

TRANSNEFT

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

FOR THE SIX MONTHS ENDED 30 JUNE 2017





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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 30 June 2017 and results of operations for the six months ended 30 June 2017, compared to the six months ended 30 June 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 six months ended 30 June 2017.

Key financial and operating results

	Six months ended 30 June 2017	Six months ended 30 June 2016	Change, %
Revenue	438,250	417,406	5.0
Profit for the period	113,879	134,521	(15.3)
Earnings before interest, income tax, depreciation and amortisation (EBITDA*)	215,727	209,613	2.9
Oil delivered to consignees, mln tons	237.4	238.8	(0.6)
including:			
Russian oil refineries, mln tons	119.8	118.2	1.4
transshipment into the CPC-R system, mln tons	0.002	0.351	(99.4)
exports to neighboring countries, mln tons	9.2	11.7	(21.4)
exports to other countries, mln tons	108.4	108.6	(0.2)
Oil products delivered to consignees, mln tons	16.6	17.2	(3.5)
including:			
Russia's domestic market, mln tons	4.2	4.2	-
exports to the Customs Union member countries, mln tons	0.20	0.43	(53.5)
exports to other countries, mln tons	12.2	12.6	(3.2)

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

The main non-operating factors which influenced the profit for the period are disclosed in the table below:

	Six months ended 30 June 2017	Six months ended 30 June 2016	Absolute change	Change, %
Profit for the period	113,879	134,521	(20,642)	(15.3)
Net gain from foreign exchange differences	(5,422)	(29,769)	24,347	(81.8)
Net interest expense	14,738	17,099	(2,361)	(13.8)
Net gain from operations with financial instruments	(296)	(4,165)	3,869	(92.9)
Share of profit from associates and jointly controlled entities	(9,476)	(11,265)	1,789	(15.9)
Gain from disposal of subsidiaries	-	(998)	998	x
Adjusted profit for the period	113,423	105,423	8,000	7.6



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 30 June 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 15.4 thousand km.

During the six months ended 30 June 2017 the Group transported more than 84% of oil produced in Russia and more than 27% 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”. 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 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 six months ended 30 June 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)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 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-Volgotradneftepererabotka 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 (with amendments included by the order of the FAS of Russia of 13.09.2016 No. 1286/16 Concerning the amendments to the order of the FAS of Russia of 22.10.2015 No. 991/15 Concerning the setting of tariff for the services of OAO AK Transneft for transportation of oil through 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 Ilskiy 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 PJSC 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;

¹ the FAS of Russia is a successor of the FTS of Russia. Decree 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 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;
- 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 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 Sheskharris from trunk pipeline system of Transneft;
- Order of FAS of Russia of 27.03.2017 No. 392/17 Concerning the setting of tariff for the services of Transneft for transportation of oil through Sindor-Mikun route of Uhta-Yaroslavl pipeline provided to OOO TSNPSEI;
- Order of FAS of Russia of 28.04.2017 No. 580/17 Concerning the setting of network tariff for the services of Transneft for transportation of oil via Kuyumba-Taishet trunk pipeline system and amending of the order of the 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 13.03.2017 No. 294/17 Concerning the setting of tariff for the services of Transneft for delivery of oil from trunk pipeline system to OOO Tomskneftepererabotka.
- 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;
 - Order of the FAS of Russia of 14.04.2017 No. 501/17 Concerning the setting of tariff for transportation of oil products through PSP Antipinskiy NPZ-DT (loading from AO Antipinskiy NPZ) – MP Primorsk.



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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.

	Six months ended 30 June 2017	Six months ended 30 June 2016	Change, %
Oil production volume in the Russian Federation, mln tons	272.3	269.9	0.9
Light oil refining volume in the Russian Federation, mln tons	61.6	60.8	1.3

Oil production volume increased for the six months ended 30 June 2017 compared to the similar period of the previous year by 2.4 mln tons or by 0.9%.

Light oil refining during the six months ended 30 June 2017 in the Russian Federation increased by 0.8 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.

	Six months ended 30 June 2017	Six months ended 30 June 2016	Change, %
Change in the rouble's exchange rate against the US dollar, %	(2.6)	(11.8)	x
Average exchange rate for the period (roubles per US dollar)	57.99	70.26	(17.5)
Exchange rate at the end of the period (roubles per US dollar)	59.09	64.26	(8.0)

2.4. Inflation rates

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

	Six months ended 30 June 2017	Six months ended 30 June 2016	Change, pp
Rouble inflation (CPI), %	2.3	3.3	(1.0)



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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:

	Six months ended 30 June 2017	Six months ended 30 June 2016	Change, %
Current income tax	33,782	39,217	(13.9)
Property tax	14,763	10,602	39.2
Other taxes and levies	741	465	59.4

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 took place.

Property tax

The amount of property tax increased by RUB 4,161 or by 39.2%. 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 six months ended 30 June 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 six months ended 30 June 2017 and the relative period of 2016.

	Six months ended 30 June 2017	Six months ended 30 June 2016	Absolute change	Change, %
Revenue	438,250	417,406	20,844	5.0
Revenue from oil transportation services	315,466	303,774	11,692	3.8
Revenue from oil products transportation services	34,960	34,140	820	2.4
Revenue from crude oil sales	70,983	67,775	3,208	4.7
Other revenue	16,841	11,717	5,124	43.7
Operating expenses net of amortisation and depreciation	(222,772)	(208,135)	(14,637)	7.0
Operating profit net of amortisation and depreciation	215,478	209,271	6,207	3.0
Amortisation and depreciation	(75,830)	(67,600)	(8,230)	12.2
Operating profit	139,648	141,671	(2,023)	(1.4)
Other income/ (expenses), net	7,100	(1,944)	9,044	x
Share of profit from associates and jointly controlled entities	9,476	11,265	(1,789)	(15.9)
Profit before income tax and finance income/ (costs)	156,224	150,992	5,232	3.5
Net finance (costs)/ income	(9,020)	16,835	(25,855)	x
Profit before income tax	147,204	167,827	(20,623)	(12.3)
Income tax expense	(33,325)	(33,306)	(19)	0.1
Profit for the reporting period	113,879	134,521	(20,642)	(15.3)
Other comprehensive loss, net of income tax	(693)	(1,058)	365	(34.5)
Total comprehensive income, net of income tax	113,186	133,463	(20,277)	(15.2)



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3.1. Revenue

Revenue by type of operations	Six months ended 30 June 2017	Share of total revenue, %	Six months ended 30 June 2016	Share of total revenue, %	Absolute change	Change, %
Revenue from crude oil transportation services	315,466	71.9	303,774	72.8	11,692	3.8
exports, except the CIS	172,758	39.4	174,625	41.8	(1,867)	(1.1)
exports in the CIS	8,492	1.9	8,340	2.0	152	1.8
domestic sales	134,216	30.6	120,809	29.0	13,407	11.1
Revenue from oil products transportation services	34,960	8.0	34,140	8.2	820	2.4
Revenue from oil compounding services	3,227	0.7	2,874	0.7	353	12.3
Revenue from sales of crude oil in the domestic market	5,229	1.3	5,999	1.4	(770)	(12.8)
Revenue from sales of oil products	2,328	0.5	831	0.2	1,497	2.8 times
Other revenue	11,286	2.6	8,012	1.9	3,274	40.9
Total revenue (without revenue from export sales of crude oil)	372,496	85.0	355,630	85.2	16,866	4.7
Revenue from export sales of crude oil	65,754	15.0	61,776	14.8	3,978	6.4
Total revenue	438,250	100.0	417,406	100.0	20,844	5.0

For the six months ended 30 June 2017, the Group's revenue increased by RUB 20,844 or by 5.0%, attributable mainly to an increase in revenue from crude oil transportation services and increase of revenue from sales of crude oil. Without taking into account revenue from export sales of crude oil, revenue for the six months ended 30 June 2017 increased by RUB 16,866 or 4.7% compared to the six months ended 30 June 2016 and accounted for 85% 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 11,692 or by 3.8% for six months ended 30 June 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 820 or by 2.4% for the six months ended 30 June 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 Rosneft.

Increase in revenue from export sales of crude oil by RUB 3,978 or 6.4% as for the six months ended 30 June 2017 compared to the six months ended 30 June 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 six months ended 30 June 2017 as compared to the six months ended 30 June 2016.

Decrease in revenue from domestic sales of crude oil as for the six months ended 30 June 2017 by RUB 770 or by 12.8% compared to the relative period of the previous year was a result of decrease of sale volumes of crude oil by the companies of the Group.

Increase in revenue from sales of oil products by RUB 1,497 or in 2.8 times as for the six months ended 30 June 2017 compared to the relative period of the previous year was a result of growth of sale volumes of oil products by the companies of the Group.



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3.1.3. Revenue from oil compounding services

Growth in revenue from oil compounding services by RUB 353 or by 12.3% as for the six months ended 30 June 2017 compared to the six months ended 30 June 2016 was a result of increase in oil compounding volumes by 11.3% (22,793.7 thousand tons for the six months ended 30 June 2017; 20,471.2 thousand tons for the six months ended 30 June 2016).

3.1.4. Other revenue

Other revenue includes revenue from oil and oil products storage services, communication services, diagnostic services, construction services, revenue from connection of objects to the trunk pipeline system, 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 depreciation and amortisation

Operating expenses net of amortisation and depreciation for the six months ended 30 June 2017, and the six months ended 30 June 2016, are detailed in the table below:

Operating expense line items	Six months ended 30 June 2017	Share of total expenses, %	Six months ended 30 June 2016	Share of total expenses, %	Absolute change	Change, %
Salaries, insurance contributions and social expenses	68,304	30.7	69,506	33.4	(1,202)	(1.7)
Energy	21,341	9.6	18,907	9.1	2,434	12.9
Materials	14,543	6.5	11,361	5.5	3,182	28.0
Repair and maintenance of relevant technical condition of pipeline	6,050	2.7	4,878	2.3	1,172	24.0
Insurance expenses	3,061	1.4	3,148	1.5	(87)	(2.8)
Taxes (other than income tax)	14,481	6.5	10,352	5.0	4,129	39.9
Pension expense	3,464	1.6	2,541	1.2	923	36.3
Cost of crude oil sold in the domestic market	4,822	2.2	5,498	2.6	(676)	(12.3)
Cost of oil products sold	2,182	1.0	946	0.5	1,236	2.3 times
Cost of other goods sold	913	0.4	175	0.1	738	5.2 times
Other operating expenses	17,608	7.8	18,705	9.0	(1,097)	(5.9)
Operating expenses (net of export crude oil sales)	156,769	70.4	146,017	70.2	10,752	7.4
Cost of export crude oil sales (including export custom duties)	66,003	29.6	62,118	29.8	3,885	6.3
Operating expenses net of depreciation and amortisation	222,772	100.0	208,135	100.0	14,637	7.0

For the six months ended 30 June 2017, compared to the six months ended 30 June 2016, the amount of operating expenses net of depreciation and amortisation increased by RUB 14,637 or by 7.0%.

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 (ref. to 3.2.6);
- increase of electricity expenses (ref. to 3.2.3);
- 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 six months ended 30 June 2017, and for the six months ended 30 June 2016, were as follows:

Operating expense line items	Six months ended 30 June 2017	Share of total expenses, %	Inflation rates (2017 to 2016), %*	Six months ended 30 June 2016 (inflated to 2017)	Share of total expenses, %	Absolute change	Change, %
Salaries, insurance contributions and social expenses	68,304	30.7	4.0	72,286	32.6	(3,982)	(5.5)
Energy	21,341	9.6	5.4	19,928	9.0	1,413	7.1
Materials	14,543	6.5	5.4	11,974	5.4	2,569	21.5
Repair and maintenance of relevant technical condition of pipeline	6,050	2.7	5.4	5,141	2.3	909	17.7
Insurance expenses	3,061	1.4	4.0	3,274	1.5	(213)	(6.5)
Taxes (other than income tax)	14,481	6.5	5.4	10,911	4.9	3,570	32.7
Pension expense	3,464	1.6	4.0	2,643	1.2	821	31.1
Cost of crude oil sold in the domestic market	4,822	2.2	10.1	6,053	2.7	(1,231)	(20.3)
Cost of oil products sold	2,182	1.0	8.6	1,027	0.5	1,155	2.1 times
Cost of other goods sold	913	0.4	5.4	184	0.1	729	5.0 times
Other operating expenses	17,608	7.8	5.4	19,715	8.9	(2,107)	(10.7)
Operating expenses (net of export crude oil sales)	156,769	70.4	X	153,136	69.1	3,633	2.4
Cost of export crude oil sales (including export custom duties)	66,003	29.6	10.1	68,392	30.9	(2,389)	(3.5)
Operating expenses net of amortisation and depreciation	222,772	100.0	X	221,528	100.0	1,244	0.6

*The inflation rates used are based on scenario prepared by the Ministry of Economic Development forecasting index-deflators, inflation and indexation of regulated prices (tariffs) for products (services) of industries of the infrastructure sector till 2020.

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 scenario prepared by the Ministry of Economic Development forecasting index-deflators, inflation and indexation of regulated prices (tariffs) for products (services) of industries of the infrastructure sector till 2020.

Unit costs for transportation of oil as per 100 tons-kilometers as for the six months ended 30 June 2017 and for the six months ended 30 June 2016 were as follows:

	Six months ended 30 June 2017	Six months ended 30 June 2016	Absolute change	Change, %
Oil transportation services				
Turnover, mln tons x km	604,935	603,486	1,449	0.2
Unit costs per 100 tons x km, RUB (2016 figures inflated to 2017)	17.24	17.59	(0.35)	(2.0)
Unit costs per 100 tons x km net of new objects expenditure, RUB (2016 figures inflated to 2017)	16.89	17.59	(0.70)	(4.0)



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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 six months ended 30 June 2017 and as for the six months ended 30 June 2016 were as follows:

	Six months ended 30 June 2017	Six months ended 30 June 2016	Absolute change	Change, %
Oil products transportation services				
Volume turnover, mln of tons	16.6	17.2	(0.6)	(3.5)
Unit costs per ton, RUB (2016 figures inflated to 2017)	696.96	634.32	62.64	9.9
Unit costs per ton net of new objects expenditure, RUB (2016 figures inflated to 2017)	664.34	634.32	30.03	4.7

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 six months ended 30 June 2017 salaries, insurance contributions and social expenses decreased insignificantly as compared to the six months ended 30 June 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.

	Six months ended 30 June 2017	Six months ended 30 June 2016	Absolute change	Change, %
Employers' contributions to JSC "NPF "Transneft" in favor of employees	2,787	2,401	386	16.1

3.2.3. Energy

Energy expenses for the six months ended 30 June 2017 increased by RUB 2,434 or 12.9% compared to the same period of the previous year. The increase of energy (power) expenses was caused by growth of weighted-average tariff for energy (power) and by growth of energy purchased because of putting into use Zapolyarie-Purpe, Kuyumba-Taishet trunk oil pipelines.

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

	Six months ended 30 June 2017	Six months ended 30 June 2016	Absolute change	Change, %
Consumption of energy, mln kW*h	7,294	7,193	101	1.4

3.2.4. Materials

Expenses on materials for the six months ended 30 June 2017 as compared to the same period of 2016, increased by RUB 3,182 or 28.0%. 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 1,172 or by 24.0% 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 six months ended 30 June 2017 in the amount of RUB 66,003 includes cost of sales in the amount of RUB 51,483 of crude oil purchased from Rosneft under a contract signed in April 2009 and custom duties in the amount of RUB 14,520. 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 six months ended 30 June 2017 amounted to RUB 676 or 12.3% as compared to the relative period of 2016 and was caused by decrease in sale volumes of oil by the Group's subsidiaries.

Increase in cost of oil products sold in the domestic market as for the six months ended 30 June 2017 by RUB 1,236 or in 2.3 times compared to the relative period of 2016 was caused by growth of sale volumes of oil products 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 39.9% 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.

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 decrease of the amount of profit recognised by the Group in "Share of profit from associates and jointly controlled entities" as for the six months ended 30 June 2017 as compared to the relative period of 2016 amounted to RUB 1,789.

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	Six months ended 30 June 2017	Six months ended 30 June 2016	Absolute change	Change, %
Interest income from cash and equivalents	2,267	953	1,314	2.4 times
Interest income from other financial assets	7,852	9,385	(1,533)	(16.3)
Other interest income	409	374	35	9.4
Total interest receivable	10,528	10,712	(184)	(1.7)
Less interest income on the temporary investment of borrowings	(247)	(789)	542	(68.7)
Total interest income recognised in the statement of profit or loss and other comprehensive income	10,281	9,923	358	3.6



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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	Six months ended 30 June 2017	Six months ended 30 June 2016	Absolute change	Change, %
Interest expenses on loans and borrowings	23,364	23,174	190	0.8
Distribution of investment income to pension liabilities	2,955	3,407	(452)	(13.3)
Other interest expenses	1,992	2,060	(68)	(3.3)
Total interest expenses	28,311	28,641	(330)	(1.2)
Less finance costs to be capitalised	(3,292)	(1,619)	(1,673)	2.0 times
Total interest expense recognised in the statement of profit or loss and other comprehensive income	25,019	27,022	(2,003)	(7.4)

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 six months ended 30 June 2017 and for the relevant period of 2016;
- interest payable on series 01-03 of non-convertible interest-bearing documentary bonds for the six months ended 30 June 2017 and for the relevant period of 2016;
- interest payable on non-convertible interest-bearing documentary marketable bonds for the six months ended 30 June 2017 and for the relevant period of 2016.

The dynamics of interest expense as for the six months ended 30 June 2017 as compared to the similar period of 2016 was mainly driven by decline of USD/RUB average exchange rate during the six months ended 30 June 2017 compared to the six months ended 30 June 2016 (ref. to 2.3), increase of roubles debt's share in total debt.

During the six months ended 30 June 2017, interest in the amount of RUB 3,045 was capitalised as part of cost of assets under construction (for the six months ended 30 June 2016 – RUB 830) including:

- interest expenses to be capitalised in the amount of RUB 3,292 (for the six months ended 30 June 2016 – RUB 1,619);
- interest income to be excluded from interest expenses to be capitalised in the amount of RUB 247 (for the six months ended 30 June 2016 – RUB 789).

Foreign currency exchange gains and losses

The amount of foreign currency exchange gains and losses for the six months ended 30 June 2017, compared to the six months ended 30 June 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 condensed interim 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:

	Six months ended 30 June 2017	Six months ended 30 June 2016	Absolute change	Change, %
Foreign exchange gains on financial assets	13,311	24,331	(11,020)	(45.3)
Foreign exchange gains on loans and borrowings	37,891	124,544	(86,653)	(69.6)
Other foreign exchange gains	3,887	16,711	(12,824)	(76.7)
Total foreign exchange gains recognised in the statement of profit or loss and other comprehensive income	55,089	165,586	(110,497)	(66.7)
Foreign exchange loss on financial assets	(21,928)	(63,577)	41,649	(65.5)
Foreign exchange loss on loans and borrowings	(23,665)	(40,485)	16,820	(41.5)
Other foreign exchange loss	(4,074)	(31,755)	27,681	(87.2)
Total foreign exchange loss recognised in the statement of profit or loss and other comprehensive income	(49,667)	(135,817)	86,150	(63.4)
Net foreign exchange gain	5,422	29,769	(24,347)	(81.8)

Dynamics of exchange differences presented in the table was driven by lesser strengthening of RUB to USD during the six months ended 30 June 2017 as compared to the strengthening of RUB to USD as for the six months ended 30 June 2016 (ref. to 2.3).

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

	Six months ended 30 June 2017	Six months ended 30 June 2016	Change, %
Profit for the period	113,879	134,521	(15.3)
Adjustments for:			
income tax expense	33,325	33,306	0.1
amortisation and depreciation	75,830	67,600	12.2
result of crude oil sales to China	249	342	(27.2)
net finance costs/ (income)	9,020	(16,835)	x
share of profit from associates and jointly controlled entities	(9,476)	(11,265)	(15.9)
other (income)/ expenses, net	(7,100)	1,944	x
EBITDA*	215,727	209,613	2.9

* Less crude oil sale and purchase operations under contracts with 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

	Six months ended 30 June 2017	Six months ended 30 June 2016	Absolute change	Change, %
Cash flows from operating activities	131,236	117,882	13,354	11.3
Cash flows used for purchase of property, plant and equipment (net)	(151,572)	(152,521)	949	(0.6)
Free cash flow	(20,336)	(34,639)	14,303	(41.3)
Cash flows from investing activities	329	61,724	(61,395)	(99.5)
Cash flows from / (used in) financing activities	21,319	(21,074)	42,393	x
Net cash flow	1,312	6,011	(4,699)	(78.2)
Change in cash and cash equivalents due to deviation of currency exchange rate	(93)	(11,850)	11,757	(99.2)
Net increase/(decrease) in cash and cash equivalents	1,219	(5,839)	7,058	x

Negative free cash flow for the six months ended 30 June 2017 amounted to RUB 20,336 (negative free cash flow as for the six months ended 30 June 2016 amounted to RUB 34,639).

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 131,236 for the six months ended 30 June 2017, which is RUB 13,354 or 11.3% higher than for the six months ended 30 June 2016.

The main factors which influenced on increase of cash generated from operating activities for the six months ended 30 June 2017 as compared to the similar period in 2016 were as follows:

- increase in cash receipts from customers by RUB 36,295;
- increase in cash paid to suppliers by RUB 19,054;
- increase in income tax paid amounting to RUB 6,417;
- decrease in the amount of interest paid by RUB 1,854.

4.2. Investing activities

The primary factors resulting in an increase in cash used in investing activities by RUB 60,446 or 66.6% as for the six months ended 30 June 2017 compared to the same period of the previous year were:

- decrease in net cash inflow as for the six months ended 30 June 2017 from purchase-and-sale transactions of debt securities, equity securities and allocation-closure of deposits in the amount of RUB 40,148 compared to the six months ended 30 June 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 60,000 as for the six months ended 30 June 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 six months ended 30 June 2016;
- increase of dividends received and other cash proceeds from associates and jointly controlled entities for the amount of RUB 27,380 during the six months ended 30 June 2017.

4.3. Financing activities

The main factors which influenced on cash inflow from financing activities for the six months ended 30 June 2017 in the amount of RUB 21,319 as compared to cash outflow from financing activities as for the six months ended 30 June 2016 in the amount of RUB 21,074 were:

- net proceeds in the amount of RUB 59,806 from issuance of non-convertible interest-bearing documentary bonds in the amount of RUB 81,990 as for the six months ended 30 June 2017 and in the amount of RUB 22,184 as for the six months ended 30 June 2016;



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4.3. Financing activities (continued)

- increase of cash flows used for repayment of bonds, loans and borrowings as for the six months ended 30 June 2017 as compared to the relative period of 2016 by RUB 26,932 which was a result of the following operations:
 - for the six months ended 30 June 2017 monthly repayments and early repayments of the loan to China Development Bank in the total amount of USD 883.3 mln (RUB 50,747 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 10,193;
 - during the six months ended 30 June 2016 monthly repayments of loan to China Development Bank were made in the amount of USD 333.3 mln (RUB 23,594 at the rate of Central Bank of the Russian Federation on the date of operation), RUB denominated bonds were repaid (repurchased) in the amount of RUB 10,414.
- fulfillment of obligations under derivatives which was included in the amount shown in Other cash used in financing activities as for the six months ended 30 June 2016 shown in Other cash used in financing activities.

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

Cash flows received from operating activities using the indirect method are disclosed in the table below in addition to the consolidated interim condensed statement of cash flows prepared using the direct method and disclosed in the consolidated interim condensed financial statements prepared in accordance with IFRS for the six months ended 30 June 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 from associates and jointly controlled entities;
- (c) all other items for which the cash effects are investing or financing cash flows.

	Six months ended 30 June 2017	Six months ended 30 June 2016
OPERATING ACTIVITIES		
Profit before income tax	147,204	167,827
Adjustments for:		
Amortisation and depreciation	75,830	67,600
Loss from disposal of property, plant and equipment	323	507
Finance income	(66,028)	(180,538)
Finance costs	75,048	163,703
Gain on disposal of subsidiaries	-	(998)
Share of profit from associates and jointly controlled entities	(9,476)	(11,265)
Others	(8,597)	(5,011)
Operating profit before changes in working capital and reserves	214,304	201,825
Changes in operating assets and liabilities:		
Changes in inventories	(780)	(1,829)
Changes in trade and other receivables relating to operating activity and VAT assets	(11,307)	(39,598)
Changes in trade and other payables, and accruals relating to operating activity	(22,544)	1,310
Cash flows from operating activities before payment of income tax expense and interest	179,673	161,708
Income tax paid	(31,855)	(25,438)
Income tax refund	252	300
Interest paid	(16,834)	(18,688)
Net cash flows received from operating activities	131,236	117,882



5. Liquidity analysis

	30 June 2017	31 December 2016	Change, %
Current assets	530,527	535,607	(0.9)
including:			
cash and cash equivalents	75,805	74,586	1.6
short-term bank deposits and bonds*	327,949	349,529	(6.2)
Current liabilities	264,153	291,488	(9.4)
Net working capital	266,374	244,119	9.1
Current ratio	2.0	1.8	x
Quick ratio**	1.7	1.6	x
Debt / EBITDA	1.7	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