



PJSC LUKOIL

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

**for the three and six-month periods ended
30 June 2017 and 2016**

The following report contains a discussion and analysis of the financial position of PJSC LUKOIL at 30 June 2017 and the results of its operations for the first half of 2017, compared to the first half of 2016, as well as significant factors that may affect its future performance. It should be read in conjunction with our International Financial Reporting Standards (“IFRS”) condensed interim consolidated financial statements, including notes.

References to “LUKOIL,” “the Company,” “the Group,” “we” or “us” are references to PJSC LUKOIL and its subsidiaries and equity affiliates. All ruble amounts are in millions of Russian rubles (“RUB”), unless otherwise indicated. Income and expenses of our foreign subsidiaries were translated to rubles at rates which approximate actual rates at the date of the transaction. Tonnes of crude oil and natural gas liquids produced were translated into barrels using conversion rates characterizing the density of crude oil from each of our oilfields and the actual density of liquids produced at our gas processing plants. Hydrocarbon extraction expenses per barrel were calculated using these actual production volumes. Other operational indicators expressed in barrels were translated into barrels using an average conversion rate of 7.33 barrels per tonne. Translations of cubic meters to cubic feet were made at the rate of 35.31 cubic feet per cubic meter. Translations of barrels of crude oil into barrels of oil equivalent (“BOE”) were made at the rate of 1 barrel per BOE and of cubic feet – at the rate of 6 thousand cubic feet per BOE.

This report includes forward-looking statements – words such as “believes,” “anticipates,” “expects,” “estimates,” “intends,” “plans,” etc. – that reflect management’s current estimates and beliefs, but are not guarantees of future results.

Table of Contents

Business overview	4
Key financial and operational results	5
Changes in Group structure	6
Main macroeconomic factors affecting our results of operations	7
International crude oil and refined products prices	7
Domestic crude oil and refined products prices	7
Changes in ruble exchange rate and inflation	8
Taxation	8
Transportation tariffs on crude oil, natural gas and refined products in Russia	13
Segments highlights	14
Exploration and production.....	14
West Qurna-2 project.....	17
Refining, marketing and distribution	19
Financial results.....	23
Sales revenues.....	24
Operating expenses	27
Cost of purchased crude oil, gas and products	28
Transportation expenses.....	29
Selling, general and administrative expenses.....	29
Depreciation, depletion and amortization	30
Equity share in income of affiliates	30
Taxes other than income taxes	30
Excise and export tariffs	31
Foreign exchange gain (loss)	31
Other income (expenses).....	32
Income taxes	32
Non-GAAP items reconciliation	33
Reconciliation of profit for the period to EBITDA.....	33
Reconciliation of Cash provided by operating activities to Free cash flow	33
Liquidity and capital resources.....	34
Operating activities	34
Investing activities	34
Financing activities	35
Other information.....	36
Sectorial sanctions against the Russian companies.....	36
Operations in Iraq	36

Business overview

The primary activities of LUKOIL and its subsidiaries are hydrocarbon exploration, production, refining, marketing and distribution.

LUKOIL is one of the world's largest publicly traded vertically integrated energy companies. Our proved reserves under SEC standards amounted to 16.4 billion BOE at 1 January 2017 and comprised of 12.5 billion barrels of crude oil and 23.5 trillion cubic feet of gas. Most of our reserves are conventional. We undertake exploration for and production of crude oil and natural gas in Russia and internationally. In Russia, our major oil producing regions are Western Siberia, Timan-Pechora, Ural and Volga region. Our international upstream segment includes stakes in PSA's and other projects in Kazakhstan, Azerbaijan, Uzbekistan, Romania, Iraq, Egypt, Ghana, Norway, Cameroon, Nigeria and Mexico. Our daily hydrocarbon production in the first half of 2017 amounted to 2.3 million BOE with liquid hydrocarbons representing approximately 81% of our overall production volumes.

LUKOIL has geographically diversified downstream assets portfolio primarily in Russia and Europe. Our downstream operations include crude oil refining, petrochemical and transport operations, marketing and trading of crude oil, natural gas and refined products, power generation, transportation and sales of electricity, heat and related services.

We own and operate four refineries located in European Russia and three refineries located outside Russia – in Bulgaria, Romania, and Italy. Moreover, we have a 45% interest in the Zeeland refinery in the Netherlands. We also own two petrochemical plants in Russia and petrochemical capacities at our refineries in Bulgaria and Italy. Along with our own production of refined products we refine crude oil at third party refineries depending on market conditions and other factors. Our refinery throughput in the first half of 2017 amounted to 1.3 million barrels per day, and we produced 0.6 million tonnes of petrochemicals.

We are marketing our own and third-party crude oil and refined products through our wholesale and retail channels in Russia, Europe, South-East Asia, Central and North America and other regions. We own petrol stations in 17 countries. Most of our retail networks are located close to our refineries. Our retail sales in the first half of 2017 amounted to 6.8 million tonnes of refined products.

We are involved in production, distribution and marketing of electrical energy and heat both in Russia and internationally. In the first half of 2017, our total output of electrical energy was 8.8 billion kWh.

Our operations and finance activities are coordinated from our headquarters in Moscow. We divide our operations into three main business segments: "Exploration and production", "Refining, marketing and distribution" and "Corporate and other".

Key financial and operational results

	2 nd quarter of 2017	2016	Change, %	1 st half of 2017	2016	Change, %
(millions of rubles, except for figures in percent)						
Sales.....	1,359,170	1,338,959	1.5	2,790,769	2,516,633	10.9
EBITDA ⁽¹⁾ , including	179,044	189,571	(5.6)	386,689	381,563	1.3
Exploration and production segment.....	113,587	138,227	(17.8)	241,364	267,813	(9.9)
Refining, marketing and distribution segment	62,468	51,643	21.0	132,995	115,153	15.5
EBITDA ⁽¹⁾ net of West Qurna-2 project	175,201	182,681	(4.1)	379,903	353,179	7.6
Profit for the period attributable to LUKOIL shareholders	138,648	62,567	121.6	200,954	105,392	90.7
Capital expenditures	124,640	122,857	1.5	254,868	248,664	2.5
Free cash flow ⁽²⁾	81,658	57,225	42.7	83,033	95,814	(13.3)
Free cash flow before changes in working capital.....	43,163	50,759	(15.0)	110,259	108,188	1.9
(thousand BOE per day, except for figures in percent)						
Production of hydrocarbons, including our share in equity affiliates.....	2,258	2,223	1.6	2,251	2,317	(2.8)
Crude oil and natural gas liquids	1,808	1,836	(1.5)	1,815	1,921	(5.5)
Gas	450	387	16.3	436	396	10.1
Refinery throughput at the Group refineries	1,321	1,322	(0.1)	1,320	1,298	1.7

⁽¹⁾ Profit from operating activities before depreciation, depletion and amortization.

⁽²⁾ Cash flow from operating activities less capital expenditures.

In the first half of 2017, profit attributable to LUKOIL shareholders amounted to 201 billion RUB, an increase of 90.7% to the first half of 2016. Our profit for the second quarter of 2017 more than doubled compared to the second quarter of 2016 and amounted to 139 billion RUB.

Our profit was supported by a currency exchange gain in the second quarter of 2017 that resulted from the ruble exchange rate volatility, compared to a loss in the second quarter of 2016. Moreover, in the second quarter of 2017, we recognized a gain on sale of JSC “Arkhangelskgeoldobycha” in the after-tax amount of 38 billion RUB.

In the first half of 2017, our EBITDA amounted to 387 billion RUB, an increase of 1.3% to the first half of 2016. Our EBITDA was sizably affected by the decrease in volumes of compensation crude oil within the West Qurna-2 project. Net of this project, the Group’s EBITDA increased by 7.6% compared to the first half of 2016.

Our results were positively impacted by an increase in share of high-margin volumes in crude oil production structure, growth in gas production volumes in Russia and Uzbekistan, better refineries’ slate, a decrease in operating, transportation and selling, general and administrative expenses and an increase in average international hydrocarbon prices. The latter however was generally offset by significant strengthening of the ruble and export duty lag effect in Russia. Among negative factors were external limitations of our liquids production in Russia due to the OPEC agreement and higher excise tax rates in Russia.

Our free cash flow amounted to 83 billion RUB, compared to 96 billion RUB in the first half of 2016. It was affected by an increase in working capital together with moderate increase in our capital expenditures.

The Group’s average daily hydrocarbon production in the first half of 2017 decreased by 2.8% compared to the first half of 2016, driven primarily by lower volume of compensation crude oil from the West Qurna-2 project, as well as temporary external limitations due to the OPEC agreement. Planned increase in production from V.Filanovsky and Pyakyakhinskoe fields, commissioned in 2016, continued.

In the first half of 2017, throughput at own refineries increased by 1,7% compared to the first half of 2016 mainly due to the higher utilization rates at refineries in Nizhny Novgorod and Volgograd. We also achieved better product slate due to modernization of our refining capacities in Russia and feedstock optimization.

Changes in Group structure

In December 2016, the Company entered into a contract with a company of the “Otkrytie Holding” group to sell the Group’s 100% interest in JSC “Arkhangelskgeoldobycha” (“AGD”), a company developing the diamond field named after V.P. Grib located in Arkhangelsk region of Russia. The transaction in the amount of Russian ruble equivalent of \$1.45 billion was completed on 24 May 2017 after all necessary governmental approvals were received. As a result the Group recognized profit before income tax in the amount of 48 billion RUB that is included in “Other income (expenses)” in the consolidated statement of profit or loss and other comprehensive income (profit after income tax – 38 billion RUB).

In February 2017, LUKOIL completed the sale of wholly owned subsidiary – LUKOIL Chemical B.V., which owns “Karpatneftekhim” petrochemical plant located in Ivano-Frankovsk area of Ukraine.

Within the framework of retail business optimization, we sold petrol station networks in Poland, Latvia, Lithuania and Cyprus in 2016.

Main macroeconomic factors affecting our results of operations

International crude oil and refined products prices

The price at which we sell crude oil and refined products is the primary driver of the Group's revenues.

The dynamics of our realized prices on international markets generally matches the dynamics of commonly used spot benchmarks such as Brent crude oil price, however our average prices are usually different from such benchmarks due to different delivery terms, quality mix, as well as specifics of regional markets in case of petroleum product sales.

During the first half of 2017, the price for Brent crude oil fluctuated between \$44 and \$56 per barrel, reached its maximum of \$56.3 in the end of February and then minimum of \$44.3 in the end of June, and averaged 29.9% higher than in the first half of 2016. Nevertheless, as a result of the ruble appreciation, the prices expressed in rubles increased less significantly.

The following tables show the average crude oil and refined product prices.

	2 nd quarter of		Change,	1 st half of		Change,
	2017	2016	%	2017	2016	%
(in US dollars per barrel, except for figures in percent)						
Brent crude.....	49.64	45.59	8.9	51.72	39.81	29.9
Urals crude (CIF Mediterranean)	48.85	44.30	10.3	50.73	38.55	31.6
Urals crude (CIF Rotterdam)	48.48	43.37	11.8	50.22	37.56	33.7
(in US dollars per metric tonne, except for figures in percent)						
Fuel oil 3.5% (FOB Rotterdam).....	278.20	199.75	39.3	284.33	167.77	69.5
Diesel fuel 10 ppm (FOB Rotterdam)	450.47	411.25	9.5	465.09	362.30	28.4
High-octane gasoline (FOB Rotterdam)	527.45	503.24	4.8	536.38	445.11	20.5
Naphtha (FOB Rotterdam).....	428.21	395.87	8.2	455.07	356.47	27.7
Jet fuel (FOB Rotterdam).....	478.78	434.00	10.3	494.74	386.10	28.1
Vacuum gas oil (FOB Rotterdam)	345.54	311.75	10.8	349.04	267.51	30.5

Source: Platts.

	2 nd quarter of		Change,	1 st half of		Change,
	2017	2016	%	2017	2016	%
(in rubles per barrel, except for figures in percent)						
Brent crude.....	2,837	3,004	(5.6)	2,999	2,797	7.2
Urals crude (CIF Mediterranean)	2,792	2,919	(4.4)	2,942	2,708	8.6
Urals crude (CIF Rotterdam)	2,770	2,858	(3.1)	2,912	2,639	10.3
(in rubles per metric tonne, except for figures in percent)						
Fuel oil 3.5% (FOB Rotterdam).....	15,898	13,161	20.8	16,487	11,787	39.9
Diesel fuel 10 ppm (FOB Rotterdam)	25,742	27,097	(5.0)	26,969	25,455	5.9
High-octane gasoline (FOB Rotterdam)	30,141	33,158	(9.1)	31,103	31,273	(0.5)
Naphtha (FOB Rotterdam).....	24,470	26,083	(6.2)	26,388	25,045	5.4
Jet fuel (FOB Rotterdam).....	27,360	28,596	(4.3)	28,688	27,126	5.8
Vacuum gas oil (FOB Rotterdam)	19,746	20,541	(3.9)	20,240	18,795	7.7

Translated into rubles using average exchange rate for the period.

Domestic crude oil and refined products prices

Most of the crude oil in Russia is produced and then refined or exported by vertically integrated oil companies. As a result, there is no liquid spot market for crude oil in Russia and no publicly available spot price benchmark. Domestic prices may deviate significantly from export netbacks and they also vary between different regions of Russia driven by supply demand balance on regional markets.

Domestic prices for refined products correlate to some extent with export netbacks, but are also materially affected by supply demand balance on regional markets.

The table below represents average domestic wholesale prices for refined products.

	2 nd quarter of		Change, %	1 st half of		Change, %
	2017	2016		2017	2016	
(in rubles per metric tonne, except for figures in percent)						
Fuel oil.....	9,025	6,794	32.8	9,354	5,674	64.9
Diesel fuel.....	31,864	28,835	10.5	31,659	28,011	13.0
High-octane gasoline (Regular).....	36,045	34,524	4.4	35,716	33,081	8.0
High-octane gasoline (Premium).....	37,069	35,777	3.6	36,151	34,637	4.4

Source: InfoTEK (excluding VAT).

Changes in ruble exchange rate and inflation

A substantial part of our revenue is either denominated in US dollars or euro or is correlated to some extent with US dollar crude oil prices, while most of our costs are settled in Russian rubles. Therefore, a devaluation of the ruble against the US dollar and euro generally causes our revenues to increase in ruble terms, and vice versa. Ruble inflation also affects the results of our operations.

The following table provides data on inflation in Russia and change in the ruble-dollar and ruble-euro exchange rates.

	2 nd quarter of		1 st half of	
	2017	2016	2017	2016
Ruble inflation (CPI), %	0.7	1.2	1.7	3.3
Ruble to US dollar exchange rate				
Average for the period	57.1	65.9	58.0	70.3
At the beginning of the period	56.4	67.6	60.7	72.9
At the end of the period.....	59.1	64.3	59.1	64.3
Ruble to euro exchange rate				
Average for the period	62.8	74.4	62.7	78.4
At the beginning of the period	60.6	76.5	63.8	79.7
At the end of the period.....	67.5	71.2	67.5	71.2

Source: CBR, Federal State Statistics Service.

Taxation

In 2015-2017, the Russian Government is implementing the tax manoeuvre in the oil industry which envisages reduction of export duty rate and increase in the crude oil extraction tax and excise tax rates. Changes within this tax manoeuvre effective from January and April 2016 had a negative impact on our upstream, refining and marketing margins. Changes effective from January 2017 had a positive impact on our upstream margins and a negative impact on our refining and marketing margins, while overall impact of tax changes on our financial results wasn't significant.

The following tables represent average enacted rates for taxes specific to the oil industry in Russia for the respective periods.

	2 nd quarter of		Change, %
	2017	2016	
(in US dollars per tonne, except for figures in percent)			
Export duties on crude oil	84.30	67.15	25.5
Export duties on refined products			
Fuel oil	84.30	55.02	53.2
Gasoline	25.27	40.89	(38.2)
Straight-run gasoline.....	46.33	47.62	(2.7)
Diesel fuel	25.27	26.83	(5.8)
Light and middle distillates.....	25.27	26.83	(5.8)
Mineral extraction tax ⁽¹⁾			
Crude oil	123.00	93.17	32.0
(in US dollars per thousand cubic meters, except for figures in percent)			
Natural gas (Nakhodkinskoe field).....	4.34	3.16	37.5
Natural gas (Pyakyakhinskoye field) ⁽²⁾	8.06	–	–

⁽¹⁾ Translated from rubles using average exchange rate for the period.

⁽²⁾ Gas production started in January 2017.

	2nd quarter of		Change, %
	2017	2016	
	(in rubles per tonne, except for figures in percent)		
Export duties on crude oil ⁽¹⁾	4,817	4,425	8.9
Export duties on refined products ⁽¹⁾			
Fuel oil	4,817	3,625	32.9
Gasoline	1,444	2,694	(46.4)
Straight-run gasoline	2,648	3,138	(15.6)
Diesel fuel	1,444	1,768	(18.3)
Light and middle distillates	1,444	1,768	(18.3)
Mineral extraction tax			
Crude oil	7,029	6,139	14.5
	(in rubles per thousand cubic meters, except for figures in percent)		
Natural gas (Nakhodkinskoe field).....	248	208	19.2
Natural gas (Pyakyakhinskoye field) ⁽²⁾	461	–	–

⁽¹⁾ Translated to rubles using average exchange rate for the period.

⁽²⁾ Gas production started in January 2017.

	1st half of		Change, %
	2017	2016	
	(in US dollars per tonne, except for figures in percent)		
Export duties on crude oil	85.36	61.08	39.8
Export duties on refined products			
Fuel oil	85.36	50.04	70.6
Gasoline	25.58	37.20	(31.2)
Straight-run gasoline	46.92	43.32	8.3
Diesel fuel	25.58	24.41	4.8
Light and middle distillates	25.58	24.41	4.8
Mineral extraction tax ⁽¹⁾			
Crude oil	129.20	72.72	77.7
	(in US dollars per thousand cubic meters , except for figures in percent)		
Natural gas (Nakhodkinskoe field).....	4.28	2.96	44.5
Natural gas (Pyakyakhinskoye field) ⁽²⁾	7.97	–	–
	(in rubles per tonne, except for figures in percent)		
Export duties on crude oil ⁽¹⁾	4,950	4,291	15.4
Export duties on refined products ⁽¹⁾			
Fuel oil	4,950	3,516	40.8
Gasoline	1,483	2,614	(43.3)
Straight-run gasoline	2,721	3,043	(10.6)
Diesel fuel	1,483	1,715	(13.5)
Light and middle distillates	1,483	1,715	(13.5)
Mineral extraction tax			
Crude oil	7,492	5,109	46.6
	(in rubles per thousand cubic meters, except for figures in percent)		
Natural gas (Nakhodkinskoe field).....	248	208	19.2
Natural gas (Pyakyakhinskoye field) ⁽²⁾	462	–	–

⁽¹⁾ Translated to and from rubles using average exchange rate for the period.

⁽²⁾ Gas production started in January 2017.

The table below illustrates the impact of tax incentives on taxation of crude oil production from different fields and deposits in our portfolio at \$50 per barrel Urals price.

	Mineral extraction tax	Export duty	Total	As % of oil price
(in US dollars per barrel, except for figures in percent)				
Under 2017 tax formulae				
Standard	17.5	11.5	29.0	58.1
Yaregskoye field	0.0	1.8	1.8	3.6
Yu. Korchagin field.....	7.3	0.0	7.3	14.5
V. Filanovsky field.....	7.5	0.0	7.5	15.0
Usinskoye (Permian layers)	7.3	11.5	18.8	37.5
Pyakyakhinskoye field	7.3	11.5	18.8	37.5
V. Vinogradov field	9.3	11.5	20.8	41.6
Fields with depletion above 80%	10.4-17.5	11.5	21.9-29.0	43.7-58.1
New fields with reserves below 5 million tonnes	11.1-17.5	11.5	22.6-29.0	45.2-58.1
Tyumen deposits	15.5	11.5	27.0	54.0

The rates of taxes specific to the oil industry in Russia are linked to international crude oil prices and are changed in line with them. The methods to determine the rates for such taxes are presented below.

Crude oil extraction tax rate is changed monthly. Crude oil extraction tax is payable in rubles for metric tonnes extracted and is calculated according to the formula below:

$$Rate = Base Rate \times (Price - 15) \times \frac{Exchange Rate}{261} - Incentive + Fixed Component,$$

where *Price* is a Urals blend price in US dollars per barrel and *Exchange Rate* is an average ruble exchange rate to US dollar during the period. The *Base Rates* and *Fixed Components* (where applicable) are presented below:

	2016	2017	2018	2019	2020	2021
(in rubles per tonne)						
Base Rate	857	919	919	919	919	919
Fixed Component.....	–	306	357	428	428	0

There are different types of tax *Incentives* on the mineral extraction tax on crude oil applied to our fields and deposits:

- A special reducing coefficient is applied to the standard tax rate depending on location, depletion, type of reserves, size and complexity of a particular field. This type of incentive with different coefficients is applied to our highly depleted fields (more than 80% depletion), our Yu. Korchagin field located in the Caspian offshore, the Permian layers of our Usinskoye field in Timan-Pechora producing high-viscous crude oil, our Pyakyakhinskoye field located in the Yamal-Nenets region of Western Siberia, a number of fields in the Nenets Autonomous region, as well as to our new small-sized fields (recoverable reserves less than 5 million tonnes) and fields and deposits with low permeability like V.N. Vinogradov field and Tyumen deposits;
- A fixed tax rate of 15% of the international Urals price is applied to our V. Filanovsky field, located in the Caspian offshore;
- A zero tax rate is applied to our Yaregskoye field producing extra-viscous crude oil, as well as to unconventional deposits (Bazhenov and others).

Some of the mineral extraction tax incentives are limited in time or by cumulative oil production volumes.

The table on the p. 10 illustrates the impact of crude oil extraction tax incentives on taxation of crude oil production from different fields and deposits at \$50 per barrel Urals price.

Natural gas extraction tax rate is calculated using a special formula depending on average wholesale natural gas price in Russia, share of gas production in total hydrocarbon production, regional location and complexity of particular gas field. Associated petroleum gas and reinjected natural gas are subject to zero extraction tax rate.

Crude oil export duty rate is denominated in US dollars per tonne of crude oil exported and is calculated on a progressive scale according to the table below.

International Urals price	Export duty rate
Less than, or equal to, \$109.5 per tonne (\$15 per barrel)	\$0 per tonne
Above \$109.5 but less than, or equal to, \$146 per tonne (\$20 per barrel)	35% of the difference between the actual price and \$109.5 per tonne (or \$0.35 per barrel per each \$1 increase in the Urals price over \$15)
Above \$146 but less than, or equal to, \$182.5 per tonne (\$25 per barrel)	\$12.78 per tonne plus 45% of the difference between the actual price and \$146 per tonne (or \$1.75 plus \$0.45 per barrel per each \$1 increase in the Urals price over \$20)
Above \$182.5 per tonne (\$25 per barrel)	2015–2016: \$29.2 per tonne plus 42% of the difference between the actual price and \$182.5 per tonne (or \$4 plus \$0.42 per barrel per each \$1 increase in the Urals price over \$25) Starting from 1 January 2017: \$29.2 per tonne plus 30% of the difference between the actual price and \$182.5 per tonne (or \$4 plus \$0.3 per barrel per each \$1 increase in the Urals price over \$25)

The export duty rate changes every month with the rate for the next month being based on average Urals price for the period from the 15th day of the previous month to the 14th day of the current month. This calculation methodology results in the so-called “export duty lag effect”, when export duty rate lags the oil price changes, which may result in sizeable impact on our financial results in the periods of high oil price volatility.

The table below illustrates the impact of the “export duty lag effect” on the Urals price net of taxes.

	2nd quarter of		Change,	1st half of		Change,
	2017	2016	%	2017	2016	%
	(in US dollars per barrel, except for figures in percent)					
Enacted export duty on crude oil	11.55	9.20	25.5	11.69	8.37	39.8
Lag effect	(0.52)	2.53	(120.5)	(0.14)	0.92	(115.3)
Urals price (Argus)	48.43	43.40	11.6	50.17	37.59	33.5
Net Urals price ⁽¹⁾	20.03	21.43	(6.5)	20.79	19.06	9.1
Net Urals price ⁽¹⁾ assuming no lag	20.55	18.90	8.7	20.93	18.14	15.4
	(in rubles per barrel, except for figures in percent)					
Enacted export duty on crude oil	660	605	9.0	678	586	15.7
Lag effect	(30)	167	(117.8)	(7)	54	(113.9)
Urals price (Argus)	2,766	2,858	(3.2)	2,911	2,610	11.5
Net Urals price ⁽¹⁾	1,144	1,412	(19.0)	1,207	1,324	(8.9)
Net Urals price ⁽¹⁾ assuming no lag	1,174	1,245	(5.7)	1,214	1,270	(4.4)

⁽¹⁾ Urals price net of export duty and crude oil extraction tax.

Crude oil produced at some of our fields is subject to special export duty rates calculated according to special formulas, which are lower than standard rates. A reduced rate is applied to crude oil produced at our Yaregskoye field producing extra-viscous crude oil and our Yu. Korchagin field in the Caspian offshore. A zero rate applies to crude oil of our V. Filanovsky field also located in the Caspian offshore.

The table on the p. 10 illustrates the impact of crude oil export duty incentives on taxation of export of crude oil produced from different fields and deposits at \$50 per barrel Urals price.

Export duty rates on refined products are calculated by multiplying the current crude oil export duty rate by a coefficient according to the table below.

	2017 and further	2016
Multiplier for:		
Light and middle distillates	0.30	0.40
Diesel fuel	0.30	0.40
Gasolines.....	0.30	0.61
Straight-run gasoline	0.55	0.71
Fuel oil	1.00	0.82

Crude oil and refined products exports from Russia are subject to two steps of customs declaration and duty payments: temporary and complete. A temporary declaration is submitted based on preliminary exports volumes and the duty is paid in rubles translated from US dollars at the date of the temporary declaration. A complete declaration is submitted after receiving the actual data on the exported volumes, but no later than six months after the date of the temporary declaration. The final amount of the export duty is adjusted depending on the actual volumes, the US dollar exchange rate at the date of the complete declaration (except for pipeline deliveries when the exchange rate at the temporary declaration date is used) and the export duty rate. If temporary and complete declarations are submitted in different reporting periods, the final amount of the export duty is adjusted in the period of submission of the complete declaration. The high volatility of the ruble-dollar exchange rates may lead to significant adjustments. For the purposes of the IFRS consolidated financial statements, data from temporary declarations at the reporting period end is translated to rubles from US dollars using the period-end exchange rate.

Crude oil and refined products exported to member countries of the Customs Union in the Eurasian Economic Union of Russia, Belarus, Kazakhstan, Armenia and the Kyrgyz Republic (Customs Union) are not subject to export duties.

Excise on refined products. The responsibility to pay excises on refined products in Russia is imposed on refined product producers (except for straight-run gasoline). Only domestic sales volumes are subject to excises.

In other countries where the Group operates, excises are paid either by producers or retailers depending on the local legislation.

Excise rates on motor fuels in Russia are tied to the ecological class of fuel. Excise tax rates for the respective periods of 2017 and 2016 are listed below.

	2 nd quarter of 2017	2016	Change, %	1 st half of 2017	2016	Change, %
	(in rubles per tonne, except for figures in percent)					
Gasoline						
Below Euro-5.....	13,100	13,100	0.0	13,100	11,800	11.0
Euro-5	10,130	10,130	0.0	10,130	8,830	14.7
Diesel fuel						
All ecological classes.....	6,800	5,293	28.5	6,800	4,722	44.0
Motor oils.....	5,400	6,000	(10.0)	5,400	6,000	(10.0)
Straight-run gasoline.....	13,100	13,100	0.0	13,100	11,800	11.0

Excise tax rates starting from 2017 are listed below.

	2017	2018	2019	2020
	(in rubles per tonne)			
Gasoline				
Below Euro-5.....	13,100	13,100	13,100	13,624
Euro-5	10,130	10,535	10,957	11,395
Diesel fuel				
All ecological classes.....	6,800	7,072	7,355	7,649
Motor oils.....	5,400	5,400	5,400	5,616
Straight-run gasoline.....	13,100	13,100	13,100	13,100

Income tax. Until 2017, the federal income tax rate was 2.0% and the regional income tax rate varied between 13.5% and 18.0%. In 2017–2020, the federal income tax rate is 3.0% and the regional income tax rate may vary between 12.5% and 17.0%.

The Company and its Russian subsidiaries file income tax returns in Russia. A number of Group companies in Russia are paying income tax as a consolidated taxpayers' group ("CTG"). This allows taxpayers to offset taxable losses generated by certain participants of a CTG against taxable profits of other participants of the CTG.

The Group's foreign operations are subject to taxes at the tax rates applicable to the jurisdictions in which they operate.

Transportation tariffs on crude oil, natural gas and refined products in Russia

Many of our production assets are located relatively far from our customers. As a result, transportation tariffs are an important factor affecting our profitability.

Crude oil produced at our fields in Russia is transported to refineries and exported primarily through the trunk oil pipeline system of the state-owned company, Transneft. In some cases, crude oil is also transported via railway infrastructure of the state-owned company, Russian Railways.

Refined products produced at our Russian refineries are transported primarily by railway (Russian Railways) and the pipeline system of Transnefteproduct, a subsidiary of Transneft.

Gas that is not sold at the wellhead is transported by the Unified Gas Supply System owned and operated by Gazprom.

Transneft, Russian Railways and Gazprom are state-controlled natural transportation infrastructure monopolies and their tariffs are regulated by the Federal Antimonopoly Service of Russia and set in rubles.

The following table sets forth the changes in the average tariffs charged by the state-controlled transportation service providers in Russia.

	2nd quarter of 2017 to 2nd quarter of 2016	1st half of 2017 to 1st half of 2016
Transneft		
Crude oil	3.5%	3.4%
Russian Railways		
Crude oil and refined products	6.0%	6.0%

Segments highlights

Our operations are divided into three main business segments:

- **Exploration and Production** – which includes our exploration, development and production operations related to crude oil and gas. These activities are primarily located within Russia, with additional activities in Azerbaijan, Kazakhstan, Uzbekistan, the Middle East, Northern and Western Africa, Norway, Romania and Mexico.
- **Refining, Marketing and Distribution** – which includes refining, petrochemical and transport operations, marketing and trading of crude oil, natural gas and refined products, generation, transportation and sales of electricity, heat and related services.
- **Corporate and other** – which includes operations related to our headquarters (which coordinates the operations of Group companies), finance activities, and certain other activities.

Each of our segments is dependent on the other, with a portion of the revenues of one segment being a part of the costs of the other. In particular, our Refining, Marketing and Distribution segment purchases crude oil from our Exploration and Production segment. As a result of certain factors considered in the “Domestic crude oil and refined products prices” section on p. 7, benchmarking crude oil market prices in Russia cannot be determined with certainty. Therefore, the prices set for inter-segment purchases of crude oil reflect a combination of market factors, primarily international crude oil market prices, transportation costs, regional market conditions, the cost of crude oil refining and other factors. We present the financial data for each segment in Note 29 “Segment information” to our condensed interim consolidated financial statements.

Exploration and production

The following table summarized key figures on our Exploration and production segment:

	2 nd quarter of		1 st half of	
	2017	2016	2017	2016
	(millions of rubles)			
EBITDA in Russia.....	95,679	124,867	207,738	222,555
EBITDA outside Russia ⁽¹⁾	17,908	13,360	33,626	45,258
EBITDA.....	113,587	138,227	241,364	267,813
Hydrocarbon extraction expenses	52,142	53,594	102,009	107,671
- in Russia.....	44,313	41,107	87,265	80,818
- outside Russia ⁽²⁾	3,108	4,080	5,701	8,243
- in Iraq.....	4,721	8,407	9,043	18,610
	(ruble per BOE)			
Hydrocarbon extraction expenses ⁽²⁾	243	239	240	232
- in Russia	248	235	245	228
- outside Russia ⁽²⁾	189	288	178	270
	(US dollar per BOE)			
Hydrocarbon extraction expenses ⁽²⁾	4.25	3.62	4.14	3.31
- in Russia.....	4.33	3.56	4.23	3.27
- outside Russia ⁽²⁾	3.31	4.36	3.08	3.86

⁽¹⁾ Including EBITDA of the West Qurna-2 project in the amounts of 3,843 million RUB and 6,890 million RUB in the second quarter of 2017 and 2016 and in the amounts of 6,786 million RUB and 28,384 million RUB in the first half of 2017 and 2016, respectively.

⁽²⁾ Excluding expenses at the West Qurna-2 field.

Our upstream EBITDA declined by 17.8%, compared to the second quarter of 2016, and by 9.9%, compared to the first half of 2016.

In Russia, our EBITDA decreased due to the export duty lag effect and ruble appreciation, as well as lower crude oil production volumes due to temporary external limitations driven by the OPEC agreement. The increase in share of high-margin volumes in our overall production mix partially offset these negative external effects.

Outside Russia, EBITDA of the West Qurna-2 project decreased substantially as we were compensated for the most part of costs incurred at the field development stage and moved to production maintenance stage. Excluding West Qurna-2, our international upstream EBITDA increased substantially due to higher average international hydrocarbon prices and positive production dynamics of our gas projects, as well as business optimization measures.

Crude oil and natural gas liquids production. In the first half of 2017, we produced (including the Company's share in equity affiliates) 43.6 million tonnes or 321.9 million barrels of crude oil, compared to 46.8 million tonnes or 342.8 million barrels of crude oil in the first half of 2016.

In the first half of 2017, the output of natural gas liquids at the Group gas processing plants in Western Siberia, Ural and Volga regions of Russia was 6.5 million BOE, compared to 6.8 million BOE in the first half of 2016.

	2 nd quarter of		1 st half of	
	2017	2016	2017	2016
	(thousand BOE per day)			
Crude oil and natural gas liquids⁽¹⁾				
Consolidated subsidiaries				
Western Siberia	809	845	815	855
Timan-Pechora	303	341	312	343
Ural region	325	323	324	323
Volga region.....	197	126	190	130
Other in Russia.....	33	36	35	36
Total in Russia.....	1,667	1,671	1,676	1,687
Iraq ⁽²⁾	36	69	34	132
Other outside Russia.....	45	37	45	43
Total outside Russia.....	81	106	79	175
Total consolidated subsidiaries	1,748	1,777	1,755	1,862
Our share in equity affiliates				
in Russia	22	21	22	20
outside Russia.....	38	38	38	39
Total share in equity affiliates.....	60	59	60	59
Total crude oil and natural gas liquids	1,808	1,836	1,815	1,921
Natural and petroleum gas⁽³⁾				
Consolidated subsidiaries				
Western Siberia	224	179	217	184
Timan-Pechora	35	33	36	32
Ural region	16	14	16	16
Volga region.....	23	27	21	24
Other in Russia.....	1	1	1	1
Total in Russia.....	299	254	291	257
Total outside Russia.....	136	118	131	125
Total consolidated subsidiaries	435	372	422	382
Share in equity affiliates				
in Russia	2	2	1	1
outside Russia.....	13	13	13	13
Total share in production of equity affiliates.....	15	15	14	14
Total natural and petroleum gas.....	450	387	436	396
Total daily hydrocarbon production	2,258	2,223	2,251	2,317

⁽¹⁾ Natural gas liquids produced at the Group gas processing plants.

⁽²⁾ Compensation oil that represented approximately 8.5% of production from the West Qurna-2 field in the first half of 2017 and 32.0% in the first half of 2016.

⁽³⁾ Natural and petroleum gas production excluding flaring, reinjection, and direction to Group's gas processing plants.

The following table presents our crude oil production in the first half of 2017 and 2016 by major regions.

(thousands of tonnes)	Change to 2016				1st half of 2016
	1st half of 2017	Total, %	Change in structure	Organic change	
Western Siberia.....	19,560	(5.2)	–	(1,069)	20,629
Timan-Pechora.....	7,821	(9.5)	–	(823)	8,644
Ural region.....	7,522	(0.3)	–	(26)	7,548
Volga region.....	4,552	44.1	–	1,392	3,160
Other in Russia.....	843	(8.6)	–	(79)	922
Crude oil produced in Russia.....	40,298	(1.5)	–	(605)	40,903
Iraq ⁽¹⁾	887	(74.7)	–	(2,623)	3,510
Other outside Russia.....	1,013	1.3	–	13	1,000
Crude oil produced outside Russia.....	1,900	(57.9)	–	(2,610)	4,510
Total crude oil produced by consolidated subsidiaries.....	42,198	(7.1)	–	(3,215)	45,413
Our share in crude oil produced by equity affiliates:					
in Russia.....	518	10.7	–	50	468
outside Russia.....	874	(2.1)	–	(19)	893
Total crude oil produced.....	43,590	(6.8)	–	(3,184)	46,774

⁽¹⁾ Compensation oil that represented approximately 8.5% of production from the West Qurna-2 field in the first half of 2017 and 32.0% in the first half of 2016.

The main oil producing region for the Company is Western Siberia where we produced 46.4% of our crude oil in the first half of 2017 (45.4% in the first half of 2016).

In October 2016, we started commercial production at two new major fields, the V. Filanovsky field in the Caspian Sea (Volga region) and the Pyakyakhinskoye field in the Bolshekhetskaya depression (Western Siberia). These fields have a major positive impact on our financial results due to high quality reserve base and tax incentives. In the first half of 2017, the Group produced 2,004 thousand tonnes of crude oil at the V. Filanovsky field and 736 thousand tonnes of liquids at the Pyakyakhinskoye field. In the second quarter of 2017, production from these fields increased by 25.8% and 11.7%, respectively, compared to the first quarter of 2017.

A decrease in our production volumes in the first half of 2017 in Russia was mainly driven by a temporary external limitation due to an agreement of OPEC and some of the non-OPEC countries, including Russia, to cut production from October 2016 levels in order to stabilize the global crude oil market. We limited production in our traditional regions (Western Siberia, Timan-Pechora, Ural) by closing least-productive wells, wells with high water cut and high lifting costs. We also decreased a number of workover operations. Moreover, crude oil production in Timan-Pechora was affected by adverse weather conditions and temporary decrease in production from one of the fields as a result of a fire. At the same time, we continued ramping up production at the V. Filanovsky and Pyakyakhinskoye fields.

The decrease in our international production was a result of lower volumes of production from the West Qurna-2 oilfield in Iraq attributable to the Company. We were compensated for most of the costs incurred within the construction stage of the project and therefore were eligible for less volumes of compensation crude oil (for details see p. 17).

The increase in our share in crude oil produced by equity affiliates in Russia was due to an increase in production at the Trebs and Titov oilfields by Bashneft-Polus, where the Group holds a 25.1% interest.

Gas production. In the first half of 2017, we produced (including our share in equity affiliates) 13,411 million cubic meters (78.9 million BOE) of gas, that is 9.4% more than in the first half of 2016.

The following table presents our gas production (excluding flaring, reinjected gas and gas used in production of natural gas liquids) by major regions.

(millions of cubic meters)	Change to 2016				
	1 st half of 2017	Total, %	Change in structure	Organic change	1 st half of 2016
Western Siberia.....	6,658	16.8	–	957	5,701
Timan-Pechora.....	1,095	9.1	–	91	1,004
Ural region	498	3.1	–	15	483
Volga region	661	(12.0)	–	(90)	751
Other in Russia.....	16	(11.1)	–	(2)	18
Gas produced in Russia	8,928	12.2	–	971	7,957
Gas produced outside Russia	4,027	4.2	–	163	3,864
Total gas produced by consolidated subsidiaries	12,955	9.6	–	1,134	11,821
Our share in gas produced by equity affiliates:					
in Russia	48	17.1	–	7	41
outside Russia	408	2.3	–	9	399
Total gas produced.....	13,411	9.4	–	1,150	12,261

Our major gas production region is Western Siberia (Bolshekhetskaya depression), where the major part of gas is produced from the Nakhodkinskoe field, which has been developed since 2005. In January 2017, we started gas production from our second field in Bolshekhetskaya depression, the Pyakyakhinskoye field, which substantially contributed to our overall gas production in Russia that increased by 12.2% compared to the first half of 2016. Of this increase, 1,412 million cubic meters is related to the Pyakyakhinskoe field. Our international gas production (including our share in affiliates' production) increased by 4.0%, compared to the first half of 2016, as a result of commissioning of new gas treatment facilities within Gissar project in Uzbekistan.

West Qurna-2 project

The West Qurna-2 field in Iraq is one of the largest crude oil fields discovered in the world, with estimated recoverable oil reserves of 12.9 billion barrels (1.8 billion tonnes). Service agreement for the West Qurna-2 field development and production was signed on 31 January 2010. Currently, the parties of the project are Iraq's state-owned South Oil Company and a consortium of contractors, consisting of a Group company (75% interest) and Iraq's state-owned North Oil Company (25% interest).

The Group launched the "Mishrif Early Oil" stage on the field and reached the production of 120 thousand barrels per day in March 2014. According to the service agreement, starting from the second quarter of 2014, we receive cost compensation. The project's target production level is 1.2 million barrels per day and the total term of the contract is 25 years.

Accounting for the cost compensation within the West Qurna-2 project in our consolidated statement of financial position and consolidated statement of profit or loss and other comprehensive income is as follows.

Capital expenditures are recognized in *Property, plant and equipment*. Extraction expenses are recognized in *Operating expenses* in respect of all the volume of crude oil production at the field regardless of the volume of compensation crude oil the Group is eligible for. As the compensation revenue is recognized, capitalized costs are amortized.

There are two steps of revenue recognition:

- The Iraqi party, on a quarterly basis, approves invoice for cost recovery and remuneration fee for which the Group is eligible in the reporting period. Amount of the invoice depends on crude oil production volumes during the period and current crude oil market prices. Approved invoice amount and remuneration fee for the reporting quarter are recognized in crude oil sales revenue.
- Based on the approved invoices, the Iraqi party arranges schedule of crude oil shipments against its liability for cost compensation and remuneration. As this crude oil is actually shipped, its cost is recognized at current market price in Cost of purchased crude oil, gas and products. Further, revenue from sales of this crude oil, or products from its refining, is recognized in *Sales*. Unsold crude oil and refined products are recognized in *Inventories*.

The following table summarizes data on capital and operating costs incurred, compensation crude oil received, costs yet unrecovered and remuneration fee.

	Costs incurred ⁽¹⁾	Remuneration fee	Crude oil received	Crude oil to be received
		(millions of US dollars)		
Cumulative at 31 December 2016	7,532	272	7,275	529
Change during the first half of 2017.....	252	30	230	52
Income tax.....	–	(60)	–	(60)
Cumulative at 30 June 2017	7,784	242	7,505	521

⁽¹⁾ Including prepayments.

The West Qurna-2 project's summary is presented below:

	2 nd quarter of			
	2017			2016
	(thousand barrels)	(thousand tonnes)	(thousand barrels)	(thousand tonnes)
Total production.....	35,755	5,212	37,044	5,400
Production related to cost compensation and remuneration ⁽¹⁾	3,309	482	6,241	909
Shipment of compensation crude oil ⁽¹⁾⁽²⁾	2,034	296	17,755	2,588
	(millions of rubles)	(millions of US dollars)	(millions of rubles)	(millions of US dollars)
Cost compensation	8,074	141	13,381	203
Remuneration fee	573	11	2,097	32
	8,647	152	15,478	235
Cost of compensation crude oil, received as liability settlement (included in <i>Cost of purchased crude oil, gas and products</i>) ⁽²⁾	5,035	88	44,518	676
Extraction expenses	4,721	83	8,407	127
Depreciation, depletion and amortization.....	3,430	60	4,968	73
EBITDA.....	3,843	67	6,890	105

⁽¹⁾ Translated into barrels using conversion rate characterizing the density of the field.

⁽²⁾ This crude oil is sold to third party customers or delivered to our refineries. After realization of these products, respective sales revenues are recognized.

	1 st half of			
	2017			2016
	(thousand barrels)	(thousand tonnes)	(thousand barrels)	(thousand tonnes)
Total production.....	71,715	10,454	75,062	10,942
Production related to cost compensation and remuneration ⁽¹⁾	6,084	887	24,081	3,510
Shipment of compensation crude oil ⁽¹⁾⁽²⁾	5,018	731	35,282	5,143
	(millions of rubles)	(millions of US dollars)	(millions of rubles)	(millions of US dollars)
Cost compensation	14,562	251	42,860	598
Remuneration fee	1,719	30	4,536	65
	16,281	281	47,396	663
Cost of compensation crude oil, received as liability settlement (included in <i>Cost of purchased crude oil, gas and products</i>) ⁽²⁾	13,367	230	73,994	1,071
Extraction expenses	9,043	156	18,610	264
Depreciation, depletion and amortization.....	5,676	98	24,345	330
EBITDA.....	6,786	117	28,384	393

⁽¹⁾ Translated into barrels using conversion rate characterizing the density of the field.

⁽²⁾ This crude oil is sold to third party customers or delivered to our refineries. After realization of these products, respective sales revenues are recognized.

The decrease in volumes of crude oil production related to cost compensation and remuneration was due to compensation of the most part of costs incurred at the field development stage and approximately threefold decrease in remuneration fee since February 2017 due to lower than target production volumes according to the provisions of the service contract.

Refining, marketing and distribution

The following table summarized key figures on our Refining, marketing and distribution segment:

	2 nd quarter of		1 st half of	
	2017	2016	2017	2016
	(millions of rubles)			
EBITDA in Russia.....	55,800	28,743	93,647	72,636
EBITDA outside Russia	6,668	22,900	39,348	42,517
EBITDA.....	62,468	51,643	132,995	115,153
Refining expenses at the Group refineries	19,991	22,804	41,002	45,254
- in Russia	9,432	11,076	19,581	21,211
- outside Russia	10,559	11,728	21,421	24,043
	(ruble per tonne)			
Refining expenses at the Group refineries	1,219	1,390	1,258	1,405
- in Russia	903	1,120	935	1,064
- outside Russia	1,776	1,799	1,841	1,957
	(US dollar per tonne)			
Refining expenses at the Group refineries	21.14	21.09	21.59	20.08
- in Russia	15.80	17.00	16.11	15.24
- outside Russia	31.07	27.30	31.74	27.93

In Russia, our downstream EBITDA increased substantially due to better product slate at our refineries, higher domestic prices, increased production volumes and decrease in refining expenses. Outside Russia, our EBITDA was affected by lower refining volumes, crude oil inventory effect at the refineries driven by declining oil price trend, as well as lower trading margins and the ruble appreciation.

Refining and petrochemicals

The following table summarizes key figures for our refining volumes:

	2 nd quarter of		1 st half of	
	2017	2016	2017	2016
	(thousands of tonnes)			
Refinery throughput at the Group refineries	16,394	16,408	32,590	32,220
- in Russia	10,447	9,889	20,953	19,937
- outside Russia, including	5,947	6,519	11,637	12,283
- crude oil	5,359	5,110	10,478	9,538
- refined products	588	1,409	1,159	2,745
Refinery throughput at third party refineries	1,678	73	3,074	165
Total refinery throughput	18,072	16,481	35,664	32,385
Production of the Group refineries in Russia	9,857	9,365	19,768	18,818
- diesel fuel	3,900	3,142	7,578	6,389
- gasoline	2,047	1,837	3,879	3,643
- fuel oil	1,212	1,116	2,711	2,672
- jet fuel	651	469	1,218	910
- lubricants and components	283	263	551	502
- straight-run gasoline	536	503	1,108	1,006
- vacuum gas oil	29	622	503	1,293
- bitumen	276	228	418	364
- coke	229	256	472	459
- other products	694	929	1,330	1,580
Production of the Group refineries outside Russia	5,622	6,095	10,949	11,509
- diesel fuel	2,437	2,601	4,749	4,895
- gasoline	1,252	1,301	2,459	2,468
- fuel oil	870	925	1,618	1,786
- jet fuel	256	236	495	420
- straight-run gasoline	204	206	397	364
- coke	46	53	84	108
- other products	557	773	1,147	1,468
Refined products produced by the Group	15,479	15,460	30,717	30,327
Refined products produced at third party refineries	1,653	71	3,031	159
Total refined products produced	17,132	15,531	33,748	30,486
Products produced at petrochemical plants and facilities	304	322	639	646
- in Russia	212	225	452	458
- outside Russia	92	97	187	188

Compared to the first half of 2016, the total volume of refined products produced by the Group increased by 1.3%.

Production at our refineries in Russia increased by 5.0% largely as a result of the planned maintenance at our refineries in Nizhny Novgorod and Volgograd in the first half of 2016.

In Russia, we continued improving our refined product slate by launching new conversion facilities and cross-supplies of dark products produced at Perm and Ukhta refineries to catalytic cracking units at our refineries in Nizhny Novgorod and Volgograd. As a result, share of gasoline and diesel fuel in our total production volumes increased by 4.6 p.p. compared the first half of 2016 and share of fuel oil and vacuum gasoil decreased by 5.0 p.p. Also, purchased additives were partially substituted with additives of own production that resulted in the optimization of operating expenses.

Internationally, the production decreased by 4.9% due to scheduled maintenance works at our refineries in Italy and Romania. At the same time, as a result of the change in price environment, the volume of crude oil processing increased by 9.9% while the volume of refined product processing decreased more than twofold.

In the periods considered, we processed our crude oil at third party refineries in Belarus and Kazakhstan. Moreover, in the end of 2016, a Group company entered into a processing agreement with a Canadian refinery. In the first half of 2017, attributable refined products output amounted to 2,918 thousand tonnes. The agreement is valid through 2019.

Marketing and trading

In addition to our production, we purchase crude oil in Russia and on international markets. In Russia, we primarily purchase crude oil from affiliated producing companies and other producers. Then we either refine or export purchased crude oil. Crude oil purchased on international markets is normally used for trading activities, for supplying our international refineries or for processing at third party refineries.

In Russia, we purchase refined products on occasion, primarily to manage supply chain bottlenecks. Refined products purchases outside Russia are either traded or supplied to our international refineries.

We undertake trading operations on international markets through our 100% subsidiary LITASCO. We use traditional physical volumes hedging techniques to hedge our trading operations to secure trading margin.

The following table shows the volumes of crude oil purchases by the Group during the periods considered.

	2 nd quarter of		1 st half of	
	2017	2016	2017	2016
	(thousands of tonnes)			
Crude oil purchases				
in Russia	264	206	511	414
for trading internationally	9,415	5,824	17,052	12,119
for refining internationally	5,242	3,951	10,855	7,293
Shipment of the West Qurna-2 compensation crude oil.....	296	2,588	731	5,143
Total crude oil purchased.....	15,217	12,569	29,149	24,969

The table below summarizes figures for our refined products marketing and trading activities.

	2 nd quarter of		1 st half of	
	2017	2016	2017	2016
	(thousands of tonnes)			
Retail sales.....	3,490	3,402	6,806	6,641
Wholesale sales.....	28,930	28,365	57,564	54,602
Total refined products sales	32,420	31,767	64,370	61,243
Refined products purchased in Russia	513	445	949	829
Refined products purchased internationally	14,779	17,245	30,894	32,632
Total refined products purchased	15,292	17,690	31,843	33,461

In 2016, in order to optimize our downstream operations, a Group company sold distribution companies operating in Poland, Lithuania, Latvia and Cyprus.

Exports of crude oil and refined products from Russia. The volumes of crude oil and refined products exported from Russia by our subsidiaries and export revenues (both to the Group companies and third parties) are summarized as follows:

	2 nd quarter of		1 st half of	
	2017	2016	2017	2016
	(thousands of tonnes)			
Exports of crude oil to Customs Union	794	972	1,429	1,954
Exports of crude oil beyond Customs Union	8,456	8,004	17,226	15,877
Total crude oil exports.....	9,250	8,976	18,655	17,831
Exports of crude oil through Transneft and other third party infrastructure.....	6,934	6,798	14,034	13,740
including volumes exported through ESPO pipeline	300	300	540	600
Exports of crude oil through the Group's transportation infrastructure.....	2,316	2,178	4,621	4,091
Total crude oil exports.....	9,250	8,976	18,655	17,831
	(millions of rubles)			
Exports of crude oil to Customs Union	11,938	15,563	22,611	27,973
Exports of crude oil beyond Customs Union	162,538	156,225	347,996	278,835
Total crude oil exports.....	174,476	171,788	370,607	306,808

	2 nd quarter of		1 st half of	
	2017	2016	2017	2016
	(thousands of tonnes)			
Refined products exports				
- diesel fuel	2,626	2,193	5,145	4,393
- gasoline	49	54	89	239
- fuel oil	651	663	1,669	1,610
- jet fuel	30	46	58	120
- motor oils	173	166	324	324
- gas refinery products	378	184	596	334
- other products.....	473	1,318	1,439	2,685
Total refined products exports.....	4,380	4,624	9,320	9,705
	(millions of rubles)			
Total refined products exports.....	101,039	99,474	218,698	189,323

In the first half of 2017, the volume of our crude oil exports from Russia increased by 4.6%, and we exported 46.3% of our domestic crude oil production (43.6% in the first half of 2016) and 225 thousand tonnes of crude oil purchased from our affiliates and third parties (216 thousand tonnes in the first half of 2016). The increase in export volumes was a result of lower domestic sales. The volume of our refined products exports decreased by 4.0% compared to the first half of 2016 following the increase in domestic sales due to higher profitability of the domestic market.

Substantially, we use the Transneft infrastructure to export our crude oil. Nevertheless, a sizeable amount of crude oil is exported through our own infrastructure. All the volume of crude oil exported that bypassed Transneft was routed beyond the Customs Union.

The Company also exports its light crude oil through the Caspian Pipeline Consortium and Eastern Siberia – Pacific Ocean pipelines that allows us to preserve the premium quality of crude oil and thus enables us to achieve higher netbacks compared to traditional exports.

Priority sales channels. We develop our priority sales channels aiming at increasing our margin on sale of refined products produced by the Group.

In the first half of 2017, we sold 5 million tonnes of motor fuels via our domestic retail network, that represented an increase of 6.5% against the first half of 2016. Outside Russia, retail sales decreased to 2 million tonnes, or by 6.0%, mostly as a result of divestment of our retail networks in Poland, the Baltic states and Cyprus.

We also supply jet fuel to airports in and outside Russia and bunker fuel to sea and river ports in Russia.

Power generation. We established a vertically integrated chain from generation to transportation and sale of power and heat for third party customers (commercial generation) and own consumption. We own commercial generation facilities in the Southern regions of European Russia. We also own renewable energy capacity in Russia and abroad. In the first half of 2017, our total output of commercial electrical energy was 8.8 billion kWh (9.0 billion kW-h in the first half of 2016), and our total output of commercial heat energy was approximately 6.3 million Gcal (7.2 million Gcal in the first half of 2016).

Financial results

The table below sets forth data from our consolidated statements of profit or loss and other comprehensive income for the periods indicated.

	2 nd quarter of		1 st half of	
	2017	2016	2017	2016
(millions of rubles)				
Revenues				
Sales (including excise and export tariffs)	1,359,170	1,338,959	2,790,769	2,516,633
Costs and other deductions				
Operating expenses	(110,574)	(113,709)	(218,066)	(226,953)
Cost of purchased crude oil, gas and products	(701,164)	(677,297)	(1,443,733)	(1,215,030)
Transportation expenses.....	(67,516)	(77,665)	(141,230)	(164,364)
Selling, general and administrative expenses.....	(39,245)	(45,302)	(75,531)	(93,125)
Depreciation, depletion and amortization	(84,162)	(71,608)	(164,936)	(155,956)
Taxes other than income taxes	(145,640)	(118,724)	(299,322)	(202,277)
Excise and export tariffs	(115,328)	(113,820)	(224,775)	(228,769)
Exploration expenses	(659)	(2,871)	(1,423)	(4,552)
Profit from operating activities.....	94,882	117,963	221,753	225,607
Finance income	3,102	3,511	6,401	7,342
Finance costs.....	(6,767)	(11,098)	(16,237)	(21,469)
Equity share in income of affiliates.....	3,955	3,425	7,685	5,778
Foreign exchange gain (loss)	27,786	(28,945)	(15,708)	(74,323)
Other income (expenses).....	47,828	(4,205)	45,341	(7,548)
Profit before income taxes	170,786	80,651	249,235	135,387
Current income taxes	(32,183)	(17,183)	(44,939)	(27,659)
Deferred income taxes	191	(774)	(2,818)	(2,064)
Total income tax expense.....	(31,992)	(17,957)	(47,757)	(29,723)
Profit for the period.....	138,794	62,694	201,478	105,664
Profit for the period attributable to non-controlling interests.....	(146)	(127)	(524)	(272)
Profit for the period attributable to PJSC LUKOIL shareholders	138,648	62,567	200,954	105,392
Basic and diluted earnings per share of common stock attributable to PJSC LUKOIL shareholders (in Russian rubles).....	195	88	282	148

The analysis of the main financial indicators of the financial statements is provided below.

Sales revenues

Sales breakdown	2 nd quarter of		1 st half of	
	2017	2016	2017	2016
(millions of rubles)				
Crude oil				
Export and sales on international markets other than Customs Union	340,942	310,014	723,145	558,242
Export and sales to Customs Union	15,526	15,366	22,109	27,768
Domestic sales	9,110	23,404	18,012	44,744
	365,578	348,784	763,266	630,754
Cost compensation and remuneration at the West Qurna-2 project	8,647	15,478	16,281	47,396
	374,225	364,262	779,547	678,150
Refined products ⁽¹⁾				
Export and sales on international markets				
Wholesale	653,221	678,358	1,367,562	1,234,942
Retail	66,393	74,011	129,100	155,463
Domestic sales				
Wholesale	84,498	56,847	152,402	107,412
Retail	100,837	90,924	195,303	172,621
	904,949	900,140	1,844,367	1,670,438
Petrochemicals				
Export and sales on international markets	13,336	8,804	25,462	18,962
Domestic sales	9,361	8,915	19,107	18,094
	22,697	17,719	44,569	37,056
Gas				
Sales on international markets	12,583	8,256	22,181	19,515
Domestic sales	7,898	6,921	14,931	14,073
	20,481	15,177	37,112	33,588
Sales of energy and related services				
Sales on international markets	2,204	2,797	5,591	6,525
Domestic sales	12,126	11,642	32,188	30,678
	14,330	14,439	37,779	37,203
Other				
Export and sales on international markets	11,085	14,545	25,715	37,302
Domestic sales	11,403	12,677	21,680	22,896
	22,488	27,222	47,395	60,198
Total sales	1,359,170	1,338,959	2,790,769	2,516,633

Sales volumes	2 nd quarter of		1 st half of	
	2017	2016	2017	2016
(thousands of tonnes)				
Crude oil				
Export and sales on international markets other than Customs Union	16,583	15,299	33,590	30,319
Export and sales to Customs Union	1,011	959	1,403	1,932
Domestic sales	637	1,585	1,195	3,467
	18,231	17,843	36,188	35,718
Crude oil volumes related to cost compensation and remuneration at the West Qurna-2 project	482	909	887	3,510
	18,713	18,752	37,075	39,228
Refined products ⁽¹⁾				
Export and sales on international markets				
Wholesale	25,350	25,597	51,117	49,084
Retail	1,042	1,034	1,999	2,127
Domestic sales				
Wholesale	3,580	2,768	6,447	5,518
Retail	2,448	2,368	4,807	4,514
	32,420	31,767	64,370	61,243
Petrochemicals				
Export and sales on international markets	252	171	484	418
Domestic sales	188	158	377	324
	440	329	861	742
Total sales volumes	51,573	50,848	102,306	101,213

⁽¹⁾ Including revenue from, and volumes of, gas refined products sales.

Realized average sales prices

		2 nd quarter of		1 st half of	
		2017	2016	2017	2016
Average realized price on international markets					
Crude oil (beyond Customs Union) ⁽¹⁾	(RUB/barrel)	2,805	2,764	2,937	2,512
Crude oil (Customs Union)	(RUB/barrel)	2,095	2,186	2,150	1,961
Refined products					
Wholesale	(RUB/tonne)	25,768	26,502	26,754	25,160
Retail.....	(RUB/tonne)	63,717	71,543	64,582	73,090
Petrochemicals.....	(RUB/tonne)	52,921	51,485	52,607	45,364
Crude oil (beyond Customs Union) ⁽¹⁾	(\$/barrel)	49.08	41.96	50.65	35.75
Crude oil (Customs Union)	(\$/barrel)	36.66	33.18	37.08	27.91
Refined products					
Wholesale	(\$/tonne)	451	402	461	358
Retail.....	(\$/tonne)	1,115	1,086	1,114	1,040
Petrochemicals.....	(\$/tonne)	926	781	907	646
Average realized price within Russia					
Crude oil	(RUB/barrel)	1,951	2,014	2,056	1,761
Refined products					
Wholesale	(RUB/tonne)	23,603	20,535	23,639	19,466
Retail.....	(RUB/tonne)	41,191	38,404	40,629	38,241
Petrochemicals.....	(RUB/tonne)	49,793	56,424	50,682	55,846

⁽¹⁾ Excluding cost compensation and remuneration at the West Qurna-2 project.

During the second quarter of 2017, our revenues increased by 20 billion RUB, or by 1.5%, compared to the second quarter of 2016. Our revenues from crude oil sales increased by 10 billion RUB, or by 2.7%, and our revenues from sales of refined products increased by 5 billion RUB, or by 0.5%.

During the first half of 2017, our revenues increased by 274 billion RUB, or by 10.9%, compared to the first half of 2016. Our revenues from crude oil sales increased by 101 billion RUB, or by 15.0%, and our revenues from sales of refined products increased by 174 billion RUB, or by 10.4%.

The main reason for that was the increase in international hydrocarbon prices as well as the increase in crude oil and refined products trading volumes. That was partially compensated for by the effect of the ruble appreciation on our revenues denominated in other currencies.

Sales of crude oil

Compared to the second quarter and the first half of 2016, our international crude oil sales revenue increased by 10.0%, or by 31 billion RUB, and by 29.5%, or by 165 billion RUB, respectively. Our international sales volumes (beyond the Customs Union) increased by 1,284 thousand tonnes, or by 8.4%, in the second quarter of 2017, and by 3,271 thousand tonnes, or by 10.8%, in the first half of 2017, due to higher volumes of crude oil trading. Our average international ruble realized prices increased by 1.5% and by 16.9% compared to the second quarter and the first half of 2016, respectively.

Our realized domestic crude oil sales price decreased by 3.1% and increased by 16.8% compared to the second quarter and the first half of 2016, respectively. Our domestic sales volumes decreased by 948 thousand tonnes, or by 59.8%, and by 2,272 thousand tonnes, or by 65.5%, respectively, in favor of export deliveries and refining and also as a result of lower production. As a consequence, in the second quarter and the first half of 2017, our domestic sales revenue decreased by 61.1%, or by 14 billion RUB, and by 59.7%, or by 27 billion RUB, respectively.

Cost compensation and remuneration at the West Qurna-2 project

Included in Group's revenue is the cost compensation and remuneration fee related to the West Qurna-2 project in Iraq.

In the first half of 2017, the volumes of crude oil related to cost compensation and remuneration fee significantly decreased to the first half of 2016. Therefore the amount of cost compensation and remuneration fee decreased by 7 billion RUB, or by 44.1%, compared to the second quarter of 2016 and by 31 billion RUB, or by 65.6%, compared to the first half of 2016. For details see p. 17.

Sales of refined products

Compared to the second quarter of 2016, our revenue from the wholesale of refined products outside Russia decreased by 25 billion RUB, or by 3.7%, as a result of the ruble appreciation, and compared to the first half of 2016, it increased by 133 billion RUB, or by 10.7%, that was both price and volume driven. During the second quarter and the first half of 2017, our sales volumes decreased by 1.0% and increased by 4.1%, respectively. Our dollar realized prices increased by 12.1% and 28.8%, and our ruble realized prices decreased by 2.8% and increased by 6.3%, respectively.

During the second quarter and the first half of 2017, our dollar realized retail prices outside Russia increased by 2.7% and 7.1%, respectively, while our ruble realized prices decreased by 10.9% and 11.6%, respectively, due to the ruble appreciation. Our sales volumes increased by 0.8% to the second quarter of 2016 and decreased by 6.0% to the first half of 2016 as a consequence of sale of our retail networks in Eastern Europe. As a result, our international retail revenue decreased by 8 billion RUB, or by 10.3%, and by 26 billion RUB, or by 17.0%, compared to the second quarter and the first half of 2016, respectively.

During the second quarter and the first half of 2017, our revenue from the wholesale of refined products on the domestic market increased by 28 billion RUB, or by 48.6%, and by 45 billion RUB, or by 41.9%, respectively. Our realized prices increased by 14.9% and 21.4%, and our sales volumes increased by 29.3% and 16.8%, respectively.

In the second quarter and the first half of 2017, our revenue from refined products retail sales in Russia increased by 10 billion RUB, or by 10.9%, and by 23 billion RUB, or by 13.1%, respectively. Our average domestic retail prices increased by 7.3% and 6.2% and our average domestic retail volumes increased by 3.4% and 6.5%, respectively.

Sales of petrochemical products

In the second quarter and the first half of 2017, our revenue from sales of petrochemical products increased by 5 billion RUB, or by 28.1%, and by 8 billion RUB, or by 20.3%, respectively, largely as a result of the increased sales volumes.

Sales of gas

Compared to the second quarter and the first half of 2016, sales of gas increased by 5 billion RUB, or by 34.9%, and by 4 billion RUB, or by 10.5%, respectively, mainly as a result of the increase in gas production.

Sales of energy and related services

Compared to the respective periods of 2016, our revenue from sales of energy and related services didn't change significantly.

Other sales

Other sales include non-petroleum sales through our retail network, transportation services, rental revenue, crude oil extraction services, and other revenue of our production and marketing companies from sales of goods and services not related to our primary activities.

During the second quarter and the first half of 2017, revenue from other sales decreased by 5 billion RUB, or by 17.4%, and by 13 billion RUB, or by 21.3%, respectively. The non-petrol revenue of our retail network didn't change significantly compared to the second quarter of 2016 and decreased by 1 billion RUB, or by 8.8%, compared to the first half of 2016 as a result of the sale of our retail networks in Europe in 2016. In the second quarter and the first half of 2017, our revenue from transportation services decreased by 2 billion RUB, or by 42.7% and by 4 billion RUB, or by 40.0%, respectively. In the second quarter and the first half of 2017, our other sales also included revenue from sales of diamonds in the amount of 1 billion RUB and 6 billion RUB, respectively (3 billion RUB and 11 billion RUB in the second quarter and the first half of 2016).

Operating expenses

Operating expenses include the following:

	2 nd quarter of		1 st half of	
	2017	2016	2017	2016
	(millions of rubles)			
Hydrocarbon extraction expenses ⁽¹⁾	47,421	45,187	92,966	89,061
Extraction expenses at the West Qurna-2 field	4,721	8,407	9,043	18,610
Own refining expenses.....	19,991	22,804	41,002	45,254
Refining expenses at third parties refineries	1,937	173	3,012	421
Expenses for crude oil transportation to refineries.....	12,571	10,917	23,385	23,228
Power generation and distribution expenses	8,878	8,618	19,699	18,889
Petrochemical expenses	2,920	3,289	5,914	6,602
Other operating expenses	12,135	14,314	23,045	24,888
Total operating expenses	110,574	113,709	218,066	226,953

⁽¹⁾ Excluding extraction expenses at the West Qurna-2 field.

The method of allocation of operating expenses above differs from the approach used in preparing data for Note 29 “Segment information” to our condensed interim consolidated financial statements. Expenditures in the segment reporting are grouped depending on the segment to which a particular company belongs. Operating expenses for the purposes of this analysis are grouped based on the nature of the costs incurred.

Compared to the respective periods of 2016, our operating expenses decreased by 3 billion RUB, or by 2.8%, in the second quarter of 2017, and by 9 billion RUB, or by 3.9%, in the first half of 2017, largely as a result of the effect of the ruble appreciation to US dollar and Euro on the ruble value of foreign subsidiaries’ expenses and the decrease in expenses at the West Qurna-2 oilfield. These effects were partially offset by the increase in expenses in Russia as a result of the increase in tariffs and inflation.

Hydrocarbon extraction expenses

Our extraction expenses include expenditures related to repairs of extraction equipment, labor costs, expenses on artificial stimulation of reservoirs, fuel and electricity costs, cost of extraction of natural gas liquids, property insurance of extraction equipment and other similar costs.

	2 nd quarter of		1 st half of	
	2017	2016	2017	2016
	(millions of rubles)			
Hydrocarbon extraction expenses ⁽¹⁾	47,421	45,187	92,966	89,061
- in Russia.....	44,313	41,107	87,265	80,818
- outside Russia ⁽¹⁾	3,108	4,080	5,701	8,243
	(ruble per BOE)			
Hydrocarbon extraction expenses ⁽¹⁾	243	239	240	232
- in Russia	248	235	245	228
- outside Russia ⁽¹⁾	189	288	178	270

⁽¹⁾ Excluding expenses at the West Qurna-2 field.

In the second quarter and the first half of 2017, our extraction expenses increased by 2 billion RUB, or by 4.9%, and by 4 billion RUB, or by 4.4%.

In Russia, average hydrocarbon extraction expenses increased driven by higher costs of materials and services, as well as shift to more costly project benefiting from tax exemptions.

The decrease in expenses outside Russia was due to planned overhauls at our project in Kazakhstan in the second quarter of 2016 as well as the ruble appreciation.

Crude oil extraction expenses at the West Qurna-2 field

Crude oil extraction expenses at the West Qurna-2 field represent expenses related to 100% production from the field, while we are only eligible for a share of production that compensates our historically incurred costs and expenses. For details see p. 17.

The decrease in expenses in the first half of 2017 was a result of completion of commissioning stage of the field development and consecutive decrease in personnel involved and associated transportation, security and other related services provided.

Own refining expense

	2 nd quarter of		1 st half of	
	2017	2016	2017	2016
	(millions of rubles)			
Refining expenses at the Group refineries	19,991	22,804	41,002	45,254
- in Russia	9,432	11,076	19,581	21,211
- outside Russia	10,559	11,728	21,421	24,043
	(ruble per tonne)			
Refining expenses at the Group refineries	1,219	1,390	1,258	1,405
- in Russia	903	1,120	935	1,064
- outside Russia.....	1,776	1,799	1,841	1,957

During the second quarter and the first half of 2017, our own refining expenses decreased by 3 billion RUB, or by 12.3%, and by 4 billion RUB, or by 9.4%, respectively.

Despite the inflation, refining expenses at our domestic refineries decreased as a result of consumption of additives of own production following our refineries' upgrade and lower overhaul costs.

Outside Russia, the decrease in expenses was a result of lower throughput volumes and the ruble appreciation and amounted to 10.0% compared to the second quarter of 2016 and 10.9% compared to the first half of 2016.

Expenses for crude oil transportation to refineries

Expenses for crude oil transportation to refineries include pipeline, railway, freight and other costs related to delivery of crude oil and refined products to refineries for further processing.

During the second quarter, our expenses for crude oil transportation to refineries increased by 2 billion RUB, or by 15.2%, largely as a result of the increase in volumes of supplies of own crude to our refineries outside Russia, and did not change significantly at the first half of 2017.

Petrochemical expenses

In the second quarter and the first half of 2017, our petrochemical expenses decreased by 11.2% and by 10.4%, respectively, largely as a result of a decrease in raw materials cost in Russia and the effect of the ruble appreciation.

Other operating expenses

Other operating expenses include expenses of the Group's upstream and downstream entities that do not relate to their core activities, namely rendering of transportation and extraction services, costs of other services provided and goods sold by our production and marketing companies, and of non-core businesses of the Group.

In the second quarter and the first half of 2017, other operating expenses decreased by 2 billion RUB, or by 15.2%, and by 2 billion RUB, or by 7.4%, respectively, largely as a result of the decreased cost of transportation services provided to third parties, non-petrol sales of our retail network and the decrease in the ruble value of other operating expenses of our foreign subsidiaries.

Cost of purchased crude oil, gas and products

Cost of purchased crude oil, gas and products includes the cost of crude oil and refined products purchased for trading or refining, gas and fuel oil to supply our power generation entities and the result of hedging of crude oil and refined products sales.

	2 nd quarter of		1 st half of	
	2017	2016	2017	2016
	(millions of rubles)			
Cost of purchased crude oil in Russia	4,172	3,290	8,379	5,663
Cost of purchased crude oil outside Russia	290,491	200,973	579,679	362,391
Compensation crude oil related to West Qurna-2 project	5,035	44,518	13,367	73,994
Cost of purchased crude oil	299,698	248,781	601,425	442,048
Cost of purchased refined products in Russia	14,946	10,928	27,523	20,678
Cost of purchased refined products outside Russia	375,613	436,916	817,459	783,462
Cost of purchased refined products	390,559	447,844	844,982	804,140
Other purchases	7,810	5,684	19,859	14,985
Net (gain) loss from hedging of trading operations	(13,467)	35,572	(37,607)	34,344
Change in oil and petroleum products inventory	16,564	(60,584)	15,074	(80,487)
Total cost of purchased crude oil, gas and products	701,164	677,297	1,443,733	1,215,030

In the second quarter and the first half of 2017, the cost of purchased crude oil, gas and products increased by 24 billion RUB, or by 3.5%, and by 229 billion RUB, or by 18.8%, respectively, following the increase in hydrocarbon prices and volumes of crude oil trading. Crude oil purchases in the second quarter and the first half of 2017 also included 5 billion RUB and 13 billion RUB related to 296 thousand tonnes and 731 thousand tonnes of compensation crude oil received from Iraq's state-owned South Oil Company within the West Qurna-2 project (45 billion RUB and 74 billion RUB related to 2,588 thousand tonnes and 5,143 thousand tonnes of compensation crude oil in the second quarter and the first half of 2016).

Transportation expenses

	2 nd quarter of		1 st half of	
	2017	2016	2017	2016
	(millions of rubles)			
Crude oil transportation expenses	21,607	25,070	46,473	49,617
Refined products transportation expenses	41,572	47,149	85,355	105,606
Other transportation expenses	4,337	5,446	9,402	9,141
Total transportation expenses	67,516	77,665	141,230	164,364

Our transportation expenses decreased by 10 billion RUB, or by 13.1%, in the second quarter of 2017 and by 23 billion RUB, or by 14.1%, in the first half of 2017.

Our expenses for transportation of crude oil decreased both in Russia and internationally. In Russia, the increase in tariffs was offset by the decrease in volumes transported. Outside Russia, the decrease in tariffs and the ruble appreciation outweighed the effect of the increase in trading volumes.

Compared to the second quarter and the first half of 2016, our domestic expenses for transportation of refined products didn't change significantly. Outside Russia, the decrease was mainly a result of a decrease in tariffs amplified by the effect of the ruble appreciation.

Selling, general and administrative expenses

Selling, general and administrative expenses include payroll costs (excluding extraction entities', refineries' and power generation entities' production staff costs), insurance costs (except for property insurance related to extraction, refinery and power generation equipment), costs of maintenance of social infrastructure, movement in bad debt provision and other expenses. Our selling, general and administrative expenses are roughly equally split between domestic and international operations.

	2 nd quarter of		1 st half of	
	2017	2016	2017	2016
	(millions of rubles)			
Labor costs included in selling, general and administrative expenses.....	14,721	17,565	29,474	34,855
Other selling, general and administrative expenses	24,116	24,140	45,996	49,013
Increase (decrease) in liability related to share-based compensation program.....	454	2,400	(2,718)	6,344
(Income) expenses on provision for doubtful debts	(46)	1,197	2,779	2,913
Total selling, general and administrative expenses	39,245	45,302	75,531	93,125

Our selling, general and administrative expenses decreased by 6 billion RUB, or by 13.4%, in the second quarter of 2017, and by 18 billion RUB, or by 18.9%, in the first half of 2017. In Russia, expenses decreased mostly as a result of decrease of liabilities within share-based compensation program due to LUKOIL share price decline during the first half of 2017. Internationally, our expenses outside Russia decreased largely as a result of the effect of the ruble appreciation on the expenses of our foreign subsidiaries and the divestment of retail networks in Poland, Lithuania, Latvia and Cyprus.

Depreciation, depletion and amortization

Our depreciation, depletion and amortization expenses increased by 13 billion RUB, or by 17.5%, compared to the second quarter of 2016, and by 9 billion RUB, or by 5.8%, compared to the first half of 2016, resulting from the increase in the depreciation rate of upstream assets following the decrease in hydrocarbon proved reserves and the increase in value of depreciable assets. This was partially offset by the decrease in expenses related to the West Qurna-2 project. Our depreciation, depletion and amortization expenses for the second quarter and the first half of 2017 included 3 billion RUB and 6 billion RUB, respectively, related to the West Qurna-2 field. In the second quarter and the first half of 2016, those expenses amounted to 5 billion RUB and 24 billion RUB, respectively.

Equity share in income of affiliates

The Group has investments in equity method affiliates and corporate joint ventures. These companies are primarily engaged in crude oil exploration, production, marketing and distribution operations in the Russian Federation, crude oil production and marketing in Kazakhstan. Currently, our largest affiliates are Tengizchevroil, exploration and production company, operating in Kazakhstan, Bashneft-Polus, an exploration and production company that develops the Trebs and Titov oilfields in Timan-Pechora, Russia, South Caucasus Pipeline Company and Caspian Pipeline Consortium, midstream companies in Azerbaijan and Kazakhstan.

Our share in income of affiliates increased by 1 billion RUB, or by 15.5%, compared to the second quarter of 2016 and by 2 billion RUB, or by 33.0%, compared to the first half of 2016, largely, as a result of the increase in income of Tengizchevroil.

Taxes other than income taxes

	2 nd quarter of		1 st half of	
	2017	2016	2017	2016
	(millions of rubles)			
In Russia				
Mineral extraction taxes.....	131,651	105,073	271,039	174,811
Social security taxes and contributions	6,598	5,808	13,288	11,835
Property tax.....	4,820	4,728	9,609	9,266
Other taxes	420	642	1,227	1,097
Total in Russia.....	143,489	116,251	295,163	197,009
International				
Social security taxes and contributions	1,297	1,586	2,548	3,159
Property tax.....	236	38	406	564
Other taxes	618	849	1,205	1,545
Total internationally	2,151	2,473	4,159	5,268
Total	145,640	118,724	299,322	202,277

In the second quarter of 2017, our taxes other than income taxes increased by 27 billion RUB, or by 22.7%, and in the first half of 2017, they increased by 97 billion RUB, or by 48.0%. This was driven by the increase in the mineral extraction tax rate in Russia resulted from the increase in crude oil prices and mineral extraction tax base rate.

The following table summarizes data on application of reduced and zero mineral extraction tax rates for crude oil and natural gas produced in Russia (excluding V. Filanovsky field).

	2 nd quarter of		1 st half of	
	2017	2016	2017	2016
	(millions of rubles)			
Decrease in extraction taxes from application of reduced and zero rates for crude oil and gas production.....	16,677	15,483	35,568	26,388
	(thousands of tonnes)			
Volume of crude oil production subject to:				
zero rates.....	254	243	464	468
reduced rates (tax holidays for specific regions and high viscosity oil).....	1,356	1,142	2,767	2,365
reduced rates (depleted fields).....	3,522	3,542	7,134	7,197
reduced rates (other).....	783	878	1,622	1,701
Total volume of production subject to reduced or zero rates.....	5,915	5,805	11,987	11,731

Excise and export tariffs

	2 nd quarter of		1 st half of	
	2017	2016	2017	2016
	(millions of rubles)			
In Russia				
Excise tax on refined products.....	28,994	23,591	54,900	40,182
Crude oil export tariffs.....	35,782	30,872	72,566	62,364
Refined products export tariffs.....	10,546	9,160	23,743	24,686
Total in Russia.....	75,322	63,623	151,209	127,232
International				
Excise tax and sales taxes on refined products.....	39,830	50,100	73,291	101,317
Crude oil export tariffs.....	91	12	109	21
Refined products export tariffs.....	85	85	166	199
Total internationally.....	40,006	50,197	73,566	101,537
Total.....	115,328	113,820	224,775	228,769

In the second quarter and the first half of 2017, export tariffs increased by 6 billion RUB, or by 15.9%, and by 9 billion RUB, or by 10.7%, respectively. Compared to the second quarter and the first half of 2016, the volumes of crude oil export beyond the Customs Union increased by 5.6% and 8.5% and the volumes of the refined products exports decreased by 5.3% and 4.0%, respectively. The increase in excise tax expenses in Russia was driven by increase in rates and domestic sales volumes, while international excise expenses decreased due to the ruble appreciation and divestment of retail networks in Eastern Europe.

Foreign exchange gain (loss)

Foreign exchange gain (loss) mostly related to revaluation of US dollar and euro net monetary position of Russian entities that largely consists of accounts receivables, loans to our foreign subsidiaries and loans received in other currencies and it's current structure results in exchange gains when the ruble devaluates and losses when it appreciates to that currencies.

The decrease in ruble exchange rate during the second quarter of 2017 resulted in 28 billion RUB foreign exchange gain, as opposed to 29 billion RUB loss in the second quarter of 2016 that resulted from exchange rate increase. In the first half of 2017 and 2016, the increase in ruble exchange rate resulted in foreign exchange losses of 16 billion RUB and 74 billion RUB, respectively.

Other income (expenses)

Other income (expenses) include the financial effects of the disposal of assets, impairment losses, extraordinary gains and losses, revisions of estimates and other non-operating gains and losses.

In the second quarter of 2017, we recognized a profit before income tax from sale of our diamond business in the amount of 48 billion RUB (38 billion RUB after income tax). Moreover, in the second quarter of 2017, we received \$74 million (approximately 4.3 billion RUB) as a repayment of previously impaired receivable related to our international upstream project.

Income taxes

The maximum statutory income tax rate in Russia is 20%. Nevertheless, the actual effective income tax rate may be higher due to non-deductible expenses or lower due to certain non-taxable gains.

In the second quarter of 2017, our total income tax expense increased by 14 billion RUB, or by 78.2%, compared to the second quarter of 2016. At the same time, our profit before income tax increased by 90 billion RUB, or by 111.8%.

In the first half of 2017, our total income tax expense increased by 18 billion RUB, or by 60.7%, compared to the first half of 2016. At the same time, our profit before income tax increased by 114 billion RUB, or by 84.1%.

In the second quarter of 2017, our effective income tax rate was 18.7%, compared to 22.3% in the second quarter of 2016. In the first half of 2017, our effective income tax rate was 19.2%, compared to 22.0% in the first half of 2016.

Non-GAAP items reconciliation

Reconciliation of profit for the period to EBITDA

EBITDA is not defined under IFRS. We define EBITDA as profit from operating activities before depreciation, depletion and amortization. We believe that EBITDA provides useful information to investors because it is an indicator of the strength and performance of our business operations, including our ability to finance capital expenditures, acquisitions and other investments and our ability to raise and service debt. EBITDA should not be considered in isolation as an alternative to profit or any other measure of performance under IFRS.

	2 nd quarter of		1 st half of	
	2017	2016	2017	2016
	(millions of rubles)			
Profit for the period	138,794	62,694	201,478	105,664
Add back				
Income tax expense.....	31,992	17,957	47,757	29,723
Financial income.....	(3,102)	(3,511)	(6,401)	(7,342)
Financial costs	6,767	11,098	16,237	21,469
Foreign exchange (gain) loss	(27,786)	28,945	15,708	74,323
Equity share in income of affiliates	(3,955)	(3,425)	(7,685)	(5,778)
Other (income) expenses.....	(47,828)	4,205	(45,341)	7,548
Depreciation, depletion and amortization	84,162	71,608	164,936	155,956
EBITDA	179,044	189,571	386,689	381,563
EBITDA by operating segments				
Exploration and production ⁽¹⁾	113,587	138,227	241,364	267,813
Refining, marketing and distribution segment	62,468	51,643	132,995	115,153
Corporate and other.....	(2,476)	(2,279)	1,407	(278)
Elimination.....	5,465	1,980	10,923	(1,125)
EBITDA	179,044	189,571	386,689	381,563

⁽¹⁾ Including EBITDA of the West Qurna-2 project in the amounts of 3,843 million RUB and 6,890 million RUB in the second quarter of 2017 and 2016 and the amounts of 6,786 million RUB and 28,384 million RUB in the first half of 2017 and 2016, respectively.

Reconciliation of Cash provided by operating activities to Free cash flow

	2 nd quarter of		1 st half of	
	2017	2016	2017	2016
	(millions of rubles)			
Net cash provided by operating activities	206,298	180,082	337,901	344,478
Capital expenditures.....	(124,640)	(122,857)	(254,868)	(248,664)
Free cash flow	81,658	57,225	83,033	95,814

Liquidity and capital resources

	2 nd quarter of		1 st half of	
	2017	2016	2017	2016
	(millions of rubles)			
Net cash provided by operating activities	206,298	180,082	337,901	344,478
including decrease (increase) in working capital	38,495	6,466	(27,226)	(12,374)
Net cash used in investing activities	(41,938)	(120,122)	(169,886)	(258,515)
Net cash (used in) provided by financing activities	(72,532)	(16,153)	(124,792)	37,267

Operating activities

Our primary source of cash flow is funds generated from our operations. In the first half of 2017, cash generated from operations didn't change significantly compared to the first half of 2016.

Investing activities

In the first half of 2017, the amount of cash used in investing activities decreased by 89 billion RUB, or by 34.3%. This decrease was a result of proceeds from sale of our diamond business in the amount of 81 billion RUB.

In the first half of 2017, our capital expenditures increased by 6 billion RUB, or by 2.5%.

	2 nd quarter of		1 st half of	
	2017	2016	2017	2016
	(millions of rubles)			
Capital expenditures				
Exploration and production				
Western Siberia	34,323	31,081	69,065	59,682
Timan-Pechora	20,735	23,447	40,679	50,749
Ural region	7,162	6,005	14,156	13,362
Volga region	14,481	9,671	27,399	19,535
Other in Russia	2,797	268	6,276	3,043
Total in Russia	79,498	70,472	157,575	146,371
Iraq	3,775	2,378	7,587	11,699
Other outside Russia	28,750	31,770	64,828	54,027
Total outside Russia	32,525	34,148	72,415	65,726
Total exploration and production	112,023	104,620	229,990	212,097
Refining, marketing and distribution				
Russia	8,837	14,538	17,200	28,485
- refining	5,155	11,724	10,124	22,502
- retail	1,445	652	2,146	1,661
- other	2,237	2,162	4,930	4,322
International	3,464	2,889	6,913	6,929
- refining	2,123	1,901	4,572	3,913
- retail	1,327	404	2,063	2,353
- other	14	584	278	663
Total refining, marketing and distribution	12,301	17,427	24,113	35,414
Corporate and other				
Russia	257	622	545	719
International	59	188	220	434
Total corporate and other	316	810	765	1,153
Total capital expenditures	124,640	122,857	254,868	248,664

In the first half of 2017, our capital expenditures in the exploration and production segment increased by 18 billion RUB, or by 8.4%. In West Siberia, we increased production drilling by 26.5% in the first half of 2017. The increase in capital expenditures in Volga region was a result of continuing development of Yu. Korchagin and V. Filanovsky fields, and the decrease in capital expenditures in Timan-Pechora was due to completion of another stage of Yaregskoe field development.

The decrease in capital expenditures in the domestic refining, marketing and distribution segment was due to completion of upgrades at our refineries.

The table below presents our exploration and production capital expenditures in new promising oil regions.

	2 nd quarter of		1 st half of	
	2017	2016	2017	2016
	(millions of rubles)			
Western Siberia (Yamal).....	4,127	4,076	8,571	13,333
Caspian region (Projects in Russia).....	13,308	6,948	25,662	15,026
Timan-Pechora (Yaregkoye field).....	4,008	6,448	5,824	12,072
Iraq (West Qurna-2 project).....	3,509	2,043	6,958	11,151
Iraq (Block-10).....	266	335	629	548
Uzbekistan	21,709	20,288	50,561	26,198
Total	46,927	40,138	98,205	78,328

Financing activities

In the first half of 2017, net movements of short-term and long-term debt generated an outflow of 39 billion RUB, compared to an inflow of 110 billion RUB in the first half of 2016.

Other information

Sectorial sanctions against the Russian companies

In July-September 2014, the United States (“US”), the European Union (“EU”) and other countries imposed a set of economic sanctions on Russia, including certain sectoral sanctions which affect several Russian oil and gas companies, including the Company. Such sectoral sanctions prohibit US and EU companies and individuals from providing, exporting, or reexporting directly or indirectly, goods, services (except for financial services), or technology in support of exploration or production for deepwater, Arctic offshore or shale projects within the territory of the Russian Federation.

In August 2017, the US issued a law that expands abovementioned sanctions on new projects not only within the territory of the Russian Federation, but also worldwide. Sanctions shall cover new projects in which the Company (among Russian oil and gas companies placed on the Sectoral Sanctions Identifications List), has a controlling interest or ownership interest of 33% or more. As of today these sanctions have not come into effect yet and certain key terms such as “controlling interest” and criteria used to determine that the project qualifies as “new” for the purpose of sanctions application, remain undefined.

The Company is not subject to any financial restrictions and is not currently involved in deepwater, Arctic offshore or shale projects in Russia. That is why we assess the impact of the sanctions on the Group’s activities in Russia as immaterial. At the same time, currently, the Company also evaluates the effect of the new sanctions on its operations.

Operations in Iraq

The Group is exposed to various risks due to its operations in Iraq. Management monitors the risks associated with the projects in Iraq and believes that there is no adverse effect on the Group’s financial position that can be reasonably estimated at present.