

OAO AK TRANSNEFT

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

FOR THE SIX MONTHS ENDED 30 JUNE 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 June 2015 and results of operations for the six months ended 30 June 2015, compared to the six months ended 30 June 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 six months ended 30 June 2015.

Key financial and operating results

	Six months ended 30 June 2015	Six months ended 30 June 2014	Change, %
Revenue	407,044	377,913	7.7
Net profit	119,775	91,978	30.2
EBITDA*	194,190	177,717	9.3
EBITDA margin, %*	58.4	60.2	x
Oil delivered to consignees, mln. tons	239.5	237.9	0.7
including:			
Russian oil refineries, mln. tons	124.0	128.6	(3.6)
transshipment into the CPC-R system, mln. tons	0.8	1.0	(20.0)
exports to neighboring countries, mln. tons	11.0	10.3	6.8
exports to other countries, mln. tons	103.7	98.0	5.8
Oil products delivered to consignees, mln. tons	16.1	15.7	2.5
including:			
Russia's domestic market, mln. tons	3.8	4.4	(13.6)
exports to the Customs Union member countries, mln.tons	0.26	0.08	2.3 times
exports to other countries, mln. tons	12.1	11.2	8.0

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

The Group's profit for the six months ended 30 June 2015 amounted to RUB 119.8 bn which is RUB 27.8 bn or 30.2% higher than for the six months ended 30 June 2014 which amounted to RUB 92.0 bn.

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

	Six months ended 30 June 2015	Six months ended 30 June 2014	Absolute change	Change, %
Profit for the period	119,775	91,978	27,797	30.2
Net loss from exchange differences	6,301	1,997	4,304	3.2 times
Net interest expense	1,989	9,143	(7,154)	(78.2)
Profit from operations with derivatives	(16,860)	(419)	(16,441)	40.2 times
Share of profit from associates and jointly-controlled entities	(3,359)	(2,019)	(1,340)	66.4
Net profit for the period net of afore-mentioned factors	107,846	100,680	7,166	7.1



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 June 2015 possesses an extensive network of trunk oil pipelines with a total length of approximately 53.2 thousand km and trunk oil products pipelines with a total length of some 18.6 thousand km.

During the six months ended 30 June 2015 the Group transported approximately 87% of oil produced in Russia and more than 26% of oil products produced in Russia, as well as significant volumes of hydrocarbons and oil products from CIS countries.

OAO AK Transneft's key competitive advantages include:

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



1.1. Key investment projects

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

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

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

- Construction of Zapolyarie–Purpe oil trunk pipeline;
- Construction of Kuyumba – Tayshet oil trunk pipeline;
- Expansion of the ESPO pipeline system in the GNPS Taishet – NPS Skovorodino section to 80 mln tons annually;
- Expansion of the ESPO pipeline system in the NPS Skovorodino – SMNP Kozmino to 50 mln. tons annually;
- Development of the trunk pipeline system for increase of deliveries of oil products to Primorsk Sea Port to 15 mln tons (Project “Sever”);
- Development of the trunk pipeline system for increase of deliveries of oil products to Primorsk Sea Port to 25 mln tons (Project “Sever”);
- Reconstruction of the trunk pipeline system for increase of transportation volumes of oil products to the Moscow area;
- The project “Yug”, 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 OJSC «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 six months ended 30 June 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 agreement:
 - Order of the FTS of Russia of 27.09.2012 No. 226-e/3 Concerning the setting of fees for the services of OAO AK Transneft for transportation of oil via the trunk pipeline system;
 - Order of the FTS of Russia of 22.12.2009 No. 455-t/1 Concerning the setting of fees for sea port services provided to OOO Specialized Oil Loading Sea Port Kozmino;
 - Order of the FTS of Russia of 24.11.2009 No. 324-e/4 Concerning the setting of a fee rate for oil loading services at the PNN Skovorodino of OAO AK Transneft's trunk pipeline system;
 - Order of the FTS of Russia of 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 Sheskharis route;
 - 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 Sheskharis;
 - 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 Sheskharis 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 Sheskharis 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.



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 state regulatory body for natural monopolies – the Federal Tariff Service of Russia (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 07.08.2019 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.

	Six months ended 30 June 2015	Six months ended 30 June 2014	Change, %
Oil production volume in the Russian Federation, mln tons	263.8	260.8	1.2
Oil refining volume in the Russian Federation, mln tons	62.3	62.5	(0.3)

Oil production volume increased for the six months ended 30 June 2015 as compared to the similar period of the previous year by 3.0 mln tons or by 1.2% (ref. to 3.1.1.).

Decline in light oil refining during the six months ended 30 June 2015 in the Russian Federation accounted for 0.2 mln tons or for 0.3% as compared to 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).

	Six months ended 30 June 2015	Six months ended 30 June 2014	Change, %
Change in the rouble's exchange rate against the US dollar, %	(1.3)	2.8	x
Average exchange rate for the period (roubles per US dollar)	57.3968	34.9796	64.1
Exchange rate at the end of the period (roubles per US dollar)	55.5240	33.6306	65.1

2.4. Inflation rates

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

	Six months ended 30 June 2015	Six months ended 30 June 2014	Change, pp
Rouble inflation (CPI), %	8.5	4.8	3.7



2.5. Taxation

Most of the Group's companies are incorporated in the Russian Federation and subject to taxation under the Tax Code of the Russian Federation.

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

	Six months ended 30 June 2015	Six months ended 30 June 2014	Change, %
Current income tax	40,776	32,697	24.7
Property tax	8,422	6,182	36.2
Other taxes and levies	444	330	34.1

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.

Increase in the amount of income tax as for the six months ended 30 June 2015 as compared to the six months ended 30 June 2014 was primarily a result of recognition in tax accounts of foreign exchange gains from loans denominated in foreign currency because of growth of exchange rate of USD to RUB (ref to 2.3).

Property tax

The amount of property tax increased by RUB 2,240 or by 36.2%. 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 six months ended 30 June 2015 and the relative period of 2014.

	Six months ended 30 June 2015	Six months ended 30 June 2014	Absolute change	Change, %
Revenue	407,044	377,913	29,131	7.7
revenue from oil transportation services	275,235	249,384	25,851	10.4
revenue from oil products transportation services	28,818	24,363	4,455	18.3
revenue from crude oil sales	88,183	92,389	(4,206)	(4.6)
other revenue	14,808	11,777	3,031	25.7
Operating expenses	(271,606)	(253,788)	(17,818)	7.0
Operating profit	135,438	124,125	11,313	9.1
Net financial income/(costs)	8,570	(10,721)	19,291	x
Share of profit from associates and jointly controlled entities	3,359	2,019	1,340	66.4
Profit before income tax	147,367	115,423	31,944	27.7
Current income tax	(40,912)	(32,715)	(8,197)	25.1
Deferred income tax	13,320	9,270	4,050	43.7
Income tax expense	(27,592)	(23,445)	(4,147)	17.7
Profit for the period	119,775	91,978	27,797	30.2
Other comprehensive (loss)/ gain, net of income tax	(2,599)	233	(2,832)	x
Total comprehensive income, net of tax	117,176	92,211	24,695	27.1

During the six months ended 30 June 2015 the Group recognised gain shown in net financial gain/(loss) in the amount of RUB 8,570 as compared to the loss amounting to RUB 10,721 for the similar period of 2014. This dynamics was caused by recognition of profit from operations with derivatives for the six months ended 30 June 2015 as compared to net loss as for the six months ended 30 June 2014.



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3.1. Revenue

Revenue by type of operations	Six months ended 30 June 2015	Share of total revenue, %	Six months ended 30 June 2014	Share of total revenue, %	Absolute change	Change, %
Revenue from crude oil transportation services	275,235	67.7	249,384	66.0	25,851	10.4
exports, except the CIS	154,606	38.0	131,974	34.9	22,632	17.1
exports in the CIS	7,200	1.8	7,572	2.0	(372)	(4.9)
domestic sales	113,429	27.9	109,838	29.1	3,591	3.3
Revenue from oil products transportation services	28,818	7.1	24,363	6.4	4,455	18.3
Revenue from oil compounding services	2,594	0.6	2,465	0.7	129	5.2
Other revenue	11,312	2.8	6,923	1.8	4,389	63.4
Total revenue (without revenue from sales of crude oil and oil products)	317,959	78.2	283,135	74.9	34,824	12.3
Revenue from export sales of crude oil	74,255	18.2	82,592	21.9	(8,337)	(10.1)
Revenue from sales of crude oil in the domestic market	13,928	3.4	9,797	2.6	4,131	42.2
Revenue from sales of oil products	902	0.2	2,389	0.6	(1,487)	(62.2)
Total revenue	407,044	100.0	377,913	100.0	29,131	7.7

For the six months ended 30 June 2015, the Group's revenue increased by RUB 29,131 or by 7.7%, 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 six months ended 30 June 2015 increased by RUB 34,824 or 12.3% compared to the six months ended 30 June 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 25,851, or by 10.4% for the six months ended 30 June 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 4,455 or by 18.3% for the six months ended 30 June 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 six months ended 30 June 2015 compared to the six months ended 30 June 2014 was a result of decline in oil market price of USD per barrel.

Increase in revenue from domestic sales of crude oil as for the six months ended 30 June 2015 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 six months ended 30 June 2015 by RUB 1,487 or by 62.2% 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 129 or by 5.2% as for the six months ended 30 June 2015 compared to the six months ended 30 June 2014 was a result of increase in oil compounding volumes by 1.4% (18,535.7 thousand tons for the six months ended 30 June 2015; 18,288 thousand tons for the six months ended 30 June 2014).



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3.1.4. Other revenue

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

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

3.2. Operating expenses

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

Operating expense line items	Six months ended 30 June 2015	Share of total revenue, %	Six months ended 30 June 2014	Share of total revenue, %	Absolute change	Change, %
Salaries, social funds contributions and social expenses	63,177	23.3	56,061	22.1	7,116	12.7
Energy	17,300	6.4	16,418	6.5	882	5.4
Materials	9,097	3.3	10,013	3.9	(916)	(9.1)
Repairs services and maintenance of relevant technical condition of pipeline	4,941	1.8	5,318	2.1	(377)	(7.1)
Insurance expenses	3,009	1.1	3,009	1.2	-	-
Taxes (except income tax)	8,485	3.1	6,204	2.4	2,281	36.8
Pension expense	6,167	2.3	1,628	0.7	4,539	3.8 times
Other operating expenses	14,636	5.4	7,985	3.1	6,651	83.3
Total operating expenses (net of D&A and cost of goods sold)	126,812	46.7	106,636	42.0	20,176	18.9
Depreciation and amortization	59,153	22.1	54,163	21.3	4,990	9.2
Cost of export crude oil sales (including export custom duties)	73,854	27.2	82,021	32.3	(8,167)	(10.0)
Cost of crude oil sold in the domestic market	10,684	3.9	8,609	3.4	2,075	24.1
Cost of oil products sold	846	0.3	2,212	0.9	(1,366)	(61.8)
Cost of other goods sold	257	0.1	147	0.1	110	74.8
Total operating expenses	271,606	100.0	253,788	100.0	17,818	7.0

For the six months ended 30 June 2015, compared to the six months ended 30 June 2014, the amount of operating expenses increased by RUB 17,818 or by 7.0%, while total operating expenses net of depreciation and amortization and cost of goods sold increased by RUB 20,176 or by 18.9%.

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 six months ended 30 June 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 six months ended 30 June 2015, and for the six months ended 30 June 2014, were as follows:

Operating expense line items	Six months ended 30 June 2015	Share of total expenses, %	Inflation rates (2015 to 2014), %*	Six months ended 30 June 2014 (inflated to 2015)	Share of total expenses, %	Absolute change	Change, %
Salaries, social funds contributions and social expenses	63,177	23.3	15.7	64,863	23.3	(1,686)	(2.6)
Energy	17,300	6.4	8.5	17,814	6.4	(514)	(2.9)
Materials	9,097	3.3	13.6	11,375	4.1	(2,278)	(20.0)
Repairs services and maintenance of relevant technical condition of pipeline	4,941	1.8	6.9	5,685	2.0	(744)	(13.1)
Insurance expenses	3,009	1.1	13.6	3,418	1.2	(409)	(12.0)
Taxes (except income tax)	8,485	3.1	13.6	7,048	2.5	1,437	20.4
Pension expense	6,167	2.3	15.7	1,884	0.7	4,283	3.3 times
Other operating expenses	14,636	5.4	13.6	9,071	3.3	5,565	61.3
Total operating expenses (net of D&A and cost of goods sold)	126,812	46.7	13.6	121,158	43.5	5,654	4.7
Depreciation and amortization	59,153	21.8	X	54,163	19.5	4,990	9.2
Cost of export crude oil sales (including export custom duties)	73,854	27.2	10.8	90,879	32.7	(17,025)	(18.7)
Cost of crude oil sold in the domestic market	10,684	3.9	10.8	9,539	3.4	1,145	12.0
Cost of oil products sold	846	0.3	3.7	2,294	0.8	(1,448)	(63.1)
Cost of other goods sold	257	0.1	13.6	167	0.1	90	53.9
Total operating expenses	271,606	100.0	X	278,200	100.0	(6,594)	(2.4)

*The inflation rates used are based on scenarios prepared by the Ministry of Economic Development for devising socio-economic development scenarios for 2015-2018, 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 used to calculate inflated operating expenses (net of depreciation, taxes, one-time expenses and cost of goods sold) is taken.

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

	Six months ended 30 June 2015	Six months ended 30 June 2014	Absolute change	Change, %
Oil transportation services				
Turnover, mln. tons x km	588,497	571,841	16,656	2.9
Unit costs per 100 tons x km, RUB		14.59	1.09	7.5
Inflated unit costs per 100 tons x km, RUB (inflated to 2015, adjusted to turnover as for 2015)	15.68	15.98	(0.30)	(1.9)

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

	Six months ended 30 June 2015	Six months ended 30 June 2014	Absolute change	Change, %
Oil products transportation services				
Volume turnover, mln. of tons	16.1	15.7	0.4	2.5
Unit costs per ton, RUB		535.12	37.59	7.0
Inflated unit costs per ton, RUB (inflated to 2015, adjusted to volume turnover as for 2015)	572.71	589.32	(16.61)	(2.8)

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 six months ended 30 June 2015 as compared to the six months ended 30 June 2014 in the amount of RUB 7,116 or 12.7% 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.



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3.2.2. Pension expense (continued)

	Six months ended 30 June 2015	Six months ended 30 June 2014	Absolute change	Change, %
Employers' contributions to NPF Transneft in favor of employees	2,897	2,224	673	30.3

3.2.3. Energy

Energy expenses for the six months ended 30 June 2015 increased by RUB 882 or 5.4% as compared to the same period of the previous year. The increase was caused by growth of tariffs of natural monopolies for energy and power consumption, as well as a decline of volume of declared power and energy consumed at the same due to the implementation of measures under the program of energy saving and development of energy efficiency of OAO AK Transneft for the period 2012-2015 as well as the Energy Strategy for the period till 2030 approved by the Russian Government.

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

	Six months ended 30 June 2015	Six months ended 30 June 2014	Absolute change	Change, %
Average annual capacity, thsd. kW	1,443	1,420	23	1.6
Consumption of energy, (mln. kW*h)	6,639	6,220	419	6.7

3.2.4. Materials

Expenses on materials for the six months ended 30 June 2015 as compared to the same period of 2014, decreased by RUB 916 or 9.1%.

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

Decrease in these expenses for the six months ended 30 June 2015, amounted to RUB 377 or 7.1% compared to the six months ended 30 June 2014.

3.2.6. Cost of crude oil and oil products sold

The cost of crude oil sold for export for the six months ended 30 June 2015 amounted to RUB 73,854 including custom duties in the amount of RUB 22,303, 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 six months ended 30 June 2015 amounted to RUB 2,075 or 24.1% 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 1,366 or 61.8% 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 detailed 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 Group recognition of profit shown in "Share of profit from associates and jointly controlled entities" for the six months ended 30 June 2015 amounting to RUB 3,359 compared to the profit amounting to RUB 2,019 as for the relative period in 2014, was mainly caused by improved performance of Group OAO NCSP during the reporting period as compared with the relative period of 2014.

The Group's effective share of control in OAO NCSP was 35.57% as at 30 June 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	Six months ended 30 June 2015	Six months ended 30 June 2014	Absolute change	Change, %
Interest income from cash and equivalents	4,760	1,983	2,777	2.4 times
Interest income from other financial assets	14,511	6,127	8,384	2.4 times
Other interest income	268	165	103	62.4
Total interest receivable	19,539	8,275	11,264	2.4 times
Less interest income on the temporary investment of borrowings	(161)	(559)	398	(71.2)
Total interest income recognised in the statement of profit and loss and other comprehensive income	19,378	7,716	11,662	2.5 times

Increase in interest income for the six months ended 30 June 2015 by RUB 11,662 or in 2.5 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	Six months ended 30 June 2015	Six months ended 30 June 2014	Absolute change	Change, %
Interest expenses on loans and borrowings	20,568	16,111	4,457	27.7
Interest expenses regarding the dismantlement provision	-	1,161	(1,161)	x
Other interest expenses	1,841	653	1,188	2.8 times
Total interest expenses	22,409	17,925	4,484	25.0
Less finance costs to be capitalised	(1,042)	(1,066)	24	(2.3)
Total interest expense recognised in the statement of profit and loss and other comprehensive income	21,367	16,859	4,508	26.7

The amount of interest expenses is composed of:

- interest payable on loan obtained in 2009 from the China Development Bank 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 2008 for a total of USD 1,050 mln for the six months ended 30 June 2015 and USD 2,350 for the six months ended 30 June 2014;
- interest payable on series 01-03 of non-convertible interest-bearing documentary bonds amounting to RUB 110 bn;
- interest payable of non-convertible interest-bearing documentary bonds on series BO-03 for the amount 15,000 for the six months ended 30 June 2015 and for the amount RUB 34,000 on series BO-01 and BO-02 for the six months ended 30 June 2014.

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

During the six months ended 30 June 2015, interest in the amount of RUB 881 was capitalised as part of cost of assets under construction (for the six months ended 30 June 2014 – RUB 507) including:

- interest expenses to be capitalised in the amount of RUB 1,042 (for the six months ended 30 June 2014 – RUB 1,066);
- interest income to be excluded from interest expenses to be capitalised in the amount of RUB 161 (for the six months ended 30 June 2014 – RUB 559).



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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 six months ended 30 June 2015, compared to the six months ended 30 June 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:

	Six months ended 30 June 2015	Six months ended 30 June 2014	Absolute change	Change, %
Foreign exchange gains on financial investments	114,457	30,061	84,396	3.8 times
Foreign exchange gains on loans and borrowings	182,328	29,958	155,370	6.8 times
Other foreign exchange gains	33,210	8,678	24,533	3.8 times
Total foreign exchange gains recognised in the statement of profit or loss and other comprehensive income	329,995	65,697	264,298	5.0 times
Foreign exchange loss on financial investments	(127,254)	(21,277)	(105,977)	6.0 times
Foreign exchange loss on loans and borrowings	(175,141)	(40,486)	(134,665)	4.3 times
Other foreign exchange loss	(33,900)	(5,931)	(27,969)	5.7 times
Total foreign exchange loss recognised in the statement of profit or loss and other comprehensive income	(336,296)	(67,964)	(286,601)	5.0 times
Net exchange differences	(6,301)	(1,997)	(4,304)	3.2 times

Dynamics of exchange differences presented in the table was driven by weakening of the rouble against the dollar and the Euro for the six months ended 30 June 2015 compared to the relative period in 2014.

Derivatives

As for the six months ended 30 June 2015 the Group recognised the net gain from operations with derivatives in the amount of RUB 16,166 as compared to the gain of RUB 419 for the same period of 2014. The dynamics was driven by significant volatility of the RUB to USD exchange rate during the reporting period (ref to 2.3).

3.5. Reconciliation of profit and EBITDA

	Six months ended 30 June 2015	Six months ended 30 June 2014	Change, %
Profit for the period	119,775	91,978	30.2
Adjustments for:			
income tax expense	27,592	23,445	17.7
depreciation and amortization	59,153	54,163	9.2
result of oil sales to China	(401)	(571)	(29.8)
net finance (income)/ costs	(8,570)	10,721	x
share of profit from associates and jointly controlled entities	(3,359)	(2,019)	66.4
EBITDA*	194,190	177,717	9.3
EBITDA margin*, %	58.4	60.2	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

	Six months ended 30 June 2015	Six months ended 30 June 2014	Absolute change	Change, %
Cash flows from operating activities	142,122	122,003	20,119	16.5
Cash flows used in investing activities	(72,894)	(111,929)	39,035	(34.9)
Free cash inflow*	69,228	10,074	59,154	6.9 times
Cash flows used in financing activities	(52,393)	(48,928)	(3,465)	7.1
Net cash inflow / (outflow)	16,835	(38,854)	55,689	x
Change in cash and cash equivalents due to deviation of currency exchange rate	(532)	4,085	(4,617)	(113.0)
Net increase / (decrease) in cash and cash equivalents	16,303	(34,769)	51,072	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 six months ended 30 June 2015 amounted to RUB 27,909 (for the six months ended 30 June 2014: RUB 5,387).

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 142,122 for the six months ended 30 June 2015, which is RUB 20,119 or 16.5% higher than for the six months ended 30 June 2014.

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

- increase in cash receipts from customers by RUB 20,599;
- increase in cash paid to suppliers by RUB 4,199;
- increase in cash received from the refund of VAT and other taxes from the budget by RUB 2,348;
- increase in amount of interest paid by RUB 3,742;
- decrease of the net amount of payments of income tax by RUB 6,658.

4.2. Investing activities

The primary factors resulting in a decrease in cash used in investment activities by RUB 39,035 or 34.9% for the six months ended 30 June 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 3,047;
- net cash inflow as for the six months ended 30 June 2015 in the amount of RUB 41,319 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 4,687;
- increase from interest and dividends received by RUB 7,698.

4.3. Financing activities

The main factors which influenced on increase of cash flows used in financing activities for the six months ended 30 June 2015 as compared to 2014 by RUB 3,465 or 7.1% were:

- decrease of cash used to repay bonds and loans and borrowings in the amount of RUB 4,391.
For the six months ended 30 June 2015 monthly repayment of the loan to China Development Bank in the total amount of USD 333.4 mln. (RUB 18,881 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 24,573 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 55.6 mln. (RUB 1,888 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 7,856 during the six months ended 30 June 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 six months ended 30 June 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.

	Six months ended 30 June 2015	Six months ended 30 June 2014
OPERATING ACTIVITIES		
Profit before tax	147,367	115,423
Adjustments for:		
Depreciation and amortization	59,153	54,163
Loss from disposal of property, plant and equipment	474	179
Finance income	(366,233)	(73,832)
Finance costs	357,663	84,553
Share of (profit)/loss from associates and jointly-controlled entities	(3,359)	(2,019)
Others	(6,197)	(1,174)
Operating profit before changes in working capital	188,868	177,293
Changes in operating assets and liabilities:		
Increase in inventories	(715)	(3,865)
(Increase)/decrease in trade and other receivables relating to operating activity and VAT assets	(3,478)	1,322
Decrease in trade and other payables, and accruals relating to operating activity	(1,336)	(8,614)
Cash flows from operating activities before payment of income tax expense and interest	183,339	166,136
Income tax paid	(24,109)	(30,782)
Income tax refund	491	506
Interest paid	(17,599)	(13,857)
Cash flows received from operating activities	142,122	122,003



5. Liquidity analysis

	30 June 2015	31 December 2014	Change, %
Current assets	687,526	697,494	(1.4)
including:			
cash and cash equivalents	129,363	113,060	14.4
short-term bank promissory notes, deposits and bonds*	382,411	408,221	(6.3)
Current liabilities	364,191	383,719	(5.1)
Net working capital	323,335	313,775	3.0
Current ratio	1.9	1.8	x
Quick ratio**	1.5	1.6	x
Debt / EBITDA	2.0	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