

Overview of PJSC LUKOIL's Basic Business Risks and Uncertainties

PJSC LUKOIL management bodies pay great attention to the risk management issues in order to ensure reasonable achievement of the set goals in the conditions characterized by uncertainties and adverse factors. PJSC LUKOIL is constantly identifying, describing, estimating and monitoring the potential events that may affect the Company's activities, and is elaborating measures to prevent them or mitigate their negative impact to the greatest extent possible if such events do take place.

The Company seeks to actively promote risk management and is presently focusing its efforts on the improvement of an enterprise-wide risk management system (ERM) based on the best international practices. The Company is constantly improving the applicable regulatory methodological risk management base which establishes requirements, uniform for all of the LUKOIL Group organizations, aimed at organizing the risk management process at all stages, and defines management standards for certain risk types of utmost importance. The Risk Committee, a dedicated body under the President of PJSC LUKOIL, was set up and began its work in 2011. In order to enhance the efficiency of the corporate-wide governance system through the establishment of a unified information environment, an automated information risk management system was brought into commercial operation in the LUKOIL Group companies in Q4, 2014. The introduction of the information system made it possible to:

- create a unified information environment for all participants of the corporate risk management process (at all managerial levels);
- automate the processes of collection, due diligence, approval and storage of risk information, thus increasing the risk response rate and risk management efficiency in general;
- develop a general presentation format for risk data;
- develop a risk management knowledge base.

Macroeconomic Risks

Macroeconomic changes resulting from the global price drop for energy carriers, foreign exchange rate fluctuations, inflation processes may have an adverse impact on the Company's financial performance.

In Q4 2015, the imbalance between demand and supply in the market persisted, which was accompanied by the negative oil price fluctuations.

The risks of slow global economic growth remain high. The greatest concerns of the market players are raised about the slow economic growth in China, the largest oil consumer. The EU and Japan demonstrate slow growth rates accompanied by the large-scale measures aimed at monetary easing. The US economy looks more confident, coming into a new cycle of rising interest rates. The US Federal Reserve System interest rate increase in December resulted in USD appreciation as compared to other foreign currencies. Since the global oil prices are denominated in USD, the USD appreciation has a negative effect on the oil prices.

In Q4 oil supply in the global market exceeded the demand. The oil and petroleum product stocks at the oil terminals reached their all-time peak. The OPEC session held in December 2015 demonstrated the intention of Saudi Arabia to maintain current production levels in its struggle for the market share. At the same time, large independent producers, such as the US and Russia, have not yet demonstrated a considerable production drop that could have balanced the market. Besides, concerns about the rapidly increasing Iranian oil supply to the market put additional pressure on the prices.

Nevertheless, we can expect growth of the oil price in the mid-term perspective due to the delayed effect of the reduced investment and cost optimization of the oil and gas companies. Signs of interrupted production growth on the part of independent manufacturers have already been noticed. Low prices will also stimulate global oil consumption.

The oil price drop and persisting sectoral sanctions against Russia continue to undermine the Russian economy: the ruble is depreciating, high interest rates are maintained, and the inflation rate is growing. The Q3 2015 witnessed a 4.1% drop in the Russian economic indicators as compared to the same period of 2014. Due to the imposed sanctions the Russian companies are struggling to obtain access to foreign funds and technologies. Low energy carrier prices, if they persist, pose a serious threat to the stability of the Russian economy. The Company has been employing a scenario approach to forecast macroeconomic indicators. One of them is defined as a base-case scenario and describes the most likely macroeconomic development trends according to the Company's management. In addition, best-case and worst-case scenarios are being developed. They assess the potential consequences of changes in macroeconomic indices for the Company.

The Company is fully committed to minimizing the potential effects resulting from the realization of macroeconomic risks. The application of the worst-case scenario makes it possible to identify assets and investment projects that are most vulnerable to macroeconomic changes. The data of this analysis serve as the basis for top management decisions to optimize the Company's asset portfolio.

Country Risks

Among other things, PJSC LUKOIL has operations in a number of countries with high political and economic risks. Should they be realized, such risks may significantly complicate the Company's business or even cause the Company to suspend its operations in a certain region. In particular, the Company has launched a number of projects in Iraq, Egypt, Uzbekistan, West African countries where country risks are deemed high.

Most of PJSC LUKOIL assets are located in the areas characterized by moderate or low country risks. The Company seeks to diversify its operations and alongside with its activities in unstable regions has been implementing projects in Europe and the US, where regional risks are considered minimal.

The major part of the Company's development and refining assets is located in the Russian Federation. The political environment in the RF is characterized by a fair degree of stability and high support of the population for the policies undertaken by the President and the Government.

The main factors which are capable of affecting LUKOIL's activities include:

- Instability of the political situation in the countries where the Company's is implementing its investment projects, due to regime changes;
- Escalation of military conflicts in the countries of the Company's presence;
- Economic instability in the countries of the Company's presence;
- Possibility of the Company's asset expropriation;
- Inefficiency of the legislation regulating economic relations, and of the court system.

When implementing projects with high country risks, the Company applies more stringent return level requirements to such projects. Besides, should the political or social and economic situation deteriorate in a region of the Company's presence, PJSC LUKOIL shall implement a set of crisis response measures, including cost saving, optimization of the investment program based on the new conditions, equity drawdown, and invite partners to share project risks.

Industry-Specific Risks

Risks Associated with Well Construction and Hard-to-recover Hydrocarbon Field Development

The risk associated with the prohibition of supply of the equipment and materials currently used for well construction is essential to the Company. The fact that a considerable share of the materials and equipment required for well construction is purchased today by the Company and its contractors from foreign contractors is regarded as a risk factor.

The greatest part of the chemical agents intended for preparation and processing of drill muds, as well as for preparation of grouting mixtures currently purchased from the EU and the US manufacturers, can be replaced with the products manufactured by the enterprises of China, Thailand, the RF and the Belarus Republic. It is also worth mentioning that the chemical products currently purchased from the EU and the US manufacturers are low-tonnage;

Based on the information received from the Company's contractors providing maintenance services during well construction, as of today the Company's projects have now stocked spare parts, equipment and supplies for 1 year.

Due to the sanctions imposed against Russia there is a risk of constraints arising as hard-to-recover-hydrocarbon fields are developed with application of the multi-zone hydrofracturing technique. The equipment for multi-zone hydrofracturing used today as part of the Company's projects knows no equals produced by the enterprises of the RF or China.

Risks Associated with the Growth of Tariffs and Suppliers' Prices for Goods/Work/Services in Operations, except Critical Raw Material

The risk associated with tariff growth is accounted for the activities of such monopolies as JSC RZhD, and other monopolies in the countries of the Company's presence, since the prices for their services grow on a regular basis.

The expenses on product logistics as the product volumes rise, directly affect the Company's profit.

There is also a risk of price growth for the services of other suppliers, including motor transportation, the services of customs brokers, warehouse storage cost, etc.

In order to minimize the risks associated with tariff growth of JSC RZhD, and other similar monopolies in the countries of its presence the Company:

diversifies ways to transport the Company's products;

in order to reduce the risks of advanced tariff growth of the above monopolies the Company participates in the coordinated operations aimed at the prevention of advanced tariff growth together with other consumers;

when suppliers are selected to cooperate on a long-term basis, the Company holds bidding procedures.

Risk of Restricted Access to Petroleum Product Transshipment Infrastructure

The risk scenario depends on the price changes for energy carriers, cost of services and the political situation.

The Company invests great efforts to find ways to reduce these risks:

- concludes long-term petroleum product transshipment agreements;
- diversifies petroleum product export lines;
- increases the volumes of petroleum product supply to the Company's terminals;
- expands production capacities of the Company's terminals;
- conducts systematic work with natural monopolies with regard to pipeline transfer to increase transportation output through the JSC AK Transneft system;
- uses river transport to the greatest possible extent to cut railway costs.

Financial Risks

Price Risks

Oil and petroleum product price fluctuations may significantly affect the issuer's financial performance and the value of its securities. The issuer has a limited influence on the output prices, which depend a lot on the market situation and measures taken by the regulatory authorities.

High oil price volatility is expected to persist in the near term as a result of the uncertainty as to the outlooks of the global economic growth, oil supply interruptions to the market, changes in the global oil demand and supply, and growth of geopolitical tensions.

The issuer is a vertically integrated oil company which embraces production, refining and distribution assets. This structure serves as a natural hedging mechanism, where multidirectional risk factors compensate each other.

The Company uses a number of measures to reduce the negative price risk impact:

- As long-term programs are developed, several price scenarios are considered, while the investment project portfolio is shaped in view of the tolerance analysis of the project performance figures to the changes in price parameters;
- A commodity supply management system has been implemented which makes it possible to respond to market changes very quickly and conduct arbitrary shipments;
- In its trading activities, the Company uses hedging operations which help significantly reduce the negative impact of the price fluctuations on the oil and petroleum product markets as part of the Group operations.

Liquidity Risks

High volatility of oil prices, exchange rates of foreign currencies to the US dollar, refining margin, petrochemistry and power generation margin, growth of tariffs and suppliers' prices, as well as possible economic sanctions as a result of Russia's political stand (including that in Ukraine) may create an imbalance in the figures included into the plans, budgets and investment programs of the LUKOIL Group, thus leading to the shortage of liquidity and sources of funding.

This risk is managed through sensitivity assessment of the performance figures included into the plans, budgets and investment programs to the changes in macroeconomic indicators. The Company also develops proposals related to plan adjustments, possible sequestering of expenses associated with the transition to the stress scenario, shifting of due dates and project implementation dates or inclusion of optional projects in the plan in case of improvements in

the macroeconomic situation, as well as the proposals to ensure well-timed financing of its business activities. Much attention is paid to cost minimization by means of bidding procedures.

LUKOIL Group's liquidity is managed on a centralized basis, but there's also an efficient global system in place to manage LUKOIL Group's liquidity, which includes an automated system of concentration and re-distribution of funds, corporate dealing, and cashflow rolling forecasts. The liquidity indicators are monitored on a continuous basis.

Despite the unfavorable market situation for the Russian borrowers, the volume of bilateral backup credit lines required to provide a sufficient level of liquidity in line with the requirements of the rating agencies is maintained at a sufficient level.

Currently, PJSC LUKOIL has an investment rating from S&P, an international rating agency (BBB- which is higher than the sovereign rating of the Russian Federation). The Company is monitoring and ensuring compliance of its financial indicators with the rating agencies' requirements on a regular basis.

The fact that its credit rating exceeds the sovereign rating of the Russian Federation testifies to high financial stability of PJSC LUKOIL.

Foreign Exchange Risks

The fact that the Company's assets are mainly concentrated in the RF makes its financial indicators dependent on the ruble to dollar exchange rate. The Company's proceeds are mainly shaped by US dollar proceeds from the oil and petroleum product sales, while operating and capital expenses are denominated in rubles. The Company has to sell foreign currency to finance ruble denominated expenses. When the ruble appreciates, in order to finance ruble denominated expenses the Company needs to sell an extra amount of its foreign currency proceeds, which will have an adverse effect on the Company's net profit in rubles.

The Company's foreign currency revenue and expenses mix serves as natural hedging. For instance, the oil price reduction, as a rule, is accompanied by a weaker ruble exchange rate, which helps partially offset the negative impact of the oil price reduction on the Company's financial indicators.

In order to mitigate the negative consequences of the changes in the currency exchange rates the Company takes advantage of its geographic diversification. The Company also applies hedging tools to its currency proceeds.

Risk of Contractor's Default, Failure to Pay on the part of the Contractor

The risk manifests itself in the possibility of untimely proceeds from the supplied goods. As related to export sales, untimely and/or incomplete proceeds may require additional funds to ensure fulfillment of the Company's financial obligations.

This risk is minimized by the contractual terms in view of which the settlements with third parties, non-members of the LUKOIL Group are either made on a pre-paid basis or secured by letters of credit or bank guarantees on the part of end buyers. The list of banks issuing letters of credit and bank guarantees is subject to approval by the Company's corporate center.

Legal Risks

Tax and Customs Regulation Risks

The actions of the RF government focused on amending the taxation and customs policy are primarily dictated by the state of the RF budget system and the way the domestic market is regulated. Increased tax burden, unexpected changes in the tax and customs duty rates, cancellation of the applicable incentive rates for a number of the Company's fields may affect financial performance of the LUKOIL Group and its organizations.

Due to considerable fluctuations of the ruble to dollar exchange rate in the recent months and a persisting trend towards further depreciation of the Russian ruble, there is a risk of additional payments of customs duties accompanied by occasional declaration of energy carrier export supplies to be larger than the planned amounts (except for pipeline transport supplies).

At the same time, in accordance with the Russian Law "On Customs Tariff" the Government of the Russian Federation reconsiders export customs duties on oil and petroleum products on a monthly basis. Customs duties are calculated based on what the oil price on the global oil markets is, therefore, as the oil price falls, the duty rates are reducing as well, however starting next calendar month.

Strong ruble rate volatility continues to bear significant risks and uncertainty in terms of the amount of the export duties paid in rubles.

To manage the specified risks the Company conducts continuous monitoring of the taxation and customs policy changes, participates in the discussions of legislative initiatives, promptly assesses the influence produced by the probable changes in the taxation and customs legislation upon the LUKOIL Group performance indicators, and takes respective measures in order to either mitigate or offset the negative consequences of the changes in the taxation policy and customs policy, for example, if possible, to be able to submit customs declarations as the ruble to US dollar exchange rate is on the rise.

Risks Associated with Changes of the Russian Legislation on Joint-Stock Companies and Securities Markets

Changes in the Russian corporate governance regulations, including those related to the structure and competences of the management bodies of a joint-stock company, due to the expected amendments made into the Federal Law “On Joint-Stock Companies”, as well as transition to practical application of the provisions of the Corporate Governance Code in view of the recommendations issued by the Bank of Russia (letter No. 06-52/2463 of April 10, 2014) may lead to changes in the Company’s corporate structure and corporate governance procedures, which in its turn may affect the Company’s decision-making process and performance.

The Company is constantly monitoring legislation changes in this field and participates in preliminary discussions on the proposed changes initiated by the professional community in order to provide detailed explanations as to LUKOIL’s attitude towards the risks and uncertainties associated with the new legislative initiatives.

The Company takes measures to ensure participation of its representatives in the activities focused on the development of efficient solutions in the area of practical application of the effective legislative innovations related to corporate governance and taxation.

Risks Associated with Circulation of the Company’s Securities

The Company’s securities circulate in regulated markets in Russia and abroad. Changes in the requirements to the issuers on the part of the regulatory authorities for securities and stock exchanges, as well as the changes in the listing structure may induce the Company to amend its corporate governance procedures and assume extra obligations as to information disclosure and shareholder relations. Should the Company fail to ensure compliance with these requirements and fulfill the required obligations, it may result in transfer of the Company’s securities to lower listing segments, including delisting, which may have an adverse impact on the liquidity and prices of the securities.

The Company monitors changes in the listing rules of stock exchanges and other requirements of stock exchanges and regulatory authorities to the issuers whose securities are admitted for circulation. The Company’s representatives participate in the working meetings and other issuer events arranged by stock exchanges and other organizations that provide consulting and educational services to the issuers of the securities circulating in regulated markets. The Company also seeks to introduce the best global practice in corporate governance and shareholder relations.

Geological Risks

The Risk of Failure to Discover Geological Reserves or Discovery of the Reserves below the Initially Expected Level

The Company’s business is exposed to the risk that while implementing new projects, and exploratory drilling, we might not discover any productive (commercially efficient) oil and gas reserves, and/or that the discovered reserves will be considerably below the initially expected level. Therefore, the Company may have to incur additional expenses or even cease operations in a number of license areas.

PJSC LUKOIL strives to manage this risk at the level sufficient for prompt risk response, by means of additional geologic exploration.

Risks Associated with Subsurface Use and Licensing

The applicable Russian legislation on subsurface use and licensing of exploration and production activities, as well as their practical application expose oil companies to a number of risks. The most important are the following ones:

- risk of early termination of the subsoil license;
- risk of failure to provide the companies with equal access to the subsoil resources of the Continental shelf;
- risk of having no legislative guarantees to grant the right to subsurface use to a legal entity that discovered a field of federal significance or a field located in the subsurface area of federal significance (Russian continental shelf, internal and territorial seas of the RF, as well as the Russian part (Russian sector) of the

Caspian sea bottom), including the subsurface users with the share of foreign investors in the companies' authorized capital);

- risk of refusal to accept bidding documents for participation in competitive sales/biddings in view of technicalities from subsurface users of the LUKOIL Group companies;
- risk of fines imposed for administrative offenses for failure to fulfill the terms of license agreements;

The Company is fully committed to minimizing the potential effects resulting from the realization of the above risks, including the following:

- conducts monitoring of the changes in the legislation and in the area of subsurface use and licensing, forwarding proposals to update the applicable regulatory framework;
- creates a list of sites associated with the Unallocated Subsoil Stock, which are of interest to the Company, in the oil and gas production companies, to ensure timely decision-making on participation of the LUKOIL Group in the bidding procedures for subsoil use rights;
- has established permanent working groups in the LUKOIL Group companies to develop the bidding documents to participate in the bidding procedures and re-register licenses.
- holds annual advanced training workshops for specialists in the area of licensing and subsoil use;
- monitors current subsoil use state with application of a special information system;
- the Company interacts with the regulatory authorities in order to mitigate the risk of early subsoil license termination.

Risk of Terrorist Attacks, Wrongful Acts by Third Parties

As the number of terrorist organizations increases, as well as that of terrorist attacks in the countries of the Company's presence, there is a possibility of terrorist attacks and other wrongful acts against the Company's assets.

There are also risks related to wrongdoings on the part of LUKOIL's competitors (specifically, risks of unfair competition), risks of financial and other abuses on the part of the LUKOIL Group employees, as well as those related to theft of financial resources and commodity stocks.

The Company manages this risk in the following key areas:

- suppresses terrorist actions, participates in the events organized by the National Anti-terrorism Committee of Russia, the RF Federal Security Service, the RF Ministry of Internal Affairs;
- identifies persons who are intentionally inflicting harm on the Company's interests for the benefit of competing and other third-party (including criminal) structures and persons;
- plans and arranges events aimed at information security improvement;
- implements the Information Safety Program in the LUKOIL Group Organizations;
- obtains licenses issued by the RF Federal Security Services to use encryption-based information security tools.

HSE Risks

The Company is exposed to the risk of failure of technical equipment at hazardous production facilities, which may result in accidents, shutdowns, harmful emissions, negative environmental impact, fire and occupational injuries, including those occurring as a result of offshore oil and gas field development. This risk may result in unscheduled shutdowns of the production capacities and, consequently, failure to receive the expected level of operating income.

In order to mitigate these risks the Company has created and is successfully implementing its industrial safety system, including:

- the use of corporate standards, including without limitation those governing environmental safety matters;
- production control over the operation of hazardous production facilities;
- dedicated expert training;
- diagnostics (non-destructive inspection) and monitoring of equipment parameters;
- assessment of workplaces based on working conditions;

- repairs and timely replacement of equipment;
- building up a reserve for continuous preparedness of emergency response teams and resources;
- other measures to minimize accident rates at the Company's production facilities.

The applicable HSE Management System certified for compliance with the requirements of ISO 14001 and OHSAS 18001 international standards ensures prompt detection of discrepancies in work organization and equipment operation, as well as development and implementation of corporate target industrial and fire safety programs and plans, training of service personnel and accident prevention services in emergency response.

Risks of Failure to Implement the Investment Program

While implementing investment projects, the Company has to face the risk of higher costs and untimely commissioning of production assets.

It should be noted that there is a considerable risk of delayed drilling start at the Vladimir Filanovsky field due to the failure to meet the deadline for pre-drilling operations.

Delays in project implementation, including those caused by the delays in preparing design and estimate documentation, obtainment of approvals, conclusion of contracts, work execution period, as well as changes in field development plans in connection with the collection of additional geological information may result in a failure to implement the investment program. This may lead to the deteriorated performance indicators for the subsequent years, undermined efficiency of investment projects and the need to raise "excessive" funds.

The Company pays great attention to managing this risk by means of quarterly monitoring of project implementation progress as well as by investment program adjustment. As the investment program is developed, the greenfield development projects without any design and estimate documentation are excluded from the plans for the coming year.

Risk Associated with the Lack of Qualified Personnel

The competence and expertise of the newly recruited employees may prove insufficient for them to adequately fulfill their duties, which, in its turn, may adversely affect the financial performance indicators of the Company.

To mitigate the negative impact of this risk, the Company focuses on integrated development of the personnel potential. The Company has created and replenishes its personnel pool consisting of the most experienced and the most promising employees; it pays special attention to the recruitment of young specialists and graduates.

Responsibility statement

I hereby confirm that to the best of my knowledge:

(a) the financial statements, prepared in accordance with the International Financial Reporting Standards, give a true and fair view of the assets, liabilities, financial position and profit or loss of the Company and the undertakings included in the consolidation taken as a whole,

(b) the management report includes a fair review of the development and performance of the business and the position of the Company and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

Alekperov V. Y.
President of PJSC LUKOIL

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This Annual Financial Report is also available at the Company's website at <http://www.lukoil.com>.