

TRANSNEFT

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

FOR THE YEAR ENDED 31 DECEMBER 2016





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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 December 2016 and results of operations for the year ended 31 December 2016, compared to the year ended 31 December 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 financial statements prepared in accordance with International financial reporting standards (hereinafter – “IFRS”) for the year ended 31 December 2016.

Key financial and operating results

	Year ended 31 December 2016	Year ended 31 December 2015	Change, %
Revenue	848,134	815,652	4.0
Net profit	232,907	143,427	62.4
EBITDA*	408,780	371,459	10.0
Oil delivered to consignees, mln. tons	483.4	481.4	0.4
including:			
Russian oil refineries, mln. tons	245.2	250.2	(2.0)
transshipment into the CPC-R system, mln. tons	0.39	1.63	(76.1)
exports to neighboring countries, mln. tons	18.6	22.0	(15.5)
exports to other countries, mln. tons	219.1	207.6	5.5
Oil products delivered to consignees, mln. tons	33.1	32.2	2.8
including:			
Russia's domestic market, mln. tons	9.3	8.7	6.9
exports to the Customs Union member countries, mln.tons	1.3	0.70	80.0
exports to other countries, mln. tons	22.6	22.79	(1.1)

* 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:

	Year ended 31 December 2016	Year ended 31 December 2015	Absolute change	Change, %
Profit for the year	232,907	143,427	89,480	62.4
Net (gain) / loss from foreign exchange differences	(41,299)	49,043	(90,342)	x
Net interest expense	35,590	14,321	21,269	2.5 times
Net (gain)/ loss from operations with financial instruments	(3,956)	3,848	(7,804)	x
Share of (profit)/loss from associates and jointly controlled entities	(19,519)	4,119	(23,638)	x
Gain from disposal of subsidiaries	(998)	-	(998)	x
Adjusted net profit for the year	202,725	214,758	(12,033)	(5.6)



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 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 December 2016 possesses an extensive network of trunk oil pipelines with a total length of approximately 52.8 thousand km and trunk oil products pipelines with a total length of some 16.2 thousand km.

During the year ended 31 December 2016 the Group transported more than 85% of oil produced in Russia and about 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, Europe, USA and Canada.

Information about some of them as per 100 tons-kilometers is presented below:

- average tariff through oil trunk pipelines of Transneft – USD 0.77/100 tkm;
- average tariff of AO KazTransOil (Kazakhstan) – USD 1.46/100 tkm (USD 1.75/100 tkm for export, USD 1.17/100 tkm – domestic);
- tariff of TAL Pipeline for transportation of oil through Trieste – Ingolstadt direction (Italy, Austria, Germany) – USD 0.87/100 tkm;
- tariff of Transpetrol (Slovakia) – USD 1.69/100 tkm;
- tariff of MERO (Czech) – USD 2.87/100 tkm;
- average tariff of AO Ukrtransnafta for transportation of oil in the direction of Hungary, Slovakia – USD 1.30/100 tkm;
- average tariff Przyjaźń (Poland) – 1.05 USD/100 tkm;
- average tariff of OAO Gomeltransneft Druzhba – USD 0.69/100 tkm;
- average tariff of OAO Polotsktransneft Druzhba – USD 0.57/100 tkm;
- average tariff of Transnafta (Serbia) – USD 2.24/100 tkm;
- average tariff of JANAF (Croatia) – USD 3.14/100 tkm;
- average tariff for transportation of oil through oil pipeline Baku-Tbilisi-Ceyhan (WTC Co consortium) – USD 1.78/100 tkm.



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 following investment projects were completed during 2016:

- Construction of Zapolyarie–Purpe oil trunk pipeline;
- Construction of Kuyumba – Taishet oil trunk pipeline (1st stage – up to 8.6 mln of tons per year);
- Development of the trunk pipeline system to increase oil products delivery to Primorsk Sea Port to 15 mln tons per year. (Project “Sever”);
- Reconstruction of the approach embankment of the special sea oil port Kozmino for the purpose of accepting tankers with deadweight of up to 150 thousand tons.

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”. 1st stage. Reconstruction of the trunk pipelines Tikhoretsk - Novorossiysk;
- Project “Yug”. 2nd 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 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 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 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 year ended 31 December 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) and Federal Antimonopoly Service (FAS of Russia)¹:
- 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 Sheskhari;
 - 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 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 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 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;

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



2.1. Oil and oil products transportation tariffs (continued)

- 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”.
- 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 Russian 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;
 - 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.

	Year ended 31 December 2016	Year ended 31 December 2015	Change, %
Oil production volume in the Russian Federation, mln tons	547.3	533.6	2.6
Light oil refining volume in the Russian Federation, mln tons	125.9	124.9	0.8

Oil production volume increased for the year ended 31 December 2016 compared to the similar period of the previous year by 13.7 mln tons or by 2.6%.

Light oil refining during the year ended 31 December 2016 in the Russian Federation increased by 1.0 mln tons or by 0.8% 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.

	Year ended 31 December 2016	Year ended 31 December 2015	Change, %
Change in the rouble's exchange rate against the US dollar, %	(16.77)	29.55	x
Average exchange rate for the period (roubles per US dollar)	67.03	60.96	10.0
Exchange rate at the end of the period (roubles per US dollar)	60.66	72.88	(16.8)

2.4. Inflation rates

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

	Year ended 31 December 2016	Year ended 31 December 2015	Change, pp
Rouble inflation (CPI), %	5.4	12.9	(7.5)

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:

	Year ended 31 December 2016	Year ended 31 December 2015	Change, %
Current income tax	55,613	42,855	29.8
Property tax	21,704	16,659	30.3
Other taxes and levies	957	921	3.9

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.



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2.5 Taxation (continued)

Property tax

The amount of property tax increased by RUB 5,045 or by 30.3%. 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 31.12.2015, 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 1.0% during 2015, 1.3% during 2016.

Other taxes and levies

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

3. Analysis of the Group's performance

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

	Year ended 31 December 2016	Year ended 31 December 2015	Absolute change	Change, %
Revenue	848,134	815,652	32,482	4.0
Revenue from oil transportation services	614,139	558,775	55,364	9.9
Revenue from oil products transportation services	64,485	57,309	7,176	12.5
Revenue from crude oil sales	142,299	171,512	(29,213)	(17.0)
Other revenue	27,211	28,056	(845)	(3.0)
Operating expenses net of amortisation and depreciation	(439,917)	(442,370)	2,453	(0.6)
Operating profit net of amortisation and depreciation	408,217	373,282	34,935	9.4
Amortisation and depreciation	(128,523)	(118,767)	(9,756)	8.2
Operating profit	279,694	254,515	25,179	9.9
Other expenses	(7,456)	(17,631)	10,175	(57.7)
Share of profit/(loss) from associates and jointly controlled entities	19,519	(4,119)	23,638	x
Profit before income tax and finance income/(costs)	291,757	232,765	58,992	25.3
Net financial income/(costs)	9,665	(67,212)	76,877	x
Profit before income tax	301,422	165,553	135,869	82.1
Income tax expense	(68,515)	(22,126)	(46,389)	3.1 times
Profit for the reporting period	232,907	143,427	89,480	62.4
Other comprehensive income / (loss), net of income tax	2,321	(5,488)	7,809	x
Total comprehensive income, net of income tax	235,228	137,939	97,289	70.5



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3.1. Revenue

Revenue by type of operations	Year ended 31 December 2016	Share of total revenue, %	Year ended 31 December 2015	Share of total revenue, %	Absolute change	Change, %
Revenue from crude oil transportation services	614,139	72.5	558,775	68.5	55,364	9.9
exports, except the CIS	351,834	41.5	309,788	38.0	42,046	13.6
exports in the CIS	16,743	2.0	14,627	1.8	2,116	14.5
domestic sales	245,562	29.0	234,360	28.7	11,202	4.8
Revenue from oil products transportation services	64,485	7.6	57,309	7.0	7,176	12.5
Revenue from oil compounding services	6,015	0.7	5,329	0.7	686	12.9
Other revenue	18,345	2.1	21,005	2.6	(2,660)	(12.7)
Total revenue (without revenue from sales of crude oil and oil products)	702,984	82.9	642,418	78.8	60,566	9.4
Revenue from export sales of crude oil	127,113	15.0	143,589	17.6	(16,476)	(11.5)
Revenue from sales of crude oil in the domestic market	15,186	1.8	27,923	3.4	(12,737)	(45.6)
Revenue from sales of oil products	2,851	0.3	1,722	0.2	1,129	65.6
Total revenue	848,134	100.0	815,652	100.0	32,482	4.0

For the year ended 31 December 2016, the Group's revenue increased by RUB 32,482 or by 4.0%, 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 year ended 31 December 2016 increased by RUB 60,566 or 9.4% compared to the year ended 31 December 2015 and accounted for 82.9% of total revenue as for the reporting period.

3.1.1. Oil and oil products transportation services

Increase in revenue from oil transportation services amounted to RUB 55,364 or by 9.9% for the year ended 31 December 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 7,176 or by 12.5% for the year ended 31 December 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 by RUB 16,476 or 11.5% as for the year ended 31 December 2016 compared to the year ended 31 December 2015 was mainly a result of decline in average 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 year ended 31 December 2016 by RUB 12,737 or by 45.6% 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.

Increase in revenue from sales of oil products as for the year ended 31 December 2016 amounted to RUB 1,129 or to 65.6%.

3.1.3. Revenue from oil compounding services

Growth in revenue from oil compounding services by RUB 686 or by 12.9% as for the year ended 31 December 2016 compared to the year ended 31 December 2015 was a result of increase in oil compounding volumes by 12.7% (42,684.9 thousand tons for the year ended 31 December 2016; 37,883.8 thousand tons for the year ended 31 December 2015).



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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 year ended 31 December 2016 compared to the relative period of the previous year was mainly caused by decrease of revenue from connection of facilities to the trunk pipeline system and revenue from trunk pipeline expansion services.

3.2. Operating expenses net of amortisation and depreciation

Operating expenses net of amortisation and depreciation for the year ended 31 December 2016, and the year ended 31 December 2015, are detailed in the table below:

Operating expense line items	Year ended 31 December 2016	Share of total expenses, %	Year ended 31 December 2015	Share of total expenses, %	Absolute change	Change, %
Salaries, social funds contributions and social expenses	144,639	32.9	132,202	29.9	12,437	9.4
Energy	38,438	8.7	34,471	7.8	3,967	11.5
Materials	29,505	6.7	24,592	5.6	4,913	20.0
Repairs services and maintenance of relevant technical condition of pipeline	15,746	3.6	14,382	3.3	1,364	9.5
Insurance expenses	7,059	1.6	6,640	1.5	419	6.3
Taxes (other than income tax)	21,362	4.9	17,005	3.8	4,357	25.6
Pension expense	4,392	1.0	5,878	1.3	(1,486)	(25.3)
Other operating expenses	33,901	7.6	36,922	8.3	(3,021)	(8.2)
Cost of export crude oil sales (including export custom duties)	127,676	29.0	141,766	32.0	(14,090)	(9.9)
Cost of crude oil sold in the domestic market	13,497	3.1	23,680	5.4	(10,183)	(43.0)
Cost of oil products sold	2,956	0.7	1,658	0.4	1,298	78.3
Cost of other goods sold	746	0.2	3,174	0.7	(2,428)	(76.5)
Operating expenses net of amortisation and depreciation	439,917	100.0	442,370	100.0	(2,453)	(0.6)

For the year ended 31 December 2016, compared to the year ended 31 December 2015, the amount of operating expenses net of amortisation and depreciation decreased by RUB 2,453 or by 0.6%.

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

- decrease in the cost of export crude oil sales and cost of crude oil sold in the domestic market (ref. to 3.2.6);
- growth of salaries, social funds contributions and social expenses (ref. to 3.2.1);
- growth of material expenses (ref. to 3.2.4).



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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 year ended 31 December 2016, and for the year ended 31 December 2015, were as follows:

Operating expense line items	Year ended 31 December 2016	Share of total expenses, %	Inflation rates (2016 to 2015), %*	Year ended 31 December 2015 (inflated to 2016)	Share of total expenses, %	Absolute change	Change, %
Salaries, social funds contributions and social expenses	144,639	32.9	7.1	141,588	31.2	3,051	2.2
Energy	38,438	8.7	8.2	37,298	8.2	1,140	3.1
Materials	29,505	6.7	3.2	25,379	5.6	4,126	16.3
Repairs services and maintenance of relevant technical condition of pipeline	15,746	3.6	8.1	15,547	3.4	199	1.3
Insurance expenses	7,059	1.6	3.2	6,852	1.5	207	3.0
Taxes (other than income tax)	21,362	4.9	3.2	17,549	3.9	3,813	21.7
Pension expense	4,392	1.0	7.1	6,295	1.4	(1,903)	(30.2)
Other operating expenses	33,901	7.6	3.2	38,104	8.4	(4,203)	(11.0)
Cost of export crude oil sales (including export custom duties)	127,676	29.0	(2.8)	137,797	30.3	(10,121)	(7.3)
Cost of crude oil sold in the domestic market	13,497	3.1	(2.8)	23,017	5.1	(9,520)	(41.4)
Cost of oil products sold	2,956	0.7	(8.0)	1,525	0.3	1,431	93.8
Cost of other goods sold	746	0.2	3.2	3,276	0.7	(2,530)	(77.2)
Operating expenses net of amortisation and depreciation	439,917	100.0	X	454,227	100.0	(14,310)	(3.2)

*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 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 year ended 31 December 2016 and for the year ended 31 December 2015 were as follows:

	Year ended 31 December 2016	Year ended 31 December 2015	Absolute change	Change, %
Oil transportation services				
Turnover, mln. tons x km	1,219,134	1,185,028	34,106	2.9
Unit costs per 100 tons x km, RUB (2015 figures inflated to 2016)	17.68	17.43	0.25	1.4
Unit costs per 100 tons x km net of new objects expenditure, RUB (2015 figures inflated to 2016)	17.26	17.43	(0.17)	(1.0)



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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 year ended 31 December 2016 and as for the year ended 31 December 2015 were as follows:

	Year ended 31 December 2016	Year ended 31 December 2015	Absolute change	Change, %
Oil products transportation services				
Volume turnover, mln. of tons	33.1	32.2	0.9	2.8
Unit costs per ton, RUB (2015 figures inflated to 2016)	724.37	725.44	(1.07)	(0.1)
Unit costs per ton net of new objects expenditure, RUB (2015 figures inflated to 2016)	722.06	725.44	(3.38)	(0.5)

3.2.1. Salaries, social funds contributions and social expenses

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

The increase in salaries, social funds contributions and social expenses for the year ended 31 December 2016 compared to the year ended 31 December 2015 in the amount of RUB 12,437 or 9.4% 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 and putting into use Zapolyarie-Purpe, Kuyumba-Taishet trunk pipelines.

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.

	Year ended 31 December 2016	Year ended 31 December 2015	Absolute change	Change, %
Employers' contributions to JSC "NPF "Transneft" in favor of employees	4,209	5,831	(1,622)	(27.8)

3.2.3. Energy

Energy expenses for the year ended 31 December 2016 increased by RUB 3,967 or 11.5% 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:

	Year ended 31 December 2016	Year ended 31 December 2015	Absolute change	Change, %
Average annual capacity, thsd. kW	1,560	1,506	54	3.6
Consumption of energy, mln. kW*h	14,492	13,867	625	4.5

3.2.4. Materials

Expenses on materials for the year ended 31 December 2016 as compared to the same period of 2015, increased by RUB 4,913 or 20.0%. Increase of material expenses was mainly caused by increase of anti-turbulent additives, capital and current repairs, as well as preparation and putting into use of new pipeline objects.



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 increased as for the reporting period by RUB 1,364 or by 9.5% 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 export for the year ended 31 December 2016 in the amount of RUB 127,676 includes cost of sales in the amount of RUB 97,669 of crude oil purchased from PAO NK Rosneft under a contract signed in April 2009 and custom duties in the amount of RUB 30,007. This figure is a result of oil supplies to the People's Republic of China (ref. to 3.1.2.).

Decrease in cost of oil sold in the domestic market as for the year ended 31 December 2016 amounted to RUB 10,183 or 43.0% as compared to the relative period of 2015 and was caused by decrease in sale volumes of oil by the Group's subsidiaries.

The cost of oil products sold as for the year ended 31 December 2016 increased by RUB 1,298 or 78.3% 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 communication services, rent expenses, transportation services, the resulting 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.

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/(loss) from associates and jointly controlled entities" by RUB 23,638 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 year ended 31 December 2016.

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	Year ended 31 December 2016	Year ended 31 December 2015	Absolute change	Change, %
Interest income from cash and equivalents	2,458	7,872	(5,414)	(68.8)
Interest income from other financial assets	17,701	27,077	(9,376)	(34.6)
Other interest income	793	605	188	31.1
Total interest receivable	20,952	35,554	(14,602)	(41.1)
Less interest income on the temporary investment of borrowings	(1,305)	(778)	(527)	67.7
Total interest income recognised in the statement of profit or loss and other comprehensive income	19,647	34,776	(15,129)	(43.5)



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3.4. Finance income and costs (continued)

Decrease in interest income for the year ended 31 December 2016 by RUB 15,129 or by 43.5% 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	Year ended 31 December 2016	Year ended 31 December 2015	Absolute change	Change, %
Interest expenses on loans and borrowings	46,883	43,064	3,819	8.9
Distribution of investment income to pension liabilities	6,747	4,646	2,101	45.2
Other interest expenses	5,044	3,323	1,721	51.8
Total interest expenses	58,674	51,033	7,641	15.0
Less finance costs to be capitalised	(3,437)	(1,936)	(1,501)	77.5
Total interest expense recognised in the statement of profit or loss and other comprehensive income	55,237	49,097	6,140	12.5

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. With consideration to earlier loan repayment during the year ended 31 December 2016 the loan matures in 2027;
- interest payable on Eurobonds issued by the Group in 2008 for a total of USD 1,050 mln for the year ended 31 December 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 year ended 31 December 2016 and for the amount of RUB 104,102 for the relevant period of 2015;
- interest payable of non-convertible interest-bearing documentary bonds for the amount RUB 104,195 for the year ended 31 December 2016 and for the amount RUB 25,045 for the relevant period of 2015.

Increase of interest expense as for the year ended 31 December 2016 as compared to the similar period of 2015 was mainly driven by higher USD/RUB average exchange rate during the year ended 31 December 2016 compared to the year ended 31 December 2015 (ref. to 2.3).

During the year ended 31 December 2016, interest in the amount of RUB 2,132 was capitalised as part of cost of assets under construction (for the year ended 31 December 2015 – RUB 1,158) including:

- interest expenses to be capitalised in the amount of RUB 3,437 (for the year ended 31 December 2015 – RUB 1,936);
- interest income to be excluded from interest expenses to be capitalised in the amount of RUB 1,305 (for the year ended 31 December 2015 – RUB 778).

Foreign currency exchange gains and losses

The amount of foreign currency exchange gains and losses for the year ended 31 December 2016, compared to the year ended 31 December 2015, 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:

	Year ended 31 December 2016	Year ended 31 December 2015	Absolute change	Change, %
Foreign exchange gains on financial assets	47,805	213,386	(165,581)	(77.6)
Foreign exchange gains on loans and borrowings	197,775	204,114	(6,339)	(3.1)
Other foreign exchange gains	21,687	89,386	(67,699)	(75.7)
Total foreign exchange gains recognised in the statement of profit or loss and other comprehensive income	267,267	506,886	(239,619)	(47.3)
Foreign exchange loss on financial assets	(103,982)	(134,493)	30,511	(22.7)
Foreign exchange loss on loans and borrowings	(83,648)	(371,486)	287,838	(77.5)
Other foreign exchange loss	(38,338)	(49,950)	11,612	(23.2)
Total foreign exchange loss recognised in the statement of profit or loss and other comprehensive income	(225,968)	(555,929)	329,961	(59.4)
Net foreign exchange gain/ (loss)	41,299	(49,043)	90,342	x

Dynamics of exchange differences presented in the table was driven by significant strengthening of RUB to USD during the year ended 31 December 2016 as compared to the weakening of RUB to USD as for the year ended 31 December 2015 (ref. to 2.3).

3.5. Reconciliation of profit and EBITDA

	Year ended 31 December 2016	Year ended 31 December 2015	Change, %
Profit for the period	232,907	143,427	62.4
Adjustments for:			
income tax expense	68,515	22,126	3.1 times
amortisation and depreciation	128,523	118,767	8.2
result of crude oil sales to China	563	(1,823)	x
net finance (income)/costs	(9,665)	67,212	x
share of (profit)/loss from associates and jointly controlled entities	(19,519)	4,119	x
other expenses	7,456	17,631	(57.7)
EBITDA*	408,780	371,459	10.0

* 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.



3. Cash flow analysis

	Year ended 31 December 2016	Year ended 31 December 2015	Absolute change	Change, %
Cash flows from operating activities	317,570	329,237	(11,667)	(3.5)
Cash flows used for purchase of property, plant and equipment	(319,958)	(322,987)	3,029	(0.9)
Free cash (outflow)/ inflow	(2,388)	6,250	(8,638)	x
Cash flows used in investing activities	69,250	112,213	(42,963)	(38.3)
Cash flows used in financing activities	(72,510)	(149,506)	76,996	(51.5)
Net cash outflow	(5,648)	(31,043)	25,395	(81.8)
Change in cash and cash equivalents due to deviation of currency exchange rate	(12,479)	29,895	(42,374)	x
Net decrease in cash and cash equivalents	(18,127)	(1,148)	(16,979)	15.8 times

Negative free cash flow excluding investments in securities and deposits for the year ended 31 December 2016 amounted to RUB 2,388 (positive free cash flow as for the year ended 31 December 2015 amounted to RUB 6,250).

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 317,570 for the year ended 31 December 2016, which is RUB 11,667 or 3.5% lower than for the year ended 31 December 2015.

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

- increase in cash receipts from customers by RUB 27,118;
- increase in cash paid to suppliers by RUB 19,655;
- decrease in cash received from the refund of VAT and other taxes from the budget by RUB 5,849;
- increase in income tax paid amounting to RUB 9,174;
- increase in amount of interest paid by RUB 1,500.

4.2. Investing activities

The primary factors resulting in an increase in cash used in investment activities by RUB 39,934 or 18.9% for the year ended 31 December 2016 compared to the same period of the previous year were:

- decrease in net cash inflow as for the year ended 31 December 2016 from purchase-and-sale transactions of debt securities and allocation/closure of deposits in the amount of RUB 14,875 compared to the relative period of 2015;
- decrease in interest and dividends received by RUB 13,431;
- 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 year ended 31 December 2016 as compared to the relative period of 2015 by RUB 76,996 or 51.5% were:

- net proceeds from issuance of non-convertible interest-bearing documentary marketable bonds in the amount of RUB 79,176;
- increase of cash used for repayment of bonds and loans and borrowings by RUB 56,611 for the year ended 31 December 2016 as compared to the relative period of 2015:

for the year ended 31 December 2016 monthly repayments of the loan to China Development Bank in the total amount of USD 1,827 mln (RUB 118,944 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 year ended 31 December 2015 monthly repayments of loan to China Development Bank were made in the amount of USD 667 mln (RUB 40,721 at the rate of Central Bank of the Russian Federation on the date of operation), RUB denominated bonds were repaid in the amount of RUB 30,943 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 15,606 during the year ended 31 December 2015;
- increase of dividends paid out by RUB 9,855 during the year ended 31 December 2016 compared to the relative period of 2015;
- settlement of derivatives liability included in Other cash used in financing activities.



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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 statement of cash flows prepared using the direct method and disclosed in the consolidated financial statements prepared in accordance with IFRS for the year ended 31 December 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 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.

	Year ended 31 December 2016	Year ended 31 December 2015
OPERATING ACTIVITIES		
Profit before income tax	301,422	165,553
Adjustments for:		
Amortisation and depreciation	128,523	118,767
Loss from disposal of property, plant and equipment	1,249	989
Finance income	(290,870)	(542,902)
Finance costs	281,205	610,114
Gain on disposal of subsidiaries	(998)	-
Share of (profit)/loss from associates and jointly controlled entities	(19,519)	4,119
Others	(5,611)	6,161
Operating profit before changes in working capital and reserves	395,401	362,801
Changes in operating assets and liabilities:		
Changes in inventories	2,939	646
Changes in trade and other receivables relating to operating activity and VAT assets	(1,652)	24,995
Changes in trade and other payables, and accruals relating to operating activity	15,609	24,178
Cash flows from operating activities before payment of income tax expense and interest	412,297	412,620
Income tax paid	(49,078)	(39,904)
Income tax refund	597	1,267
Interest paid	(46,246)	(44,746)
Net cash flows received from operating activities	317,570	329,237



5. Liquidity analysis

	31 December 2016	31 December 2015	Change, %
Current assets	535,607	640,914	(16.4)
including:			
cash and cash equivalents	74,586	92,713	(19.6)
short-term bank promissory notes, deposits and bonds*	349,529	427,192	(18.2)
Current liabilities	293,849	240,451	22.2
Net working capital	241,758	400,463	(39.6)
Current ratio	1.8	2.7	x
Quick ratio**	1.6	2.3	x
Debt / EBITDA	1.7	2.4	x
Debt / Equity	0.4	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

The following are the contractual undiscounted cash flows of financial liabilities, including estimated interest payments at the rates actual at 31 December 2016 and 31 December 2015 accordingly, with amounts denominated in foreign currency recalculated using the Central Bank of the Russian Federation exchange rates at 31 December 2016 and 31 December 2015 accordingly.

31 December 2016:

	Carrying amount	Contractual cash flows						More than 5 years
		Total	2017	2018	2019	2020	2021	
Loans and borrowings	701,552	895,916	155,594	140,634	143,184	54,811	68,786	332,907
Trade and other payables	85,823	85,823	85,823	-	-	-	-	-
	787,375	981,739	241,417	140,634	143,184	54,811	68,786	332,907

31 December 2015:

	Carrying amount	Contractual cash flows						More than 5 years
		Total	2016	2017	2018	2019	2020	
Loans and borrowings	865,003	1,094,932	129,337	133,827	157,312	133,623	65,302	475,531
Trade and other payables	76,592	76,592	76,592	-	-	-	-	-
	941,595	1,171,524	205,929	133,827	157,312	133,623	65,302	475,531

The debt structure as at 31 December 2016 assumes the possible redemption date for non-convertible interest-bearing documentary bonds in the amount of RUB 45,208 at the offer date (2017).

The debt structure as at 31 December 2015 assumes the possible redemption date for non-convertible interest-bearing documentary bonds in the amount of RUB 25,427 at the offer date (2016), RUB 45,000 at the offer date (2017).