



## PJSC Gazprom Neft

### Financial Results in Q2 2016 25 August 2016

#### Anna Sidorkina, Head of Investor Relations

Ladies and gentlemen, I apologize for the late start of the conference call, which was due to technical difficulties.

Before we start the call, which will focus on IFRS results in the second quarter of 2016, I would ask you to read slide №3 carefully and remind you that the presentation and all the commentary that will be given during the conference call may contain forward-looking statements relating to the financial situation, operations and business of Gazprom Neft.

Allow me to introduce our managers who will be taking part in the conference call today. As usual, Alexey Yankevich, our CFO, will speak first. Then we will hear about upstream business from Alexander Mikheyev, who heads the Economics and Investment Department of our Upstream Division, followed by a presentation on downstream from Vladimir Konstantinov, who heads Downstream Economics and Investment. Finally, Alexey Yankevich will comment on financial results in the second quarter.

Thank you very much. Let me hand over to Alexey Yankevich.

#### Alexey Yankevich, Chief Financial Officer

Ladies and gentlemen, good evening. We bring you the first-half results of Gazprom Neft. The first thing I would like to say is this: we, the company Gazprom Neft remain a growing company, despite the negative impact of the external environment, which was felt at the beginning of this year compared with last year. We improved our operating results despite worsening of the price environment and growth of the tax burden compared with 2015. Our production grew by 10% compared with last year. As you all know, 10% growth is a lot in the oil and gas industry. In downstream, we increased retail sales by 3.6%. Yes, refining volumes were down, but refining volume isn't an absolute indicator of efficiency – the amount was optimal in the price conditions that existed in the first half of the year. As a result, operating profit (EBITDA) increased by 1.9%. That is a modest figure, but if you look more closely, which we will do in a minute, you see that the growth would have been 15% without worsening of the price environment and increase of the tax burden. That, in principle, is a good result. Net income in our financial accounts declined, but that was solely the effect of non-recurring operations. If you take out the non-recurring effects, the increase was about 7%. Last year, there was a paper gain on write-off of promissory notes of Yukos structures. But this year, on the contrary, we had losses due to provisions in two areas: first, we created a provision for an advance that we provided and, second, we created a reserve for possible impairment of various non-current assets.

As regards quarterly results, we also see a positive trend in the second quarter compared with the first. Production was steady and other indicators showed growth: growth of sales, EBITDA and net income. There weren't many important strategic events in the second quarter (we hope that we will have something more to offer you in the third quarter), but a few things are worth mentioning. In Upstream we had the Novoport launch. We already announced it in the previous quarter. Everything is going according to plan and we intend to significantly increase shipments. For that purpose, we launched three out of six new, modern ice-class tankers (Arc7) in this quarter, so we will be able to increase shipments in coming quarters. In the fourth quarter, I am sure, you will see growth of shipments and respective growth of financial results. As regards current assets, I would note the launch of a gas turbine plant at the Shinginskoye field, which lets us make use of gas and create added value. In Downstream, I would point out two acquisitions that are small, but strategically important for us in terms of development of our premium channels. We acquired a stake in the company NOVA-Brit, which produces innovative bitumen materials. You all know that we plan to be a technology leader in that segment and create products with high added value, even though they are originally just heavy residues. And we also acquired Rospolychem, which makes high-tech lubricants – another segment in which we plan to make strong technological progress.

That is what I had to say by way of introduction. I give the floor to representatives of our divisions, starting with Alexander Mikheyev, Head of Upstream Finance and Economics.



### **Alexander Mikheyev, Head of Economics and Investment (Upstream)**

Good evening, ladies and gentlemen. I will present our results for the first half year in exploration and production.

As already mentioned, hydrocarbon production including our share in joint ventures increased by 10% in H1 to 41.82 million tonnes of oil equivalent. The major y-o-y growth was primarily due to growth of output after the commissioning of new wells at the Prirazlomnoye and Novoport fields, helped, of course, by year-round oil exports from the Novoport field through the Arctic terminal and its shipment by a tanker fleet. There was also an increase of production in Iraq thanks to the commissioning of new wells in the Badra project. Gas production at Arcticgas fields increased further, mainly due to industrial launch of the gas section of the Yaro-Yakhinskoye field. We increased our ownership interest in the Northgas project. At our established brownfields we increased supply of associated gas to the Vyngapurovsky gas-processing plant, launched the South Priobsky plant in Khanty-Mansiysk and increased supply of associated gas to the Orenburg gas-processing plant. Management remains focused on improvements to operating efficiency.

The next slide shows our results in drilling. Our key objectives for increase of efficiency in drilling were reducing down time and speeding up the construction of wells. The share of horizontal wells at mature assets increased, but we still managed to speed up well construction considerably: the time required to drill horizontal wells was reduced by 10.5%.

This next slide shows operating cost trends, which remain steady and substantially below the average industry growth rate. Operating costs in the first half were up by 9% y-o-y at 1605 rubles per tonne of oil equivalent. Growth of lifting costs was very modest at about 5% and unit lifting costs per tonne of oil equivalent were 1227 rubles.

We are continuing work on new projects including significant progress at Novoport where the Arctic Gates terminal has been launched and three of six new ice-class Arc7 tankers are already in service. We shipped 14 tankers of oil from the Prirazlomnoye field this year. In the Messoyakha project we have completed work on administrative and residential facilities, all sections of the pressurized oil pipeline have been put in place we are carrying out pre-launch work on the gas-turbine generating station. In Iraq we are still shipping cost oil in the Badra project and three new production wells have been commissioned. In the Kurdistan project, the plan for development of the Garmian block has been approved by the Kurdistan Ministry of Natural Resources.

We are still implementing our technology strategy. The next slide shows the results of drilling work at a unique well with a 1500 metre horizontal section where we carried out a 30-stage hydraulic fracturing project (six frac stages per day). The operational capacity of the well was about 130 tonnes per day. So we continue to work on our multi-stage fracing technology. The key targets are significant reduction of time needed for multi-stage fracing operations and increase of well production rates at launch.

Work continues to monetize associated gas and obtain more value from its use. The next slide shows data on the launch of a gas turbine station at the Shinginskoye field. The official launch was in August, but we were already supplying electricity to the grid in May in a range from 4 to 9 MW. The stations has now been commissioned and it has four gas turbines, each with 6 MW capacity. So about 70 million cubic meters of associated gas per year is being usefully used. That gives a brief outline of Upstream. I will hand over to Vladimir Konstantinov.

### **Vladimir Konstantinov, Head of Economics and Investment (Downstream)**

Good evening, ladies and gentlemen!

The second quarter of 2016 was not very favorable for Downstream. The oil price grew during the quarter by \$9 per barrel to reach \$48 dollars in June. That meant more expensive oil for Downstream, which affected financial results, refining margins. Overall, the oil price increase was not compensated by a respective increase in prices for petroleum products. The situation was also affected by an increase of excise taxes, which was announced and effectively came into force from 1 April. As a result, refining margins were significantly lower in the second quarter than in the first, as you can see on the chart. We had a repeat of what happened last year when the second quarter was less efficient after a successful first quarter. Margin was at minimum level, but for the first half as a whole we had a fairly acceptable level of refining margins: we are operating in the black, our refineries generate profit for the company.



You can see what happened with refining volumes if you look at the graphic on the right of the slide: the difference between Q1 2016 and Q2 2016 (growth of 1.9%) reflects seasonal differences. But the second quarter of 2016 was different from the second quarter of 2015 for the reasons Alexey Yankevich has already explained. Minus 4.7% is due to optimization of our refining volumes in the environment that Downstream had to operate in during the second quarter of 2016. Similarly, if we look at the next slide, we see that refining volumes were deliberately reduced at all our plants. The reduction at the Omsk Refinery was more than 4%, at the Moscow Refinery it was over 6%, and refining at Slavneft facilities (Yaroslavl and Mozyr) fell by more than 4%. Overall, refining volume fell by 900,000 tonnes compared with 2015, which, I repeat, was a deliberate step to optimize the financial result. We can see how it affected main efficiency indicators in refining if we look at the right side of the slide. Processing depth increased at the Yaroslavl and Moscow Refineries. The increase at the Moscow Refinery was quite substantial. This was due to reduction of refining volumes. There was an opposite trend at Omsk, primarily due to lower output of marine fuel. That was caused by two factors: first, the market for marine fuel declined; and, second, it was due to lower refining volume. Light product yield increased by 2.6 percentage points for the company as a whole and the trend was positive at all our refineries. One reason for the higher light-product yield at Omsk was increase in processing of gas condensate.

Moving on to sales, the total volume of premium sales in Downstream fell by 4%, but this was mainly due to two business segments: bunkering and aviation fuel. There was an objective reason for it, namely substantial decline of the aviation refuelling and bunkering markets, with special factors at play for aviation refuelling – the disappearance of Transaero, to which we sold quite large volumes, and the loss of foreign tourist destinations, which also accounted for quite significant volumes in 2015. I have already mentioned what caused the trend in bunkering sales: it was market decline and the decline in output of marine fuel. Our sale of motor fuels were much better than the market. On the left side of the slide you can see that our small wholesale motor fuel business grew by 2.4% and retail sales of motor fuels through filling stations grew by 3.6%. On the right side you have the figures for Russia: the top shows market trends for petrol and diesel fuel and the bar chart at the bottom shows our sales. You can see that our sales of diesel fuel and gasoline are growing, despite a falling market.

Now for the two projects, which Alexey already mentioned. These are two acquisitions. The first is Rospolychem group, which has total production capacity of 5000 tonnes and its main products are ether compounds and products based on them, as well as specialized products for the steel industry, technology sectors and special equipment. It adds one more efficient asset to the assets, which you see on the left side of the slide: Omsk, Fryazino and foreign assets. As a result, our total lubricant sales in H1 2016 were 263,000 tonnes, which is 5% more than in the same period of 2015. Premium sales grew by 16% y-o-y in the first half. The other asset that we acquired, and which I would like to tell you about is NOVA-Brit, which we have added to our existing six production sites. It makes 30 items, including mastics for road, bridge and airport construction work, sealants and emulsions, and bitumen tape. Total sales of bitumen products in the first half of 2016, including the new asset, were more than 900,000 tonnes. Again, the y-o-y increase is 5%. Our company is still the Russian leader in the market for bitumen materials and our level of premium sales in the segment more than doubled during the year.

That gives a brief overview of our downstream business results in the second quarter and first half of 2016. Thank you.

#### **Alexey Yankevich, Chief Financial Officer**

Colleagues, coming back to our financial results, as I said, we showed good financial results for the first six months of the year. EBITDA grew by 1.9%. As such 1.9% is a modest increase, but in the context of serious negative factors, such as the major decline of oil prices by more than 30% and increase of the tax burden, the increase of operating efficiency was quite significant. The situation with net income is more complicated. We have tried to show in the chart what really happened. Formally, net income in the first half last year was 112 billion, but 15 billion of those were paper gains from the write-off of debt on promissory notes. That was an old story and really had nothing to do with the first half of last year. It was just that the agreement was signed in 2015. So actual income last year was about 97 billion. This year we reported net income of 90 billion for six months, but, again, this year there are non-recurring negative adjustments. Without them, net income would have been 104. So net income grew by 7%.



I'll go straight onto the next slide. What you see here is the factor analysis that I referred to. You can see 30 billion rubles, which the company earned – that is work by management, our efforts to launch new fields, increase production, optimize the downstream business. Now, 30 billion is 15% of 200 (EBITDA in the first half of 2015). But, unfortunately, the growth was reduced to 1.9% due to the fact that, firstly, prices fell (minus 12 billion) and, secondly, the tax burden increased (minus 14 billion). That is how our operating income trend looks.

As for the q-o-q analysis, what we see is mainly the effect of the external environment. The second quarter was the best, so we see that about 5 billion of the total growth is the price effect and about 6 billion is the effect of the delay in change of duty rates, the so-called duty lag. The effect of the latter was quite limited for us. If you look carefully at the reports of other companies, which have bigger exports, you will see that the effect for them was bigger.

The next slide shows cash flows. Here we see that free cash flow was minus 21 billion rubles. Yes, it is negative, but, in principle, we planned and predicted it at all our meetings and communications with analysts and investors. We said that we are at an investment peak in 2016-2017. The peak effect was intensified by the external environment, which made things tougher for us. We restructured, postponed and optimized a part of the investments, but we couldn't completely erase the negative effect. So there is a definite minus. This is a temporary phenomenon: I think this trend will surely be broken by the end of 2017, in 2018, and we will have steady, positive cash flows. But it was minus 21 in the first six months this year. Also, we reduced our loan portfolio, we carried out scheduled repayment of loans. As a result, the total cash flow was minus 35. Essentially, this is the change of our cash position: cash balances decreased by 35 billion. This was partly offset by 48 billion income from bank deposits, but, really, you need to look at 48 and 35 together. Formally, though, by IFRS standards, bank deposits aren't part of "Cash and equivalents".

A few words about investments. Investments under IFRS increased by 12%. The main driver for this growth was Downstream, though investment growth in the past has been in Upstream. What we are seeing is the start of the active phase of the second stage of our oil refinery reconstruction: modernization of refineries, including increase of refining depth. We have begun these projects in earnest. We had a short pause when we finished off quality, did some planning work and made the transition to the more active phase of modernization. Now we are in that phase and investments in refining will tend to rise for a certain time, while we carry out modernization.

To conclude, a few words about financing. It is traditional for us to say something about the state of the loan portfolio, about borrowings, and I would like to mention our practice of issuing public instruments, which, I believe, has been extremely successful. We took a break from public instruments, because we had a lot of loans, but we have recently made a number of placements that have been very successful by the standards of the Russian market. The most recent of them isn't strictly an event of the second quarter, as it happened yesterday. We announced completion of the placement of 15 billion in ruble bonds. These are 30-year bonds with an option after five years, but essentially they are five-year borrowing. The rate was very low, perhaps even a record, at 9.4% per annum in rubles. I don't think I would be wrong to say that it was the best placement by a corporate borrower in the last two or two and a half years. In general, we feel confident about our loan portfolio. We have sources for repayment of loans that fall due before the end of the year and we have already started work on next year's loan programme. All our needs this year are already covered by transactions that we have either closed or that have been prepared. So we feel confident as regards financial stability and borrowings.

That concludes my presentation. To finish I will say that, despite the turbulent, volatile external environment, Gazprom Neft remains a confidently growing company. Our financial results are growing too, though maybe not as fast as they would if the external environment had not changed. We also look into the future with confidence. As I have said, there weren't many events in Q2, but we will definitely have some pleasant surprises from you in Q3 and Q4. We have successfully launched Novoport. The Messoyakha field is next: we will certainly launch it before the end of the year, and we will try to do so as soon as possible. That will let us go into next year feeling confident and with resources to grow. Thanks for your attention. We are ready to answer questions.

**Question №1****Evgenia Dyshlyuk, Gazprombank**

Good evening! Thank you very much for the presentation and the opportunity to ask a question. My first question relates to news in the media that the Ministry of Energy proposes to cancel privileges at the Novoport field, because, according to their data, Novoport achieved a 16% profitability threshold in the first quarter of 2016, if I understand correctly. Could you comment on whether the news is correct, how it should be interpreted and whether it could really happen? Thank you.

**Alexey Yankevich, Chief Financial Officer**

Evgenia, thanks for the question. I think it will be the hit of our conference call. Let me try to answer. First, I will try to clarify what is happening and what the proposals are. There is no question at present of cancelling the privileges. The Novoport field, like all fields that have privileges, is now subject to a standard monitoring procedure. That is part of the procedure: monitoring is carried out in each period to check whether the scale of the privileges, which were originally provided, correspond to current field parameters. The scale of the privileges is revised based on change of macro parameters and other parameters of the model. That is the result of the monitoring – it defines the adjusted scale of privileges that a particular field deserves. This process of agreeing the level of privileges for Novoport is now underway. Accordingly, we have a number of points to discuss with ministries regarding details of the technique used to calculate the privileges, which the field is entitled to. I will say straight away that the target of 16.3% is to be understood as a forecast a planned figure. The target is 16.3% for the entire project life cycle, which is to say that Novoport should reach 16.3% in 30 years. It is at not at 16.3% today and it will or will not reach this payback level over the entire project lifecycle. Remember that the model is very sensitive and the magnitude of error may be large. Accordingly, we now have a disagreement with the Ministry about the volume of privileges, calculated by this method. There is a debate, as a result of which we need to agree on the size of the privileges, which the Novoport field receives. You also have to remember that this is a unique field. A number of the technologies that are being used there are innovative and are not used in many other places. So it is very hard to make an accurate forecast of the capital costs for the entire project life cycle, particularly taking account of the changing macro environment and major fluctuation of prices and exchange rates. It is also difficult to predict income for the entire life cycle of the project. So what is happening now is a constructive dialogue with the ministries as to what should be the right and fair adjusted level of privileges for the Novoport field. We are in dialogue with the relevant ministries, meetings are being held to clarify parameters of the method. And I think that we will eventually come to a considered compromise on an adjusted level of privileges, which should be applied at the Novoport field.

Evgenia did you have a question for clarification?

**Evgenia Dyshlyuk, Gazprombank**

Yes, I have an additional question, in order to clarify. For you, in the company, based on your estimates, at current oil prices – when, roughly, should the privileges at the field cease to apply? What period of time are we talking about? Is it 4-5 years?

**Alexey Yankevich, Chief Financial Officer**

Evgenia, I can't disclose confidential details of the model, since it is a field in the process of development and these are commercial numbers. It's certainly less than 4-5 years. Absolutely. But I can't give you an exact number today.

**Evgenia Dyshlyuk, Gazprombank**

Thank you. And the second question, just to clarify. Based on production data at the field for the first half year, could you give any forecast of production for the whole year - this year and maybe next year.

**Alexey Yankevich, Chief Financial Officer**

About 2.5 or 2.6 million tonnes of oil this year.

**Evgenia Dyshlyuk, Gazprombank**

Thank you.

### Question №2

**Ekaterina Rodina, VTB Capital**

Hello and thank you very much for your presentation. I have two questions. One is about slide 11, which gives information about the new well, which, as I understand it, is unique in Russia. Could you specify at which field this is? And another question – I probably didn't fully understand, – what are the production indicators for this well after the interventions that were carried out. That is the first question. Shall I ask the second straight away?

**Anna Sidorkina, Head of Investor Relations**

Katya, we will answer the first question, and then you can ask your second question. OK?

**Ekaterina Rodina, VTB Capital**

Yes, thank you.

**Alexander Mikheyev, Head of Economics and Investment (Upstream)**

Ekaterina, it is a well drilled at the Priobskoye field in Khanty-Mansi Autonomous District and current operational capacity is estimated at 130 tonnes of oil per day.

**Ekaterina Rodina, VTB Capital**

That is the average flow rate?

**Alexander Mikheyev, Head of Economics and Investment (Upstream)**

This is the current daily rate.

**Ekaterina Rodina, VTB Capital**

Thank you. The second question: in view of the fact that the Moscow Refinery will be undergoing partial repair and reconstruction at the beginning of next year, what approximate refining volumes do you plan at the Refinery in Q1 2017?

**Vladimir Konstantinov, Head of Economics and Investment (Downstream)**

Yes, there will be major repair work at the Moscow Refinery from January to May 2017, including repairs to the largest primary processing facility, AVDT-6. The reforming unit will also be under repair. We have not decided the exact amount of refining, the business plan is being prepared. Of course, the volume will be lower than it was in Q1 and Q2 2016, but I would say that the biggest drop in refining volume will probably be in February-April, which is when the two units I just mentioned will be out of action at the same time. As regards products, I suppose your question concerns how we will maintain supplies to the market. Indeed, we will accumulate resources, buy fuel on the market. It is possible to do that at present, and in quite large quantities. If necessary, we will consider delivering products from the Omsk Refinery.

**Ekaterina Rodina, VTB Capital**

Thank you.

### Question №3

**Pavel Kushnir, Deutsche Bank**

Good afternoon. I have three quick questions. One of them is a little more complicated. First, can you please tell me what your refining margins were in Q1 and Q2? The second question is: what internal rate of return, IRR, do you build into your programme for the second phase of refinery reconstruction? And the third question: what do you think will be the decision on the mineral extraction tax for oil in 2017, given the news that we read today in *Vedomosti* newspaper? Thank you.



**Alexey Yankevich, Chief Financial Officer**

Pavel, thank you very much for your questions. I'll answer the last one first, so in reverse order. About mineral extraction tax. No doubt *Vedomosti* has got it right, but we are a company, not a ministry. So I also read it only today. There is probably a lot of truth in it. To be honest, we build several alternatives into our business plan scenarios, including the alternative that we all saw in the article today. That was a mineral extraction tax level of 400-500 rubles per tonne, I think.

The next question was about IRR. I can't tell you exactly, since it depends on the project, but certainly more than 20%.

I will ask Vladimir Konstantinov to answer the first question about margin.

**Vladimir Konstantinov, Head of Economics and Investment (Downstream)**

Refining margin fluctuated during the first half of the year (without the premium segment and without small wholesale) between 1000 rubles in the worst months and 2500 rubles. For the premium segment, you can add 1000-1500 per tonne. So refining margin, including the small wholesale segment, was at a fairly comfortable level.

**Anna Sidorkina, Head of Investor Relations**

Anna Sidorkina, Investor Relations. Ladies and gentlemen, allow me to conclude our conference call. Thank you very much for following our company so attentively. Our apologies again that you had to wait 30 minutes. If you have further questions, please call. All the best! Until next time.