

## **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*You should read the following management's discussion in conjunction with our unaudited consolidated interim condensed financial information as of and for the three months ended March 31, 2012. The consolidated interim condensed financial information has been prepared in accordance with International Accounting Standard 34 "Interim financial reporting" ("IAS 34"). This financial information should be read together with the consolidated financial statements for the year ended December 31, 2011, prepared in accordance with International Financial Reporting Standards ("IFRS").*

### **OVERVIEW**

We are one of the world's largest gas and oil companies in terms of reserves, production and market capitalization. Our revenues are primarily derived from sales of natural gas, crude oil and other hydrocarbon products to Western and Central Europe, Russia and other former Soviet Union countries.

We divide our operations into the following principal businesses:

- Production of gas – exploration and production of gas;
- Transport – transportation of gas;
- Distribution – sales of gas within Russian Federation and abroad;
- Gas storage – storage of extracted and purchased gas in underground gas storages;
- Production of crude oil and gas condensate – exploration and production of oil and gas condensate, sales of crude oil and gas condensate;
- Refining – processing of oil, gas condensate and other hydrocarbons, and sales of refined products; and
- Electric and heat energy generation and sales.

Other businesses primarily comprise production of other products and sales of several goods, works, services.

Our main business segments are mutually dependent, with a significant portion of the revenues of one segment comprising a part of the costs of another segment. In particular, our Distribution segment purchases natural gas from our Production of gas segment and transportation services from our Transport segment. Our Refining segment purchases gas from our Production of gas segment and crude oil and gas condensate from the Production of crude oil and gas condensate segment. We establish internal transfer prices with reference to the specific funding requirements of the individual subsidiaries within each segment. Accordingly, the results of operations of these segments on a stand-alone basis do not necessarily represent each segment's underlying financial position and results of operations as if it was a stand-alone business. For this reason, we do not analyze any of our main segments separately in the discussion that follows.

## RESULTS OF OPERATIONS

(RUB million)

	<b>Three months periods ended March 31,</b>	
	<b>2012</b>	<b>2011</b>
Sales	1,224,878	1,316,747
Net gain (loss) from trading activity	1,490	(330)
Operating expenses	<u>(927,401)</u>	<u>(817,909)</u>
<b>Operating profit</b>	<b>298,967</b>	<b>498,508</b>
Finance income	139,201	73,968
Finance expense	(30,041)	(20,278)
Share of net income of associated undertakings and jointly controlled entities	48,370	38,519
(Losses) gains on disposal of available-for-sale financial assets	<u>(200)</u>	<u>349</u>
<b>Profit before profit tax</b>	<b>456,297</b>	<b>591,066</b>
Current profit tax expense	(101,378)	(108,864)
Deferred profit tax benefit (expense)	<u>12,696</u>	<u>(3,702)</u>
Profit tax expense	(88,682)	(112,566)
<b>Profit for the period</b>	<b>367,615</b>	<b>478,500</b>
<b>Other comprehensive income</b>		
Gains arising from change in fair value of available-for-sale financial assets, net of tax	3,551	7,173
Share of other comprehensive loss of associated undertakings and jointly controlled entities	(2,758)	(5,579)
Translation differences	(47,419)	(19,624)
Gains from cash flow hedges, net of tax	<u>6,218</u>	<u>-</u>
<b>Other comprehensive loss for the period, net of tax</b>	<b>(40,408)</b>	<b>(18,030)</b>
<b>Total comprehensive income for the period</b>	<b>327,207</b>	<b>460,470</b>
<b>Profit attributable to:</b>		
owners of OAO Gazprom	357,841	467,969
non-controlling interest	<u>9,774</u>	<u>10,531</u>
	<b>367,615</b>	<b>478,500</b>
<b>Total comprehensive income attributable to:</b>		
owners of OAO Gazprom	320,067	451,528
non-controlling interest	<u>7,140</u>	<u>8,942</u>
	<b>327,207</b>	<b>460,470</b>

## Sales

The following table sets out our volumes and realized prices for the three months periods ended March 31, 2012 and 2011.

(RUB million unless indicated otherwise)	<b>Three months periods ended March 31,</b>	
	<b>2012</b>	<b>2011</b>
<b>Sales of gas</b>		
<i>Europe and other countries</i>		
Gross sales <sup>(1)</sup>	492,302	468,121
Customs duties	(105,702)	(69,588)
Net sales	386,600	398,533
Volumes in billion cubic meters (bcm)	42.7	46.6
Gross average price, U.S.\$ per mcm <sup>(2)</sup> (including customs duties) <sup>(3)</sup>	383.8	343.1
Gross average price, RUB per mcm <sup>(2)</sup> (including customs duties)	11,525.7	10,041.5
<i>FSU (Former Soviet Union)</i>		
Gross sales (net of value added tax (VAT))	172,365	220,243
Customs duties	(28,040)	(14,849)
Net sales	144,325	205,394
Volumes in bcm	20.0	29.2
Gross average price, U.S.\$ per mcm <sup>(2)</sup> (including customs duties, net of VAT) <sup>(2)</sup>	287.5	258.0
Gross average price, RUB per mcm <sup>(2)</sup> (including customs duties, net of VAT)	8,633.4	7,552.3
<i>Russian Federation</i>		
Gross sales (net of VAT)	269,070	266,042
Net sales	269,070	266,042
Volumes in bcm	99.6	102.5
Gross average price, RUB per mcm (net of VAT)	2,701.3	2,596.1
<i>Total sales of gas</i>		
Gross sales (net of VAT)	933,737	954,406
Customs duties	(133,742)	(84,437)
Effect of retroactive gas price adjustments	(78,505)	-
Net sales	721,490	869,969
Volumes in bcm	162.3	178.3
Net sales of refined products (net of excise tax, VAT and customs duties)	255,971	214,887
Net sales of electric and heat energy (net of VAT)	111,601	112,536
Net sales of crude oil and gas condensate (net of VAT and customs duties)	65,193	57,345
Gas transportation net sales (net of VAT)	32,059	28,796
Other revenues (net of VAT)	38,564	33,214
<b>Total sales (net of excise tax, VAT and customs duties)</b>	<b>1,224,878</b>	<b>1,316,747</b>

Notes:

<sup>(1)</sup> VAT is not charged on sales to Europe and other countries.

<sup>(2)</sup> One mcm is equivalent to 35,316 cubic feet.

<sup>(3)</sup> Calculated on the basis of average exchange rate between RUB and U.S.\$.

Total sales (net of VAT, excise tax and customs duties) decreased by RUB 91,869 million, or 7%, to RUB 1,224,878 million in the three months period ended March 31, 2012 compared to the same period of the prior year.

Net sales of gas accounted for 59% and 66% of total net sales in the three months periods ended March 31, 2012 and 2011, respectively.

Net sales of gas decreased from RUB 869,969 million in the three months period ended March 31, 2011 to RUB 721,490 million in the three months period ended March 31, 2012 or, by 17%.

Net sales of gas to Europe and other countries decreased in the three months period ended March 31, 2012 compared to the three months period ended March 31, 2011, by RUB 11,933 million, or 3%, to RUB 386,600 million. The

overall decrease in net sales of gas to Europe and other countries relates to decrease in volume of gas sold by 8%. The gross average RUB price (including customs duties) increased by 15% in the three months period ended March 31, 2012, compared to the three months period ended March 31, 2011.

During 2012 year management of the Group renegotiated prices for long-term gas supply contracts with certain European customers. As a result of these renegotiations, gas prices for the periods prior 2012 were reconsidered. Effect of retroactive gas price adjustments was recognized as debit to revenue in the amount of RUB 78,505 million.

Net sales of gas to FSU countries decreased in the three months period ended March 31, 2012 compared to the three months period ended March 31, 2011, by RUB 61,069 million, or 30%, to RUB 144,325 million. This decrease was mainly due to the decrease in volumes of gas sold to FSU countries by 32% in the three months period ended March 31, 2012 compared to the three months period ended March 31, 2011. The gross average RUB price (including customs duties, net of VAT) increased by 14% in the three months period ended March 31, 2012 compared to the same period of the prior year.

Net sales of gas in the Russian Federation increased in the three months period ended March 31, 2012 compared to the same period of the prior year, by RUB 3,028 million, or 1%, to RUB 269,070 million. This increase was due to the increase in the gross average price for domestic gas sales by 4% in the three months period ended March 31, 2012 compared to the same period of the prior year. The volume of gas sold in the three months period ended March 31, 2012 decreased by 3%, compared to the three months period ended March 31, 2011.

Net sales of refined products (net of excise tax, VAT and customs duties) increased by RUB 41,084 million, or 19%, to RUB 255,971 million in the three months period ended March 31, 2012 in comparison with the same period of the prior year. The increase mainly resulted from the increase in prices for refined products and increase in volumes sold in the three months period ended March 31, 2012 compared to the same period of the prior year. In the three months periods ended March 31, 2012 and 2011 Gazprom Neft Group's sales comprised 83% of the total amount of our net sales of refined products.

Net sales of electric and heat energy (net of VAT) decreased by RUB 935 million, or 1%, to RUB 111,601 million in the three months period ended March 31, 2012 compared to the same period of the prior year. The decrease was mainly due to the reduction of electricity prices at the day-ahead market and decrease of generation of electric energy.

Net sales of crude oil and gas condensate (net of VAT and customs duties) increased by RUB 7,848 million, or 14%, to RUB 65,193 million in the three months period ended March 31, 2012 compared to RUB 57,345 million in the three months period ended March 31, 2011. The increase was mainly caused by the increase in oil and gas condensate prices in the three months period ended March 31, 2012 compared to the same period of the prior year. Also the increase was supported by the increase of the volume of gas condensate sold in the three months period ended March 31, 2012 compared to the same period of the prior year. Sales of crude oil included in net sales of crude oil and gas condensate (net of VAT and customs duties), amounted to RUB 51,187 million and RUB 48,362 million in the three months periods ended March 31, 2012 and 2011, respectively.

Gas transportation net sales (net of VAT) increased by RUB 3,263 million, or 11%, to RUB 32,059 million in the three months period ended March 31, 2012 from RUB 28,796 million in the three months period ended March 31, 2011. The increase was mainly caused by the increase in gas transportation tariffs for independent gas suppliers in the three months period ended March 31, 2012 compared to the same period of the prior year.

Other revenues increased by RUB 5,350 million, or 16%, to RUB 38,564 million in the three months period ended March 31, 2012 compared to RUB 33,214 million in the three months period ended March 31, 2011.

## Operating expenses

Operating expenses increased by 13% in the three months period ended March 31, 2012 to RUB 927,401 million from RUB 817,909 million in the three months period ended March 31, 2011. Operating expenses as a percentage of sales increased from 62% in the three months period ended March 31, 2011 to 76% in the three months period ended March 31, 2012. The table below presents a breakdown of operating expenses in each period:

	<b>Three months periods ended March 31,</b>	
	<b>2012</b>	<b>2011</b>
Purchased gas and oil	201,587	263,513
Taxes other than on income	157,578	101,886
Staff costs	96,705	87,812
Transit of gas, oil and refined products	82,451	63,746
Depreciation	80,015	66,968
Cost of goods for resale, including refined products	34,652	24,092
Exchange rate differences on operating items	33,707	20,434
Repairs and maintenance	27,231	31,644
Materials	23,263	25,050
Losses from derivatives	20,209	365
Electricity and heating expenses	18,503	21,248
Heat transmission	11,809	12,262
Charge for impairment provisions	9,123	391
Transportation services	5,451	9,046
Research and development expenses	5,211	3,822
Rental expenses	5,195	4,404
Insurance expenses	4,799	4,142
Social expenses	4,067	7,242
Processing services	3,326	2,105
Other	<u>47,172</u>	<u>26,196</u>
	<b><u>872,054</u></b>	<b><u>776,368</u></b>
Changes in inventories of finished goods, work in progress and other effects	<u>55,347</u>	<u>41,541</u>
<b>Total operating expenses</b>	<b><u>927,401</u></b>	<b><u>817,909</u></b>

### *Purchased gas and oil*

Cost of purchased gas and oil decreased by 24% to RUB 201,587 million in the three months period ended March 31, 2012 from RUB 263,513 million in the three months period ended March 31, 2011. Cost of purchased gas decreased by RUB 79,801 million, or 38%. This decrease mainly relates to the decrease in volumes of gas purchased and prices for gas purchased from third parties outside the Russia Federation. The cost of purchased oil included in the cost of purchased gas and oil increased by RUB 17,875 million, or 32%, and amounted to RUB 73,920 million in the three months period ended March 31, 2012 in comparison with RUB 56,045 million in the three months period ended March 31, 2011 due to the increase in oil prices.

### *Taxes other than on income*

Taxes other than on income consist of:

(RUB million)	<b>Three months periods ended March 31,</b>	
	<b>2012</b>	<b>2011</b>
Natural resources production tax	114,589	65,993
Property tax	13,883	11,506
Other taxes	<u>29,106</u>	<u>24,387</u>
<b>Taxes other than on income</b>	<b><u>157,578</u></b>	<b><u>101,886</u></b>

The natural resources production tax increased by 74% to RUB 114,589 million in the three months period ended March 31, 2012 from RUB 65,993 million in the three months period ended March 31, 2011. The increase mainly resulted from the general increase of natural resources production tax rate for gas from RUB 237 to RUB 509 per thousand cubic meters from January 1, 2012 as well as from the increase in natural resources production tax rate for oil due to the increase in average world oil prices.

#### *Staff costs*

Staff costs increased by 10% to RUB 96,705 million in the three months period ended March 31, 2012 from RUB 87,812 million in the three months period ended March 31, 2011. The increase mainly resulted from the salary indexation.

#### *Transit of gas, oil and refined products*

Transit of gas, oil and refined products increased by 29% to RUB 82,451 million in the three months period ended March 31, 2012 from RUB 63,746 million in the three months period ended March 31, 2011. This increase mainly relates to the increase in costs of transportation through Ukraine and through the “Nord Stream” pipeline.

#### *Depreciation*

Depreciation increased by 19%, or RUB 13,047 million, to RUB 80,015 million in the three months period ended March 31, 2012 from RUB 66,968 million in the three months period ended March 31, 2011. The increase primarily relates to the growth in the fixed asset base.

#### *Cost of goods for resale, including refined products*

Cost of goods for resale, including refined products increased by 44% to RUB 34,652 million in the three months period ended March 31, 2012 from RUB 24,092 million in the three months period ended March 31, 2011. The increase in cost of goods for resale, including refined products, mainly results from the increase in volumes of refined products purchased by the Gazprom Neft Group, expanding of Gazprom Group’s scope of consolidation and the increase in prices for refined products.

#### *Exchange rate differences on operating items*

Exchange rate differences on operating items in the three months periods ended March 31, 2012 and 2011 amounted to a net loss of RUB 33,707 million and RUB 20,434 million, respectively. The change was primarily driven by the depreciation of USD and EURO against RUB by 9% and 6%, respectively, in the three months period ended March 31, 2012, compared to depreciation of USD and EURO against RUB by 7% and 1%, respectively, in the same period of the prior year.

#### *Repairs and maintenance*

Cost of repairs and maintenance decreased by 14% to RUB 27,231 million in three months period ended March 31, 2012 from RUB 31,644 million in the three months period ended March 31, 2011. This decrease was caused by the decrease in volume of repair services rendered by third parties to the Group in the three months period ended March 31, 2012.

#### *Materials*

Cost of materials decreased by 7% to RUB 23,263 million in the three months period ended March 31, 2012 from RUB 25,050 million in the three months period ended March 31, 2011. The change mainly resulted from the decrease in volume of purchased materials.

#### *Losses from derivatives*

Derivative financial instruments of the Group are primarily represented by commodity contracts to sell gas to third parties which are marked to market. Derivative loss is caused by the significant market gas price increase for the three months ended March 31, 2012 comparing to relatively stable market gas prices for the three months ended March 31, 2011.

#### *Electricity and heating expenses*

Electricity and heating expenses decreased by 13% to RUB 18,503 million in the three months period ended March 31, 2012 from RUB 21,248 million in the three months period ended March 31, 2011. The decrease mainly resulted from the decrease in volumes of electricity purchased from third parties.

### *Other operating expenses*

Other operating expenses increased by 80% to RUB 47,172 million in the three months period ended March 31, 2012 from RUB 26,196 million in the three months period ended March 31, 2011. Other expenses include bank charges, security services, legal and consulting services, charity and finance aid, advertising and software services.

### *Changes in inventories of finished goods, work in progress and other effects*

Changes in inventories of finished goods, work in progress and other effects increased by 33% from RUB 41,541 million in the three months period ended March 31, 2011 to RUB 55,347 million in the three months period ended March 31, 2012. The positive amount of changes in inventory of finished goods, work in progress and other effects in the three months period, ended March 31, 2012 relates mainly to the decrease in the balances of finished goods as of March 31, 2012 in comparison with those as of December 31, 2011.

### **Operating profit**

As a result of the factors discussed above, our operating profit decreased by RUB 199,541 million, or 40%, to RUB 298,967 million in the three months period ended March 31, 2012 from RUB 498,508 million in the same period of the prior year. Our operating profit margin decreased from 38% in the three months period ended March 31, 2011 to 24% in the three months period ended March 31, 2012.

### **Net finance income**

(RUB million)	Three months periods ended March 31,	
	2012	2011
Exchange gains	133,647	69,830
Exchange losses	<u>(14,547)</u>	<u>(3,360)</u>
Net exchange gain	119,100	66,470
Interest income	5,548	4,042
Interest expense	(15,494)	(16,918)
Gains on extinguishment of restructured liabilities	<u>6</u>	<u>96</u>
<b>Net finance income</b>	<b>109,160</b>	<b>53,690</b>

Exchange gains increased by RUB 63,817 million to RUB 133,647 million in the three months period ended March 31, 2012 from RUB 69,830 million in the same period of the prior year. Exchange losses increased by RUB 11,187 million to RUB 14,547 million in the three months period ended March 31, 2012 from RUB 3,360 million in the same period of the prior year. The increase in net exchange gains resulted from higher fluctuation of USD and Euro exchange rates against RUB in the three months period ended March 31, 2012 in comparison with the same period of the prior year.

Interest income increased by 37% to RUB 5,548 million in the three months period ended March 31, 2012 from RUB 4,042 million in the same period of the prior year, mainly due to consolidation of OAO Beltransgaz in the fourth quarter 2011.

Interest expense decreased by 8% to RUB 15,494 million in the three months period ended March 31, 2012 from RUB 16,918 million in the same period of the prior year, mainly due to the decrease in loans and borrowings, percentage from which relates to finance expenses.

### **Share of net income of associated undertakings and jointly controlled entities**

Share of net income of associated undertakings and jointly controlled entities increased by RUB 9,851 million, or 26%, to RUB 48,370 million in the three months ended March 31, 2012 compared to RUB 38,519 million in the same period of the prior year. The increase of the Group's share of net income of associated undertakings and jointly controlled entities in the three months period ended March 31, 2012 relates mainly to the increase in net income of Sakhalin Energy Investment Company Ltd. due to the growth of liquefied natural gas sales and crude oil sales; increase in net income of OAO NGK Slavneft and its subsidiaries caused by the growth of oil prices. This effect was partly offset by the decrease in net income of Gazprombank Group in the three months period ended March 31, 2012 compared to the same period of the prior year.

### **Profit tax**

Total profit tax expense decreased by RUB 23,884 million, or 21%, to RUB 88,682 million in the three months period ended March 31, 2012 compared to RUB 112,566 million in the three months period ended March 31, 2011. The effective profit tax rate was 19.4% and 19.0% in the three months periods ended March 31, 2012 and 2011, respectively. Increase of the effective profit tax rate mainly resulted from a relative increase of non-deductable expenses in the three months period ended March 31, 2012 compared to the same period of the prior year.

### **Profit for the period attributable to owners of OAO Gazprom**

As a result of the factors discussed above, our profit for the period attributable to owners of OAO Gazprom decreased by RUB 110,128 million, or 24%, from RUB 467,969 million in the three months period ended March 31, 2011 to RUB 357,841 million in the three months period ended March 31, 2012.

### **Profit for the period attributable to non-controlling interest**

Profit for the period attributable to non-controlling interest decreased by RUB 757 million, or 7%, to RUB 9,774 million in the three months period ended March 31, 2012 compared to RUB 10,531 million in the three months period ended March 31, 2011.

## **LIQUIDITY AND CAPITAL RESOURCES**

The following table summarizes our statements of cash flows for the three months ended March 31, 2012 and 2011:

(RUB million)	<b>Three months periods ended March 31,</b>	
	<b>2012</b>	<b>2011</b>
Net cash provided by operating activities	597,621	390,425
Net cash used for investing activities	(351,393)	(408,766)
Net cash (used for) provided by financing activities	(44,496)	25,671

#### *Net cash provided by operating activities*

Net cash provided by operating activities amounted to RUB 597,621 million in the three months period ended March 31, 2012 compared to RUB 390,425 million in the three months period ended March 31, 2011. The increase was primarily due to the positive dynamic of changes in working capital in the three months period ended March 31, 2012 in comparison with the same period of the prior year. This effect was partly offset by the decrease in operating profit in the three months period ended March 31, 2012 in comparison with the same period of the prior year.

#### *Net cash used for investing activities*

Net cash used for investing activities decreased by RUB 57,373 million, or 14%, to RUB 351,393 million in the three months period ended March 31, 2012 compared to RUB 408,766 million in the three months period ended March 31, 2011. The decrease was primarily due to the increase in proceeds from associated undertakings and jointly controlled entities in the three months period ended March 31, 2012 in comparison with the same period of the prior year and due to the decrease of cash used on acquisition of subsidiaries, in the three months period ended March 31, 2012 in comparison with the same period of the prior year.

#### *Net cash (used for) provided by financing activities*

Net cash used for financing activities amounted to RUB 44,496 million in the three months period ended March 31, 2012 compared to net cash provided by financing activities in the amount of RUB 25,671 million in the three months period ended March 31, 2011. This change was mainly due to the decrease in proceeds from long-term borrowings in the three months period ended March 31, 2012 compared to the same period of the prior year and due to the increase in repayment of long-term borrowings in the three months period ended March 31, 2012 compared to the same period of the prior year.

## Capital expenditures

Total capital expenditures (excluding the effect of acquisitions of subsidiaries) by segment for the three months periods ended March 31, 2012 and 2011 in nominal RUB terms, amounted to the following:

(RUB million)	Three months periods ended March 31 <sup>(1)</sup> ,	
	2012	2011
Transport	104,159	87,547
Production of gas	49,233	54,926
Production of crude oil and gas condensate	25,260	18,978
Refining	24,070	16,751
Electric and heat energy generation and sales	6,813	9,668
Distribution	6,710	11,287
Gas storage	1,765	1,408
All other segments	<u>3,638</u>	<u>4,294</u>
<b>Total</b>	<b>221,648</b>	<b>204,859</b>

Note:

(1) The capital expenditures in the present analysis differ from the capital additions disclosed within the Group's business segments in IFRS interim condensed financial information of OAO Gazprom primarily due to VAT.

Total capital expenditures (excluding the effect of acquisitions of subsidiaries) increased by RUB 16,789 million, or 8%, from RUB 204,859 million in the three months period ended March 31, 2011 to RUB 221,648 million in the three months period ended March 31, 2012.

The increase of our capital expenditures in the Transport segment was primarily due to increased capital expenditures on the construction of major transportation projects, including Pipeline Bovanenkovo-Ukhta, Pipeline Ukhta-Torzhok and Pipeline Nord Stream. The decrease of our capital expenditures in the Production of gas segment was primarily due to the acquisition of assets of OAO RUSIA Petroleum in the three months period ended March 31, 2011 which was partly offset by the increase in capital expenditures for infrastructure development of Bovanenkovskoe field. The increase of our capital expenditures in the Production of crude oil and gas condensate segment was primarily due to increased capital expenditures of the Gazprom Neft Group. The increase of our capital expenditures in the Refining segment was primarily due to increased capital expenditures of Gazprom Neft Group and OOO Novourengoisky GCC.

## Debt obligations

Net debt balance (defined as the sum of short-term borrowings, current portion of long-term borrowings, short-term promissory notes payable, long-term borrowings and long-term promissory notes payable, net of cash and cash equivalents and balances of cash and cash equivalents restricted as to withdrawal under the terms of certain borrowings and other contractual obligations) decreased by RUB 316,399 million, or 31%, from RUB 1,034,941 million as of December 31, 2011 to RUB 718,542 million as of March 31, 2012. This decrease resulted mainly from the repayment of long-term and short-term loans and borrowings, appreciation of RUB against USD and Euro and increase in cash and cash equivalents.