

ОАО АК ТРАНСНЕФТ

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

FOR THE NINE MONTHS ENDED 30 SEPTEMBER 2013





OAO AK TRANSNEFT
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(in millions of Russian roubles, if not stated otherwise)

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The following analysis provides an overview of the financial position of OAO AK Transneft and its subsidiaries (hereinafter – the “Group”) as at 30 September 2013 and results of operations for the nine months ended 30 September 2013, compared to the nine months ended 30 September 2012, 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 2013.

Key financial and operating results

	Nine months ended 30 September 2013	Nine months ended 30 September 2012	Change, %
Revenue	561,586	548,314	2.4
Profit for the period	132,873	142,993	(7.1)
EBITDA	264,945	246,826	7.3
EBITDA margin, %*	59.2	57.3	x
Oil delivered to consignees, mln. tons including	359.9	360.0	-
Russian oil refineries, mln. tons	186.7	179.5	4.0
transshipment into the CPC-R system, mln. tons	1.5	0.3	5.0 times
exports to FSU countries, mln. tons	20.5	21.2	(3.4)
exports to ROW, mln. tons	151.2	159.0	(4.9)
Oil products delivered to consignees, mln. tons including:	24.1	20.6	17.0
Russia's domestic market, mln. tons	7.7	6.8	13.2
exports to the Customs Union member countries, mln. tons	0.2	1.9	(89.5)
exports to ROW, mln. tons	16.1	11.9	35.3

* 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 2013 amounted to RUB 132.9 bn which is RUB 10.1 bn or 7.1% lower than for the nine months ended 30 September 2012 which amounted to RUB 143.0 bn.

The profit for the nine months ended 30 September 2013 contains net foreign currency exchange loss amounting to RUB 5.8 bn (net foreign gain as for the nine months ended 30 September 2012 amounting to RUB 8.0 bn), net interest expense amounting to RUB 14.9 bn (RUB 13.6 bn – for the nine months ended 30 September 2012), gain from changes in the fair value of derivatives amounting to RUB 0.3 bn (there was no effect for the nine months ended 30 September 2012). Should these factors be excluded the profit for the nine months ended 30 September 2013 would amount to RUB 153.3 bn (for the nine months ended 30 September 2012 – RUB 148.6 bn) showing an increase of RUB 4.7 bn or 3.2%.



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, 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 2013 possesses an extensive network of trunk oil pipelines with a total length of approximately 53.6 thousand km and trunk oil products pipelines with a total length of some 19.1 thousand km.

During the nine months ended 30 September 2013 the Group transported 88% of oil produced in Russia and more than 27% 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 and Western Europe.



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.

During 2010 – 2013 the Group has carried out investment projects in the area of building and expanding pipeline systems, the largest of which are:

- The Eastern Siberia–Pacific Ocean pipeline system, stage two, the Skovorodino–SMNP Kozmino section (ESPO II);
- Expansion of the Eastern Siberia–Pacific Ocean pipeline system's capacity, the GNPS Taishet–NPS Skovorodino section, to 50 mln tons annually;
- The Baltic Pipeline System 2, stage one (BPS-2, 1st stage);
- The Purpe– Samotlor pipeline;
- The Zapolyarie–Purpe pipeline;
- Expansion of the pipeline system to ensure transportation of 12 mln tons of oil annually to OOO RN-Tuapse Refinery;
- The construction Kuyumba – Tayshet trunk pipeline.

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 (in edition of the Order of the FTS of Russia of 07.12.2007 No. 437-e/24).

During 2012 and the nine months ended 30 September 2013, 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 31.08.2011 No. 202-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 29.07.2011 No. 183-e/1 Concerning the setting of fees for the services of OAO AK Transneft for transportation of Oil along the Klin-Andreapol' route;
 - 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 Sheskhari route;
 - Order of the FTS of Russia of 29.07.2010 No. 172-e/6 Concerning the setting of a fee for the services of OAO AK Transneft for transportation of oil via the Tikhoretsk–Tuapse Oil Refinery pipeline section for OAO NK Rosneft;
 - 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 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 05.08.2008 No. 129-e/3 Concerning the approval of fees for oil loading services at the LPDS Krotovka of OAO AK Transneft's trunk pipeline system for OAO TNK-BP Holding;
 - Order of the FTS of Russia of 29.12.2011 No. 448-e/1 Concerning the setting of fees for the services of OAO AK Transneft for transportation of transit oil via the trunk pipeline system;
 - Order of the FTS of Russia of 28.02.2012 No. 15-e/1 Concerning the setting of fees for the services of OAO AK Transneft for transportation of oil at the Oil Base Ust-Luga and the inclusion of amendments to the order of the FTS of Russia of 31.08.2011 No. 202-e/2;
 - Order of the FTS of Russia of 27.04.2012 No. 72-e/2 Concerning the setting of fees for the services of OAO AK Transneft for transportation of oil along the Klin-Andreapol' route;
 - Order of the FTS of Russia of 10.07.2012 No. 174-e/2 Cancelling the order of the FTS of Russia of 05.08.2008 concerning the setting of fees for oil loading services at the LPDS Krotovka of OAO AK Transneft's trunk pipeline system for OAO TNK-BP Holding;
 - Order of the FTS of Russia of 31.08.2012 No. 208-e/1 Concerning the setting of fees for the services of OAO AK Transneft for transportation of oil via the trunk pipeline system and the inclusion of amendments to the order of the FTS of Russia of 31.08.2011 No. 202-e/2;
 - 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 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 Sheskhari 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 27.09.2012 No. 227-e/3 Concerning the cancelling of the orders of the FTS:
 - of 31.08.2011 No. 202-e/2 Concerning the setting of fees for the services of OAO AK Transneft for transportation of oil via the trunk pipeline system;



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- of 28.02.2012 No. 15-e/1 Concerning the setting of fees for the services of OAO AK Transneft for transportation of oil at the Oil Base Ust-Luga and the inclusion of amendments to the order of the FTS of Russia of 31.08.2011 No. 202-e/2;
- of 27.04.2012 No. 72-e/2 Concerning the setting of fees for the services of OAO AK Transneft for transportation of oil along the Klin-Andreapol' route;
- of 31.08.2012 No. 208-e/1 Concerning the setting of fees for the services of OAO AK Transneft for transportation of oil via the trunk pipeline system and the inclusion of amendments to the order of the FTS of Russia of 31.08.2011 No. 202-e/2;
- Order of the FTS of Russia of 30.10.2012 No. 252-e/2 Concerning the cancelling of the order of the FTS of Russia of 29.07.2010 No. 172-e/6 Concerning the setting of a fee for the services of OAO AK Transneft for transportation of oil via the Tikhoretsk-Tuapse Oil Refinery pipeline section for OAO NK Rosneft;
- Order of the FTS of Russia of 14.12.2012 No. 392-e/12 Concerning the cancelling of the order of the FTS of Russia of 29.12.2011 No. 448-e/1 Concerning the setting of fees for the services of OAO AK Transneft for transportation of transit oil via the trunk pipeline system;
- Order of the FTS of Russia of 14.12.2012 No. 391-e/11 Concerning the cancelling of the 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 Sheskhari route;
- The intergovernmental agreement on transportation of Azerbaijan oil through the territory of the Russian Federation of 16.02.1996, Baku;
- Order of the Government of the Russian Federation of 05.05.2013 No. 746-r about the cancelling of the intergovernmental agreement on transportation of Azerbaijan oil through the territory of the Russian Federation.
- 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;
 - 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.



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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 2013	Nine months ended 30 September 2012	Change, %
Oil mining volume in the Russian Federation, mln tons	390.3	386.6	1.0
Oil products refining volume in the Russian Federation, mln tons	89.6	88.0	1.8

Oil mining volume increased for the nine months ended 30 September 2013 as compared to the nine months ended 30 September 2012 for 3.7 mln tons or by 1.0% (ref. to subparagraph 3.1.1.).

Growth in oil products refining during the nine months ended 30 September 2013 in the Russian Federation for 1.6 mln tons or by 1.8% has influenced in growth of oil products transportation (ref. to subparagraph 3.1.1.).

For 9 months of 2013 the volume of delivery of oil to refinery plants of the Russian Federation exceeded the volume of oil transportation for export to CIS and international markets. This would result in the growth of oil refining volumes and will lead to growth of transportation volumes of oil products (ref. to subparagraph 3.1.1.).

2.3. The rouble's exchange rate against foreign currencies

Oil transportation services are paid for in Russian roubles except for the transit of crude oil from Azerbaijan which is set off in US Dollars.

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'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.

	Nine months ended 30 September 2013	Nine months ended 30 September 2012	Change, %
Change in the rouble's exchange rate against the US dollar, %	6.49	(3.97)	x
Average exchange rate for the period (roubles per US dollar)	31.6170	31.0984	1.67
Exchange rate at the end of the period (roubles per US dollar)	32.3451	30.9169	4.62

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 2013	Nine months ended 30 September 2012	Change, pp
Rouble inflation (CPI), %	4.7	5.2	(0.5)



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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:

	Nine months ended 30 September 2013	Nine months ended 30 September 2012	Change, %
Current income tax	35,927	42,595	(15.7)
Property tax	7,640	3,353	2.3 times
Other taxes and levies	744	669	11.2

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 due increased by RUB 4,287 or 2.3 times. The significant increase was a result of introduction on 1 January 2013 of the Federal Law of 29.11.2012 # 202-FZ «Concerning amendments to Part two of the Tax Code of the Russian Federation», which cancelled tax advantages for property tax relating to the trunk pipeline facilities as well as of any structures constituting an integral technological part of these facilities, as well as the completion of construction and putting into operation during 2012 a number of investment projects, including the Baltic Pipeline System (BPS-2) and the second phase of the pipeline system Eastern Siberia - Pacific Ocean (ESPO-II).

The property tax is assessed at a rate not exceeding 2.2% of average annual fixed asset book value.

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 periods showed therein.

	Nine months ended 30 September 2013	Nine months ended 30 September 2012	Absolute change	Change, %
Revenue				
Revenue from oil transportation services	378,939	369,668	9,271	2.5
Revenue from crude oil sales	124,107	126,893	(2,786)	(2.2)
Other revenue	58,540	51,753	6,787	13.1
Operating expenses	(370,509)	(362,621)	(7,888)	2.2
Operating profit	191,077	185,693	5,384	2.9
Exchange gains	50,197	110,116	(59,919)	(54.4)
Exchange losses	(56,030)	(102,131)	46,101	(45.1)
Interest income	13,057	8,159	4,898	60.0
Interest expense	(28,035)	(21,807)	(6,228)	28.6
Net change in fair value of derivatives	343	1	342	X
Share of profit from associates and jointly controlled entities	1,264	2,870	(1,606)	(56.0)
Profit before income tax	171,783	182,901	(11,028)	(6.0)
Current income tax	(35,572)	(42,655)	7,083	(16.6)
Deferred income tax	(3,428)	2,747	(6,175)	X
Income tax expense	(39,000)	(39,908)	908	(2.3)
Profit for the period	132,873	142,993	(10,120)	(7.1)
Defined benefit plan actuarial gains	323	-	323	X
Other comprehensive loss, net of income tax	-	(60)	60	X
Total comprehensive income	133,196	142,933	(9,737)	(6.8)
Profit attributable to:				
Shareholders of OAO AK Transneft	128,599	140,776	(12,177)	(8.6)
Non-controlling interests	4,274	2,217	2,057	92.8
Total comprehensive income attributable to:				
Shareholders of OAO AK Transneft	128,922	140,716	(11,794)	(8.4)
Non-controlling interests	4,274	2,217	2,057	92.8



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3.1. Revenue

Revenue By Type Of Operations	Nine months ended 30 September 2013	Share Of Total Revenue, %	Nine months ended 30 September 2012	Share of total revenue, %	Absolute change	Change, %
Revenue from crude oil transportation services	378,939	67.4	369,668	67.4	9,271	2.5
Exports and sales in international markets, except the CIS	204,596	36.4	201,505	36.8	3,091	1.5
Exports and sales in the CIS	12,445	2.2	11,707	2.1	738	6.3
Domestic sales	161,898	28.8	156,456	28.5	5,442	3.5
Revenue from oil products transportation services	33,088	5.9	24,056	4.4	9,032	37.5
Revenue from oil compounding services	4,026	0.7	4,667	0.9	(641)	(13.7)
Other revenue	16,217	3.0	11,850	2.2	4,367	36.9
Total revenue (less revenue from sales of crude oil and oil products)	432,270	77.0	410,241	74.8	22,029	5.4
Revenue from export sales of crude oil	114,096	20.3	117,516	21.4	(3,420)	(2.9)
Revenue from sales of crude oil in the domestic market	10,011	1.8	9,377	1.7	634	6.8
Revenue from sales of oil products	5,209	0.9	11,180	2.0	(5,971)	(53.4)
Total revenue	561,586	100.0	548,314	100.0	13,272	2.4

During the nine months ended 30 September 2013, the Group's revenue increased by RUB 13,272, or 2.4%, attributable mainly to an increase in revenue from of oil transportation services and revenue from sales of crude oil and oil products, including oil sales to China National United Oil Corporation. Without taking into account crude oil sales and oil products sales, revenue for the nine months ended 30 September 2013, amounted to RUB 432,270, which is RUB 22,029, or 5.4% higher than for the nine months ended 30 September 2012.

3.1.1. Oil and oil products transportation services

An increase in revenue from oil transportation services by RUB 9,271, or 2.5%, was driven by the following factors:

- growth in oil transportation tariffs (ref to paragraph 2.1);
- growth in turnover by 2.2% (864,776 mln tons x km for the nine months ended 30 September 2013; 846,119 mln tons x km for the nine months ended 30 September 2012).

An increase in revenue from oil products transportation services by RUB 9,032 or 37.5% was driven by the following factors:

- by growth in oil products transportation tariffs (ref to paragraph 2.1);
- growth in turnover by 26.4% (for the nine months ended 30 September 2013 – 31,673.1 mln tons x km; and 25,057.1 mln tons x km in the nine months ended 30 September 2012).



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 a collateral for a loan obtained from the China Development Bank. The respective oil volumes are being purchased from OAO NK Rosneft.

Decline in revenue from export sales of crude oil as for the nine months ended 30 September 2013 compared to the nine months ended 30 September 2012 was a result of decrease of oil price nominated in US Dollars per 1 barrel for the nine months ended 30 September 2013.

Decline in revenue from sales of marketable oil products for the nine months ended 30 September 2013 by RUB 5,971 or by 53.4%, was driven by decrease in volumes of marketable oil products sales by the Group's companies as non-core business.

3.1.3. Revenue from oil compounding services

A decrease in revenue from oil compounding services by RUB 641 or by 13.7% as for the nine months ended 30 September 2013 compared to the nine months ended 30 September 2012 was a result of decline in oil compounding volumes by 15.8% (29,450.1 thousand tons for the nine months ended 30 September 2013; 34,959.9 thousand tons for the nine months ended 30 September 2012).

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.

An increase in the amount of other revenue for the nine months ended 30 September 2013 as compared to the similar period of the previous year was a result of:

- increase of revenue for activities on the organization of transportation of cargoes by railways by RUR 872;
- increase of revenue for construction services in the amount of RUR 1,737;
- increase of insurance services by RUR 566.



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3.2. Operating expenses

Operating expenses for the nine months ended 30 September 2013, and the nine months ended 30 September 2012, are detailed in the table below:

Operating expense line items	Nine months ended 30 September 2013	Share of total expenses, %	Nine months ended 30 September 2012	Share of total expenses, %	Absolute change	Change, %
Staff costs	88,478	24.0	78,568	21.7	9,910	12.6
Energy	23,787	6.4	23,503	6.5	284	1.2
Transportation of oil using railways	4,783	1.3	23,686	6.5	(18,903)	(79.8)
Materials	14,726	4.0	12,687	3.5	2,039	16.1
Repairs services and maintenance of relevant technical condition of pipeline	10,033	2.7	9,328	2.6	705	7.6
Insurance expenses	5,234	1.4	4,375	1.2	859	19.6
Taxes (except income tax)	7,781	2.1	3,768	1.0	4,013	2.1 times
Other operating expenses	11,778	3.2	8,341	2.3	3,437	41.2
Total operating expenses (net of D&A and cost of crude oil and oil products sold)	166,600	45.1	164,256	45.3	2,344	1.4
Depreciation and amortization	73,868	19.9	61,133	16.9	12,735	20.8
One-time non-production expenses	2,299	0.6	-	-	2,299	-
Cost of export crude oil sales (including export custom duties)	113,458	30.6	117,852	32.5	(4,394)	(3.7)
Cost of crude oil sold in the domestic market	9,335	2.5	8,790	2.4	545	6.2
Cost of oil products sold	4,949	1.3	10,590	2.9	(5,641)	(53.3)
Total operating expenses	370,509	100.0	362,621	100.0	7,888	2.2

For the nine months ended 30 September 2013, compared to the nine months ended 30 September 2012, the amount of operating expenses (less depreciation and amortization, one-time non-production expenses and cost of crude oil and oil products sold) increased by RUB 2,344 or 1.4%, while total operating expenses increased by RUB 7,888 or 2.2%.

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

- growth in depreciation and amortization by RUB 12,735 or 20.8%. The growth of depreciation associated mainly with putting into operation of the Baltic Pipeline System (BPS-2) in early 2012, as well as putting into operation of The Eastern Siberia–Pacific Ocean pipeline system, stage two the Skovorodino–SMNP Kozmino section (ESPO-II);
- growth in the amount of taxes by RUB 4,013 or in 2.1 times as a result of amendments to the Tax Code of the Russian Federation (ref. paragraph 2.5);
- growth in staff costs by RUB 9,910 or by 12.6% (ref. paragraph 3.2.1.).



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After applying deflation rates, operating expenses for the nine months ended 30 September 2013, and for the nine months ended 30 September 2012, were as follows:

Operating expense line items	Deflation rates (2013 To 2012)	Nine months ended 30 September 2013 (Deflated To 2012)	Share of total expenses, %	Nine months ended 30 September 2012	Share of total expenses, %	Absolute change	Change, %
Staff costs	6.7	82,936	23.5	78,568	21.7	4,368	5.6
Energy	10.9	21,457	6.1	23,503	6.5	(2,046)	(8.7)
Transportation of oil using railways	11.2	4,300	1.2	23,686	6.5	(19,386)	(81.8)
Materials	3.4	14,235	4.0	12,687	3.5	1,548	12.2
Repairs services and maintenance of relevant technical condition of pipeline	5.6	9,501	2.7	9,328	2.6	(173)	(1.9)
Insurance expenses	3.5	5,059	1.4	4,375	1.2	684	15.6
Taxes (except income tax)	3.5	7,521	2.1	3,768	1.0	3,753	99.6
Other operating expenses	3.5	11,385	3.3	8,341	2.3	3,044	36.5
Total operating expenses (net of D&A and cost of crude oil and oil products sold)	X	156,394	44.3	164,256	45.3	(7,862)	(4.8)
Depreciation and amortization	X	73,868	21.0	61,133	16.9	12,735	20.8
One-time non-production expenses	X	2,299	0.7	-	-	2,299	x
Cost of export crude oil sales	7.3	105,694	30.1	117,852	32.5	(12,158)	(10.3)
Cost of crude oil sold in the domestic market	7.3	8,696	2.5	8,790	2.4	(94)	(1.1)
Cost of oil products sold	4.0	4,759	1.4	10,590	2.9	(5,831)	(55.1)
Total operating expenses	X	351,710	100.0	362,621	100.0	(10,911)	(3.0)

The deflation rates used are based on scenarios prepared by the Ministry of Economic Development for devising socio-economic development scenarios for 2012-2016, as well as on 2012-2013 inflation rates.



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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.

	Oil transportation services	Oil products transportation services	Adjustment entries	Total operating expenses*
For the nine months ended 30 September 2013				
Operating expenses	167,836	16,024	(17,260)	166,600
Cargo turnover, mln tons x km	864,776	31,673	-	-
For the nine months ended 30 September 2012				
Operating expenses	158,287	14,300	(8,331)	164,256
Cargo turnover, mln tons x km	846,119	25,057	-	-

*Operating expenses were reported net of D&A and cost of crude oil and oil products sold.

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 and cost of crude oil and oil products sold).

Unit costs of oil and oil products transportation per 100 tons x km for the nine months ended 30 September 2013, and for the nine months ended 30 September 2012, were as follows:

	For the nine months ended 30 September 2013	For the nine months ended 30 September 2012	Absolute change in unit costs, RUB per 100 tons x km	Change in unit costs, RUB per 100 tons x km, %
Oil transportation services				
Unit costs per 100 tons x km, RUB	19.41	18.71	0.70	3.7
Deflated unit costs per 100 tons x km, RUB	18.14		(0.57)	(3.0)
Oil products transportation services				
Unit costs per 100 tons x km, RUB	50.59	57.07	(6.48)	(11.4)
Deflated unit costs per 100 tons x km, RUB	47.28		(9.79)	(17.2)

3.2.1. Staff costs

Staff costs comprise wages, accrual of provision for annual bonus, provision for unused vacation, pension contributions, insurance premiums, staff training, social security expenses and other remuneration.

The increase in staff costs for the nine months ended 30 September 2013 as compared to the nine months ended 30 September 2012 in the amount of RUB 9,910 or 12.6% was influenced by an increase of average employee headcount related primarily to construction and operation of new oil pipelines, indexation of salaries.

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.

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

	Nine months ended 30 September 2013	Nine months ended 30 September 2012	Absolute change	Change, %
Employers' contributions to NPF Transneft* in favor of employees	4,717	4,980	(263)	(5.3)

* NPF Transneft – Non-state pension fund Transneft



3.2.2. Energy

Energy expenses for the nine months ended 30 September 2013, increased insignificantly by RUB 284 or 1.2%, 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.

3.2.3. 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 2013 decreased by RUB 18,903 or 79.8% 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).

3.2.4. Materials

Expenses on materials for the nine months ended 30 September 2013, increased by RUB 2,039 or 16.1%, due to expansion of operations:

- increase in rendering of construction services to third parties;
- increase in the amount of expenses, connected with putting into operation of new oil pipelines.

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

An increase in these expenses for the nine months ended 30 September 2013, amounted to RUB 705 or 7.6% compared to the nine months ended 30 September 2012.

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 2013, amounted to RUB 113,458, including custom duties in the amount of RUB 55,168, 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 5,641 or 53.3% due to decline in the Group companies' oil products sales volumes as non-core activity (ref. to paragraph 3.1.2).

3.2.7. Taxes (except income tax)

The Group's other taxes include primarily the property tax, which amounted to RUB 7,640 for the nine months ended 30 September 2013. Increase in the amount of RUB 4,283 or in 2.3 times as compared to the prior period was a result of cancellation on 1 January 2013 of property tax advantages, as well as putting into operation a number of investment projects (ref. to paragraph 2.5).

3.2.8. Other operating expenses

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

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

3.2.9. Share of profit 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 profit from associates and jointly controlled entities for the nine months ended 30 September 2013 compared to the relative period in 2012, was mainly attributed to decline in profit of OAO Novorossiysk Commercial Sea Port. The Group's share in OAO Novorossiysk Commercial Sea Port is 27.38%.

3.2.10. Interest income and expenses

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



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An increase in interest income for the nine months ended 30 September 2013, by RUB 4,898 or 60.0%, was driven by an growth in income from fixed-income securities as well as decline in the amount of income generated by investing temporarily available cash and cash equivalents (ref. to paragraph 5).

Interest income	Nine months ended 30 September 2013	Nine months ended 30 September 2012	Absolute change	Change, %
Interest income from cash and equivalents	5,113	5,031	82	1.6
Interest income from other financial assets	10,118	5,927	4,191	70.7
Other interest income	213	285	(72)	(25.3)
Total interest receivable	15,444	11,243	4,201	37.4
less interest income on the temporary investment of borrowings	(2,387)	(3,084)	697	(22.6)
Total interest income recognised in the statement of profit and loss and other comprehensive income	13,057	8,159	4,898	60.0

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

Interest expenses	Nine months ended 30 September 2013	Nine months ended 30 September 2012	Absolute change	Change, %
Interest expenses on loans and borrowings	25,860	25,645	215	0.8
Interest expenses regarding the dismantlement provision	4,335	5,421	(1,086)	(20.0)
Other interest expenses	781	469	312	66.5
Total interest expenses	30,976	31,535	(559)	(1.8)
Less finance costs to be capitalised	(2,941)	(9,728)	6,787	(69.8)
Total interest expense recognised in the statement of profit and loss and other comprehensive income	28,035	21,807	6,228	28.6

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 2,950 mln for the nine months ended 30 September 2013 and USD 3,450 and 700 mln Euros for the similar period of the previous year;
- interest payable on series 01-03 non-convertible interest-bearing documentary bonds for a total of 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 June 2012 the Group repaid in full and on time two Eurobonds issues in the amount of USD 500 mln and 700 mln Euros.

During the nine months ended 30 September 2013, interest in the amount of RUB 554 was capitalised as part of cost of assets under construction (for the nine months ended 30 September 2012 – RUB 6,644) including:

- interest expenses to be capitalised in the amount of RUB 2,941 (for the nine months ended 30 September 2012 – RUB 9,728);
- interest income to be excluded from interest expenses to be capitalised in the amount of RUB 2,387 (for the nine months ended 30 September 2012 – RUB 3,084).

Increase in interest expenses for the nine months ended 30 September 2013 as compared to the nine months ended 30 September 2012 amounted to RUB 6,228 or 28.6% and was mainly attributable to the completion of investment projects which were financed by loans and borrowings.



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3.2.11. 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 2013, compared to the nine months ended 30 September 2012, 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.

The most pronounced effect on the sum total of currency-translation differences were differences for foreign-currency-denominated loans and borrowings facilities:

Exchange differences	Nine months ended 30 September 2013	Nine months ended 30 September 2012	Absolute change	Change, %
Foreign exchange gains on financial investments	27,426	26,446	980	3.7
Foreign exchange gains on loans and borrowings	15,698	72,082	(56,385)	(78.2)
Other foreign exchange gains	7,073	11,588	(4,514)	(39.0)
Total foreign exchange gains recognised in other comprehensive income	50,197	110,116	(59,919)	(54.4)
Foreign exchange loss on financial investments	(10,257)	(31,584)	21,327	(67.5)
Foreign exchange loss on loans and borrowings	(41,878)	(56,464)	14,587	(25.8)
Other foreign exchange loss	(3,895)	(14,083)	10,188	(72.3)
Total foreign exchange loss recognised in other comprehensive income	(56,030)	(102,131)	46,101	(45.1)

The dynamic of currency-translation effects presented in the table was driven by weakening of the rouble against the US dollar and the Euro for the nine months ended 30 September 2013 and by strengthening for the nine months ended 30 September 2012.

3.3. Reconciliation of profit and EBITDA

	Nine months ended 30 September	Nine months ended 30 September	Change, %
Profit for the period	132,873	142,993	(7.1)
Increased (decreased) by:			
income tax	39,000	39,908	(2.3)
depreciation and amortization	73,868	61,133	20.8
net change in fair value of derivatives	(343)	(1)	X
interest expenses	28,035	21,807	28.6
interest and dividend income	(13,057)	(8,159)	45.1
exchange gains	(50,197)	(110,116)	(54.4)
exchange losses	56,030	102,131	(45.1)
share of profit from associates and jointly controlled entities	(1,264)	(2,870)	(56.0)
EBITDA	264,945	246,826	7.3
EBITDA margin*, %	59.2	57.3	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.



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4. Cash flow analysis

	Nine months ended 30 September 2013	Nine months ended 30 September 2012	Absolute change	Change, %
Cash flows from operating activities	253,532	146,398	107,134	73.2
Cash flows used in investing activities	(194,700)	(152,035)	(42,665)	28.1
Free cash flows*	58,832	(5,637)	64,469	11.4 times
Cash flows used in financing activities	(36,642)	(52,478)	15,836	(30.2)
Net cash flows	22,190	(58,115)	80,305	1.4 times
Change in cash due to deviation of currency exchange rate	2,856	(2,582)	5,438	X
Net increase/ (decrease) in cash and cash equivalents	25,046	(60,697)	85,743	1.4 times

*Including purchase and sale of promissory notes. Free cash flows excluding investments in promissory notes for the nine months ended 30 September 2013 amounted to RUB 103,898 (the nine months ended 30 September 2012: RUB 17,038)

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 253,532 for the nine months ended 30 September 2013, which is RUB 107,134 or in 1.7 times higher than for the nine months ended 30 September 2012.

This dynamics was driven by a decrease in cash payments to suppliers and contractors by RUB 23,527. The key drivers of the increase in cash received from operating activities was an increase in cash receipts from customers by RUB 23,527, decrease in cash paid to suppliers by RUB 19,661, increase in cash received from the recovery of VAT and other taxes from the budget by RUB 42,650 and simultaneous decrease in income tax payments amounting to RUB 21,221.

4.2. Investing activities

The primary factors resulting in a general increase in cash used in investment activities by RUB 42,665 or 28.1% for the nine months ended 30 September 2013, as compared to the same period for the previous year, were:

- an increase by RUB 22,391 or by 9.9% in cash used in purchase-and-sale transactions in regards to promissory notes for the purpose of investing of temporarily available funds (which amounted to RUB 45,066 for the nine months ended 30 September 2013, and RUB 22,675 for the nine months ended 30 September 2012);
- increase in the amount of purchase of property, plant and equipment by RUB 12,035;
- RUB 6,996 used for acquiring shares in the joint-control entity OAO Novorossiysk Commercial Sea Port. As at 30 September 2013 2.33% of ordinary shares were acquired for RUB 1,748.

4.3. Financing activities

For the nine months ended 30 September 2013 cash outflow amounted to RUB 36,642 which was RUB 15,836 less compared with the same period of 2013. The dynamics was driven by the following:

- a decrease by RUB 26,333 in cash used for payments on Eurobonds (repayment of Eurobonds in the amount of USD 600 million (RUB 19,859 at the rate of Central Bank of the Russian Federation on the date of operation in 2013) and the redemption of the Eurobonds for USD 500 million and 700 million euros (RUB 46,192 at the rate of Central Bank of the Russian Federation on the date of operation in 2012);
- increase of the funds used for the acquisition of a non-controlling interest in the amount of RUB 8,950. For 9 months of 2013 the Group purchased a non-controlling interest in OAO Uralsibnefteprovod (24.5%) for RUB 10,437 and in OAO Uraltransnefteproduct (13.8%) for RUB 2,113, comparing with the similar acquisition of OAO VOSTOKNEFTETTRANS (49%) for RUB 3,600 for the nine months of 2012
- increase in dividend payments amounting to RUB 1,970;



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- attracting a loan from a dependent company LatRosTrans in the amount of RUB 632.

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 2013.

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

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

	<u>Nine months ended 30 September 2013</u>	<u>Nine months ended 30 September 2012</u>
OPERATING ACTIVITIES		
Profit before tax	171,873	182,901
Adjustments for:		
Depreciation and amortization	73,868	61,133
Loss from disposal of property, plant and equipment	(459)	257
Interest income and share of profit from associates and jointly controlled entities	(14,321)	(11,029)
Interest expenses	28,035	21,807
Loss/ (profit) from currency-translation differences	5,833	(7,985)
Others	(1,040)	(6,792)
Operating profit before changes in working capital	263,789	240,292
Changes in operating assets and liabilities:		
Increase in inventories	(1,802)	(4,354)
Decrease / (increase) in trade and other receivables relating to operating activity and VAT assets	34,662	(11,394)
Decrease in trade and other payables, and accruals relating to operating activity	(1,006)	(14,077)
Cash flows from operating activities before payment of income tax expense and interest	295,643	210,467
Income tax paid	(23,823)	(50,153)
Income tax refund	8,966	14,075
Interest paid	(27,254)	(27,991)
Cash flows received from operating activities	253,532	146,398



5. Liquidity analysis

	30 September 2013	31 December 2012	Change, %
Current assets	508,063	461,669	10.0
including:			
cash and cash equivalents	103,863	84,517	22.9
short-term bank promissory notes and deposits*	271,857	213,473	27.3
Current liabilities	194,432	147,943	31.4
Net working capital	313,631	313,726	(0.03)
Current ratio	2.6	3.1	(16.1)
Quick ratio**	2.1	2.3	(8.7)
Debt / EBITDA	1.7	1.8	(5.6)
Debt / Equity	0.4	0.5	-

* Short-term bank promissory-notes consist of promissory notes by banks with investment-grade international credit ratings (76.2%), banks with credit ratings not lower than B-/B3/B- (8.4%) per the S&P/Moody's/Fitch classification. Thus, short-term bank promissory notes consist of highly reliable or reliable financial instruments.

** Less deposits classified as held for sale

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

The growth in cash and cash equivalents in the amount of RUB 19,346 as at 30 September 2013 as compared to cash and cash equivalents as at 31 December 2012 was a result of cash received from operating activities (ref. to paragraph 4.1).