PJSC LUKOIL

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CONDITION AND RESULTS OF OPERATIONS

for the years ended 31 December 2016, 2015 and 2014

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Key financial and operational results 395,525

	2016	Change to 2015, %	2015	Change to 2014, %	2014
			(millions of rubles)		
Sales	5,227,045	(9.1)	5,749,050	4.4	5,504,856
EBITDA[(1)], including	730,731	(10.5)	816,705	15.8	705,386
Exploration and production segment	521,190	(12.5)	595,408	17.2	507,917
Refining, marketing and distribution segment	233,297	(0.4)	234,211	20.0	195,108
EBITDA[(1)] net of West Qurna-2 project	691,263	1.7	679,539	15.7	587,266
Profit for the period attributable to LUKOIL shareholders	206,794	(29.0)	291,135	(26.4)	395,525
Capital expenditures, including non-cash transactions	511,525				

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Key operational developments

Exploration and production

15 new oil and gas fields were brought into production (2015 – 14 oil and gas fields).

13 new oilfields discovered.

In the third quarter of 2016, production started at the Company's two major green fields, the V. Filanovsky field in the Caspian Sea and the Pyakyakhinskoye field in Western Siberia. As a result, the Group s daily hydrocarbon production increased by 3.3% in December 2016 compared to July 2016. Production at the newly launched fields is subject to special tax rates, which results in substantially higher contribution of the projects to the financial results relative to their contribution to our overall production volumes.

Refining

In the second quarter of 2016 construction works were finalized at the hydrocracking facility at the Volgograd refinery, which is the last major facility built as part of the major refinery upgrade program. Launches of new secondary processing facilities resulted in substantial enhancement of the product slate with a respective positive impact on the refining margins.

These and other achievements in 2016 are described in detail further in this report.

Changes in Group structure

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

In December of 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 exploring the diamond field named after V.P. Grib located in Arkhangelsk region of Russia. The value of the transaction is the ruble equivalent of $1.45 billion, including debt repayment by AGD to the Group. This value may be adjusted for changes in working capital at the transaction closing date. The closing of the transaction is expected after government authorities approvals.

In line with the Company's strategy of optimizing its downstream operations in Europe, we sold petrol station networks in Poland, Latvia, Lithuania and Cyprus in 2016 and petrol stations networks in Ukraine and Estonia in 2015.

In August 2015, a Group company closed the transaction to sell its 50% interest in Caspian Investment Resources Ltd, an exploration and production company operating in Kazakhstan, to a Sinopec group company for $1,067 million (70.1 billion RUB). Related structural decrease in the Group's crude oil production amounted to approximately 20 thousand barrels per day.

OPEC and non-OPEC agreed production cut

In November 2016, OPEC and some of the non-OPEC countries, including Russia, agreed to cut production from October 2016 levels in order to stabilize the global crude oil market. Although our crude oil production volumes in Russia are also affected, on our estimates this will not have a significant impact on our financial results.

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 Russian oil and gas companies. Such sectoral sanctions prohibit US and the EU companies and indivi

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

	2016	Change to 2015, %	2015	Change to 2014, %	2014
	(in rubles per metric tonne, except for figures in percent)				
Fuel oil	7,525	13.9	6,604	(29.3)	9,342
Diesel fuel	28,899	(1.1)	29,215	3.6	28,206
High-octane gasoline (Regular)	33,784	5.2	32,120	3.6	30,993
High-octane gasoline (Premium)	35,491	5.6	33,612	4.9	32,050

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.

	2016	2015	2014
Ruble inflation (CPI), %	5.4	12.0	11.4
Ruble to US dollar exchange rate			
Average for the period	67.0	61.0	38.4
At the beginning of the period	72.9	56.3	32.7
At the end of the period	60.7	72.9	56.3
Ruble to euro exchange rate			
Average for the period	74.2	67.8	50.8
At the beginning of the period	79.7	68.3	45.0
At the end of the period	63.8	79.7	68.3

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 may have a positive impact on our upstream margins and a negative impact on our refining and marketing margins, and we expect the overall impact of tax changes on our financial results not to be significant.

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:

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. 9 illustrates the impact of crude oil extraction tax incentives on the tax rate at $50 per barrel Urals price.

The tax rate is zero when the average international Urals price is less than, or equal to, $15.00 per barrel. In 2016, each $1.00 per barrel increase in the international Urals price above $15.00 per barrel results in an increase in the tax rate by $0.45 per barrel ($0.40 per barrel in 2015, $0.26 per barrel in 2014).

Natural gas extraction tax rate. Starting from 1 July, 2014, the 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. Previously, the rate was fixed and amounted to 471 rubles per thousand cubic meters of gas extracted in the first half of 2014.

In 2016, actual average natural gas extraction tax rate for our major gas field – Nakhodkinskoe in Western Siberia amounted to 208 rubles per thousand cubic meters (162 rubles per thousand cubic meters in 2015). In the first half of 2014, the rate was 471 rubles per thousand cubic meters and in the second half of 2014 it

Excise tax rates starting from 2017 are listed below.

	2019 and further	2018	2017
		(in rubles per tonne)	
Gasoline			

Operational highlights

Reserves base

The table below summarizes the net proved reserves of consolidated subsidiaries and our share in equity affiliates under the standards of the US Securities and Exchange Commission (until the economic limit of commercial production is reached) that have been derived from our reserve reports audited by Miller and Lents Ltd, our independent reservoir engineers, at 31 December 2016 and 2015.

		Changes in 2016			
(millions of BOE)	**31 December 2016**	**Production[1]**	**Extensions, discoveries and changes in structure**	**Revision of previous estimates**	**31 December 2015**
Western Siberia	8,563	(375)	186	34	8,718
Timan-Pechora	2,337	(141)			

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 compared to 2015 (for details see p. 15).

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.

The decrease in our share in crude oil produced by equity affiliates outside Russia mainly resulted from the disposal of our 50% share in Caspian Investment Resources Ltd in the middle of 2015.

Natural and petroleum gas production. In 2016, we produced (including our share in equity affiliates) 24,922 million cubic meters (146.7 million BOE) of gas, that is 4.0% more than in 2015. Our available for sale gas production amounted to 20,315 million cubic meters (119.6 million BOE), compared to 20,251 million cubic meters (119.2 million BOE) in 2015.

The following table presents our available for sale gas production in 2016 and 2015 by major regions.

		Change to 2015			
(millions of cubic meters)	**2016**	**Total, %**	**Change in structure**	**Organic change**	**2015**
Western Siberia					

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

Refining, marketing and trading

Refining

The following table summarizes key figures for our refining activities:

	2016	2015	2014
	(thousands of tonnes)		
Refinery throughput at the Group refineries	66,061	64,489	66,570
- in Russia	41,752	41,855	45,285
- outside Russia, including	24,309	22,634	21,285
- crude oil	20,356	18,832	16,886
- refined products	3,953	3,802	4,399
Refinery throughput at third party refineries	744	896	1,849
Total refinery throughput	**66,805**	**65,385**	**68,419**

Production of the GtiBTF1 9 T2

	2016	2015	2014
		(thousands of tonnes)	
Refined products exports			
- diesel fuel	8,030	7,328	7,273
- gasoline	408	283	171
- fuel oil	3,697	6,801	8,090
- jet fuel	202	159	117
- motor oils	605	576	638
- other products	5,197	5,299	7,088
Total refined products exports	**18,139**	**20,446**	**23,377**
		(millions of RUB)	
Total refined products exports	**375,722**	**439,874**	**581,445**

Sales revenues

Sales breakdown	2016	2015	2014
		(millions of rubles)	
Crude oil			

Realized average sales prices

		2016	2015	2014
Average realized price international				
Crude oil (beyond Customs Union) [1]	(RUB/barrel)	2,712	2,916	3,653
Crude oil (Customs Union)	(RUB/barrel)	1,989	2,034	1,771
Refined products				
Wholesale	(RUB			

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.

2016 vs. 2015

In 2016, the volumes of crude oil related to cost compensation and remuneration fee significantly decreased to the respective period of 2015. Therefore the amount of cost compensation and remuneration fee decreased by 113 billion RUB. For details see p. 15.

2015 vs. 2014

In 2015, the amount of cost compensation and remuneration fee related to the West Qurna-2 project increased by 43 billion RUB compared to 2014.

Sales of refined products

2016 vs. 2015

Compared to 2015, our revenue from the wholesale of refined products outside Russia decreased by 435 billion RUB, or by 14.9%, that was both price and volume driven. Our sales volumes decreased by 6.9%, largely as a result of the decrease in volumes of trading. Our dollar and ruble realized prices decreased by 17.0% and 8.7%, respectively.

In 2016, our dollar and ruble realized retail prices outside Russia decreased by 9.9% and 0.9%, respectively. Our sales volumes decreased by 9.4% as a consequence of sale of our retail networks in Eastern Europe. As a result, our international retail revenue decreased by 33 billion RUB, or by 10.2%, compared to 2015.

In 2016, our revenue from the wholesale of refined products on the domestic market didn't change significantly. Our realized prices decreased by 9.2%, but our sales volumes increased by 10.5%.

In 2016, our revenue from refined products retail sales in Russia increased by 21 billion RUB, or by 5.9%. Our average domestic retail prices and volumes both increased by 2.9%.

2015 vs. 2014

Compared to 2014, our revenue from the wholesale of refined products outside of Russia increased by 3.5%, or by 99 billion RUB. Our dollar and ruble realized prices decreased by 41.1% and 6.6%, respectively. That was offset by the increase in sales volumes by 10.8

Sales of gas and gas products

2016 vs. 2015

Compared to 2015, sales of gas and gas refined products decreased by 22 billion RUB, or by 15.9%, mainly as a result of the decrease in sales prices.

In 2016, natural gas sales revenue decreased by 12 billion RUB, or by 16.6%. Gas products revenue decreased by 10 billion RUB, or by 15.1%.

2015 vs. 2014

Sales of gas and gas refined products increased by 13 billion RUB, or by 10.3%, compared to 2014.

Natural gas sales revenue increased by 16 billion RUB, or by

Other operating expenses

Other operating expenses include expenses of the Group's upstream and downstream entities that do not relate to their core activities,

Transportation expenses

	2016	2015	2014
	(millions of rubles)		
Crude oil transportation expenses	91,628	91,251	59,728
Refined products transportation expenses			

Depreciation, depletion and amortization

2016 vs. 2015

Our depreciation, depletion and amortization expenses decreased by 39 billion RUB, or by 11.2%. The effect of the increase in the depreciation rate of upstream assets following the decrease in hydrocarbon proved reserves was offset by the decrease of expenses related to the West Qurna-2 project. Our depreciation, depletion and amortization expenses for 2016 and 2015 included 31 billion RUB and 127 billion RUB, respectively, related to the West Qurna-2 field. Other international subsidiaries' depreciation, depletion and amortization expenses increased as a result of the effect of the decrease in annual average ruble exchange rate. Depreciation, depletion and amortization expenses of our downstream assets increased following the increase in value of depreciable assets.

2015 vs. 2014

Our depreciation, depletion and amortization expenses increased by 58 billion RUB, or by 19.8%, compared to 2014. Our depreciation, depletion and amortization expenses for 2015 and 2014 included 127 billion RUB and 114 billion RUB, respectively, related to the West Qurna-2 field. Other international subsidiaries' depreciation, depletion and amortization increased as a result of the effect of the ruble devaluation.

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 oilfelds in Timan-Pechora, Russia, South Caucasus Pipeline Company and Caspian Pipeline Consortium, midstream companies in Azerbaijan and Kazakhstan. One of our major affiliates was Caspian Investments Resources Ltd. which was sold in August 2015.

2016 vs. 2015

Our share in income of affiliates increased by 1 billion RUB, or by 13.1%, compared to 2015.

2015 vs. 2014

Our share in income of affiliates decreased by 13 billion RUB, or by 64.6%, compared to 2014, largely as a result of the decrease in income of our upstream affiliates in Kazakhstan.

Taxes other than income taxes

	2016	2015	2014
	(millions of rubles)		
In Russia			
Mineral extraction taxes	388,835	470,013	420,946
Social security taxes and contributions	22,863	21,183	17,462

2015 vs. 2014

In 2015, our taxes other than income taxes increased by 55 billion RUB, or by 11.7%, compared to 2014, largely driven by the increase in the mineral extraction tax 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).

	2016	2015	2014
	(millions of rubles)		
Decrease in extraction taxes from application of reduced and zero rates for crude oil and gas production	59,527	72,300	83,162
	(thousands of tonnes)		
Volume of crude oil production subject to:			
zero rates	977	808	7,807
reduced rates (tax holidays for specific regions and high viscosity oil)	4,854	6,127	–
reduced rates (depleted fields)	14,202	14,928	16,025
reduced rates (other)	3,480	2,661	1,668
Total volume of production subject to reduced or zero rates	**23,513**	**24,524**	**25,500**

2015 vs. 2014

In 2015, our total income tax expense increased by 6 billion RUB, or by 6.1%, compared to 2014. At the same time, our profit before income tax decreased by 96 million RUB, or by 19.7%, and our effective income tax rate was 24.8%, compared to 18.7% in 2014. The high level of the effective tax rate in 2015 was a result of non-deductible losses and write-offs.

Non-GAAP items reconciliation

Reconciliation of profit from operating activities 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 is a non-IFRS measure and should not be considered in isolation as an alternative to profit from operating activities, profit or any other measure of performance under IFRS.

	2016	2015	2014
	(millions of rubles)		
EBITDA reconciliation			
Profit from operating activities	419,143	465,729	412,334
Depreciation, depletion and amortization	311,588	350,976	293,052
EBITDA	**730,731**	**816,705**	**705,386**
EBITDA by operating segments			
Exploration and production (excluding West Qurna-2 project)	481,722	458,242	389,797
West Qurna-2 project in Iraq	139,468	137,166	138,420

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The decrease in capital expenditures in the domestic refining, marketing and distribution segment in Russia was due to completion of upgrades at our Russian refineries. The decrease in the international segment was a result of completion of the construction of a heavy residue processing complex at our Bulgarian refinery.

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

	2016	**2015**	**2014**
		(millions of rubles)	
Western Siberia (Pyakyakhinskoye field)			

Debt maturity

The following table displays our total contractual obligations and other commitments:

	Total	2017	2018	2019	2020	2021	After
				(millions of rubles)			
Short term debt	18,048	18,048	–	–	–	–	–
Long-term bank loans and borrowings	277,404	9,361	22,374	63,751	24,695	117,514	39,709
6,356% Non-convertible US dollar bonds, maturing 2017	30,328	30,328	–	–	–	–	–
3,416% Non-convertible US dollar bonds, maturing 2018	90,689	–	90,689	–	–	–	–
7,250% Non-convertible US dollar bonds, maturing 2019	36,304	–	–	36,304	–	–	–
6,125% Non-convertible US dollar bonds, maturing 2020	60,585	–	–		60,585	–	–
6,656% Non-convertible US dollar bonds, maturing 2022	30,328	–	–	–	–	–	30,328
4,563% Non-convertible US dollar bonds, maturing 2023	90,689	–	–	–	–	–	90,689
4,750% Non-convertible US dollar bonds, maturing 2026	60,657						

Litigation and claims

The Group is involved in various claims and legal proceedings arising in the normal course of business. While these claims may seek substantial damages against the Group and are subject to uncertainty inherent in any litigation, management does not believe that the ultimate resolution of such matters will have a material adverse impact on the Group's operating results or financial condition. See Note 29 G@7LRQ

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Forward-looking statements

Certain statements in this document are not historical facts and are "forward-looking." We may from time to time make written or oral forward-looking statements in reports to shareholders and in other communications. Examples of such forward-looking statements include, but are not limited to:

- statements of our plans, objectives or goals, including those related to products or services
- statements of future economic performance
- statements of assumptions underlying such statements.

Forward looking statements that may be made by us from time to time (but that are not included in this document) may also include projections or expectations of revenues, income (or loss), earnings (or loss) per share, dividends, capital structure or other financial items or ratios. Words such as "believes," "anticipates," "expects," "estimates," "intends" and "plans" and similar expressions are intended to identify forward-looking statements but are not the exclusive means of identifying such statements. By their very nature, forward-looking statements involve inherent risks and uncertainties, both general and specific, and risks exist that the predictions, forecasts, projections and other forward-looking statements will not be achieved. You should be aware that a number of important factors could cause actual results to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward-looking statements.

These factors include:

- inflation, interest rate and exchange rate fluctuations
- the price of oil
- the effects of, and changes in, Russian government policy
- the effects of competition in the geographic and business areas in which we conduct operations
- the effects of changes in laws, regulations, taxation or accounting standards or practices
- our ability to increase market share for our products and control expenses
- acquisitions or divestitures
- technological changes
- our success at managing the risks of the aforementioned factors.

This list of important factors is not exhaustive. When relying on forward-looking statements, you should carefully consider the foregoing factors and other uncertainties and events, especially in light of the political, economic, social and legal environment in which we operate. Such forward-looking statements speak only as of the date on which they are made, and, subject to any continuing obligations under the Listing Rules of the U.K. Listing Authority, we do not undertake any obligation to update or revise any of them, whether as a result of new information, future events or otherwise. We do not make any representation, warranty or prediction that the results anticipated by such forward-looking statements will be achieved, and such forward-looking statements represent, in each case, only one of many possible scenarios and should not be viewed as the most likely or standard scenario.