

**OAO AK TRANSNEFT**

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

**FOR THE NINE MONTHS ENDED 30 SEPTEMBER 2014**





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

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The following analysis provides an overview of the financial position of OAO AK Transneft and its subsidiaries (hereinafter – the “Group”) as at 30 September 2014 and results of operations for the nine months ended 30 September 2014, compared to the nine months ended 30 September 2013, 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 nine months ended 30 September 2014.

### Key financial and operating results

	Nine months ended 30 September 2014	Nine months ended 30 September 2013	Change, %
Revenue	573,935	561,586	2.2
Profit for the period	117,978	132,873	(11.2)
EBITDA	264,551	264,307	0.1
EBITDA margin, %*	59.1	59.1	x
Oil delivered to consignees, mln. tons	359.6	359.9	(0.1)
including:			
Russian oil refineries, mln. tons	195.9	186.7	4.9
transshipment into the CPC-R system, mln. tons	1.3	1.5	(13.3)
exports to FSU countries, mln. tons	15.7	20.5	(23.4)
exports to ROW, mln. tons	146.7	151.2	(3.0)
Oil products delivered to consignees, mln. tons	24.0	24.1	(0.4)
including:			
Russia's domestic market, mln. tons	7.4	7.7	(3.9)
exports to the Customs Union member countries, mln.tons	0.15	0.21	(28.6)
exports to ROW, mln. tons	16.4	16.1	1.9

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

The Group's profit for the nine months ended 30 September 2014 amounted to RUB 118.0 bn which is RUB 14.9 bn or 11.2% lower than for the nine months ended 30 September 2013 which amounted to RUB 132.9 bn.

The Group's profit as for the nine months ended 30 September 2014 was mainly affected by net finance costs in the amount of RUB 36.7 bn (RUB 20.5 bn as for the nine months ended 30 September 2013) (refer to p. 3.2.10) presented by net currency exchange losses, net interest expenses and losses from operations with derivatives as well as the share of profit from associates and jointly controlled entities in the amount of RUB 0.05 bn (RUB 1.3 bn as for the nine months ended 30 September 2013) (refer to p.3).

Without taking into consideration the afore-mentioned factors the profit for the nine months ended 30 September 2014 would amount to RUB 154.6 bn (RUB 152.1 as for the nine months ended 30 September 2013) and would increase by RUB 2.5 bn or by 1.6%.



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

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

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

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

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

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

The Group also provides services of oil storage in the trunk pipeline system, oil compounding, crude oil sales.

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

The Group as at 30 September 2014 possesses an extensive network of trunk oil pipelines with a total length of approximately 53.2 thousand km and trunk oil products pipelines with a total length of some 19.1 thousand km.

During the nine months ended 30 September 2014 the Group transported 87% of oil produced in Russia and more than 25% of oil products produced in Russia, as well as significant volumes of hydrocarbons and oil products from CIS countries.

OAO AK Transneft's key competitive advantages include:

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



### 1.1. Key investment projects

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

Fulfillment of the investment projects regarding development of the system of trunk pipelines will allow to create unified pipelines system that allows for the effective redistribution of export flows of both the Western and Eastern directions depending on the situation market.

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

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

### 1.2. Environmental policy

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

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

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

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



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

### 2.1. Oil and oil products transportation tariffs

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

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

During 2013 and nine months ended 30 September 2014, OAO AK Transneft was performing its core operations:

- a) of transporting oil, by charging fees for its services in accordance with oil transportation tariff rates approved by orders of the state regulatory body for natural monopolies – the Federal Tariff Service of Russia (FTS of Russia) and by intergovernmental agreement:
  - Order of the FTS of Russia of 27.09.2012 No. 226-e/3 Concerning the setting of fees for the services of OAO AK Transneft for transportation of oil via the trunk pipeline system;
  - 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 24.11.2009 No. 324-e/4 Concerning the setting of a fee rate for oil loading services at the PNN Skovorodino of OAO AK Transneft's trunk pipeline system;
  - Order of the FTS of Russia of 01.02.2011 No. 12-e/7 Concerning the setting of a fee for the services of OAO AK Transneft for transportation of oil along the Makhachkala–NB Sheshkharis route;
  - Order of the FTS of Russia of 11.12.2012 No. 369-e/27 Concerning the setting of a fee for the services of OAO AK Transneft for transportation of oil along the Makhachkala–NB Sheshkharis route;
  - Order of the FTS of Russia of 27.11.2012 No. 274-e/2 Concerning the setting of fees for the services of OAO AK Transneft for transportation of oil via the trunk pipeline system;
  - Order of the FTS of Russia of 22.08.2013 No. 165-e/2 Concerning the cancelling of the order of the FTS of Russia of 27.11.2012 No. 274-e/2 Concerning the setting of a fee for the services of OAO AK Transneft for transportation of oil through the territory of the Russian Federation;
  - Order of the FTS of Russia of 03.12.2013 No. 225-e/6 Concerning the setting of fees for the services of OAO AK Transneft for transportation of oil via the Purpe – Samotlor trunk pipeline system rendered to OAO NK Rosneft;
  - Order of the FTS of Russia of 26.11.2013 No. 219-e/1 Concerning the setting of fees for the services of OAO AK Transneft for transportation of oil via the Tikhoretsk – Tuapse-2 trunk pipeline section for OAO NK Rosneft;
  - Order of the FTS of Russia of 03.12.2013 No. 224-e/5 Concerning the setting of fees for the services of ZAO Morskoy portoviy servis for filling of railway wagons with oil in the territory of Grushevaya industrial site of the transshipment complex Sheshkharis;
  - Order of the FTS of Russia of 08.04.2014 No. 74-e/1 Concerning the setting of fee for the service of OAO AK Transneft for transportation of oil via the Border of the Republic of Azerbaijan/the Russian Federation (Shirvanovka) – PK Sheshkharis route;
  - The intergovernmental agreement on transportation of Azerbaijan oil through the territory of the Russian Federation of 16.02.1996, Moscow;
  - Agreement dated 14.02.2014 No. 0014502 for provision of oil transportation services by transiting through the territory of the Russian Federation during 2014 between OAO AK Transneft and GNKAR.
- b) of transporting oil products, by charging fees for its services in accordance with fee rates approved by OAO AK Transneft in accordance with orders of the state regulatory body for natural monopolies – the Federal Tariff Service of Russia (FTS of Russia):
  - Order of the FTS of Russia of 24.12.2010 No. 471-e/1 Concerning the setting of fees for the services of OAO AK Transneft and its affiliated entities for transportation of oil products via the trunk pipeline system;
  - Order of the FTS of Russia of 23.09.2010 No. 234-e/2 Concerning fee rates for the services of OOO BalttransService for transportation of oil products from the trunk pipeline system in the Primorsk Commercial Seaport;



## 2.1. Oil and oil products transportation tariffs (continued)

- Order of the FTS of Russia of 24.12.2010 No. 472-e/2 Concerning the inclusion of amendments to the Order of the FTS of Russia of 23.09.2010 No. 234-e/2 Concerning fee rates for the services of OOO BalttransService for transportation of oil products from the trunk pipeline system in the Primorsk Commercial Seaport
- Order of the FTS of Russia of 15.02.2011 No. 23-e/3 Concerning the setting of fees for the services of OAO AK Transneft and its affiliated entities for transportation of oil products via the trunk pipeline system, and the inclusion of amendments to the Order of the FST of Russia of 24.12.2010 No. 471-e/1;
- Order of the FTS of Russia of 05.06.2012 No. 138-e/1 Concerning the inclusion of amendments to the Order of the FTS of Russia of 24.12.2010 No. 471-e/1 Concerning the setting of fees for the services of OAO AK Transneft and its affiliated entities for transportation of oil products via the trunk pipeline system;
- Order of the FTS of Russia of 03.07.2012 No. 165-e/3 Concerning the inclusion of amendments to the Order of the FTS of Russia of 24.12.2010 No. 471-e/1 Concerning the setting of fees for the services of OAO AK Transneft and its affiliated entities for transportation of oil products via the trunk pipeline system;
- 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.

## 2.2. Oil mining and oil products refining volumes

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

	Nine months ended 30 September 2014	Nine months ended 30 September 2013	Change, %
Oil mining volume in the Russian Federation, mln tons	392.7	390.3	0.6
Oil products refining volume in the Russian Federation, mln tons	94.3	89.6	5.2

Oil mining volume increased for the nine months ended 30 September 2014 as compared to the nine months ended 30 September 2013 for 2.4 mln tons or by 0.6% (ref. to subparagraph 3.1.1.).

Growth in oil products refining during the nine months ended 30 September 2014 in the Russian Federation for 4.7 mln tons or by 5.2% influenced the growth of oil products transportation.

During the nine months ended 30 September of 2014 the volume of delivery of crude oil to refinery plants of the Russian Federation showed positive dynamics while the volume of oil transportation for export to CIS and international markets decreased as compared to the same period of 2013.

## 2.3. The rouble's exchange rate against foreign currencies

Services for transportation of oil through trunk oil pipelines which are situated in the territory of the Russian Federation are paid for in Russian roubles except for the transit of crude oil from Azerbaijan which is paid for in US Dollars till 13 February 2014.

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

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



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### 2.3. The rouble's exchange rate against foreign currencies (continued)

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

The Group's has a significant portion of US dollars nominated loans. Increase of US dollars' to Russian roubles exchange rate may result in additional expenses in regard to servicing and settlement of liabilities nominated in foreign currency.

	<b>Nine months ended 30 September 2014</b>	<b>Nine months ended 30 September 2013</b>	<b>Change, %</b>
Change in the rouble's exchange rate against the US dollar, %	20.3	6.5	x
Average exchange rate for the period (roubles per US dollar)	35.3878	31.6170	11.9
Exchange rate at the end of the period (roubles per US dollar)	39.3866	32.3451	21.8

### 2.4. Inflation rates

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

	<b>Nine months ended 30 September 2014</b>	<b>Nine months ended 30 September 2013</b>	<b>Change, pp</b>
Rouble inflation (CPI), %	6.3	4.7	1.6

### 2.5. Taxation

Most of the Group's companies are incorporated in the Russian Federation, with their financial activity taxable under the Tax Code of the Russian Federation.

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

	<b>Nine months ended 30 September 2014</b>	<b>Nine months ended 30 September 2013</b>	<b>Change, %</b>
Current income tax	36,480	35,927	1.5
Property tax	8,832	7,640	15.6
Other taxes and levies	549	744	(26.2)

#### Income tax

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

#### Property tax

The amount of property tax increased by RUB 1,192 or by 15.6%. The increase was a result of use of different tax rates in relation to trunk pipelines as well as to constructions which are integral technological part of these pipelines. These properties are taxes at the rates set locally by regions of the Russian Federation and can not be more than 0.4% during 2013, 0.7% during 2014.

#### 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 and loss and other comprehensive income for the periods showed therein.

	<b>Nine months ended 30 September 2014</b>	<b>Nine months ended 30 September 2013</b>	<b>Absolute change</b>	<b>Change, %</b>
<b>Revenue</b>	<b>573,935</b>	<b>561,586</b>	<b>12,349</b>	<b>2.2</b>
Revenue from oil transportation services	376,743	378,939	(2,196)	(0.6)
Revenue from oil products transportation services	36,194	33,088	3,106	9.4
Revenue from crude oil sales	143,235	124,107	19,128	15.4
Other revenue	17,763	25,452	(7,689)	(30.2)
Operating expenses	(389,352)	(370,509)	(17,785)	5.1
<b>Operating profit</b>	<b>184,583</b>	<b>191,077</b>	<b>(6,494)</b>	<b>(3.4)</b>
Finance income	131,231	63,254	67,977	2.1 times
Finance costs	(167,893)	(83,722)	(84,171)	2.0 times
<b>Total net financial items</b>	<b>(36,662)</b>	<b>(20,468)</b>	<b>(16,194)</b>	<b>79.1</b>
Share of profit from associates and jointly controlled entities	49	1,264	(1,215)	(96.1)
<b>Profit before income tax</b>	<b>147,970</b>	<b>171,873</b>	<b>(23,903)</b>	<b>(13.9)</b>
Current income tax	(36,566)	(35,572)	(994)	2.8
Deferred income tax	6,574	(3,428)	10,002	x
<b>Income tax expense</b>	<b>(29,992)</b>	<b>(39,000)</b>	<b>9,008</b>	<b>(23.1)</b>
<b>Profit for the period</b>	<b>117,978</b>	<b>132,873</b>	<b>(14,895)</b>	<b>(11.2)</b>
Other comprehensive gain, net of income tax	806	323	483	2.5 times
<b>Total comprehensive income</b>	<b>118,784</b>	<b>133,196</b>	<b>(14,412)</b>	<b>(10.8)</b>

During the nine months ended 30 September 2014 the Group recognised profit shown in the line "Share of profit from associates and jointly controlled entities" in the amount of RUB 49 as compared to the profit amounting to RUB 1,264 for the relative period of 2013. This dynamics was caused by decrease of total comprehensive income of OAO NCSP in the reporting period mainly because of significant weakening of the RUB to USD (ref. to 2.3).



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### 3.1. Revenue

Revenue by type of operations	Nine months ended 30 September 2014	Share of total revenue, %	Nine months ended 30 September 2013	Share of total revenue, %	Absolute change	Change, %
<b>Revenue from crude oil transportation services</b>	<b>376,743</b>	<b>65.7</b>	<b>378,939</b>	<b>67.3</b>	<b>(2,196)</b>	<b>(0.6)</b>
Exports and sales in international markets, except the CIS	198,538	34.6	204,596	36.4	(6,058)	(3.0)
Exports and sales in the CIS	10,879	1.9	12,445	2.2	(1,566)	(12.6)
Domestic sales	167,326	29.2	161,898	28.8	5,428	3.4
<b>Revenue from oil products transportation services</b>	<b>36,194</b>	<b>6.3</b>	<b>33,088</b>	<b>6.0</b>	<b>3,106</b>	<b>9.4</b>
Revenue from oil compounding services	3,678	0.6	4,026	0.7	(348)	(8.6)
Other revenue	10,547	1.8	16,217	2.9	(5,670)	(35.0)
<b>Total revenue (less revenue from sales of crude oil and oil products)</b>	<b>427,162</b>	<b>74.4</b>	<b>432,270</b>	<b>76.8</b>	<b>(5,108)</b>	<b>(1.2)</b>
Revenue from export sales of crude oil	125,945	22.0	114,096	20.3	11,849	10.4
Revenue from sales of crude oil in the domestic market	17,290	3.0	10,011	1.8	7,279	72.7
Revenue from sales of oil products	3,538	0.6	5,209	0.9	(1,671)	(32.1)
<b>Total revenue</b>	<b>573,935</b>	<b>100.0</b>	<b>561,586</b>	<b>100.0</b>	<b>12,349</b>	<b>2.2</b>

For the nine months ended 30 September 2014, the Group's revenue increased by RUB 12,349, or 2.2%, attributable mainly to an increase in revenue from oil products transportation services and sales of crude oil. Without taking into account crude oil sales and oil products sales, revenue for the nine months ended 30 September 2014, amounted to RUB 427,162, which is RUB 5,108 or 1.2% lower than for the nine months ended 30 September 2013.

#### 3.1.1. Oil and oil products transportation services

A decrease in revenue from oil transportation services amounted to RUB 2,196, or 0.6% for the nine months ended 30 September 2014 comparable to the same period of 2013. The decrease in revenue for oil transportation services was influenced by changes in oil transportation turnover and turnover volumes.

An increase in revenue from oil products transportation services by RUB 3,106 or 9.4% for the nine months ended 30 September 2014 as compared to the same period of 2013 was driven by growth in oil products transportation tariffs as well as growth in turnover.

#### 3.1.2. Revenue from sales of crude oil and oil products

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

Increase in revenue from export sales of crude oil as for the nine months ended 30 September 2014 compared to the nine months ended 30 September 2013 was a result of fluctuation of the RUB/USD exchange rate.

Decrease in revenue from sales of oil products as for the nine months ended 30 September 2014 by RUB 1,671 or by 32.1% was driven by a decline of oil products turnover as the Group's non-core activity.

#### 3.1.3. Revenue from oil compounding services

A decline in revenue from oil compounding services by RUB 348 or by 8.6% as for the nine months ended 30 September 2014 compared to the nine months ended 30 September 2013 was a result of decrease in oil compounding volumes by 7.9% (27,130.3 thousand tons for the nine months ended 30 September 2014; 29,450.1 thousand tons for the nine months ended 30 September 2013).



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### 3.1.4. Other revenue

Other revenue includes revenue from oil and oil products storage services, information services related to oil transportation, property leasing, and insurance services, rent services, organization of transporting services, as well as other services.

A decrease in the amount of other revenue for the nine months ended 30 September 2014 as compared to the similar period of the previous year was a result of:

- decrease of insurance services by RUB 2,923 because of disposal of ZAO SK Transneft from the Group in 2013;
- decrease of revenue for activities on the organization of transportation of cargoes by railways by RUB 1,311;
- reporting revenue from connection of companies to the trunk pipeline system in the amount of RUB 1,184 in 2013.

### 3.2. Operating expenses

Operating expenses for the nine months ended 30 September 2014, and the nine months ended 30 September 2013, are detailed in the table below:

Operating expense line items	Nine months ended 30 September 2014	Share of total revenue, %	Nine months ended 30 September 2013	Share of total revenue, %	Absolute change	Change, %
Salaries, social funds contributions and social expenses	86,694	22.3	85,026	22.9	1,668	2.0
Energy	24,226	6.2	23,787	6.4	439	1.8
Materials	15,750	4.0	14,726	4.0	1,024	7.0
Repairs services and maintenance of relevant technical condition of pipeline	9,748	2.5	10,033	2.7	(285)	(2.8)
Insurance expenses	4,575	1.2	5,234	1.4	(659)	(12.6)
Taxes (except income tax)	9,144	2.3	7,781	2.1	1,363	17.5
Pension expense	2,277	0.6	3,452	1.0	(1,175)	(34.0)
Transportation of oil using railways	1,779	0.5	4,783	1.3	(3,004)	(62.8)
Other operating expenses	9,906	2.5	11,010	3.1	(1,104)	(10.0)
<b>Total operating expenses (net of D&amp;A, one-time non-production expenses and cost of goods sold)</b>	<b>164,099</b>	<b>42.1</b>	<b>165,832</b>	<b>44.9</b>	<b>(1,733)</b>	<b>(1.0)</b>
Depreciation and amortization	81,872	21.1	73,868	19.9	8,004	10.8
Cost of export crude oil sales (including export custom duties)	124,041	31.9	113,458	30.6	10,583	9.3
Cost of crude oil sold in the domestic market	15,817	4.1	9,335	2.5	6,482	69.4
Cost of oil products sold	3,283	0.8	4,949	1.3	(1,666)	(33.7)
Cost of other goods sold	240	0.1	768	0.2	(528)	(68.8)
One-time non-production expenses	-	-	2,299	0.6	(2,299)	(100.0)
<b>Total operating expenses</b>	<b>389,352</b>	<b>100.0</b>	<b>370,509</b>	<b>100.0</b>	<b>18,843</b>	<b>5.1</b>

For the nine months ended 30 September 2014, compared to the nine months ended 30 September 2013, the amount of operating expenses (less depreciation and amortization, one-time non-production expenses and cost of crude oil and oil products sold) decreased by RUB 1,733 or 1.0%, while total operating expenses increased by RUB 18,843 or 5.1%.

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

- growth in depreciation and amortization. The growth of depreciation was mainly associated with putting into operation of new items of PPE, reconstruction and modernization of PPE in 2013;
- growth in cost of crude oil sold;
- growth in the amount of other taxes recognised in operating expenses (ref. paragraph 3.2.8).



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**3.2 Operating expenses (continued)**

After applying inflation rates\*, operating expenses for the nine months ended 30 September 2014, and for the nine months ended 30 September 2013, were as follows:

Operating expense line items	Nine months ended 30 September 2014	Share of total expenses, %	Inflation rates (2014 to 2013), %*	Nine months ended 30 September 2013 (inflated to 2014)	Share of total expenses, %	Absolute change	Change, %
Salaries, social funds contributions and social expenses	86,694	22.3	7.4	91,288	23.7	(4,594)	(5.0)
Energy	24,226	6.2	7.4	25,539	6.6	(1,313)	(5.1)
Materials	15,750	4.0	4.9	15,453	4.0	297	1.9
Repairs services and maintenance of relevant technical condition of pipeline	9,748	2.5	4.5	10,489	2.7	(741)	(7.1)
Insurance expenses	4,575	1.2	4.9	5,493	1.4	(918)	(16.7)
Taxes (except income tax)	9,144	2.3	4.9	8,165	2.1	979	12.0
Pension expense	2,277	0.6	7.4	3,706	1.0	(1,429)	(38.6)
Transportation of oil using railways	1,779	0.5	8.3	5,182	1.4	(3,403)	(65.7)
Other operating expenses	9,906	2.5	4.9	11,554	3.0	(1,648)	(14.3)
<b>Total operating expenses (net of D&amp;A, one-time non-production expenses and cost of goods sold)</b>	<b>164,099</b>	<b>42.1</b>	<b>6.7</b>	<b>176,869</b>	<b>45.8</b>	<b>(12,770)</b>	<b>(7.2)</b>
Depreciation and amortization	81,872	21.0	X	73,868	19.2	8,004	10.8
Cost of export crude oil sales (including export custom duties)	124,041	31.9	3.5	117,381	30.4	6,660	5.7
Cost of crude oil sold in the domestic market	15,817	4.1	3.5	9,658	2.5	6,159	63.8
Cost of oil products sold	3,283	0.8	(0.9)	4,904	1.3	(1,621)	(33.1)
Cost of other goods sold	240	0.1	4.9	806	0.2	(566)	(70.2)
One-time non-production expenses	-	-	X	2,299	0.6	(2,299)	X
<b>Total operating expenses</b>	<b>389,352</b>	<b>100.0</b>	<b>X</b>	<b>385,785</b>	<b>100.0</b>	<b>3,567</b>	<b>0.9</b>

\*The inflation rates used are based on scenarios prepared by the Ministry of Economic Development for devising socio-economic development scenarios for 2013-2017, as well as on 2013-2014 inflation rates.



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### 3.2 Operating expenses (continued)

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

The Group's management analyzes expenses broken down by the Oil transportation, Oil products transportation and Oil sales to the People's Republic of China segments based on indicators developed under the Russian Accounting Standards (RAS) without adjustment entries for compliance with the IFRS. Operating expenses of segments Services of oil transportation and Services of oil products transportation are shown net of administrative and commercial expenses. Administrative and commercial expenses are included in unallocated expenses.

	Oil transportation services	Oil products transportation services	Other segments, adjustments and unallocated expenses	Total operating expenses
<b>For the nine months ended 30 September 2014</b>				
Operating expenses (net of D&A, one-time non-production expenses and cost of goods sold)	102,954	11,653	49,492	164,099
Cargo turnover, mln tons x km	864,996	31,950	-	-
<b>For the nine months ended 30 September 2013</b>				
Operating expenses (net of D&A, one-time non-production expenses and cost of goods sold)	107,581	11,771	46,480	165,832
Cargo turnover, mln tons x km	864,785	31,673	-	-

Unit costs per 100 tons x km for each of the segments are based on operating expenses calculated under the Russian Accounting Standards (RAS) without adjustment entries for compliance with the IFRS and cargo turnover. Deflated unit costs are calculated using deflation rate for deflating operating expenses (net of D&A, one-time non-production expenses and cost of goods sold).

Unit costs of oil and oil products transportation per 100 tons x km for the nine months ended 30 September 2014, and for the nine months ended 30 September 2013, were as follows:

	For the nine months ended 30 September 2014	For the nine months ended 30 September 2013	Absolute change in unit costs, RUB per 100 tons x km	Change in unit costs, RUB per 100 tons x km, %
<b>Oil transportation services</b>				
Unit costs per 100 tons x km, RUB		12.44	(0.54)	(4.3)
Inflated unit costs per 100 tons x km, RUB	11.90	13.27	(1.37)	(10.3)
<b>Oil products transportation services</b>				
Unit costs per 100 tons x km, RUB		37.16	(0.69)	(1.9)
Inflated unit costs per 100 tons x km, RUB	36.47	39.65	(3.18)	(8.0)

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

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

The increase in salaries, social funds contributions and social expenses for the nine months ended 30 September 2014 as compared to the nine months ended 30 September 2013 in the amount of RUB 1,668 or 2.0% was influenced by an increase of average employee headcount related primarily to construction and putting into operation of new oil pipelines.



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### 3.2.2. Pension expense

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

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

The non-state pension fund which offers different corporate plan options is an important part of the social policy.

	Nine months ended 30 September 2014	Nine months ended 30 September 2013	Absolute change	Change, %
Employers' contributions to NPF Transneft in favor of employees	3,278	4,717	(1,439)	(30.5)

### 3.2.3. Energy

Energy expenses for the nine months ended 30 September 2014 increased by RUB 439 or 1.8% as compared to the same period of the previous year. The increase was caused by growth of tariffs of natural monopolies for energy and power consumption, as well as a decline of volume of declared power and energy consumed at the same due to the implementation of measures under the program of energy saving and development of energy efficiency of OAO AK Transneft for the period 2012-2015 as well as the Energy Strategy for the period till 2030 approved by the Russian Government.

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

	Nine months ended 30 September 2014	Nine months ended 30 September 2013	Absolute change	Change, %
Consumption of power, MW	12,559	13,494	(935)	(6.9)
Consumption of energy, (mln. kW*h)	9,300	9,902	(602)	(6.1)

### 3.2.4. Transportation of oil using railways

This category of expenses represents expenditures on a complete set of services related to oil transportation by railways, including preparation and delivery of railway cars for oil loading, oil transportation by railway along the Skovorodino–SMNP Kozmino section, delivery of railway cars for oil unloading, and return of empty railway cars to Skovorodino.

The amount of expenses on transportation of oil using railways as for the nine months ended 30 September 2014 decreased by RUB 3,004 or 62.8% as compared to the previous period as a result of putting into operation of The Eastern Siberia–Pacific Ocean pipeline system, stage two, the Skovorodino–SMNP Kozmino section (ESPO-II) and decrease in volume of oil transportation by railways.

### 3.2.5. Materials

Expenses on materials for the nine months ended 30 September 2014 as compared to the same period of 2013, increased by RUB 1,024 or 7.0%.

### 3.2.6. Repairs services and maintenance of relevant technical condition of pipeline

A decrease in these expenses for the nine months ended 30 September 2014, amounted to RUB 285 or 2.8% compared to the nine months ended 30 September 2013.

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

The cost of crude oil sold for export for the nine months ended 30 September 2014, amounted to RUB 124,041, including custom duties in the amount of RUB 59,669, which was a result of the start of oil supplies to the People's Republic of China (ref. to 3.1.2.). These expenses are related to the cost of oil purchased from OAO NK Rosneft under a contract signed in April 2009.

The cost of marketable oil products sold decreased by RUB 1,666 or 33.7% due to decline in the Group companies' oil products sales volumes (ref. to paragraph 3.1.2).



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### 3.2.8. Taxes (except income tax)

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

### 3.2.9. Other operating expenses

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

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

### 3.2.10. 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 decrease in the Group's share of results from associates and jointly controlled entities for the nine months ended 30 September 2014 compared to the relative period in 2013, was mainly attributed to decline in profit of OAO Novorossiysk Commercial Sea Port (ref. to para 3). The Group's share in OAO Novorossiysk Commercial Sea Port was 35.57% as at 30 September 2014.

### 3.2.11. Finance income and costs

#### Interest income and expenses

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

A decrease in interest income for the nine months ended 30 September 2014, by RUB 1,576 or 12.1%, was driven by decline in income from fixed-income securities.

Interest income	Nine months ended 30 September 2014	Nine months ended 30 September 2013	Absolute change	Change, %
Interest income from cash and equivalents	2,923	5,113	(2,190)	(42.8)
Interest income from other financial assets	9,029	10,118	(1,089)	(10.8)
Other interest income	287	213	74	34.7
<b>Total interest receivable</b>	<b>12,239</b>	<b>15,444</b>	<b>(3,205)</b>	<b>(68.2)</b>
less interest income on the temporary investment of borrowings	(758)	(2,387)	1,629	(68.2)
<b>Total interest income recognised in the statement of profit and loss and other comprehensive income</b>	<b>11,481</b>	<b>13,057</b>	<b>(1,576)</b>	<b>(12.1)</b>

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

Interest expenses	Nine months ended 30 September 2014	Nine months ended 30 September 2013	Absolute change	Change, %
Interest expenses on loans and borrowings	24,193	25,860	(1,667)	(6.4)
Interest expenses regarding the dismantlement provision	1,744	4,335	(2,591)	(59.8)
Other interest expenses	1,107	781	326	41.7
<b>Total interest expenses</b>	<b>27,044</b>	<b>30,976</b>	<b>(3,932)</b>	<b>(12.7)</b>
Less finance costs to be capitalised	(1,579)	(2,941)	1,362	(46.3)
<b>Total interest expense recognised in the statement of profit and loss and other comprehensive income</b>	<b>25,465</b>	<b>28,035</b>	<b>(2,570)</b>	<b>(9.2)</b>



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

The amount of interest expenses is composed of:

- interest payable on a USD 10bn loan obtained from the China Development Bank at a variable LIBOR-linked rate with a 20-year maturity repayable in equal installments starting in the sixth year from the moment of issue;
- interest payable on Eurobonds issued by the Group in 2007-2008 for a total of USD 2,350 mln for the nine months ended 30 September 2014 and USD 2,950 for the similar period of the previous year;
- interest payable on series 01-03 of non-convertible interest-bearing documentary bonds amounting to RUB 135,000;
- interest payable on series BO-01 and BO-02 of non-convertible interest-bearing documentary bonds amounting to RUB 34,000.

In March 2014 the Group repaid in full the issue of Eurobonds in the nominal of USD 1,300.

Starting from June 2014 the Group makes planned monthly repayments of the loan from China Development Bank in the amount of USD 55.6 each.

During the nine months ended 30 September 2014, interest in the amount of RUB 821 was capitalised as part of cost of assets under construction (for the nine months ended 30 September 2013 – RUB 554) including:

- interest expenses to be capitalised in the amount of RUB 1,579 (for the nine months ended 30 September 2013 – RUB 2,941);
- interest income to be excluded from interest expenses to be capitalised in the amount of RUB 758 (for the nine months ended 30 September 2013 – RUB 2,387).

**Foreign currency exchange gains and losses**

The sum of foreign currency exchange gains and losses and their growth for the nine months ended 30 September 2014, compared to the nine months ended 30 September 2013, was a result of changes in the exchange rates of the US dollar and the Euro to the Russian rouble during the relative periods.

Due to a restatement of assets and liabilities denominated in foreign currencies at the end of every month, positive and negative currency-translation changes results, which are presented in the reporting on gross base. Disclosure of foreign exchange differences by sources is presented in the tables below:

	Nine months ended 30 September 2014	Nine months ended 30 September 2013	Absolute change	Change, %
Foreign exchange gains on financial investments	72,638	27,426	45,212	2.6 times
Foreign exchange gains on loans and borrowings	26,961	15,701	11,260	71.7
Other foreign exchange gains	20,151	7,070	13,081	2.9 times
<b>Total foreign exchange gains recognised in the statement of profit or loss and other comprehensive income</b>	<b>119,750</b>	<b>50,197</b>	<b>69,553</b>	<b>2.4 times</b>
Foreign exchange loss on financial investments	(20,400)	(10,257)	(10,143)	98.9
Foreign exchange loss on loans and borrowings	(102,781)	(41,879)	(58,502)	2.5 times
Other foreign exchange loss	(7,919)	(3,894)	(4,025)	2.0 times
<b>Total foreign exchange loss recognised in the statement of profit or loss and other comprehensive income</b>	<b>(131,100)</b>	<b>(56,030)</b>	<b>(75,070)</b>	<b>2.3 times</b>
<b>Net exchange differences</b>	<b>(11,350)</b>	<b>(5,833)</b>	<b>(5,517)</b>	<b>94.6</b>

Dynamics of exchange differences presented in the table was driven by weakening of the rouble against the dollar and the Euro for the nine months ended 30 September 2014 compared to the relative period in 2013.

**Derivatives**

As for the nine months ended 30 September 2014 the Group recognised the net loss from operations with derivatives in the amount of RUB 11,328 as compared to the gain of RUB 343 for the same period of 2013. The dynamics was driven by increased volatility and weakening of the RUB/USD exchange rate by more than 20% (see para 2.3).





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**3.3. Reconciliation of profit and EBITDA**

	Nine months ended 30 September 2014	Nine months ended 30 September 2013	Change, %
<b>Profit for the period</b>	<b>117,978</b>	<b>132,873</b>	<b>(11.2)</b>
Increased/(decreased) by:			
income tax expense	29,992	39,000	(23.1)
depreciation and amortization	81,872	73,868	10.8
result of oil sales to China	(1,904)	(638)	3.0 times
finance income	(131,231)	(63,254)	2.1 times
finance costs	167,893	83,722	2.0 times
share of profit from associates and jointly controlled entities	(49)	(1,264)	(96.1)
<b>EBITDA</b>	<b>264,551</b>	<b>264,307</b>	<b>0.1</b>
<b>EBITDA margin*, %</b>	<b>59.1</b>	<b>59.1</b>	<b>X</b>

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

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



## 4. Cash flow analysis

	Nine months ended 30 September 2014	Nine months ended 30 September 2013	Absolute change	Change, %
Cash flows from operating activities	189,111	253,532	(64,421)	(25.4)
Cash flows used in investing activities	(150,598)	(194,700)	44,102	22.7
<b>Free cash inflow*</b>	<b>38,513</b>	<b>58,832</b>	<b>(20,319)</b>	<b>(34.5)</b>
Cash flows used in financing activities	(62,888)	(36,642)	(26,246)	1.7 times
<b>Net cash (outflow) / inflow</b>	<b>(24,375)</b>	<b>22,190</b>	<b>(46,565)</b>	<b>x</b>
Change in cash and cash equivalents due to deviation of currency exchange rate	11,074	2,856	8,218	3.9 times
<b>Net (decrease)/increase in cash and cash equivalents</b>	<b>(13,301)</b>	<b>25,046</b>	<b>(38,347)</b>	<b>x</b>

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

Free cash flows excluding investments in promissory notes of banks and deposits for the nine months ended 30 September 2014 amounted to RUB 2,451 (the nine months ended 30 September 2013: RUB 103,898).

### 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 189,111 for the nine months ended 30 September 2014, which is RUB 64,421 or 25.4% less than for the nine months ended 30 September 2013.

The main factors which influenced on the decrease of cash from operating activities for the nine months ended 30 September 2014 as compared to the similar period in 2013 were as follows:

- an increase in cash receipts from customers by RUB 19,040;
- increase in cash paid to suppliers by RUB 29,780;
- increase in cash received from the refund of VAT and other taxes from the budget by RUB 29,677;
- increase of the net amount of payments of income tax amounting to RUB 26,552.

### 4.2. Investing activities

The primary factors resulting in a decrease in cash used in investment activities by RUB 44,102 or 22.7% for the nine months ended 30 September 2014, as compared to the same period for the previous year, were:

- increase in the amount of purchase of property, plant and equipment by RUB 47,968;
- a decrease by RUB 81,128 in cash used in purchase-and-sale transactions in regards to promissory notes and placement of funds in deposits for the purpose of investing of temporarily available funds (which amounted to RUB 36,133 for the nine months ended 30 September 2014, and RUB 45,066 for the nine months ended 30 September 2013);
- a cash receipt from the sale of subsidiaries in the amount of RUB 3,007 as for the nine months ended 30 September 2014, and a cash outflow from the purchase of share in jointly controlled entities and subsidiaries in the amount of RUB 7,371 as for the nine months ended 30 September 2014, as well.

### 4.3. Financing activities

For the nine months ended 30 September 2014 cash outflow increased by RUB 26,246 which was caused by repayment of Eurobonds in the amount of USD 1,300 million (RUB 47,040 at the rate of Central Bank of the Russian Federation on the date of operation) and a monthly repayment of the loan to China Development Bank in the amount of USD 222.4 (RUB 7,969 at the rate of Central Bank of the Russian Federation on the date of operation).

The repayment of dividends for the nine months ended 30 September 2014 in the amount of RUB 3,159 as well as payments for acquiring of non-controlling interests in OAO Uralsibnefteprovod (24.5%) for RUB 10,437 and in OAO Uraltransnefteproduct (13.8%) for RUB 2,113 also affected the above dynamics.



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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 statements of cash flows prepared using the direct method and disclosed in the consolidated financial statements prepared in accordance with IFRS for the nine months ended 30 September 2014.

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

- (a) changes during the period in inventories and operating receivables and payables;
- (b) non-cash items such as depreciation, provisions, unrealized foreign currency gains and losses, and undistributed profits of associates;
- (c) all other items for which the cash effects are investing or financing cash flows.

	<b>Nine months ended 30 September 2014</b>	<b>Nine months ended 30 September 2013</b>
<b>OPERATING ACTIVITIES</b>		
<b>Profit before tax</b>	<b>147,970</b>	<b>171,873</b>
<b>Adjustments for:</b>		
Depreciation and amortization	81,872	73,868
Loss from disposal of property, plant and equipment	416	(459)
Share of profit of associates and jointly controlled entities	(49)	(1,264)
Finance income	(131,231)	(63,254)
Finance costs	167,893	83,722
Others	(3,112)	(697)
<b>Operating profit before changes in working capital</b>	<b>263,759</b>	<b>263,789</b>
Changes in operating assets and liabilities:		
Increase in inventories	(2,482)	(1,802)
(Increase ) / decrease in trade and other receivables relating to operating activity and VAT assets	(1,456)	34,662
Decrease in trade and other payables, and accruals relating to operating activity	(4,242)	(1,006)
<b>Cash flows from operating activities before payment of income tax expense and interest</b>	<b>255,579</b>	<b>295,643</b>
Income tax paid	(41,929)	(23,823)
Income tax refund	520	8,966
Interest paid	(25,059)	(27,254)
<b>Cash flows received from operating activities</b>	<b>189,111</b>	<b>253,532</b>



## 5. Liquidity analysis

	30 September 2014	31 December 2013	Change, %
Current assets	535,479	532,017	(0.7)
including:			
cash and cash equivalents	91,441	104,742	(12.7)
short-term bank promissory notes and deposits*	313,184	300,910	4.1
Current liabilities	314,852	227,921	38.1
Net working capital	220,627	304,096	(27.4)
Current ratio	1.7	2.3	(26.1)
Quick ratio**	1.4	2.0	(30.0)
Debt / EBITDA	1.8	1.7	-
Debt / Equity	0.4	0.4	-

\* Short-term bank promissory-notes consist of promissory notes by banks with investment-grade international credit ratings 36.9%, banks with credit ratings not lower than B-/B3/B- per the S&P/Moody's/Fitch classification. Thus, short-term bank promissory notes and deposits consist of highly reliable or reliable financial instruments.

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

The decrease in cash and cash equivalents in the amount of RUB 13,301 as at 30 September 2014 as compared to cash and cash equivalents as at 31 December 2013 was a result of a decline in cash received from operating activities (ref. to paragraph 4.1).