

ОАО АК ТРАНСНЕФТ

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

FOR THE THREE MONTHS ENDED 31 MARCH 2014





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 31 March 2014 and results of operations for the three months ended 31 March 2014, compared to the three months ended 31 March 2013, as well as other important factors which could affect the future results of the Group. This analysis should be read in conjunction with the Consolidated interim condensed financial statements prepared in accordance with International financial reporting standards (hereinafter – “IFRS”) for the three months ended 31 March 2014.

Key financial and operating results

	Three months ended 31 March 2014	Three months ended 31 March 2013	Change, %
Revenue	188,114	183,871	2.3
Profit for the period	40,637	46,524	(12.7)
EBITDA	90,995	91,632	(0.7)
EBITDA margin, %*	62.6	62.9	x
Oil delivered to consignees, mln. tons	118.4	118.0	0.3
including:			
Russian oil refineries, mln. tons	64.5	60.8	6.1
transshipment into the CPC-R system, mln. tons	0.5	0.3	66.7
exports to FSU countries, mln. tons	5.1	6.9	(26.1)
exports to ROW, mln. tons	48.2	50.0	(3.6)
Oil products delivered to consignees, mln. tons	7.7	8.0	(3.8)
including:			
Russia's domestic market, mln. tons	1.7	2.0	(15.0)
exports to the Customs Union member countries, mln.tons	0.04	0.08	(50.0)
exports to ROW, mln. tons	5.9	5.9	x

* 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 three months ended 31 March 2014 amounted to RUB 40.6 bn which is RUB 5.9 bn or 12.7% lower than for the three months ended 31 March 2013 which amounted to RUB 46.5 bn.

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

	Three months ended 31 March 2014	Three months ended 31 March 2013	Change, %
Profit for the period	40,637	46,524	(12.7)
Net loss from exchange differences	3,660	2,270	61.2
Net interest expense	4,078	6,496	(37.2)
Loss/(profit) from fair value changes in derivatives	5,118	(203)	x
Share of loss/(profit) from associates and jointly-controlled entities	408	(538)	x
Net profit for the period net of afore-mentioned factors	53,901	54,549	(1.2)



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, crude oil sales.

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

The Group as at 31 March 2014 possesses an extensive network of trunk oil pipelines with a total length of approximately 53.7 thousand km and trunk oil products pipelines with a total length of some 19.1 thousand km.

During the three months ended 31 March 2014 the Group transported 87% of oil produced in Russia and more than 24% 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 Eastern Siberia–Pacific Ocean pipeline system's capacity. The GNPS Taishet–NPS Skovorodino section to 80 mln tons annually and the NPS Skovorodino-SMNP Kozmino to 50 mln. Tons annually;
- The project “Yug”, 1st stage, reconstruction of the trunk pipelines Tikhoretsk-Novorossiysk and the project “Yug”, 2nd stage, construction of MNPP Volgograd-Tikhoretsk;
- Extension of trunk pipeline system for increasing of oil products transportation to Primorsrk to 15 mln tons annually (project “Sever”).

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 2013 and three months ended 31 March 2014, OAO AK Transneft was performing its core operations:

- a) of transporting oil, by charging fees for its services in accordance with oil transportation tariff rates approved by orders of the state regulatory body for natural monopolies – the Federal Tariff Service of Russia (FTS of Russia) and by intergovernmental agreement:
 - Order of the FTS of Russia of 27.09.2012 No. 226-e/3 Concerning the setting of fees for the services of OAO AK Transneft for transportation of oil via the trunk pipeline system;
 - Order of the FTS of Russia of 22.12.2009 No. 455-t/1 Concerning the setting of fees for sea port services provided to OOO Specialized Oil Loading Sea Port Kozmino;
 - Order of the FTS of Russia of 24.11.2009 No. 324-e/4 Concerning the setting of a fee rate for oil loading services at the PNN Skovorodino of OAO AK Transneft's trunk pipeline system;
 - Order of the FTS of Russia of 01.02.2011 No. 12-e/7 Concerning the setting of a fee for the services of OAO AK Transneft for transportation of oil along the Makhachkala–NB Sheshkharis route;
 - Order of the FTS of Russia of 11.12.2012 No. 369-e/27 Concerning the setting of a fee for the services of OAO AK Transneft for transportation of oil along the Makhachkala–NB Sheshkharis route;
 - Order of the FTS of Russia of 27.11.2012 No. 274-e/2 Concerning the setting of fees for the services of OAO AK Transneft for transportation of oil via the trunk pipeline system;
 - Order of the FTS of Russia of 22.08.2013 No. 165-e/2 Concerning the cancelling of the order of the FTS of Russia of 27.11.2012 No. 274-e/2 Concerning the setting of a fee for the services of OAO AK Transneft for transportation of oil through the territory of the Russian Federation;
 - Order of the FTS of Russia of 03.12.2013 No. 225-e/6 Concerning the setting of fees for the services of OAO AK Transneft for transportation of oil via the Purpe – Samotlor trunk pipeline system rendered to OAO NK Rosneft;
 - Order of the FTS of Russia of 26.11.2013 No. 219-e/1 Concerning the setting of fees for the services of OAO AK Transneft for transportation of oil via the Tikhoretsk – Tuapse-2 trunk pipeline section for OAO NK Rosneft;
 - Order of the FTS of Russia of 03.12.2013 No. 224-e/5 Concerning the setting of fees for the services of ZAO Morskoy portoviy servis for filling of railway wagons with oil in the territory of Grushevaya industrial site of the transshipment complex Sheshkharis;
 - The intergovernmental agreement on transportation of Azerbaijan oil through the territory of the Russian Federation of 16.02.1996, Moscow;
 - Agreement dated 14.02.2014 #0014502 for provision of oil transportation services by transiting through the territory of the Russian Federation during 2014 between OAO AK Transneft and GNKAR.
- b) of transporting oil products, by charging fees for its services in accordance with fee rates approved by OAO AK Transneft in accordance with orders of the state regulatory body for natural monopolies – the Federal Tariff Service of Russia (FTS of Russia):
 - Order of the FTS of Russia of 24.12.2010 No. 471-e/1 Concerning the setting of fees for the services of OAO AK Transneft and its affiliated entities for transportation of oil products via the trunk pipeline system;
 - Order of the FTS of Russia of 23.09.2010 No. 234-e/2 Concerning fee rates for the services of OOO BalttransService for transportation of oil products from the trunk pipeline system in the Primorsk Commercial Seaport;
 - 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



2.1. Oil and oil products transportation tariffs (continued)

- Order of the FTS of Russia of 15.02.2011 No. 23-e/3 Concerning the setting of fees for the services of OAO AK Transneft and its affiliated entities for transportation of oil products via the trunk pipeline system, and the inclusion of amendments to the Order of the FST of Russia of 24.12.2010 No. 471-e/1;
- Order of the FTS of Russia of 05.06.2012 No. 138-e/1 Concerning the inclusion of amendments to the Order of the FTS of Russia of 24.12.2010 No. 471-e/1 Concerning the setting of fees for the services of OAO AK Transneft and its affiliated entities for transportation of oil products via the trunk pipeline system;
- Order of the FTS of Russia of 03.07.2012 No. 165-e/3 Concerning the inclusion of amendments to the Order of the FTS of Russia of 24.12.2010 No. 471-e/1 Concerning the setting of fees for the services of OAO AK Transneft and its affiliated entities for transportation of oil products via the trunk pipeline system;
- Order of the FTS of Russia of 30.04.2013 No. 90-e/2 Concerning the setting of maximum tariff rates for services of OAO AK Transneft for execution of orders and scheduling deliveries of oil products which are in transit to LPDS Sokur and are further exported outside the customs territory of the Russian Federation and the states - members of the Customs Union;
- Order of the FTS of Russia of 07.08.2013 No. 155-e/7 Concerning the setting of tariff for services rendered by OAO AK Transneft for transportation of oil products through the route "LUKOIL – Nizhegorodnefteorgsynthez" – MP "Primorsk" for OAO NK LUKOIL.

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.

	Year ended 31 December 2013	Year ended 31 December 2012	Change, %
Oil mining volume in the Russian Federation, mln tons	130.0	128.4	1.2
Oil products refining volume in the Russian Federation, mln tons	31.5	29.6	6.5

Oil mining volume increased for the three months ended 31 March 2014 as compared to the three months ended 31 March 2013 for 1.6 mln tons or by 1.2% (ref. to subparagraph 3.1.1.).

Growth in oil products refining during the three months ended 31 March 2014 in the Russian Federation for 1.9 mln tons or by 6.5% influenced the growth of oil products transportation.

During the 1st quarter of 2014 the volume of delivery of crude oil to refinery plants of the Russian Federation showed positive dynamics while the volume of oil transportation for export to CIS and international markets decreased as compared to the same period of 2013.

2.3. The rouble's exchange rate against foreign currencies

Services for transportation of oil through trunk oil pipelines which are situated in the territory of the Russian Federation are paid for in Russian roubles except for the transit of crude oil from Azerbaijan which is paid for in US Dollars since 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'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



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

	Three months ended 31 March 2014	Three months ended 31 March 2013	Change, %
Change in the rouble's exchange rate against the US dollar, %	9.04	2.34	x
Average exchange rate for the period (roubles per US dollar)	34.9591	30.4142	14.94
Exchange rate at the end of the period (roubles per US dollar)	35.6871	31.0834	14.81

2.4. Inflation rates

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

	Three months ended 31 March 2014	Three months ended 31 March 2013	Change, pp
Rouble inflation (CPI), %	2.3	1.9	0.4

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:

	Three months ended 31 March 2014	Three months ended 31 March 2013	Change, %
Current income tax	13,650	9,222	48.0
Property tax	3,284	2,578	27.4
Other taxes and levies	161	154	4.5

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.

The increase of the current income tax for the three months ended 31 March 2014 as compared to the relative period of 2013 was caused by putting into operation of trunk oil pipeline system Eastern Siberia-Pacific Ocean, 2nd stage, the Skovorodino-SMNP Kozmino section (ESPO II) in 2012 and adoption of amortisation premium for tax accounting in 2013.

Property tax

The amount of property tax increased by RUB 706 or by 27.4%. The increase was a result of use of different tax rates in relation to trunk pipelines as well as to constructions which are integral technological part of these pipelines. These properties are taxes at the rates set locally by regions of the Russian Federation and can not be more than 0.4% during 2013, 0.7% during 2014.

Other taxes and levies

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



3. Analysis of the Group's performance

The table below presents consolidated statement of profit and loss and other comprehensive income for the periods showed therein.

	Three months ended 31 March 2014	Three months ended 31 March 2013	Absolute change	Change, %
Revenue	188,114	183,871	4,243	2.3
Revenue from oil transportation services	123,353	123,974	(621),	(0.5)
Revenue from crude oil sales	46,299	40,814	5,485	13.4
Other revenue	18,462	19,083	(621),	(3.3)
Operating expenses	(123,297)	(118,119)	(5,178)	4.4
Operating profit	64,817	65,752	(935),	(1.4)
Net exchange loss	(3,660)	(2,270)	(1,390),	(62.1)
Net interest expense	(4,078)	(6,496)	2,418	(37.2)
Net change in fair value of derivatives	(5,118)	203	(5,321)	x
Total net financial items	(12,856)	(8,563)	(4,293)	50.1
Share of profit from associates and jointly controlled entities	(408)	538,	(946)	X
Profit before income tax	51,553	57,727	(6,174)	(10.7)
Current income tax	(13,635)	(9,220)	(4,415)	47.9
Deferred income tax	2,719	(1,983)	4,702	x
Income tax expense	(10,916)	(11,203)	287	(2.6)
Profit for the period	40,637	46,524	(5,887)	(12.7)
Other comprehensive gain, net of income tax	606	285	321	2.1 times
Total comprehensive income	41,243	46,809	(5,566)	(11.9)

During the three months ended 31 March 2014 the Group recognised loss shown in the line "Net change in fair value of derivatives" in the amount of RUB 5,118 as compared to the profit amounting to RUB 203 for the same period of 2013. This dynamics was caused by significant fluctuations and weakening of RUB to USD for the reporting period for more than 9% (ref. to 2.3).

During the three months ended 31 March 2014 the Group recognised loss shown in the line "Share of profit from associates and jointly controlled entities" in the amount of RUB 408 as compared to the profit amounting to RUB 538 for the relative period of 2013. This dynamics was caused by decrease of total comprehensive income of OAO NCSP because of significant weakening of the RUB to USD.



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3.1. Revenue

Revenue by type of operations	Three months ended 31 March 2014	Share of total revenue, %	Three months ended 31 March 2013	Share of total revenue, %	Absolute change	Change, %
Revenue from crude oil transportation services	123,353	65.5	123,974	67.4	(621)	(0.5)
Exports and sales in international markets, except the CIS	64,392	34.3	56,176	30.5	8,216	14.6
Exports and sales in the CIS	3,846	2.0	15,664	8.5	(11,818)	(75.4)
Domestic sales	55,115	29.3	52,134	28.4	2,981	5.7
Revenue from oil products transportation services	12,391	6.6	11,247	6.1	1,144	10.2
Revenue from oil compounding services	1,304	0.7	1,271	0.7	33	2.6
Other revenue	3,655	1.9	4,955	2.7	(1,300)	(26.2)
Total revenue (less revenue from sales of crude oil and oil products)	140,703	74.8	141,447	76.9	(744)	(0.5)
Revenue from export sales of crude oil	42,740	22.7	38,090	20.7	4,650	12.2
Revenue from sales of crude oil in the domestic market	3,559	1.9	2,724	1.5	835	30.7
Revenue from sales of oil products	1,112	0.6	1,610	0.9	(498)	(30.9)
Total revenue	188,114	100.0	183,871	100.0	4,243	2.3

For the three months ended 31 March 2014, the Group's revenue increased by RUB 4,243, or 2.3%, attributable mainly to an increase in revenue from of oil transportation services and sales of crude oil. Without taking into account crude oil sales and oil products sales, revenue for the three months ended 31 March 2014, amounted to RUB 140,703, which is RUB 744 or 0.5% lower than for the three months ended 31 March 2013.

3.1.1. Oil and oil products transportation services

A decrease in revenue from oil transportation services amounted to RUB 621, or 0.5%. The decrease in revenue for oil transportation services for the three months ended 31 March 2014 as compared to the three months ended 31 March 2013 was influenced by changes in oil transportation turnover and turnover volumes. An increase in revenue from oil products transportation services by RUB 1,144 or 10.2% was driven by growth in oil products transportation tariffs as well as growth in turnover.

3.1.2. Revenue from sales of crude oil and oil products

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

Increase in revenue from export sales of crude oil as for the three months ended 31 March 2014 compared to the three months ended 31 March 2013 was a result of fluctuation of the RUB/USD exchange rate.

3.1.3. Revenue from oil compounding services

An increase in revenue from oil compounding services by RUB 33 or by 2.6% as for the three months ended 31 March 2014 compared to the three months ended 31 March 2013 was a result of increase in oil compounding volumes by 6.0% (9,884.7 thousand tons for the three months ended 31 March 2014; 9,329.5 thousand tons for the three months ended 31 March 2013).



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3.1.4. Other revenue

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

A decrease in the amount of other revenue for the three months ended 31 March 2014 as compared to the similar period of the previous year was a result of:

- decrease of insurance services by RUB 946 because of disposal of ZAO SK Transneft from the Group in 2013;
- decrease of revenue for activities on the organization of transportation of cargoes by railways by RUB 471.

3.2. Operating expenses

Operating expenses for the three months ended 31 March 2014, and the three months ended 31 March 2013, are detailed in the table below:

Operating expense line items	Three months ended 31 March 2014	Share of total revenue, %	Three months ended 31 March 2013	Share of total revenue, %	Absolute change	Change, %
Staff costs	27,851	22,6	26,879	22,8	972	3.6
Energy	8,230	6,7	8,363	7,1	(133)	(1.6)
Transportation of oil using railways	485	0,4	1,575	1,3	(1,090)	(69.2)
Materials	4,835	3,9	4,063	3,4	772	19.0
Repairs services and maintenance of relevant technical condition of pipeline	1,911	1,5	2,101	1,8	(190)	(9.0)
Insurance expenses	1,484	1,2	1,300	1,1	184	14.2
Taxes (except income tax)	3,311	2,7	2,657	2,2	654	24.6
Other operating expenses	2,096	1,7	2,862	2,4	(766)	(26.8)
Total operating expenses (net of D&A, one-time non-production expenses and cost of goods sold)	50,203	40,7	49,800	42,1	403	0.8
Depreciation and amortization	27,229	22,1	25,992	22,0	1,237	4.8
Cost of export crude oil sales (including export custom duties)	41,689	33,8	37,978	32,2	3,711	9.8
Cost of crude oil sold in the domestic market	3,070	2,5	2,710	2,3	360	13.3
Cost of oil products sold	1,039	0,8	1,518	1,3	(479)	(31.6)
Cost of other goods sold	67	0,1	121	0,1	(54)	(44.6)
Total operating expenses	123,297	100,0	118,119	100,0	5,178	4.4

For the three months ended 31 March 2014, compared to the three months ended 31 March 2013, 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 403 or 0.8%, while total operating expenses increased by RUB 5,178 or 4.4%.

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

- growth in depreciation and amortization. The growth of depreciation was mainly associated with putting into operation of new items of PPE, reconstruction and modernization of PPE in 2013;
- growth in material expenses (ref. para 3.2.4);
- growth in staff costs (ref. paragraph 3.2.1.);
- growth in the amount of other taxes recognised in operating expenses (ref. paragraph 3.2.7).



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3.2 Operating expenses (continued)

After applying inflation rates, operating expenses for the three months ended 31 March 2014, and for the three months ended 31 March 2013, were as follows:

Operating expense line items	Three months ended 31 March 2014	Share of total expenses, %	Inflation rates (2014 To 2013), %	Three months ended 31 March 2013 (inflated to 2014)	Share of total expenses, %	Absolute change	Change, %
Staff costs	27,851	22.6	5.9	28,460	22.9	(609)	(2.1)
Energy	8,230	6.7	7.3	8,970	7.2	(740)	(8.3)
Transportation of oil using railways	485	0.4	1.0	1,591	1.3	(1,106)	(69.5)
Materials	4,835	3.9	6.7	4,335	3.5	500	11.5
Repairs services and maintenance of relevant technical condition of pipeline	1,911	1.5	5.0	2,205	1.8	(294)	(13.3)
Insurance expenses	1,484	1.2	6.7	1,387	1.1	97	7.0
Taxes (except income tax)	3,311	2.7	6.7	2,835	2.3	476	16.8
Other operating expenses	2,096	1.7	6.7	3,054	2.6	(958)	(31.3)
Total operating expenses (net of D&A, one-time non-production expenses and cost of goods sold)	50,203	40.7	X	52,838	42.5	(2,635)	(5.0)
Depreciation and amortization	27,229	22.1	X	25,992	20.9	1,237	4.8
Cost of export crude oil sales	41,689	33.7	7.8	40,937	32.9	752	1.8
Cost of crude oil sold in the domestic market	3,070	2.5	7.8	2,921	2.3	149	5.1
Cost of oil products sold	1,039	0.8	4.9	1,592	1.3	(553)	(34.7)
Cost of other goods sold	67	0.1	6.7	129	0.1	(62)	(48.1)
Total operating expenses	123,297	100.0	X	124,409	100.0	(1,112)	(0.9)

The inflation 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 2013-2014 inflation rates.



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3.2 Operating expenses (continued)

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

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

	Oil transportation services	Oil products transportation services	Other segments, adjustments and unallocated expenses	Total operating expenses
	For the three months ended 31 March 2014			
Operating expenses (net of D&A)	29,037	3,739	17,427	50,203
Cargo turnover, mln tons x km	283,013	11,104	-	-
	For the three months ended 31 March 2013			
Operating expenses (net of D&A)	28,819	3,449	17,532	49,799
Cargo turnover, mln tons x km	281,191	10,688	-	-

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 (cost of crude oil and oil products sold).

Unit costs of oil and oil products transportation per 100 tons x km for the three months ended 31 March 2014, and for the three months ended 31 March 2013, were as follows:

	For the three months ended 31 March 2014	For the three months ended 31 March 2013	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		10.25	0.01	0.1
Inflated unit costs per 100 tons x km, RUB	10.26	10.87	(0.61)	(5.6)
Oil products transportation services				
Unit costs per 100 tons x km, RUB		32.27	1.40	4.3
Inflated unit costs per 100 tons x km, RUB	33.67	34.24	(0.57)	(1.7)

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 three months ended 31 March 2014 as compared to the three months ended 31 March 2013 in the amount of RUB 972 or 3.6% was influenced by an increase of average employee headcount related primarily to putting into operation of new oil pipelines.

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.



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3.2.1. Staff costs (continued)

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

	Three months ended 31 March 2014	Three months ended 31 March 2013	Absolute change	Change, %
Employers' contributions to NPF Transneft* in favor of employees	1,285	2,022	(737)	(36.4)

3.2.2. Energy

Energy expenses for the three months ended 31 March 2014 decreased by RUB 133 or 1.6% as compared to the same period of the previous year. The growth of tariffs of natural monopolies resulted in the increase of energy consumed by RUB 410 and the increase of consumption of declared power by RUB 329. At the same time despite the putting into operation of the new oil pipelines the decline of volume of declared power and energy consumed resulted in the decrease of expenses by RUB 341 and RUB 390 respectively, 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:

	Three months ended 31 March 2014	Three months ended 31 March 2013	Absolute change	Change, %
Consumption of power, MW	4,253	4,611	(358)	(7.8)
Consumption of energy, (mln. kW*h)	2,836	3,135	(299)	(9.5)

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 three months ended 31 March 2014 decreased by RUB 1,090 or 69.2% as compared to the previous period as a result of putting into operation of The Eastern Siberia–Pacific Ocean pipeline system, stage two, the Skovorodino–SMNP Kozmino section (ESPO-II) and decrease in volume of oil transportation by railways.

3.2.4. Materials

Expenses on materials for the three months ended 31 March 2014, increased by RUB 772 or 19.0%, due to following:

- increase in repairs and elimination of defects;
- provision of construction services to third parties.

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

A decrease in these expenses for the three months ended 31 March 2014, amounted to RUB 190 or 9.0% compared to the three months ended 31 March 2013.

3.2.6. Cost of crude oil and oil products sold

The cost of crude oil sold for export for the three months ended 31 March 2014, amounted to RUB 41,689, including custom duties in the amount of RUB 19,812, 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 479 or 31.6% due to decline in the Group companies' oil products sales volumes (ref. to paragraph 3.1.2.).

* NPF Transneft – Non-state pension fund Transneft



3.2.7. Taxes (except income tax)

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

3.2.8. 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 website.

3.2.9. Share of results from associates and jointly controlled entities

The Group holds a number of financial investments in associated and jointly controlled entities reported on an equity method basis. The decrease in the Group's share of results from associates and jointly controlled entities for the three months ended 31 March 2014 compared to the relative period in 2013, was mainly attributed to decline in profit of OAO Novorossiysk Commercial Sea Port (ref. to para 3). The Group's share in OAO Novorossiysk Commercial Sea Port was 35.57% as at 31 March 2014.

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.

An increase in interest income for the three months ended 31 March 2014, by RUB 1,415 or 48.4%, was driven by growth in income from fixed-income securities and deposits as well as decline in the amount interest from income generated by investing temporarily available cash and cash equivalents as they are spent on investments projects.

Interest income	Three months ended 31 March 2014	Three months ended 31 March 2013	Absolute change	Change, %
Interest income from cash and equivalents	1,133	1,565	(432)	(27.6)
Interest income from other financial assets	3,425	2,070	1,355	65.5
Other interest income	81	-	81	x
Total interest receivable	4,639	3,635	1,004	27.6
less interest income on the temporary investment of borrowings	(284)	(709)	425	(59.9)
Total interest income recognised in the statement of profit and loss and other comprehensive income	4,355	2,926	1,429	48.8

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

Interest expenses	Three months ended 31 March 2014	Three months ended 31 March 2013	Absolute change	Change, %
Interest expenses on loans and borrowings	8,317	8,945	(178)	(2.1)
Interest expenses regarding the dismantlement provision	580	1,441	(861)	(59.8)
Other interest expenses	264	372	(108)	(29.0)
Total interest expenses	9,161	10,308	(1,147)	(11.1)
Less finance costs to be capitalised	(728)	(886)	158	(17.8)
Total interest expense recognised in the statement of profit and loss and other comprehensive income	8,433	9,422	(989)	(10.5)



3.2.10. Interest income and expenses (continued)

The amount of interest expenses is composed of:

- interest payable on a USD 10bn loan obtained from the China Development Bank at a variable LIBOR-linked rate with a 20-year maturity repayable in equal installments starting in the sixth year from the moment of issue;
- interest payable on Eurobonds issued by the Group in 2007-2008 for a total of USD 2,350 mln for the three months ended 31 March 2014 and USD 2,950 for the similar period of the previous year;
- interest payable on series BO-01 and BO-02 of non-convertible interest-bearing documentary bonds amounting to RUB 34,000.

In August 2013 the Group repaid in full and on time another Eurobonds issue in the amount of USD 600 mln.

During the three months ended 31 March 2014, interest in the amount of RUB 444 was capitalised as part of cost of assets under construction (for the three months ended 31 March 2013 – RUB 177) including:

- interest expenses to be capitalised in the amount of RUB 728 (for the three months ended 31 March 2013 – RUB 886);
- interest income to be excluded from interest expenses to be capitalised in the amount of RUB 284 (for the three months ended 31 March 2013 – RUB 709).

3.2.11. Foreign currency exchange gains and losses

The sum of foreign currency exchange gains and losses and their growth for the three months ended 31 March 2014, compared to the three months ended 31 March 2013, was a result of changes in the exchange rates of the US dollar and the Euro to the Russian rouble during the relative periods.

Due to a restatement of assets and liabilities denominated in foreign currencies at the end of every month, positive and negative currency-translation changes results, which are presented in the reporting on gross base.

Disclosure of foreign exchange differences by sources is presented in the tables below:

	Three months ended 31 March 2014	Three months ended 31 March 2013	Absolute change	Change, %
Foreign exchange gains on financial investments	31,635	8,296	23,339	3.8 times
Foreign exchange gains on loans and borrowings	4,021	4,506	(485)	(10.8)
Other foreign exchange gains	5,524	1,558	3,967	3.5 times
Total foreign exchange gains recognised in the statement of profit or loss and other comprehensive income	41,180	14,360	26,820	2.9 times
Foreign exchange loss on financial investments	(3,294)	(2,433)	(861)	35.4
Foreign exchange loss on loans and borrowings	(40,361)	(13,714)	(26,647)	2.9 times
Other foreign exchange loss	(1,185)	(483)	(702)	2.5 times
Total foreign exchange loss recognised in the statement of profit or loss and other comprehensive income	(44,840)	(16,630)	(28,210)	2.7 times
Net exchange differences	(3,660)	(2,270)	(1,390)	(61.2)

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 three months ended 31 March 2014 and by its strengthening for the three months ended 31 March 2013.



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3.3. Reconciliation of profit and EBITDA

	Three months ended 31 March 2014	Three months ended 31 March 2013	Change, %
Profit for the period	40,637	46,524	(12.7)
Increased/(decreased) by:			
income tax expense	10,916	11,203	(2.6)
depreciation and amortization	27,229	25,992	4.8
result of oil sales to China	(1,051)	(112)	X
net change in fair value of derivatives	5,118	(203)	X
interest expenses	8,433	9,422	(10.5)
interest income	(4,355)	(2,926)	48.8
exchange gains	(41,180)	(14,360)	2.9 times
exchange losses	44,840	16,630	2.7 times
share of loss/(profit) from associates and jointly controlled entities	408	(538)	X
EBITDA	90,995	91,632	(0.7)
EBITDA margin*, %	62.6	62.9	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

	Three months ended 31 March 2014	Three months ended 31 March 2013	Absolute change	Change, %
Cash flows from operating activities	100,325	83,905	16,420	19.6
Cash flows used in investing activities	(55,827)	(70,201)	14,374	(20.5)
Free cash inflow*	44,498	13,704	30,794	3.2 times
Cash flows used in financing activities	(46,948)	-	(46,948)	X
Net cash (outflow) / inflow	(2,450)	13,704	(16,154)	X
Change in cash and cash equivalents due to deviation of currency exchange rate	6,618	876	5,742	7.6 times
Net increase in cash and cash equivalents	4,168	14,580	(10,412)	(71.4)

*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 three months ended 31 March 2014 amounted to RUB 42,120 (the three months ended 31 March 2013: RUB 40,267).

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 100,325 for the three months ended 31 March 2014, which is RUB 16,420 or 19.6% higher than for the three months ended 31 March 2013.

The main factors which influenced on the increase of cash from operating activities for the three months ended 31 March 2014 as compared to the similar period in 2013 were as follows:

- an increase in cash receipts from customers by RUB 9,819;
- increase in cash paid to suppliers by RUB 7,492;
- increase in cash received from the refund of VAT and other taxes from the budget by RUB 19,166;
- increase of the net amount of payments of income tax amounting to RUB 5,319.

4.2. Investing activities

The primary factors resulting in a decrease in cash used in investment activities by RUB 14,374 or 20.5% for the three months ended 31 March 2014, as compared to the same period for the previous year, were:

- increase in the amount of purchase of property, plant and equipment by RUB 14,554;
- a decrease by RUB 28,941 in cash used in purchase-and-sale transactions in regards to promissory notes and placement of funds in deposits for the purpose of investing of temporarily available funds (which amounted to RUB 2,378 for the three months ended 31 March 2014, and RUB 26,563 for the three months ended 31 March 2013).

4.3. Financing activities

For the three months ended 31 March 2014 cash outflow increased by RUB 46,948 which was caused by repayment on Eurobonds in the amount of USD 1,300 million (RUB 46,948 at the rate of Central Bank of the Russian Federation on the date of operation).



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 three months ended 31 March 2014.

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

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

	Three months ended 31 March 2014	Three months ended 31 March 2013
OPERATING ACTIVITIES		
Profit before tax	51,553	57,727
Adjustments for:		
Depreciation and amortization	27,229	25,992
Loss from disposal of property, plant and equipment	263	729
Interest income and share of (profit)/loss	(3,947)	(3,464)
Interest expenses	8,433	9,422
Net loss from currency exchange differences	3,660	2,270
Net change in fair value of derivatives	5,118	-
Others	(816)	(3,042)
Operating profit before changes in working capital	91,493	89,634
Changes in operating assets and liabilities:		
Increase in inventories	(1,741)	(200)
Decrease in trade and other receivables relating to operating activity and VAT assets	15,171	5,358
Increase/(decrease) in trade and other payables, and accruals relating to operating activity	11,355	(322)
Cash flows from operating activities before payment of income tax expense and interest	116,278	94,470
Income tax paid	(10,168)	(4,722)
Income tax refund	410	283
Interest paid	(6,195)	(6,126)
Cash flows received from operating activities	100,325	83,905



5. Liquidity analysis

	31 March 2014	31 December 2013	Change, %
Current assets	545,068	532,017	2.5
including:			
cash and cash equivalents	108,910	104,742	4.0
short-term bank promissory notes and deposits*	325,522	300,911	8.2
Current liabilities	217,675	227,921	(4.5)
Net working capital	327,393	304,096	7.7
Current ratio	2.5	2.3	8.7
Quick ratio**	2.2	2.0	10.0
Debt / EBITDA	1.7	1.7	-
Debt / Equity	0.4	0.4	-

* Short-term bank promissory-notes consist of promissory notes by banks with investment-grade international credit ratings 65.7%, banks with credit ratings not lower than B-/B3/B- per the S&P/Moody's/Fitch classification. Thus, short-term bank promissory notes and deposits consist of highly reliable or reliable financial instruments.

Short-term bank deposits are shown net of deposits classified as available-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 4,168 as at 31 March 2014 as compared to cash and cash equivalents as at 31 December 2013 was a result of cash received from operating activities (ref. to paragraph 4.1).