 31 March 2017 from purchase-and-sale transactions of debt securities and allocation/closure of deposits in the amount of RUB 9,038 compared to the three months ended 31 March 2016;
- increase in consideration paid for acquisition of share of associates and jointly controlled entities by RUB 47,503 which was a result of acquisition of 57.4% share in closed combined mutual investment fund Gazprombank – Finansoviy for RUB 60 billion as for the three months ended 31 March 2017 compared to the acquisition of the 50% share in the 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) as for the three months ended 31 March 2016.

### 4.3. Financing activities

The main factors which influenced on cash flows from financing activities for the three months ended 31 March 2017 in the amount of RUB 1,343 as compared to cash used in financing activities as for the three months ended 31 March 2016 by RUB 12,486 were:

- net proceeds from issuance of non-convertible interest-bearing documentary bonds for the amount of RUB 34,996 as for the three months ended 31 March 2017;



#### 4.3. Financing activities (continued)

- increase of cash flows used for repayment of bonds, loans and borrowings as for the three months ended 31 March 2017 as compared to the relative period of 2016 by RUB 21,494 which was a result of the following operations:
  - for the three months ended 31 March 2017 monthly repayments and early repayments of the loan to China Development Bank in the total amount of USD 416.7 mln (RUB 24,042 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 billion;
  - during the three months ended 31 March 2016 monthly repayments of loan to China Development Bank were made in the amount of USD 166.7 mln (RUB 12,550 at the rate of Central Bank of the Russian Federation on the date of operation).

#### 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 three months ended 31 March 2017.

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 amortisation and depreciation, provisions, unrealized foreign currency gains and losses, interest income and expenses, share of profit/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 2017	Three months ended 31 March 2016
<b>OPERATING ACTIVITIES</b>		
<b>Profit before income tax</b>	<b>99,828</b>	<b>93,591</b>
<b>Adjustments for:</b>		
Amortisation and depreciation	37,379	34,895
Loss from disposal of property, plant and equipment	31	119
Finance income	(41,891)	(111,541)
Finance costs	36,140	97,876
Gain on disposal of subsidiaries	-	(998)
Share of profit from associates and jointly controlled entities	(17,265)	(6,805)
Others	(6,496)	(3,767)
<b>Operating profit before changes in working capital and reserves</b>	<b>107,726</b>	<b>103,370</b>
Changes in operating assets and liabilities:		
Changes in inventories	2,294	(140)
Changes in trade and other receivables relating to operating activity and VAT assets	2,007	(23,538)
Changes in trade and other payables, and accruals relating to operating activity	4,693	5,533
<b>Cash flows from operating activities before payment of income tax expense and interest</b>	<b>116,720</b>	<b>85,225</b>
Income tax paid	(10,933)	(3,264)
Income tax refund	43	39
Interest paid	(9,857)	(10,380)
<b>Net cash flows received from operating activities</b>	<b>95,973</b>	<b>71,620</b>



## 5. Liquidity analysis

	31 March 2017	31 December 2016	Change, %
Current assets	475,937	535,607	(11,1)
including:			
cash and cash equivalents	102,072	74,586	36,9
short-term bank deposits and bonds*	266,857	349,529	(23,7)
Current liabilities	249,848	291,488	(14,3)
Net working capital	226,089	244,119	(7,4)
Current ratio	1,9	1,8	x
Quick ratio**	1,6	1,6	x
Debt / EBITDA	1,6	1,7	x
Debt / Equity	0,4	0,4	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