



PJSC LUKOIL

CONDITION AND RESULTS OF OPERATIONS

For the three-month periods ended 31 March 2017 and 2016

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Business overview

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

LUKOIL is one of the world's largest publicly traded vertically integrated energy companies in terms of hydrocarbon reserves and production. 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 quarter of 2017 amounted to 2.2 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

Key financial and operational results

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

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

	3 months of		Change, %
	2017	2016	
	(in rubles per metric tonne, except for figures in percent)		
Fuel oil.....	9,682	4,555	112.6
Diesel fuel.....	31,453	27,186	15.7
High-octane gasoline (Regular)	35,387	31,637	11.9
High-octane gasoline (Premium)	35,233	33,497	5.2

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.

	3 months of	
	2017	2016
Ruble inflation (CPI), %	1.0	2.1

	3 months of		
	2017	2016	Change, %
	(in rubles per tonne, except for figures in percent)		
Export duties on crude oil ⁽¹⁾	5,086	4,104	23.9
Export duties on refined products ⁽¹⁾			

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. 8 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 the first quarter of 2017, 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 \$0.48 per barrel (\$0.45 per barrel in the first quarter of 2016).

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.

The table on the p. 8 illustrates the impact of crude oil export duty incentives on the duty rate 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,

Crude oil and natural gas liquids production. In the first quarter of 2017, we produced (including the Company's share in equity affiliates) 21,802 thousand tonnes or 161.0 million barrels of crude oil, compared to 24,495 thousand tonnes or 179.2 million barrels of crude oil in the first quarter of 2016.

In the first quarter of 2017, the output of natural gas liquids at the Group gas processing plants in Western Siberia, Ural and Volga regions of Russia was 3.0 million BOE, compared to 3.4 million BOE in the first quarter of 2016.

2017 Q1

3 months of

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

(thousands of tonnes)	Change to 2016				3 months of 2016
	3 months of 2017	Total, %	Change in structure	Organic change	
Western Siberia	9,810	(6.0)	—	(627)	10,437
Timan-Pechora	4,002	(8.1)	—	(352)	4,354
Ural region	3,755	(0.5)	—	(19)	3,774
Volga region	2,189	34.5	—	561	1,628
Other in Russia	422	(7.7)	—	(35)	457
Crude oil produced in Russia	20,178	(2.3)	—	(472)	20,650
Iraq ⁽¹⁾	405	(84.4)	—	(2,196)	2,601
Other outside Russia	517	(7.8)	—	(44)	561
Crude oil produced outside Russia	922	(70.8)	—	(2,240)	3,162
Total cru	48.12 8.255 121 0 311.4 reW*W*20.479				

	Costs incurred ⁽¹⁾	Remuneration fee (millions of US dollars)	Crude oil received	Crude oil to be received
Cumulative at 31 December 2016.....	7,532	272	7,275	529
Change during the first quarter of 2017	109	19	142	(14)
Cumulative at 31 March 2017	7,641	291	7,417	515

⁽¹⁾ Including prepayments.

The amount of remuneration within the West Qurna-2 project decreased approximately threefold since February 2017 following the provisions of the service contract due to lower than target production volumes.

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

	3 months of			
	2017		2016	
	(thousand barrels)	(thousand tonnes)	(thousand barrels)	(thousand tonnes)
Total production ⁽¹⁾	35,960	5,242	38,018	5,542
Production related to cost compensation and remuneration ⁽¹⁾	2,775	405	17,840	2,601
Shipment of compensation crude oil ^{(1) (2)}	2,984	435	17,527	2,555
	(millions of rubles)	(millions of US dollars)	(millions of rubles)	(millions of US dollars)
Cost compensation ⁽³⁾	6,488	110	29,479	

Our domestic refineries’ earnings in the first quarter of 2017 were negatively impacted by the changes in export duties and excise rates within the tax maneuver that was partially offset by increased production volumes, better product slate as a result of completed modernization program and continued throughput optimization. At the same time, our retail earnings in Russia were affected by an increase in excise rates. Outside Russia, refineries’ earnings were positively impacted by the increase in refining margins and better product slate.

Refining and petrochemicals

The following table summarizes key figures for our refining volumes:

	3 months of
2017	2016

Sales revenues**Sales breakdown**

3 months of
2017 2016
(millions of rubles)

Crude oil

Realized average sales prices

		3 months of	
		2017	2016
Average realized price on international markets			
Crude oil (beyond Customs Union) ⁽¹⁾	(RUB/barrel)	3,066	2,255
Crude oil (Customs Union)	(RUB/barrel)	2,291	1,739
Refined products			
Wholesale	(RUB/tonne)	27,723	23,697
Retail.....	(RUB/tonne)	65,524	74,555
Petrochemicals.....	(RUB/tonne)	52,267	41,126
Crude oil (beyond Customs Union) ⁽¹⁾	(\$/barrel)	52.11	30.21
Crude oil (Customs Union)	(\$/barrel)	38.95	23.30
Refined products			
Wholesale	(\$/tonne)	471.19	317.54
Retail.....	(\$/tonne)	1	

In the first quarter of 2017, our revenue from the wholesale of refined products on the domestic market increased by 17 billion RUB, or by 34.3%. Our realized prices increased by 28.8% and our sales volumes increased by 4.3%.

In the first quarter of 2017, our revenue from refined products retail sales in Russia increased by 13 billion RUB,

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.

	3 months of	
	2017	2016
	(millions of rubles)	
Hydrocarbon extraction expenses ⁽¹⁾	45,545	43,874
- in Russia.....	42,952	39,711
-		

Petrochemical expenses

In the first quarter of 2017, operating expenses of our petrochemical plants and facilities decreased by 0.3 billion RUB, or by 9.6%, 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 first quarter of 2017, other operating expenses didn't change significantly.

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.

	3 months of	
	2017	2016
	(millions of rubles)	
Cost of purchased crude oil in Russia	4,207	2,373
Cost of purchased crude oil outside Russia	289,188	161,418
Compensation crude oil related to West Qurna-2 project	8,332	29,476
Cost of purchased crude oil	301,727	193,267
Cost of purchased refined products in Russia	12,577	9,750
Cost of purchased refined products outside Russia	441,846	346,546
Cost of purchased refined products	454,423	356,296
Other purchases	12,049	9,301
Net gain from hedging of trading operations	(24,140)	(1,228)
Change in oil and petroleum products inventory	(1,490)	(19,903)
Total cost of purchased crude oil, gas and products	742,569	537,733

In the first quarter of 2017, the cost of purchased crude oil, gas and products increased by 205 billion RUB, or by 38.1%, following the increase in hydrocarbon prices and volumes of trading. Crude oil purchases also included 8 billion RUB related to 435 thousand tonnes of compensation crude oil received from Iraq's state-owned South Oil Company within the W-10(h)6(m(r)-3(ulate)-3(d)-5()-38(to)-4()JTJETBT1 0 0 1 284BT/F

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 and refinery 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.

	3 months of	
	2017	2016
	(millions of rubles)	
Labor costs included in selling, general and administrative expenses	15,831	18,473
Other selling, general and administrative expenses	21,880	24,873
(Decrease) increase in liability related to share-based remuneration program.....	(4,250)	2,761
Expenses on provision for doubtful debts.....	2,825	1,716
Total selling, general and administrative expenses	36,286	47,823

Our selling, general and administrative expenses decreased by 12 billion RUB, or by 24.1%. 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 quarter of 2017. Internationally, o 1 85.104 731267 Tm\$1104 731262nf,

Taxes other than income taxes

	3 months of	
	2017	2016
	(millions of rubles)	
In Russia		
Mineral extraction taxes.....	139,388	69,738
Social security taxes and contributions	6,690	6,027
Property tax.....	4,789	4,538
Other taxes	807	455
Total in Russia.....	151,674	80,758
International		
Social security taxes and contributions	1,251	1,573
Property tax.....	170	526
Other taxes	587	696
Total internationally	2,008	2,795
Total	153,682	83,553

Our taxes other than income taxes increased by 70 billion RUB, or by 83.9%, compared to the first quarter of 2016. This was driven by the increase in the mineral extraction tax rate in Russia resulted from

Foreign exchange loss

Foreign exchange loss mostly related to revaluation of US dollar and euro net monetary position of Russian entities that largely consists of accounts receivables and loans to our foreign subsidiaries.

In the first quarter of 2017, ruble to US dollar exchange rate decreased from 60.66 rubles per dollar to 56.38 rubles per dollar, or by 7.1%, that resulted in a 43 billion RUB foreign exchange loss. In the first quarter of 2016, ruble to US dollar exchange rate decreased from 72.88 rubles per dollar to 67.61 rubles per dollar, or by 7.2%, that resulted in a 45 billion RUB foreign exchange loss.

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 first quarter of 2017, our total income tax expense increased by 4 billion RUB, or by 34.0%, compared to the first quarter of 2016 and our profit before income tax increased by 24 billion RUB, or by 43.3%. Our effective income tax rate in the first quarter of 2017 was 20.1%, compared to 21.5% in the first quarter of 2016.

Liquidity and capital resources

	3 months of	
	2017	2016
	(millions of rubles)	
Net cash provided by operating activities	131,603	164,396
including changes in working capital	(65,721)	(18,840)
Net cash used in investing activities	(127,948)	(138,393)
Net cash (used in) provided by financing activities	(52,260)	53,420

Operating activities

Our primary source of cash flow is funds generated from our operations. In the first quarter of 2017, cash generated from operations decreased by 33 billion RUB, or by 19.9%, compared to the first quarter of 2016, mainly as a result of the increase in working capital.

Investing activities

In the first quarter of 2017, the amount of cash used in investing activities decreased by 10 billion RUB, or by 7.5%.

In the first quarter of 2017, our capital expenditures increased by 4 billion RUB, or by 3.5%.

	3 months of	
	2017	2016
	(millions of rubles)	
Capital expenditures		
Exploration and production		
Western Siberia	37,113	32,004
Timan-Pechora	18,785	24,555
Ural region	6,705	5,816
Volga region.....	11,356	8,564
Other in Russia.....	2,699	1,970
Total in Russia	76,658	72,909
Iraq	2,491	9,296
Other outside Russia	31,524	22,681
Total outside Russia	34,015	31,977
Total exploration and production		

Other information