

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 2015





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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 2015 and results of operations for the nine months ended 30 September 2015, compared to the nine months ended 30 September 2014, 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 2015.

Key financial and operating results

	Nine months ended 30 September 2015	Nine months ended 30 September 2014	Change, %
Revenue	610,016	573,935	6.3
Net profit	134,463	117,978	14.0
EBITDA*	285,574	264,551	7.9
EBITDA margin, %*	57.1	59.1	X
Oil delivered to consignees, mln. tons	360.6	359.6	0.3
including:			
Russian oil refineries, mln. tons	188.3	195.9	(3.9)
transshipment into the CPC-R system, mln. tons	1.1	1.3	(15.4)
exports to neighboring countries, mln. tons	16.5	15.6	5.8
exports to other countries, mln. tons	154.7	146.7	5.5
Oil products delivered to consignees, mln. tons	24.0	24.0	-
including:			
Russia's domestic market, mln. tons	6.6	7.4	(10.8)
exports to the Customs Union member countries, mln.tons	0.49	0.15	3.3 times
exports to other countries, mln. tons	16.9	16.4	3.0

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

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

	Nine months ended 30 September 2015	Nine months ended 30 September 2014	Absolute change	Change, %
Profit for the period	134,463	117,978	16,485	14.0
Net loss from exchange differences	29,224	11,350	17,874	2.6 times
Net interest expense	5,100	13,984	(8,884)	(63.5)
Net loss from operations with derivatives	2,152	11,328	(9,176)	(81.0)
Share of profit from associates and jointly-controlled entities	(1,619)	(49)	(1,570)	33.0 times
Net profit for the period net of afore-mentioned factors	169,320	154,591	14,729	9.5



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, 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-and-delivery facilities, and for data collection and summarizing.

The Group as at 30 September 2015 possesses an extensive network of trunk oil pipelines with a total length of approximately 53.3 thousand km and trunk oil products pipelines with a total length of some 18.9 thousand km.

During the nine months ended 30 September 2015 the Group transported more than 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. General information and overview of the Group's activities (continued)

1.1. Key investment projects of the Group

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”, 1st stage, reconstruction of the trunk pipelines Tikhoretsk-Novorossiysk;
- The 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 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. OAO AK 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 OAO AK Transneft have developed, introduced and certified the environmental management System. All subsidiaries of the Company has received the international certificate DQS and IQNet conformity to the standard ISO 14001.



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

2.1. Oil and oil products transportation tariffs

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 the year 2014 and nine months ended 30 September 2015 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 agreements:
 - 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 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 and concerning amendments to the order of FTS of Russia of 27.09.2012 №226-e/3»;
 - 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;
 - Order of the FTS of Russia of 31.10.2014 No. 240-e/2 Concerning the setting of fee for the service of OAO AK Transneft for transportation of oil via the Ephimoffka – OOO LUKoil-Volgogradneftepererabotka route rendering for OAO LUKoil;
 - Order of the FTS of Russia of 27.11.2014 No. 275-e/1 Concerning the setting of fee for the service of OAO AK Transneft for transportation of oil via the trunk pipeline system;
 - Order of the FTS of Russia of 10.02.2015 No. 18-e/1 Concerning the setting of fee for the service of OAO AK Transneft for transportation of oil via Tikhoretsk – Tuapse-2 rendering for OAO NK Rosneft;
 - Order of the FTS of Russia of 07.04.2015 №71-e/1 Concerning the setting of fee for the service of OAO AK Transneft for transportation of oil via Frontier of Azerbaijan republic/ Russian Federation (Shirvanovka) – PK Sheshkharis route and concerning amendments to the order of FTS of Russia of 27.11.2014 №275-e/1»;
 - The agreement on transportation of Azerbaijan oil through the territory of the Russian Federation of 16.02.1996, Baku;
 - 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;
 - Agreement dated 05.12.2014 No. 0015502 for provision of oil transportation services by transiting through the territory of the Russian Federation during 2015 between OAO AK Transneft and GNKAR;
 - Amendment No.1 to the agreement dated 05.12.2014 No. 0015502 for provision of oil transportation services by transiting through the territory of the Russian Federation during 2015 between OAO AK Transneft and GNKAR.



2.1. Oil and oil products transportation tariffs (continued)

- 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 FTS of Russia:
- Order of the FTS of Russia of 23.09.2010 No. 234-e/2 Concerning fee rates for the services of OAO Transneft for transportation of oil products from the trunk pipeline system in the Primorsk Commercial Seaport;
 - 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 (repealed with issuance of the Order of the FTS of Russia No. 224-e/2 dated 07.10.2014 put into force from the date of put into force of Order of the FTS of Russia No.223-e/1 of 07.10.2014);
 - 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 FTS 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 07.08.2013 No. 155-e/7 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 30.05.2014 No. 132-e/2 Concerning the setting of tariff for services rendered by OAO AK Transneft for transportation of oil products through the route “LUKOIL – Nizhegorodnefteorgsynthez” – MP “Primorsk” for OAO NK LUKOIL;
 - Order of the FTS of Russia of 02.09.2014 No. 211-e/1 Concerning the setting of tariff for the services rendered by OAO AK Transneft for transportation of oil products through OOO KINEF – MP “Primorsk” route for OAO Surgutneftegaz;
 - Order of the FTS of Russia No.223-e/1 of 07.10.2014 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 No. 224-e/2 of 07.10.2014 Concerning the cancellation of orders of the FTS No. 471-e/1 and No. 234-e/2;
 - Order of the FTS of Russia No.307-e/1 of 24.12.2014 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 No.19-e/2 of 10.02.2015 Concerning the setting of maximum rate of tariff for the services of OAO AK Transneft and making amendments to appendix 1 of the Order of the FTS of Russian No.223-e/1 of 07.10.2014;
 - Order of the FTS of Russia of 11.06.2015 No. 234-e/4 Concerning the setting of tariff for the services rendered by OAO AK Transneft for transportation of oil products through OOO KINEF – MP “Primorsk” route for OAO Surgutneftegaz (acting from 17.07.2015).



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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.

	Nine months ended 30 September 2015	Nine months ended 30 September 2014	Change, %
Oil production volume in the Russian Federation, mln tons	398.1	392.7	1.4
Oil refining volume in the Russian Federation, mln tons	94.3	94.3	-

Oil production volume increased for the nine months ended 30 September 2015 as compared to the similar period of the previous year by 5.4 mln tons or by 1.4% (ref. to 3.1.1.).

Light oil refining during the nine months ended 30 September 2015 in the Russian Federation remained at the same level as it was in the relative period of the previous year (ref. to 3.1.1.).

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.

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 has a significant portion of US dollar-denominated loans. Increase of US dollar to Russian rouble exchange rate may result in additional expenses in regard to servicing and settlement of liabilities nominated in foreign currency (ref. to 3.4).

	Nine months ended 30 September 2015	Nine months ended 30 September 2014	Change, %
Change in the rouble's exchange rate against the US dollar, %	17.7	20.3	x
Average exchange rate for the period (roubles per US dollar)	59.2777	35.3878	67.5
Exchange rate at the end of the period (roubles per US dollar)	66.2367	39.3866	68.2

2.4. Inflation rates

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

	Nine months ended 30 September 2015	Nine months ended 30 September 2014	Change, pp
Rouble inflation (CPI), %	10.4	6.3	4.1



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:

	Nine months ended 30 September 2015	Nine months ended 30 September 2014	Change, %
Current income tax	39,369	36,480	7.9
Property tax	12,571	8,832	42.3
Other taxes and levies	679	549	23.7

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 3,739 or by 42.3%. The increase was a result of putting into use of fixed assets, revaluation held at 31.12.2014 as well as increase in a tax rate applied to trunk pipelines as well as constructions which are integral technological part of these pipelines. These properties are taxed at the rates set locally by regions of the Russian Federation and can not be more than 0.7% during 2014, 1.0% during 2015.

Other taxes and levies

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



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3. Analysis of the Group's performance

The table below presents consolidated statement of profit and loss and other comprehensive income for the nine months ended 30 September 2015 and the relative period of 2014.

	Nine months ended 30 September 2015	Nine months ended 30 September 2014	Absolute change	Change, %
Revenue	610,016	573,935	36,081	6.3
revenue from oil transportation services	415,446	376,743	38,703	10.3
revenue from oil products transportation services	42,525	36,194	6,331	17.5
revenue from crude oil sales	131,545	143,235	(11,690)	(8.2)
other revenue	20,500	17,763	2,737	15.4
Operating expenses	(411,099)	(389,352)	(21,747)	5.6
Operating profit	198,917	184,583	14,334	7.8
Net financial costs	(36,476)	(36,662)	186	(0.5)
Share of profit from associates and jointly controlled entities	1,619	49	1,570	33.0 times
Profit before income tax	164,060	147,970	16,090	10.9
Current income tax	(39,649)	(36,566)	(3,083)	8.4
Deferred income tax	10,052	6,574	3,478	52.9
Income tax expense	(29,597)	(29,992)	395	(1.3)
Profit for the period	134,463	117,978	16,485	14.0
Other comprehensive (loss)/ gain, net of income tax	(2,400)	806	(3,206)	x
Total comprehensive income, net of income tax	132,063	118,784	13,279	11.2



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3.1. Revenue

Revenue by type of operations	Nine months ended 30 September 2015	Share of total revenue, %	Nine months ended 30 September 2014	Share of total revenue, %	Absolute change	Change, %
Revenue from crude oil transportation services	415,446	68.1	376,743	65.7	38,703	10.3
exports, except the CIS	230,553	37.8	198,538	34.6	32,015	16.1
exports in the CIS	10,669	1.7	10,879	1.9	(210)	(1.9)
domestic sales	174,224	28.6	167,326	29.2	6,898	4.1
Revenue from oil products transportation services	42,525	7.0	36,194	6.3	6,331	17.5
Revenue from oil compounding services	4,006	0.7	3,678	0.6	328	8.9
Other revenue	15,261	2.4	10,547	1.8	4,714	44.7
Total revenue (without revenue from sales of crude oil and oil products)	477,238	78.2	427,162	74.4	50,076	11.7
Revenue from export sales of crude oil	109,824	18.0	125,945	22.0	(16,121)	(12.8)
Revenue from sales of crude oil in the domestic market	21,721	3.6	17,290	3.0	4,431	25.6
Revenue from sales of oil products	1,233	0.2	3,538	0.6	(2,305)	(65.1)
Total revenue	610,016	100.0	573,935	100.0	36,081	6.3

For the nine months ended 30 September 2015, the Group's revenue increased by RUB 36,081 or by 6.3%, attributable mainly to an increase in revenue from crude oil transportation and oil products transportation services. Without taking into account revenue from crude oil sales and oil products sales, revenue for the nine months ended 30 September 2015 increased by RUB 50,076 or 11.7% compared to the nine months ended 30 September 2014 and accounted for 78.2% 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 38,703, or by 10.3% for the nine months ended 30 September 2015 comparable to the same period of 2014 and was attributable to increase of tariffs and to change in oil transportation turnover and turnover volumes.

Increase in revenue from oil products transportation services by RUB 6,331 or by 17.5% for the nine months ended 30 September 2015 as compared to the same period of 2014 was driven by growth 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 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.

Decrease in revenue from export sales of crude oil as for the nine months ended 30 September 2015 compared to the nine months ended 30 September 2014 was a result of decline in oil market price of USD per barrel during the reporting period.

Increase in revenue from domestic sales of crude oil as for the nine months ended 30 September 2015 by 4,431 or by 25.6% as compared to the relative period of the previous year was a result of increase of sale volumes of crude oil by the companies of the Group.

Decrease in revenue from sales of oil products as for the nine months ended 30 September 2015 by RUB 2,305 or by 65.1% was driven by decline of oil products volume sold.

3.1.3. Revenue from oil compounding services

Growth in revenue from oil compounding services by RUB 328 or by 8.9% as for the nine months ended 30 September 2015 compared to the nine months ended 30 September 2014 was a result of increase in oil compounding volumes by 5.3% (28,567.1 thousand tons for the nine months ended 30 September 2015; 27,130.3 thousand tons for the nine months ended 30 September 2014).



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3.1.4. Other revenue

Other revenue includes revenue from connection of companies to the trunk pipeline system and revenue from trunk pipeline expansion services, information services related to oil transportation, oil and oil products storage services, communication services, diagnostic services, construction services, connection of companies to the trunk pipeline system, trunk pipeline expansion services, rent services, organization of transporting services, as well as other services.

Increase in the amount of other revenue for the nine months ended 30 September 2015 as compared to the similar period of the previous year was generally a result of recognition of revenue from connection of companies to the trunk pipeline system and revenue from trunk pipeline expansion services in the reporting period.

3.2. Operating expenses

Operating expenses for the nine months ended 30 September 2015, and the nine months ended 30 September 2014, are detailed in the table below:

Operating expense line items	Nine months ended 30 September 2015	Share of total revenue, %	Nine months ended 30 September 2014	Share of total revenue, %	Absolute change	Change, %
Salaries, social funds contributions and social expenses	97,815	23.8	86,694	22.3	11,121	12.8
Energy	25,560	6.2	24,226	6.2	1,334	5.5
Materials	15,179	3.7	15,750	4.0	(571)	(3.6)
Repairs services and maintenance of relevant technical condition of pipeline	8,852	2.2	9,748	2.5	(896)	(9.2)
Insurance expenses	4,450	1.1	4,575	1.2	(125)	(2.7)
Taxes (except income tax)	12,676	3.0	9,144	2.3	3,532	38.6
Pension expense	9,292	2.3	2,277	0.6	7,015	4.1 times
Other operating expenses	21,378	5.2	11,685	3.0	9,693	83.0
Total operating expenses (net of D&A and cost of goods sold)	195,202	47.5	164,099	42.1	31,103	19.0
Depreciation and amortization	88,188	21.5	81,872	21.0	6,316	7.7
Cost of export crude oil sales (including export custom duties)	108,293	26.3	124,041	31.9	(15,748)	(12.7)
Cost of crude oil sold in the domestic market	17,685	4.3	15,817	4.1	1,868	11.8
Cost of oil products sold	1,141	0.3	3,283	0.8	(2,142)	(65.2)
Cost of other goods sold	590	0.1	240	0.1	350	2.5 times
Total operating expenses	411,099	100.0	389,352	100.0	21,747	5.6

For the nine months ended 30 September 2015, compared to the nine months ended 30 September 2014, the amount of operating expenses increased by RUB 21,747 or by 5.6%, while total operating expenses net of depreciation and amortization and cost of goods sold increased by RUB 31,103 or by 19.0%.

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 during 2014 and nine months ended 30 September 2015;
- growth of salaries, social funds contributions and social expenses (ref. to 3.2.1);
- growth in pension contributions (ref. to 3.2.2);
- growth in the amount of other taxes recognised in operating expenses (ref. to 3.2.7).



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3.2 Operating expenses (continued)

After applying inflation rates*, operating expenses for the nine months ended 30 September 2015, and for the nine months ended 30 September 2014, were as follows:

Operating expense line items	Nine months ended 30 September 2015	Share of total expenses, %	Inflation rates (2015 to 2014), %*	Nine months ended 30 September 2014 (inflated to 2015)	Share of total expenses, %	Absolute change	Change, %
Salaries, social funds contributions and social expenses	97,815	23.3	15.4	100,045	23.5	(2,230)	(2.2)
Energy	25,560	6.4	7.8	26,116	6.1	(556)	(2.1)
Materials	15,179	3.3	12.5	17,719	4.2	(2,540)	(14.3)
Repairs services and maintenance of relevant technical condition of pipeline	8,852	1.8	5.6	10,294	2.4	(1,442)	(14.0)
Insurance expenses	4,450	1.1	12.5	5,147	1.2	(697)	(13.5)
Taxes (except income tax)	12,676	3.1	12.5	10,287	2.4	2,389	23.2
Pension expense	9,292	2.3	15.4	2,628	0.6	6,664	3.5 times
Other operating expenses	21,378	5.4	12.5	13,146	3.1	8,232	62.6
Total operating expenses (net of D&A and cost of goods sold)	195,202	46.7	13.0	185,382	43.5	9,820	5.3
Depreciation and amortization	88,188	21.8	X	81,872	19.2	6,316	7.7
Cost of export crude oil sales (including export custom duties)	108,293	27.2	10.9	137,561	32.3	(29,268)	(21.3)
Cost of crude oil sold in the domestic market	17,685	3.9	10.9	17,541	4.1	144	0.8
Cost of oil products sold	1,141	0.3	4.4	3,427	0.8	(2,286)	(66.7)
Cost of other goods sold	590	0.1	12.5	270	0.1	320	2.2 times
Total operating expenses	411,099	100.0	X	426,053	100.0	(14,954)	(3.5)

*The inflation rates used are based on scenarios prepared by the Ministry of Economic Development for devising socio-economic development scenarios to 2018, as well as on 2014-2015 inflation rates.



3.2 Operating expenses (continued)

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

Unit costs km are calculated using operating expenses indicator formed under aggregated RAS data with previous year indicator adjusted for change in oil turnover / volume turnover of oil products transportation and turnover for each of the above-mentioned activities. For calculation of inflated unit costs the index of inflation is used which is based on key macroeconomic assumptions of social and economic development of Russia till 2018 prepared by Ministry of Economic Development of the Russian Federation, as well as inflation rate for 2014-2015.

Unit costs for transportation of oil as per 100 tons-kilometers as for the nine months ended 30 September 2015 and for the nine months ended 30 September 2014 were as follows:

	Nine months ended 30 September 2015	Nine months ended 30 September 2014	Absolute change	Change, %
Oil transportation services				
Turnover, mln. tons x km	883,587	864,996	18,591	2.1
Unit costs per 100 tons x km, RUB		15.14	0.89	5.9
Inflated unit costs per 100 tons x km, RUB (inflated to 2015, adjusted to turnover as for 2015)	16.03	16.90	(0.87)	(5.1)

Unit costs for oil products transportation per ton as for the nine months ended 30 September 2015 and as for the nine months ended 30 September 2014 were as follows:

	Nine months ended 30 September 2015	Nine months ended 30 September 2014	Absolute change	Change, %
Oil products transportation services				
Volume turnover, mln. of tons	24.0	24.0	-	-
Unit costs per ton, RUB		543.58	99.31	18.3
Inflated unit costs per ton, RUB (inflated to 2015, adjusted to volume turnover as for 2015)	642.89	595.90	46.99	7.9

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 2015 as compared to the nine months ended 30 September 2014 in the amount of RUB 11,121 or 12.8% was influenced by an increase of average employee headcount related primarily to construction and putting into operation of new oil trunk pipelines and indexation of wages in 2015 and improvements in remuneration system of oil-products transportation subsidiaries as well as growth of social funds contributions because of increase of accrual base ceiling.

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.

An important area of social protection of employees of the industry is a non-state pension system providing various options for corporate programs.

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

The amount of pension expenses increased under following factors which influence expenses from 31 December 2014:

- inclusion of pension liabilities of NPF Transneft in the consolidated interim condensed financial statements of the Group;
- recognition of obligations of the Group under defined benefit plan in accordance with IAS 19 and related expenses accrued.



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3.2.2. Pension expense (continued)

	Nine months ended 30 September 2015	Nine months ended 30 September 2014	Absolute change	Change, %
Employers' contributions to NPF Transneft in favor of employees	4,106	3,277	829	25.3

3.2.3. Energy

Energy expenses for the nine months ended 30 September 2015 increased by RUB 1,334 or 5.5% as compared to the same period of the previous year. The increase was caused by growth of tariffs of natural monopolies for energy and by growth of turnover.

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 2015	Nine months ended 30 September 2014	Absolute change	Change, %
Average annual capacity, thsd. kW	1,428	1,397	32	2.3
Consumption of energy, (mln. kW*h)	9,821	9,329	492	5.3

3.2.4. Materials

Expenses on materials for the nine months ended 30 September 2015 as compared to the same period of 2014, decreased by RUB 571 or 3.6%.

3.2.5. Repairs services and maintenance of relevant technical condition of pipeline

The amount of expense for repair services and maintenance of relevant technical condition of pipeline decreased as for the reporting period by RUB 896 or by 9.2% as compared to the relative period of the previous year. The decline was caused by results of diagnostics which led to increased repairs performed with the trunk pipeline during the nine months of 2014.

3.2.6. Cost of crude oil and oil products sold

The cost of crude oil sold for export for the nine months ended 30 September 2015 amounted to RUB 108,293 including custom duties in the amount of RUB 33,595, which was a result 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.

Increase in cost of marketable oil sold in the domestic market as for the nine months ended 30 September 2015 amounted to RUB 1,868 or 11.8% as compared to the relative period of 2014 and was caused by increase in sale volumes of marketable oil.

The cost of marketable oil products sold decreased by RUB 2,142 or 65.2% due to decline in the Group companies' oil products sales volumes (ref. to 3.1.2.).

3.2.7. Taxes (except for the 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 2.5).

3.2.8. Other operating expenses

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

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

3.3. Share of results from associates and jointly controlled entities

The Group holds a number of financial investments in associated and jointly controlled entities reported on an equity method basis. The main activities of those entities are stevedoring operations, towing services, ship repair and the provision of additional port services, cargo handling, transport of oil products, wholesale of electric and heat power.

The increase of profit shown in "Share of profit from associates and jointly controlled entities" for RUB 1,570 was mainly caused by improved performance of Group PAO NCSP during the reporting period as compared with the relative period of 2014.

The Group's effective share of control in PAO NCSP was 35.57% as at 30 September 2015.



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3.4. Finance income and costs

Interest income and expenses

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

Interest income	Nine months ended 30 September 2015	Nine months ended 30 September 2014	Absolute change	Change, %
Interest income from cash and equivalents	6,319	2,923	3,396	2.2 times
Interest income from other financial assets	21,447	9,029	12,418	2.4 times
Other interest income	425	287	138	48.1
Total interest receivable	28,191	12,239	15,952	2.3 times
Less interest income on the temporary investment of borrowings	(425)	(758)	333	(43.9)
Total interest income recognised in the statement of profit and loss and other comprehensive income	27,766	11,481	16,285	2.4 times

Increase in interest income for the nine months ended 30 September 2015 by RUB 16,285 or in 2.4 times as compared with the relative period of 2014 was driven mainly by:

- inclusion of interest income from deposits and other financial assets of NPF Transneft in the consolidated interim condensed financial statements;
- increase of interest income from placement of cash in deposits;
- weakening of RUB to USD exchange rate (ref. to 2.3).

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

Interest expenses	Nine months ended 30 September 2015	Nine months ended 30 September 2014	Absolute change	Change, %
Interest expenses on loans and borrowings	32,081	24,193	7,888	32.6
Other interest expenses	2,555	2,851	(296)	(10.4)
Total interest expenses	34,636	27,044	7,592	28.1
Less finance costs to be capitalised	(1,770)	(1,579)	(191)	12.1
Total interest expense recognised in the statement of profit and loss and other comprehensive income	32,866	25,465	7,401	29.1

The amount of interest expenses was composed of:

- interest payable on loan obtained in 2009 from the China Development Bank with a 20-year maturity repayable in equal installments after five years from the moment of issue;
- interest payable on Eurobonds issued by the Group in 2008 for a total of USD 1,050 mln for the nine months ended 30 September 2015 and USD 2,350 mln for the nine months ended 30 September 2014;
- interest payable on series 01-03 of non-convertible interest-bearing documentary bonds amounting to RUB 104 bn for the nine months ended 30 September 2015 and for the amount of RUB 135 bn for the nine months ended 30 September 2014;
- interest payable of non-convertible interest-bearing documentary bonds on series BO-04 for the amount RUB 10,000 and on series BO-03 for the amount RUB 15,000 for the nine months ended 30 September 2015 and for the amount RUB 34,000 on series BO-01 and BO-02 for the nine months ended 30 September 2014.

Increase in interest expense as for the nine months ended 30 September 2015 as compared to the similar period of 2014 was mainly driven by depreciation of exchange rate of RUB to USD.

During the nine months ended 30 September 2015, interest in the amount of RUB 1,345 was capitalised as part of cost of assets under construction (for the nine months ended 30 September 2014 – RUB 821) including:

- interest expenses to be capitalised in the amount of RUB 1,770 (for the nine months ended 30 September 2014 – RUB 1,579);
- interest income to be excluded from interest expenses to be capitalised in the amount of RUB 425 (for the nine months ended 30 September 2014 – RUB 758).



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3.4. Finance income and costs (continued)

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 2015, compared to the nine months ended 30 September 2014, 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 2015	Nine months ended 30 September 2014	Absolute change	Change, %
Foreign exchange gains on financial investments	172,615	72,638	99,977	2.4 times
Foreign exchange gains on loans and borrowings	184,778	26,961	157,817	6.9 times
Other foreign exchange gains	64,949	20,151	44,798	3.2 times
Total foreign exchange gains recognised in the statement of profit or loss and other comprehensive income	422,342	119,750	302,592	3.5 times
Foreign exchange loss on financial investments	(125,246)	(20,400)	(104,846)	6.1 times
Foreign exchange loss on loans and borrowings	(286,698)	(102,781)	(183,917)	2.8 times
Other foreign exchange loss	(39,622)	(7,919)	(31,703)	5.0 times
Total foreign exchange loss recognised in the statement of profit or loss and other comprehensive income	(451,566)	(131,100)	(320,466)	3.4 times
Net exchange differences	(29,224)	(11,350)	(17,874)	2.6 times

Dynamics of exchange differences presented in the table was driven by significant fluctuations of the rouble against the dollar and the Euro for the nine months ended 30 September 2015 compared to the relative period in 2014.

Derivatives

As for the nine months ended 30 September 2015 the loss recognized by the Group from operations with derivatives decreased by 72.0% and amounted to RUB 3,173 as compared to the loss of RUB 11,328 for the relative period of 2014. The dynamics was driven by weakening of the RUB to USD exchange rate during the reporting period (ref to 2.3).

3.5. Reconciliation of profit and EBITDA

	Nine months ended 30 September 2015	Nine months ended 30 September 2014	Change, %
Profit for the period	134,463	117,978	14.0
Adjustments for:			
income tax expense	29,597	29,992	(1.3)
depreciation and amortization	88,188	81,872	7.7
result of oil sales to China	(1,531)	(1,904)	(19.6)
net finance costs	36,476	36,662	(0.5)
share of profit from associates and jointly controlled entities	(1,619)	(49)	33.0 times
EBITDA*	285,574	264,551	7.9
EBITDA margin*, %	57.1	59.1	x

* 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

	line months ended 30 September 2015	Nine months ended 30 September 2014	Absolute change	Change, %
Cash flows from operating activities	211,520	189,111	22,409	11.8
Cash flows used in investing activities	(69,597)	(150,598)	81,001	(53.8)
Free cash inflow*	141,923	38,513	103,410	3.7 times
Cash flows used in financing activities	(134,617)	(62,888)	(71,729)	2.1 times
Net cash inflow / (outflow)	7,306	(24,375)	31,681	x
Change in cash and cash equivalents due to deviation of currency exchange rate	24,177	11,074	13,103	2.2 times
Net increase / (decrease) in cash and cash equivalents	31,483	(13,301)	44,784	x

*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 2015 amounted to RUB 32,156 (for the nine months ended 30 September 2014: RUB 7,573).

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 211,520 for the nine months ended 30 September 2015, which is RUB 22,409 or 11.8% higher than for the nine months ended 30 September 2014.

The main factors which influenced on increase of cash generated from operating activities for the nine months ended 30 September 2015 as compared to the similar period in 2014 were as follows:

- increase in cash receipts from customers by RUB 27,699;
- increase in cash paid to suppliers by RUB 5,158;
- increase in cash received from the refund of VAT and other taxes from the budget by RUB 5,280;
- increase in amount of interest paid by RUB 8,867;
- decrease of the net amount of payments of income tax by RUB 5,513.

4.2. Investing activities

The primary factors resulting in a decrease in cash used in investment activities by RUB 81,001 or 53.8% for the nine months ended 30 September 2015, as compared to the same period for the previous year, were:

- increase in the amount of purchase of property, plant and equipment by RUB 10,434;
- net cash inflow as for the nine months ended 30 September 2015 in the amount of RUB 109,767 from purchase-and-sale transactions of promissory notes and allocation/closure of funds in deposits as compared to net cash inflow for 2014 amounting to RUB 30,940;
- increase from interest and dividends received by RUB 15,699.

4.3. Financing activities

The main factors which influenced on increase of cash flows used in financing activities for the nine months ended 30 September 2015 as compared to 2014 by RUB 71,729 or 2.1 times were:

- increase of cash used to repay bonds and loans and borrowings in the amount of RUB 6,703.
For the nine months ended 30 September 2015 monthly repayment of the loan to China Development Bank in the total amount of USD 500.0 mln. (RUB 29,731 at the rate of Central Bank of the Russian Federation on the date of operation), repayment of rouble-nominated bonds in the amount of RUB 30,898 and repayment of loan to OOO LatRosTrans amounting to RUB 1,083;
During the similar period of the previous year Eurobonds in the amount of USD 1,300 mln. were settled (RUB 47,040 at the rate of Central Bank of the Russian Federation on the date of operation) and repayment of loan to China Development Bank was made in the amount of USD 222.4 mln. (RUB 7,969 at the rate of Central Bank of the Russian Federation on the date of operation);
- payments for acquisition of non-controlling interests in OAO SZMN (36%) and 25% in OOO Transneft-Terminal amounting to RUB 11,731 during the nine months ended 30 September 2015.



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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 interim condensed statements of cash flows prepared using the direct method and disclosed in the consolidated interim condensed financial statements prepared in accordance with IFRS for the nine months ended 30 September 2015.

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 and amortisation, 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.

	Nine months ended 30 September 2015	Nine months ended 30 September 2014
OPERATING ACTIVITIES		
Profit before tax	164,060	147,970
Adjustments for:		
Depreciation and amortization	88,188	81,872
Loss from disposal of property, plant and equipment	630	416
Finance income	(451,129)	(131,231)
Finance costs	487,605	167,893
Share of profit from associates and jointly-controlled entities	(1,619)	(49)
Others	(10,010)	(3,112)
Operating profit before changes in working capital	277,725	263,759
Changes in operating assets and liabilities:		
Changes in inventories	(2,397)	(2,482)
Changes in trade and other receivables relating to operating activity and VAT assets	2,430	(1,456)
Changes in trade and other payables, and accruals relating to operating activity	3,584	(4,242)
Cash flows from operating activities before payment of income tax expense and interest	281,342	255,579
Income tax paid	(36,981)	(41,929)
Income tax refund	1,085	520
Interest paid	(33,926)	(25,059)
Cash flows received from operating activities	211,520	189,111



5. Liquidity analysis

	30 September 2015	31 December 2014	Change, %
Current assets	674,997	697,494	(3.2)
including:			
cash and cash equivalents	144,543	113,060	27.8
short-term bank promissory notes, deposits and bonds*	387,634	441,654	(12.2)
Current liabilities	255,336	383,719	(33.5)
Net working capital	419,661	313,775	33.7
Current ratio	2.6	1.8	x
Quick ratio**	2.2	1.6	x
Debt / EBITDA	2.2	2.2	x
Debt / Equity	0.5	0.6	x

* Short-term bank promissory-notes, deposits and bonds consist of promissory notes, deposits and bonds issued by banks 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