PJSC LUKOIL

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

**for the three-month periods ended
30 June and 31 March 2018
and six-month periods ended
30 June 2018 and 2017**

The following report contains a discussion and analysis of the financial position of PJSC LUKOIL at 30 June 2018 and the results of its operations for the three-month periods ended 30 June and 31 March 2018 and six-month periods ended 30 June 2018 and 2017, 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 for the respective periods.

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.

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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 16.0 billion BOE at 1 January 2018 and comprised of 12.1 billion barrels of crude oil and 23.6 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 West 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 2018 amounted to 2.3 million BOE, with liquid hydrocarbons representing approximately 77% 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 have 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 2018 amounted to 1.3 million barrels per day, and we produced 0.6 million tonnes of petrochemicals.

We market 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 18 countries. Most of our retail networks are located close to our refineries. Our retail sales in the first half of 2018 amounted to 7.2 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 2018, our total output of electrical energy was 9.1 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

	Q2 2018	Q1 2018	Change, %	1st half of 2018	1st half of 2017	Change, %
	(millions of rubles, except for figures in percent)					
Sales	2,056,058	1,630,728	26.1	3,686,786	2,790,769	32.1
EBITDA[1], including	295,151	219,524	34.5	514,675	386,689	33.1
Exploration and production segment	239,699	171,918	39.4	411,617	241,364	70.5
Refining, marketing and distribution segment	71,620	46,849	52.9	118,469	132,995	(10.9)
EBITDA[1] net of West Qurna-2 project	288,854	213,789	35.1	502,643	379,903	32.3
Profit for the period attributable to LUKOIL shareholders	167,322	109,058	53.4	276,380	200,954	37.5
Capital expenditures	105,777	121,057	(12.6)	226,834	254,868	(11.0)
Free cash flow[2]	137,172	45,935	198.6	183,107	83,033	120.5
Free cash flow before changes in working capital	157,169	93,791	67.6	250,960	110,259	127.6
	(thousand BOE per day, except for figures in percent)					
Production of hydrocarbons, including our share in equity affiliates	2,313	2,320	(0.3)	2,316	2,251	2.9
Crude oil and natural gas liquids	1,787	1,797	(0.6)	1,792	1,815	(1.3)
Gas	526	523	0.6	524	436	20.2
Refinery throughput at the Group refineries	1,348	1,312	2.7	1,330	1,320	0.8

(1) Profit from operating activities before depreciation, depletion and amortization.
(2) Cash flow from operating activities less capital expenditures.

Our results were positively impacted by an increase in international hydrocarbon prices and ruble devaluation, higher share of high-margin projects in crude oil production structure, positive export duty lag effect, growth in gas production volumes in Uzbekistan, as well as positive inventory effect at our refineries. Among the restraining factors were domestic refined products prices lagging the export netbacks, as well as external limitations of our liquids production in Russia due to the OPEC agreement.

As a result, our EBITDA amounted to 295 billion RUB in the second quarter of 2018, an increase of 34.5% to the first quarter of 2018, and to 515 billion RUB in the first half of 2018, an increase of 33.1% to the first half of 2017.

Our profit was positively impacted by a foreign exchange gain and negatively impacted by increased depreciation, depletion and amortization.

As a result, in the second quarter of 2018, profit attributable to LUKOIL shareholders amounted to 167 billion RUB, an increase of 53.4% to the first quarter of 2018 and in the first half of 2018, our profit amounted to 276 billion RUB, an increase of 37.5% to the first half of 2017. In the second quarter of 2017, we recognized a gain on sale of JSC “Arkhangelskgeoldobycha” in the after-tax amount of 38 billion RUB. Excluding this factor, our profit increased by 69.0% compared to the first half of 2017.

Our free cash flow increased three-fold compared to the first quarter of 2018 and more than two-fold compared to the first half of 2017 due to increased operating cash flow and lower capital expenditures.

The Group’s average daily hydrocarbon production didn’t change significantly compared to the first quarter of 2018, and increased by 2.9% compared to the first half of 2017, driven primarily by growth in gas production volumes in Uzbekistan. Planned increase in production from V.Filanovsky and Pyakyakhinskoe fields, commissioned in 2016, continued, as well as growth at other high-margin projects.

Compared to the first quarter of 2018 and the first half of 2017, throughput at own refineries increased by 2.7% and by 0.8%, respectively, due to maintenance schedule. Moreover, we achieved further improvement in refined product slate in the first half of 2018 due to better utilization of our newly built facilities 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, the Group completed the sale of wholly owned subsidiary – LUKOIL Chemical B.V., which owns "Karpatneftekhim" petrochemical plant located in the Ivano-Frankovsk area of Ukraine.

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.

In the first half of 2018, the price for Brent crude oil fluctuated between $61 and $80 per barrel, reached its maximum of $80.3 in the middle of May and its minimum of $61.5 in early February. Average price expressed in US dollars increased by 11.1% compared to the first quarter of 2018 and by 36.4% compared to the first half of 2017. Moreover, as a result of the ruble devaluation, the prices expressed in rubles increased even faster.

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

	Q2 2018	**Q1 2018**	**Change, %**	**1st half of 2018**	**1st half of 2017**	**Change, %**
	(in US dollars per barrel, except for figures in percent)					
Brent crude	74.23	66.81	11.1	70.54	51.72	36.4
Urals crude (CIF Mediterranean)	72.62	65.23	11.3	68.95	50.73	35.9
Urals crude (CIF Rotterdam)	72.05	65.28	10.4	68.68	50.22	36.8
	(in US dollars per metric tonne, except for figures in percent)					
Diesel fuel 10 ppm (FOB Rotterdam)	657.94	591.62	11.2	624.96	465.09	34.4
High-octane gasoline (FOB Rotterdam)	712.16	644.57	10.5	678.55	536.38	26.5
Naphtha (FOB Rotterdam)	631.37	569.84	10.8	600.77	455.07	32.0
Jet fuel (FOB Rotterdam)	706.06	646.87	9.2	676.63	494.74	36.8
Vacuum gas oil (FOB Rotterdam)	510.99	466.78	9.5	489.01	349.04	40.1
Fuel oil 3.5% (FOB Rotterdam)	400.63	353.98	13.2	377.43	284.33	32.7

Source: Platts.

	Q2 2018	**Q1 2018**	**Change, %**	**1st half of 2018**	**1st half of 2017**	**Change, %**
	(in rubles per barrel, except for figures in percent)					
Brent crude	4,588	3,800	20.7	4,187	2,999	39.6
Urals crude (CIF Mediterranean)	4,488	3,710	21.0	4,092	2,942	39.1
Urals crude (CIF Rotterdam)	4,453	3,713	19.9	4,077	2,912	40.0
	(in rubles per metric tonne, except for figures in percent)					
Diesel fuel 10 ppm (FOB Rotterdam)	40,660	33,651	20.8	37,094	26,969	37.5
High-octane gasoline (FOB Rotterdam)	44,011	36,663	20.0	40,274	31,103	29.5
Naphtha (FOB Rotterdam)	39,018	32,412	20.4	35,658	26,388	35.1
Jet fuel (FOB Rotterdam)	43,634	36,794	18.6	40,160	28,688	40.0
Vacuum gas oil (FOB Rotterdam)	31,579	26,551	18.9	29,025	20,240	43.4
Fuel oil 3.5% (FOB Rotterdam)	24,759	20,134	23.0	22,402	16,487	35.9

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 for the respective periods.

	Q2 2018	Q1 2018	Change, %	1st half of 2018	2017	Change, %
	(in rubles per metric tonne, except for figures in percent)					
Diesel fuel	41,476	36,821	12.6	39,149	31,659	23.7
High-octane gasoline (Regular)	42,768	35,664	19.9	39,216	35,716	9.8
High-octane gasoline (Premium)	43,778	36,192	21.0	39,985	36,151	10.6
Fuel oil	15,459	11,928	29.6	13,694	9,354	46.4

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 the ruble-euro exchange rates.

	Q2 2018	Q1 2018	1st half of 2018	2017
Ruble inflation (CPI), %	1.3	0.8	2.1	1.7
Ruble to US dollar exchange rate				
Average for the period	61.8	56.9	59.4	58.0
At the beginning of the period	57.3	57.6	57.6	60.7
At the end of the period	62.8	57.3	62.8	59.1
Ruble to euro exchange rate				
Average for the period	73.8	69.9	71.8	62.7
At the beginning of the period	70.6	68.9	68.9	63.8
At the end of the period	73.0	70.6	73.0	67.5

Source: CBR, Federal State Statistics Service.

Taxation

Between 2015 and 2017, the Russian Government implemented the tax manoeuvre in the oil industry which involved reduction of export duty rate and increase in the crude oil extraction tax and excise tax rates. Changes that became 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. In 2018, there have been no material amendments to the export duty and crude oil mineral extraction tax rates calculation formulas.

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

	Q2 2018	Q1 2018	Change, %	1st half of 2018	2017	Change, %
	(in US dollars per tonne, except for figures in percent)					
Export duties on crude oil	120.54	116.90	3.1	118.73	85.36	39.1
Export duties on refined products						
Fuel oil	120.54	116.90	3.1	118.73	85.36	39.1
Motor gasoline	36.13	35.04	3.1	35.58	25.58	39.1
Straight-run gasoline	66.22	64.24	3.1	65.24	46.92	39.1
Diesel fuel and refined products	36.13	35.04	3.1	35.58	25.58	39.1
Mineral extraction tax(1)						
Crude oil	208.22	182.93	13.8	196.16	129.20	51.8
	(in US dollars per thousand cubic meters, except for figures in percent)					
Natural gas (Nakhodkinskoe field)	4.84	5.26	(8.0)	5.04	4.28	18.0
Natural gas (Pyakyakhinskoye field)	8.83	8.98	(1.6)	8.90	7.97	11.8

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

	Q2 2018	Q1 2018	Change, %	1st half of 2018	2017	Change, %
	(in rubles per tonne, except for figures in percent)					
Export duties on crude oil[1]	7,449	6,649	12.0	7,047	4,950	42.4
Export duties on refined products[1]						
Fuel oil	7,449	6,649	12.0	7,047	4,950	42.4
Motor gasoline	2,233	1,993	12.0	2,112	1,483	42.4
Straight-run gasoline	4,092	3,654	12.0	3,872	2,721	42.4
Diesel fuel and refined products	2,233	1,993	12.0	2,112	1,483	42.4
Mineral extraction tax						
Crude oil	12,868	10,405	23.7	11,643	7,492	55.4
	(in rubles per thousand cubic meters, except for figures in percent)					
Natural gas (Nakhodkinskoe field)	299	299	-	299	248	20.7
Natural gas (Pyakyakhinskoye field)	546	511	6.9	528	462	14.4

[1] Translated to rubles using average exchange rate for the period.

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 2018 tax formulae				
Standard	**17.7**	**11.5**	**29.2**	**58.4**
Yaregskoye field	0.0	1.8	1.8	3.6
Yu. Korchagin field	7.4	0.0	7.4	14.9
V. Filanovsky field	7.5	0.0	7.5	15.0
Usinskoye (Permian layers)	7.4	11.5	18.9	37.9
Pyakyakhinskoye field	7.4	11.5	18.9	37.9
V. Vinogradov field	9.5	11.5	21.0	42.0
Fields with depletion above 80%	10.5–17.7	11.5	22.0–29.2	44.0–58.4
New fields with reserves below 5 million tonnes	11.3–17.7	11.5	22.8–29.2	45.6–58.4
Tyumen deposits	15.6	11.5	27.1	54.3

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:

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

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 Factors* (where applicable) are presented below:

	2017	2018	2019	2020	2021	2022 and further
			(rubles)			
Base Rate	919	919	919	919	919	919
Fixed Factor	306	357	428	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 Autonomous region of West 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 particular unconventional deposits.

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

The table on p. 9 illustrates the impact of crude oil extraction tax incentives on taxation of crude oil production from our different fields and deposits at $50 per barrel Urals price.

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

Gas produced from our two major fields, Nakhodkinskoye and Pyakyakhinskoe, is taxed at the rates subject to application of reducing coefficients due the fields' geographical location and the depth of reservoir.

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, $146.0 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 crude oil price over $15 per barrel)
Above $146.0 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 $146.0 per tonne (or $1.75 plus $0.45 per barrel per each $1 increase in crude oil price over $20 per barrel)
Above $182.5 per tonne ($25 per barrel)	$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 crude oil price over $25 per barrel)

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.

	Q2 2018	Q1 2018	Change, %	1st half of 2018	2017	Change, %
	(in US dollars per barrel, except for figures in percent)					
Urals price (Argus)	72.46	65.17	11.2	68.84	50.17	37.2
Export duty on crude oil	16.51	16.01	3.1	16.26	11.69	39.1
Mineral extraction tax on crude oil	28.52	25.06	13.8	26.87	17.70	51.8
Net Urals price(1)	27.43	24.10	13.8	25.70	20.78	23.7
Export duty lag effect	1.72	0.04	4,732.7	0.88	(0.15)	(706.9)
Net Urals price(1) assuming no lag	25.71	24.06	6.8	24.82	20.93	18.6
	(in rubles per barrel, except for figures in percent) (2)					
Urals price (Argus)	4,478	3,707	20.8	4,086	2,909	40.5
Export duty on crude oil	1,020	911	12.0	965	678	42.4
Mineral extraction tax on crude oil	1,763	1,425	23.7	1,595	1,026	55.4
Net Urals price(1)	1,695	1,371	23.6	1,526	1,205	26.6
Export duty lag effect	106	2	5,200.0	52	(8)	(750.0)
Net Urals price(1) assuming no lag	1,589	1,369	16.1	1,474	1,213	21.5

(1) Urals price net of export duty and mineral extraction tax on crude oil.
(2) Translated to rubles using average exchange rate for the period.

Crude oil produced at some of our fields is subject to special export duty rates calculated according to specified 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 p. 9 illustrates the impact of crude oil export duty incentives on taxation of export of crude oil produced from our 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
Multiplier for:	
Light and middle distillates	0.30
Diesel fuel	0.30
Gasolines	0.30
Straight-run gasoline	0.55
Fuel oil	1.00

Crude oil and refined products exported 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 ruble-US dollar exchange rate at the date of the complete declaration (except for pipeline deliveries for which 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.

Changes in tax legislation. In July–August 2018, new laws were adopted introducing a number of changes in the taxation of the oil industry in Russia which will come into effect on 1 January 2019.

The changes relate to the continuation of a so called tax maneuver, the objective of which is the gradual reduction of crude oil export duty rate to zero with the equivalent increase in the extraction tax rate for crude oil. The rates for fields benefiting from tax incentives are adjusted accordingly. To eliminate the negative effect of export duty reduction on refining margins, a negative excise on refinery feedstock is introduced.

An additional adjusting factor will be applied to the standard crude oil export duty rate calculated in accordance with the table on p. 10:

	2019	**2020**	**2021**	**2022**	**2023**	**2024** and further
Adjusting factor	0.833	0.667	0.5	0.333	0.167	0

The Company expects that the above mentioned tax changes combined will not have a material impact on the Group's financial results.

Starting from 2019, a tax on additional income from the hydrocarbon production (additional income tax – hereinafter AIT) will be implemented for certain fields. The AIT rate is set at 50% and is applied to the estimated sales revenue less actual and estimated costs. For crude oil production subject to AIT, a special mineral extraction tax rate formula is applied.

The Company expects those changes to have significant positive influence on development plans for, and production profile of, its brownfields subject to AIT.

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 taxes 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, excise taxes 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 periods considered are listed below.

	Q2 2018	**Q1 2018**	**Change, %**	**1st half of 2018**	**1st half of 2017**	**Change, %**
	(in rubles per tonne, except for figures in percent)					
Gasoline						
Below Euro-5	13,100	13,100	–	13,100	13,100	–
Euro-5	10,224	11,213	(8.8)	10,716	10,130	5.8
Diesel fuel						
All ecological classes	7,006	7,665	(8.6)	7,334	6,800	7.9
Motor oils	5,400	5,400	–	5,400	5,400	–
Straight-run gasoline	13,100	13,100	–	13,100	13,100	–

From June to December 2018, excise rates on refined products are temporarily reduced by 3,000 rubles per tonne of motor gasoline (Euro-5) and by 2,000 rubles per tonne of diesel fuel (all ecological classes).

Established excise tax rates starting from 2018 are listed below.

	1 January to 31 May, 2018	**1 June to 31 December, 2018**	**2019**	**2020**	**2021**
	(in rubles per tonne)				
Gasoline					
Below Euro-5	13,100	13,100	13,100	13,100	13,624
Euro-5	11,213	8,213	12,314	12,752	13,262
Diesel fuel					
All ecological classes	7,665	5,665	8,541	8,835	9,188
Motor oils	5,400	5,400	5,400	5,616	5,841
Straight-run gasoline	13,100	13,100	13,912	14,720	15,533
Jet fuel	2,800	2,800	2,800	2,800	2,800
Middle distillates	8,662	6,665	9,241	9,535	9,916

Income tax. The federal income tax rate in Russia 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 transportated 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 through 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 2018 to 1st quarter of 2018	**1st half of 2018 to 1st half of 2017**
Transneft		
Crude oil	0.0%	4.1%
Russian Railways		
Crude oil and refined products	0.0%	5.3%

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 operations of the Group companies), finance activities, and certain other activities, that are not primary to the Group.

Each of our segments is dependent on the others, with a portion of the revenues of one segment being a part of the costs of the others. 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, benchmark 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 28 "Segment information" to our condensed interim consolidated financial statements.

Exploration and production

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

	Q2 2018	Q1 2018	1st half of 2018	1st half of 2017
	(millions of rubles)			
EBITDA	239,699	171,918	411,617	241,364
- in Russia	203,525	144,657	348,182	207,738
- outside Russia	36,174	27,261	63,435	33,626
- including the West Qurna-2 project	6,297	5,735	12,032	6,786
Hydrocarbon extraction expenses	53,091	50,670	103,761	102,009
- in Russia	43,717	42,857	86,574	87,265
- outside Russia and Iraq	5,113	4,238	9,351	5,701
- in Iraq	4,261	3,575	7,836	9,043
	(ruble per BOE)			
Hydrocarbon extraction expenses (excluding Iraq)	241	235	238	240
- in Russia	246	244	245	245
- outside Russia and Iraq	207	176	192	178
	(US dollar per BOE)			
Hydrocarbon extraction expenses (excluding Iraq)	3.90	4.14	4.02	4.14
- in Russia	3.98	4.28	4.13	4.23
- outside Russia and Iraq	3.35	3.09	3.22	3.08

Our upstream EBITDA increased by 39.4%, compared to the first quarter of 2018, and by 70.5%, compared to the first half of 2017.

Compared both to the first quarter of 2018 and the first half of 2017, our upstream EBITDA in Russia increased as a result of higher hydrocarbon prices, the effect of the ruble devaluation, positive export duty lag effect, as well as increase in production from our high-margin fields.

Compared both to the first quarter of 2018 and the first half of 2017, our upstream EBITDA outside Russia increased mainly due to higher hydrocarbon prices, growth in gas production in Uzbekistan and the effect of the ruble devaluation. Moreover, in the second quarter of 2018, our EBITDA was supported by a reversal of bad debt provision related to one of our projects.

The following table summarizes our hydrocarbon production by major regions.

	Q2 2018	Q1 2018	1st half of 2018	1st half of 2017
	(thousand BOE per day)			
Crude oil and natural gas liquids				
Consolidated subsidiaries				
West Siberia	770	771	771	815
Timan-Pechora	314	317	316	312
Ural region	327	326	327	324
Volga region	225	216	220	190
Other in Russia	31	31	31	35
Total in Russia	1,667	1,661	1,665	1,676
Iraq[1]	24	34	29	34
Other outside Russia	46	50	47	45
Total outside Russia	70	84	76	79
Total consolidated subsidiaries	**1,737**	**1,745**	**1,741**	**1,755**
Our share in equity affiliates				
in Russia	13	14	13	22
outside Russia	37	38	38	38
Total share in equity affiliates	**50**	**52**	**51**	**60**
Total crude oil and natural gas liquids	**1,787**	**1,797**	**1,792**	**1,815**
Natural and petroleum gas[2]				
Consolidated subsidiaries				
West Siberia	212	217	215	217
Timan-Pechora	33	33	33	36
Ural region	14	15	14	16
Volga region	27	26	27	21
Other in Russia	1	1	1	1
Total in Russia	287	292	290	291
Total outside Russia	226	219	222	131
Total consolidated subsidiaries	**513**	**511**	**512**	**422**
Share in equity affiliates				
in Russia	1	2	1	1
outside Russia	12	10	11	13
Total share in production of equity affiliates	**13**	**12**	**12**	**14**
Total natural and petroleum gas	**526**	**523**	**524**	**436**
Total daily hydrocarbon production	**2,313**	**2,320**	**2,316**	**2,251**
Including natural gas liquids produced at the gas processing plants	41	38	40	36

(1) Compensation crude oil related to the Group.

(2) Natural and petroleum gas production excluding flaring, reinjected gas and gas used in production of natural gas liquids.

Crude oil production by major regions is presented in the table below.

	Q2 2018	Q1 2018	1st half of 2018	2017
	(thousands of tonnes)			
West Siberia	9,270	9,203	18,473	19,560
Timan-Pechora	3,976	3,966	7,942	7,821
Ural region	3,772	3,725	7,497	7,522
Volga region	2,681	2,556	5,237	4,552
Other in Russia	397	397	794	843
Crude oil produced in Russia	20,096	19,847	39,943	40,298
Iraq[(1)]	318	451	769	887
Other outside Russia	457	490	947	1,013
Crude oil produced outside Russia	775	941	1,716	1,900
Total crude oil produced by consolidated subsidiaries	**20,871**	**20,788**	**41,659**	**42,198**
Our share in crude oil produced by equity affiliates:				
in Russia	157	158	315	518
outside Russia	425	431	856	874
Total crude oil produced	**21,453**	**21,377**	**42,830**	**43,590**

[(1)] Compensation crude oil related to the Group.

Our main oil producing region is West Siberia where we produced 44.4% and 44.3% of our crude oil in the second quarter and the first half of 2018 (44.3% in the first quarter of 2018, 46.4% in the first half of 2017).

Compared to the first quarter of 2018, daily liquids production in Russia didn't change significantly. The decrease in our production volumes compared to the first half of 2017 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 (West 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.

At the same time we continued increasing production at the V. Filanovsky (Volga region, Caspian sea) and Pyakyakhinskoye fields and other high-margin fields, which have a major positive impact on our financial results due to high quality reserve base and tax incentives.

The third well was launched in June 2018 at the second development stage of the V. Filanovsky field. In the first half of 2018, we produced 2,859 thousand tonnes of crude oil at this field, an increase of 43%, compared to the first half of 2017. In May 2018, the drilling of the first production well started at the second development stage of the Yu. Korchagin field, which was completed in July. We also produced 790 thousand tonnes of liquids at the Pyakyakhinskoye field, an increase of 7%, compared to the first half of 2017.

Active development of the Yaregskoye field and the Permian layers of our Usinskoye field in Timan-Pechora led to the increase in the high-viscous crude oil production by 35% compared to the first half of 2017.

In June 2018, the OPEC+ countries agreed to increase the crude oil production quotas that resulted in an increase in our domestic crude oil daily production by approximately 30 thousand BOE by August.

Gas production (excluding flaring, reinjected gas and gas used in production of natural gas liquids) by major regions is presented in the table below.

	Q2 2018	Q1 2018	1st half of 2018	1st half of 2017
	(millions of cubic meters)			
West Siberia	3,282	3,318	6,600	6,658
Timan-Pechora	508	515	1,023	1,095
Ural region	212	229	441	498
Volga region	423	404	827	661
Other in Russia	6	7	13	16
Gas produced in Russia	4,431	4,473	8,904	8,928
Uzbekistan	3,131	2,921	6,052	3,046
Other outside Russia	362	422	784	981
Gas produced outside Russia	3,493	3,343	6,836	4,027
Total gas produced by consolidated subsidiaries	**7,924**	**7,816**	**15,740**	**12,955**
Our share in gas produced by equity affiliates:				
in Russia	25	23	48	48
outside Russia	178	160	338	408
Total gas produced	**8,127**	**7,999**	**16,126**	**13,411**

In Russia, our major gas production region is West 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. Gas production from Pyakyakhinskoe field amounted to 1,912 million cubic meters, an increase of 35.4% to the first half of 2017. Our international gas production (including our share in affiliates' production) increased by 61.8%, compared to the first half of 2017, as a result of commissioning of new gas treatment facilities within Gissar and Kandym projects in Uzbekistan.

West Qurna-2 project

The West Qurna-2 field in Iraq is developed under the service contract, signed in January 2010. In May 2018, a Group company and Iraqi party signed a new development plan of the field, according to which, crude oil production is planned to increase to 800 thousand barrels per day by 2025.

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 amount of costs claimed for reimbursement. Approved invoice amount for the reporting quarter is 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 2017	8,072	303	7,842	533
Change in the first half of 2018	264	58	463	(141)
Cumulative at 30 June 2018	**8,336**	**361**	**8,305**	**392**

[(1)] Including prepayments.

The West Qurna-2 project summary is presented below:

	Q2 2018		Q1 2018	
	(thousand barrels)	(thousand tonnes)	(thousand barrels)	(thousand tonnes)
Total production	34,869	5,098	32,801	4,795
Production related to cost compensation and remuneration	2,175	318	3,088	451
Shipment of compensation crude oil[(1)]	4,899	716	1,988	291
	(millions of rubles)	(millions of US dollars)	(millions of rubles)	(millions of US dollars)
Cost compensation	8,829	143	7,749	136
Remuneration fee	1,856	30	1,610	28
	10,685	173	9,359	164
Cost of compensation crude oil, received as liability settlement (included in *Cost of purchased crude oil, gas and products*)[(1)]	21,146	342	6,889	121
Extraction expenses	4,261	69	3,575	63
Depreciation, depletion and amortization	4,560	74	4,251	75
EBITDA	6,297	102	5,735	101

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

	1st half of 2018		1st half of 2017	
	(thousand barrels)	(thousand tonnes)	(thousand barrels)	(thousand tonnes)
Total production	67,670	9,893	71,715	10,454
Production related to cost compensation and remuneration	5,263	769	6,084	887
Shipment of compensation crude oil[(1)]	6,887	1,007	5,018	731
	(millions of rubles)	(millions of US dollars)	(millions of rubles)	(millions of US dollars)
Cost compensation	16,578	279	14,562	251
Remuneration fee	3,466	58	1,719	30
	20,044	337	16,281	281
Cost of compensation crude oil, received as liability settlement (included in *Cost of purchased crude oil, gas and products*)[(1)]	28,035	463	13,367	230
Extraction expenses	7,836	132	9,043	156
Depreciation, depletion and amortization	8,811	149	5,676	98
EBITDA	12,032	203	6,786	117

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

In February-June 2017, due to a so-called performance factor that represents a ratio of actual production volumes to target production volumes according to the provisions of the service contract, our per barrel remuneration fee was approximately three times lower. The parties agreed not to apply the performance factor from the third quarter of 2017.

Refining, marketing and distribution

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

	Q2 2018	Q1 2018	1st half of 2018	1st half of 2017
	(millions of rubles)			
EBITDA	71,620	46,849	118,469	132,995
- in Russia	52,695	42,299	94,994	93,647
- outside Russia	18,925	4,550	23,475	39,348
Refining expenses at the Group refineries	25,677	21,996	47,673	41,002
- in Russia	10,730	9,325	20,055	19,581
- outside Russia	14,947	12,671	27,618	21,421
	(ruble per tonne)			
Refining expenses at the Group refineries	1,534	1,365	1,451	1,258
- in Russia	1,006	875	941	935
- outside Russia	2,464	2,321	2,397	1,841
	(US dollar per tonne)			
Refining expenses at the Group refineries	24.83	24.00	24.42	21.69
- in Russia	16.28	15.39	15.83	16.11
- outside Russia	39.87	40.81	40.32	31.74

Our refining, marketing and distribution EBITDA was 52.9% higher than in the first quarter of 2018, and 10.9% lower than in the first half of 2017.

In Russia, most of the downstream EBITDA growth both quarter-on-quarter and year-on-year was driven by our refineries thanks to strong positive inventory effect, as well as better product slate as compared to the first half of 2017. Moreover, our refineries' results for the second quarter of 2018 included the effect of excise tax downward recalculation according to the new rates introduced after the period end date, but effective from 1 June 2018. Downstream performance in Russia was also supported by stronger results of our bunkering, lubricants, and aircraft refueling businesses. Key constraining factor for the results were domestic prices lagging international netbacks.

Outside Russia, the quarter-on-quarter increase of EBITDA was mostly due to improved results of the refineries and seasonally better performance of retail. At our international refineries, positive inventory effect and higher throughput volumes on the back of the previous quarter's maintenance works were key EBITDA growth factors. The year-on-year dynamics of our downstream EBITDA outside Russia was mainly defined by accounting specifics of our trading operations that resulted in material gains in the first half of 2017, while significant positive inventory effect at our refineries was partially offset by lower refining margins.

Refining and petrochemicals

The following table summarizes key figures for our refining and petrochemical volumes.

	Q2 2018	Q1 2018	1st half of 2018	1st half of 2017
	(thousands of tonnes)			
Refinery throughput at the Group refineries	16,734	16,113	32,847	32,590
- in Russia	10,668	10,655	21,323	20,953
- outside Russia, including	6,066	5,458	11,524	11,637
- crude oil	5,340	4,549	9,889	10,478
- refined products	726	909	1,635	1,159
Refinery throughput at third party refineries	1,631	1,660	3,291	3,074
Total refinery throughput	**18,365**	**17,773**	**36,138**	**35,664**
Production of the Group refineries in Russia[(1)]	**10,045**	**10,066**	**20,111**	**19,768**
- diesel fuel	3,986	4,131	8,117	7,578
- motor gasoline	2,022	2,030	4,052	3,879
- fuel oil	1,096	1,274	2,370	2,711
- jet fuel	738	616	1,354	1,218
- lubricants and components	188	281	469	551
- straight-run gasoline	570	557	1,127	1,108
- vacuum gas oil	135	62	197	503
- bitumen	227	135	362	418
- coke	289	287	576	472
- other products	794	693	1,487	1,330
Production of the Group refineries outside Russia	**5,761**	**5,023**	**10,784**	**10,949**
- diesel fuel	2,369	1,994	4,363	4,749
- motor gasoline	1,066	987	2,053	2,459
- fuel oil	740	709	1,449	1,618
- jet fuel	317	297	614	495
- straight-run gasoline	532	459	991	935
- coke	51	53	104	84
- other products	686	524	1,210	609
Refined products produced by the Group	**15,806**	**15,089**	**30,895**	**30,717**
Refined products produced at third party refineries	1,597	1,643	3,240	3,031
Total refined products produced	**17,403**	**16,732**	**34,135**	**33,748**
Reference: Net of cross-supplies of refined products among the Group refineries	485	471	956	877
Products produced at petrochemical plants and facilities	**302**	**335**	**637**	**639**
- in Russia	225	250	475	452
- outside Russia	77	85	162	187

(1) Net of cross-supplies of refined products among the Group.

The total volume of refined products produced by the Group increased by 4.8%, compared to the first quarter of 2018, and by 0.6%, compared to the first half of 2017.

Compared to the first quarter of 2018, production at our refineries in Russia didn’t change significantly. Compared to the first half of 2017, production increased by 1.7%, mainly due to higher utilization rates at our refinery in Volgograd. In Russia, we continued improving our refined product slate through higher utilization rates of our newly-launched conversion facilities and cross-supplies of own dark products to catalytic cracking units at our refineries in Nizhny Novgorod and Volgograd and to coking unit in Perm. As a result, the share of gasoline and diesel fuel in our total production volumes increased by 2.6 p.p. compared to the first half of 2017 and the share of fuel oil and vacuum gasoil decreased by 3.5 p.p.

At our international refineries, production increased as a result of maintenance works in the first quarter of 2018.

In the periods considered, we processed our crude oil at third party refineries in Belarus, Kazakhstan and Canada. In 2016, a Group company entered into a tolling agreement valid through 2019 with a Canadian refinery. In the second quarter and the first half of 2018, attributable refined products output amounted to 1.6 million tonnes and 3.2 million tonnes, respectively (1.6 million tonnes in the first quarter of 2018 and 3.0 million tonnes in the first half of 2017).

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 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.

	Q2 2018	Q1 2018	1st half of 2018	1st half of 2017
	(thousands of tonnes)			
Crude oil purchases				
in Russia	189	215	404	511
for trading internationally	12,245	10,055	22,300	17,052
for refining internationally	5,459	5,232	10,691	10,855
Shipment of the West Qurna-2 compensation crude oil	716	291	1,007	731
Total crude oil purchased	**18,609**	**15,793**	**34,402**	**29,149**

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

	Q2 2018	Q1 2018	1st half of 2018	1st half of 2017
	(thousands of tonnes)			
Refined products retail sales	3,742	3,429	7,171	6,806
Refined products wholesale sales	26,244	27,429	53,673	57,564
Total refined products sales	**29,986**	**30,858**	**60,844**	**64,370**
Refined products purchased in Russia	223	357	580	949
Refined products purchased internationally	13,715	13,835	27,550	30,894
Total refined products purchased	**13,938**	**14,192**	**28,130**	**31,843**
Petrochemical products purchased in Russia	8	8	16	22
Petrochemical products purchased internationally	133	146	279	216
Total petrochemical products purchased	**141**	**154**	**295**	**238**

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

	Q2 2018	Q1 2018	1st half of 2018	1st half of 2017
	(thousands of tonnes)			
Exports of crude oil to Customs Union	687	683	1,370	1,429
Exports of crude oil beyond Customs Union	8,295	7,992	16,287	17,226
Total crude oil exports	**8,982**	**8,675**	**17,657**	**18,655**
Exports of crude oil through Transneft and other third party infrastructure including:	7,017	6,466	13,483	14,034
ESPO pipeline	300	300	600	540
CPC pipeline	1,144	1,055	2,199	1,523
Exports of crude oil through the Group's transportation infrastructure	1,965	2,209	4,174	4,621
Total crude oil exports	**8,982**	**8,675**	**17,657**	**18,655**
	(millions of rubles)			
Exports of crude oil to Customs Union	17,074	13,639	30,713	22,611
Exports of crude oil beyond Customs Union	264,279	210,600	474,879	347,996
Total crude oil exports	**281,353**	**224,239**	**505,592**	**370,607**

	Q2	Q1	1st half of	
	2018	**2018**	**2018**	**2017**
	(thousands of tonnes)			
Refined products exports				
- diesel fuel	2,388	2,811	5,199	5,145
- gasoline	46	177	223	89
- fuel oil	195	621	816	1,669
- jet fuel	12	24	36	58
- lubricants and components	128	177	305	324
- gas refinery products	244	301	545	596
- other products	625	554	1,179	1,439
Total refined products exports	**3,638**	**4,665**	**8,303**	**9,320**
Total petrochemical products exports	**73**	**99**	**172**	**164**
	(millions of rubles)			
Total refined products and petrochemicals exports	**140,206**	**145,120**	**285,326**	**227,508**

The volume of our crude oil exports from Russia increased by 3.5% compared to the first quarter of 2018, and decreased by 5.3% compared to the first half of 2017. In the second quarter and first half of 2018 we exported 44.7% and 44.2% of our domestic crude oil production (43.7% in the first quarter of 2018 and 46.3% in the first half of 2017) and 48 thousand tonnes and 91 thousand tonnes of crude oil purchased from our affiliates and third parties (43 thousand tonnes in the first quarter of 2018 and 225 thousand tonnes in the first half of 2017), respectively. In the second quarter of 2018, the increase in export volumes was driven by crude oil volumes redirection from domestic market to export. In the first half of 2018, the decrease in export volumes was primarily a result of higher refinery throughput.

The volume of our refined products exports decreased by 22.0% compared to the first quarter of 2018, and by 10.9% compared to the first half of 2017 driven by higher domestic demand for our products.

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.

Besides our own infrastructure, we also export the 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 export routes.

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 second quarter and the first half of 2018, we sold 2.7 million tonnes and 5.1 million tonnes of motor fuels via our domestic retail network, which was 9.6% more compared to the first quarter of 2018 and 7.0% more compared to the first half of 2017. Outside Russia, retail sales increased by 8.0% compared to the first quarter of 2018 due to seasonality factor, and by 1.4%, compared to the first half of 2017.

We also supply jet fuel to airports and bunker fuel to sea and river ports in and outside 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 second quarter and the first half of 2018, our total output of commercial electrical energy was 3.8 billion kWh and 9.1 billion kWh, respectively (5.3 billion kWh in the first quarter of 2018 and 8.8 billion kWh in the first half of 2017), and our total output of commercial heat energy was approximately 1.4 million Gcal and 6.5 million Gcal, respectively (5.1 million Gcal in the first quarter of 2018 and 6.3 million Gcal in the first half of 2017).

Financial results

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

	Q2	Q1	1st half of	
	2018	2018	2018	2017
	(millions of rubles)			
Revenues				
Sales (including excise and export tariffs)	2,056,058	1,630,728	3,686,786	2,790,769
Costs and other deductions				
Operating expenses	(112,221)	(108,640)	(220,861)	(218,066)
Cost of purchased crude oil, gas and products	(1,187,883)	(891,429)	(2,079,312)	(1,443,733)
Transportation expenses	(68,207)	(66,055)	(134,262)	(141,230)
Selling, general and administrative expenses	(40,409)	(36,754)	(77,163)	(75,531)
Depreciation, depletion and amortization	(97,593)	(87,690)	(185,283)	(164,936)
Taxes other than income taxes	(213,970)	(186,667)	(400,637)	(299,322)
Excise and export tariffs	(137,402)	(121,191)	(258,593)	(224,775)
Exploration expenses	(815)	(468)	(1,283)	(1,423)
Profit from operating activities	**197,558**	**131,834**	**329,392**	**221,753**
Finance income	4,648	3,514	8,162	6,401
Finance costs	(8,279)	(7,322)	(15,601)	(16,237)
Equity share in income of affiliates	6,104	5,249	11,353	7,685
Foreign exchange gain (loss)	22,394	(1,432)	20,962	(15,708)
Other (expenses) income	(10,562)	699	(9,863)	45,341
Profit before income taxes	**211,863**	**132,542**	**344,405**	**249,235**
Current income taxes	(39,952)	(18,237)	(58,189)	(44,939)
Deferred income taxes	(3,916)	(4,880)	(8,796)	(2,818)
Total income tax expense	**(43,868)**	**(23,117)**	**(66,985)**	**(47,757)**
Profit for the period	**167,995**	**109,425**	**277,420**	**201,478**
Profit for the period attributable to non-controlling interests	(673)	(367)	(1,040)	(524)
Profit for the period attributable to PJSC LUKOIL shareholders	**167,322**	**109,058**	**276,380**	**200,954**
Basic and diluted earnings per share of common stock attributable to PJSC LUKOIL shareholders (in Russian rubles)	235.79	153.68	389.47	282.19

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

Sales revenues

Sales breakdown	Q2 2018	Q1 2018	1st half of 2018	1st half of 2017
	(millions of rubles)			
Crude oil				
Export and sales on international markets other than Customs Union	702,110	454,627	1,156,737	723,145
Export and sales to Customs Union	17,224	13,765	30,989	22,109
Domestic sales	10,626	13,618	24,244	18,012
	729,960	**482,010**	**1,211,970**	**763,266**
Cost compensation and remuneration at the West Qurna-2 project	10,685	9,359	20,044	16,281
	740,645	**491,369**	**1,232,014**	**779,547**
Refined products[(1)]				
Export and sales on international markets				
Wholesale	897,216	783,963	1,681,179	1,367,562
Retail	86,802	71,998	158,800	129,100
Domestic sales				
Wholesale	111,298	84,829	196,127	152,402
Retail	121,219	103,672	224,891	195,303
	1,216,535	**1,044,462**	**2,260,997**	**1,844,367**
Petrochemicals				
Export and sales on international markets	15,068	15,554	30,622	25,462
Domestic sales	11,189	10,580	21,769	19,107
	26,257	**26,134**	**52,391**	**44,569**
Gas				
Sales on international markets	26,266	19,980	46,246	22,181
Domestic sales	8,420	8,330	16,750	14,931
	34,686	**28,310**	**62,996**	**37,112**
Sales of energy and related services				
Sales on international markets	3,413	2,622	6,035	5,591
Domestic sales	10,545	17,758	28,303	32,188
	13,958	**20,380**	**34,338**	**37,779**
Other				
Export and sales on international markets	11,893	9,894	21,787	25,715
Domestic sales	12,084	10,179	22,263	21,680
	23,977	**20,073**	**44,050**	**47,395**
Total sales	**2,056,058**	**1,630,728**	**3,686,786**	**2,790,769**

[(1)] Including revenue from gas refined products sales.

Sales volumes	Q2 2018	Q1 2018	1st half of 2018	2017
	(thousands of tonnes)			
Crude oil				
Export and sales on international markets other than Customs Union	21,424	16,551	37,975	33,590
Export and sales to Customs Union	693	689	1,382	1,403
Domestic sales	443	713	1,156	1,195
	22,560	**17,953**	**40,513**	**36,188**
Crude oil volumes related to cost compensation and remuneration at the West Qurna-2 project	318	451	769	887
	22,878	**18,404**	**41,282**	**37,075**
Refined products(1)				
Export and sales on international markets				
Wholesale	22,445	24,171	46,616	51,117
Retail	1,052	974	2,026	1,999
Domestic sales				
Wholesale	3,799	3,258	7,057	6,447
Retail	2,690	2,455	5,145	4,807
	29,986	**30,858**	**60,844**	**64,370**
Petrochemicals				
Export and sales on international markets	234	261	495	484
Domestic sales	195	193	388	377
	429	**454**	**883**	**861**
	(millions of cubic meters)			
Gas				
Sales on international markets	3,309	3,138	6,447	3,699
Domestic sales	3,509	3,483	6,992	6,794
	6,818	**6,621**	**13,439**	**10,493**

(1) Including volumes of gas refined products sales.

Realized average sales prices

		Q2 2018	Q1 2018	1st half of 2018	2017
Average realized price on international markets					
Crude oil (beyond Customs Union) (1)	(RUB/barrel)	4,471	3,747	4,156	2,937
Crude oil (Customs Union)	(RUB/barrel)	3,391	2,726	3,059	2,150
Refined products					
Wholesale	(RUB/tonne)	39,974	32,434	36,064	26,754
Retail	(RUB/tonne)	82,511	73,920	78,381	64,582
Petrochemicals	(RUB/tonne)	64,393	59,594	61,863	52,607
Gas (excluding royalty)	(RUB/1,000 m^3)	7,938	6,367	7,173	5,996
Crude oil (beyond Customs Union)(1)	($/barrel)	72.34	65.88	70.01	50.65
Crude oil (Customs Union)	($/barrel)	54.87	47.93	51.54	37.08
Refined products					
Wholesale	($/tonne)	647	570	608	461
Retail	($/tonne)	1,335	1,300	1,321	1,114
Petrochemicals	($/tonne)	1,042	1,048	1,042	907
Gas (excluding royalty)	($/1,000 m^3)	128	112	121	103
Average realized price within Russia					
Crude oil	(RUB/barrel)	3,272	2,606	2,861	2,056
Refined products					
Wholesale	(RUB/tonne)	29,297	26,037	27,792	23,639
Retail	(RUB/tonne)	45,063	42,229	43,711	40,629
Petrochemicals	(RUB/tonne)	57,379	54,819	56,106	50,682
Gas(2)	(RUB/1,000 m^3)	2,400	2,392	2,396	2,198

(1) Excluding cost compensation and remuneration at the West Qurna-2 project.
(2) As most of our gas production in Russia is sold ex-field, the price does not include cost of transportation by Unified Gas Supply System of Gazprom.

In the second quarter of 2018, our revenues increased by 425 billion RUB, or by 26.1%, compared to the first quarter of 2018. Our revenues from crude oil sales increased by 249 billion RUB, or by 50.7%, and our revenues from sales of refined products increased by 171 billion RUB, or by 16.4%. This was mainly driven by the increase in hydrocarbon prices and crude oil trading volumes, as well as the effect of the ruble devaluation on our revenues denominated in the US dollars and euro.

Compared to the first half of 2017, our revenues increased by 896 billion RUB, or by 32.1%. Our revenues from crude oil sales increased by 452 billion RUB, or by 58%, and our revenues from sales of refined products increased by 414 billion RUB, or by 22.5%, largely, as a result of the increase in hydrocarbon prices and the effect of the ruble devaluation on our revenues denominated in the US dollars and euro.

Sales of crude oil

Compared to the first quarter of 2018, our international crude oil sales revenue increased by 54.4%, or by 247 billion RUB. Our international sales volumes (beyond the Customs Union) increased by 4,873 thousand tonnes, or by 29.4%, mainly due to higher volumes of crude oil trading, production and export from Russia. Moreover, our average international ruble realized prices increased by 19.3%. In the second quarter of 2018, our realized domestic crude oil sales price increased by 25.6%, but our sales volumes decreased by 270 thousand tonnes, or by 37.9%, as a result of an increase in volumes of export deliveries. As a consequence, our domestic sales revenue decreased by 22.0%, or by 3 billion RUB.

Compared to first half of 2017, our international crude oil sales revenue increased by 60.0%, or by 434 billion RUB. In the first half of 2018, our international sales volumes (beyond the Customs Union) increased by 4,385 thousand tonnes, or by 13.1%, as a result of an increase in trading volumes. Our average international ruble realized prices increased by 41.5%. Our domestic sales volumes decreased by 39 thousand tonnes, or by 3.3%, while our realized sales price increased by 39.2%. As a consequence, in the first half of 2018, our domestic sales revenue increased by 34.6%, or by 6 billion RUB.

Sales of refined products

Compared to the first quarter of 2018, our revenue from the wholesale of refined products outside Russia increased by 113 billion RUB, or by 14.4%, as a result of an increase in our realized ruble prices by 23.2%. Our sales volumes decreased by 7.1%, due to the decrease in trading activities.

In the second quarter of 2018, our international retail revenue increased by 15 billion RUB, or by 20.6%. Our international retail realized ruble prices increased by 11.6% largely as a result of devaluation of the ruble against euro, while our sales volumes increased by 78 thousand tonnes, or by 8.0%, due to a seasonality factor.

Compared to the first quarter of 2018, our revenue from the wholesale of refined products on the domestic market increased by 26 billion RUB, or by 31.2%, as a result of an increase in our realized ruble prices and sales volumes by 12.5% and 16.6%, respectively.

In the second quarter of 2018, our revenue from refined products retail sales in Russia increased by 18 billion RUB, or by 16.9%, compared to the first quarter of 2018. Our average domestic retail prices increased by 6.7% and volumes – by 9.6% due to a seasonality factor.

Compared to the first half of 2017, our revenue from the wholesale of refined products outside Russia increased by 314 billion RUB, or by 22.9%, that was price driven. Our dollar and ruble realized prices increased by 31.7% and by 34.8%, respectively. Our sales volumes decreased by 8.8% as a result of the decrease in trading volumes.

Compared to the first half of 2017, our dollar and ruble realized retail prices outside Russia increased by 18.6% and by 21.4%, respectively. Our sales volumes increased by 1.4%. As a result, our international retail revenue increased by 30 billion RUB, or by 23.0%.

In the first half of 2018, our revenue from the wholesale of refined products on the domestic market increased by 44 billion RUB, or by 28.7%, compared to the first half of 2017. Our realized prices and sales volumes increased by 17.6% and by 9.5%, respectively. The increase in sales volumes was a result of higher domestic demand.

Our revenue from refined products retail sales in Russia increased by 30 billion RUB, or by 15.1%, compared to the first half of 2017. Our average domestic retail prices and volumes increased by 7.6% and by 7.0%, respectively.

Sales of petrochemical products

Compared to the first quarter of 2018, our revenue from sales of petrochemical products didn't change significantly.

Compared to the first half of 2017, our revenue from sales of petrochemical products increased by 8 billion RUB, or by 17.6%, largely as a result of growth in realized prices.

Sales of gas

Sales of gas increased by 6 billion RUB, or by 22.5%, compared to the first quarter of 2018, and by 26 billion RUB, or by 69.7%, compared to the first half of 2017.

This increase mostly related to our operations outside Russia and was a result of production growth within Gissar and Kandym projects in Uzbekistan. Higher gas prices also contributed to the increase in our gas sales revenue.

Sales of energy and related services

Compared to the first quarter of 2018, our revenue from sales of energy and related services decreased by 6 billion RUB, or by 31.5%, due to a seasonality factor.

Compared to the first half of 2017, our revenue from sales of energy and related services decreased by 3 billion RUB, or by 9.1%, due to a sale of energy distribution subsidiary in the fourth quarter of 2017.

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.

In the second quarter of 2018, revenue from other sales increased by 4 billion RUB, or by 19.4%, compared to the first quarter of 2018, largely as a result of a seasonal increase in non-petrol revenue of our retail network and the effect of the ruble devaluation on our other sales revenue denominated in other currencies.

Compared to the first half of 2017, revenue from other sales decreased by 3 billion RUB, or by 7.1%, largely due to the sale of our diamond business in June 2017 that was partially compensated by the effect of the ruble devaluation.

Operating expenses

Operating expenses include the following:

	Q2 2018	Q1 2018	1st half of 2018	1st half of 2017
		(millions of rubles)		
Hydrocarbon extraction expenses(1)	48,830	47,095	95,925	92,966
Extraction expenses at the West Qurna-2 field	4,261	3,575	7,836	9,043
Own refining expenses	25,677	21,996	47,673	41,002
Refining expenses at third-party refineries	1,374	2,656	4,030	3,012
Expenses for crude oil transportation to refineries	12,856	11,709	24,565	23,385
Power generation and distribution expenses	6,871	7,627	14,498	16,180
Petrochemical expenses	2,780	2,866	5,646	5,914
Other operating expenses	9,572	11,116	20,688	26,564
Total operating expenses	**112,221**	**108,640**	**220,861**	**218,066**

(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 28 “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 and do not include adjustments related to elimination of intra-group service margin. Operating expenses for the purposes of this analysis are grouped based on the nature of the costs incurred.

Our operating expenses increased by 4 billion RUB, or by 3.3%, compared to the first quarter of 2018 and by 3 billion RUB, or by 1.3%, compared to the first half of 2017.

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.

	Q2	Q1	1st half of	
	2018	2018	2018	2017
		(millions of rubles)		
Hydrocarbon extraction expenses(1)	48,830	47,095	95,925	92,966
- in Russia	43,717	42,857	86,574	87,265
- outside Russia(1)	5,113	4,238	9,351	5,701
		(ruble per BOE)		
Hydrocarbon extraction expenses(1)	241	235	238	240
- in Russia	246	244	245	245
- outside Russia(1)	207	176	192	178

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

Compared to the first quarter of 2018, our extraction expenses increased by 1.7 billion RUB, or by 3.7%. The average hydrocarbon extraction expenses in Russia didn't change significantly. Outside Russia, the average hydrocarbon extraction expenses increased by 17.6% largely as a result of a decrease in our share in profit crude oil at the Karachaganak project due to higher oil prices, as well as an increase in expenses for repairs and the ruble depreciation to the US dollar.

In the first half of 2018, our extraction expenses increased by 3.0 billion RUB, or by 3.2%, compared to the first half of 2017. In Russia, our average hydrocarbon extraction expenses didn't change. Outside Russia, our hydrocarbon extraction expenses increased by 64.0% that was mainly a result of launching new production facilities as part of the Gissar and Kandym project in Uzbekistan. At the same time, our average hydrocarbon extraction expenses outside Russia increased by 7.9% due to higher expenses for repairs, a decrease in our share in profit crude oil at the Karachaganak project, as well as the ruble depreciation to the US dollar.

Own refining expense

	Q2	Q1	1st half of	
	2018	2018	2018	2017
		(millions of rubles)		
Refining expenses at the Group refineries	25,677	21,996	47,673	41,002
- in Russia	10,730	9,325	20,055	19,581
- outside Russia	14,947	12,671	27,618	21,421
		(ruble per tonne)		
Refining expenses at the Group refineries	1,534	1,365	1,451	1,258
- in Russia	1,006	875	941	935
- outside Russia	2,464	2,321	2,397	1,841

Our own refining expenses increased by 3.7 billion RUB, or by 16.7%, compared to the first quarter of 2018, and by 6.7 billion RUB, or by 16.3%, compared to the first half of 2017.

Compared to the first quarter of 2018, the increase in expenses at our domestic refineries was driven by an increase in consumption of purchased additives due to a seasonal growth in gasolines production volumes. Compared to the first half of 2017, the increase was due to higher production volumes.

Compared to both the first quarter of 2018 and the first half of 2017, our refining expenses outside Russia increased largely as a result of an increase in fuel cost and the ruble depreciation to euro. Moreover, dynamics of the expenses were impacted by costs of planned repairs at ISAB and Burgas refineries in the first quarter 2018.

Refining expenses at third-party refineries

Along with our own production of refined products we process crude oil at third-party refineries.

At the end of 2016, as part of our trading business development, a Group company entered into a 3-year tolling agreement with a Canadian refinery. Related refining expenses represent variable toll that is mostly the difference between the price of feedstocks supplied, including various related costs, and the selling price of the refined products taken. When the refined products are sold, this toll is naturally offset by the respective refined products sales revenue. The agreed compensation is received by the Group company for execution of this agreement.

In the second quarter of 2018 this tolling fee decreased to 1.3 billion RUB from 2.5 billion RUB in the first quarter of 2018 due to the reduction of the actual refinery margin.

In the first half of 2018, this tolling fee amounted to 3.8 billion RUB, compared to 2.7 billion RUB in the first half of 2017.

Expenses for crude oil transportation to refineries

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

Compared to the first quarter of 2018, our expenses for crude oil transportation to refineries increased by 1.1 billion RUB, or by 9.8%, as a result of an increase in supply of own crude oil for processing at our refineries outside Russia.

Compared to the first half of 2017, our expenses for crude oil transportation to refineries increased by 1.2 billion RUB, or by 5.0%. The growth of expenses related to higher throughput and transportation tariffs which was partially offset by a decrease in refinery throughput volumes outside Russia.

Petrochemical expenses

Compared to the first quarter of 2018 and the first half of 2017, our petrochemical expenses decreased by 3.0% and by 4.5%, respectively, due to a decrease in production.

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.

Compared to the first quarter of 2018, other operating expenses decreased by 1.5 billion RUB, or by 13.9%. Compared to the first half of 2017, they decreased by 5.9 billion RUB, or by 22.1%, mostly as a result of the sale of our diamond business in the middle of 2017.

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.

	Q2	**Q1**	**1st half of**	
	2018	**2018**	**2018**	**2017**
		(millions of rubles)		
Cost of purchased crude oil in Russia	4,909	4,621	9,530	8,379
Cost of purchased crude oil outside Russia	583,337	412,283	995,620	579,679
Compensation crude oil related to West Qurna-2 project	21,146	6,889	28,035	13,367
Cost of purchased crude oil	**609,392**	**423,793**	**1,033,185**	**601,425**
Cost of purchased refined products in Russia	9,559	12,181	21,740	27,523
Cost of purchased refined products outside Russia	528,126	446,005	974,131	817,459
Cost of purchased refined products	**537,685**	**458,186**	**995,871**	**844,982**
Other purchases	12,559	14,426	26,985	19,859
Net loss (gain) from hedging of trading operations	28,452	6,639	35,091	(37,607)
Change in crude oil and petroleum products inventory	(205)	(11,615)	(11,820)	15,074
Total cost of purchased crude oil, gas and products	**1,187,883**	**891,429**	**2,079,312**	**1,443,733**

Compared to the first quarter of 2018, the cost of purchased crude oil, gas and products increased by 296 billion RUB, or by 33.3%, largely as a result of an increase in hydrocarbon prices, volumes of crude oil trading and ruble devaluation to the US dollar. These factors were partially offset by a decrease in volumes of refined product trading. Moreover, in the second quarter of 2018, the Group realized oil inventory taking advantage of favorable price environment.

Compared to the first half of 2017, the cost of purchased crude oil, gas and products increased by 636 billion RUB, or by 44.0%, following the increase in hydrocarbon prices and volumes of crude oil trading, as well as the ruble devaluation to the US dollar.

Transportation expenses

	Q2	Q1	1st half of	
	2018	2018	2018	2017
		(millions of rubles)		
Crude oil transportation expenses	23,298	20,335	43,633	46,473
Refined products transportation expenses	40,207	42,146	82,353	85,355
Other transportation expenses	4,702	3,574	8,276	9,402
Total transportation expenses	**68,207**	**66,055**	**134,262**	**141,230**

Our transportation expenses increased by 2 billion RUB, or by 3.3%, compared to the first quarter of 2018 and decreased by 7 billion RUB, or by 4.9%, compared to the first half of 2017.

Compared to the first quarter of 2018, our expenses for transportation of crude oil increased by 3 billion RUB, or by 14.6%. Outside Russia, transportation expenses increased as a result of the sales volumes growth and the ruble devaluation to the US dollar, despite the decline in freight rates. In Russia, transportation expenses increased due to higher volumes of exports.

Compared to the first half of 2017, our expenses for transportation of crude oil decreased by 3 billion RUB, or by 6.1%. Outside Russia, transportation expenses decreased due to the decline in freight rates, despite the sales volumes growth and the ruble devaluation to the US dollar. In Russia, transportation expenses decreased as a result of the export sales volume decline and changes in domestic shipment directions.

Compared to the first quarter of 2018, our expenses for transportation of refined products decreased by 2 billion RUB, or by 4.6%, as a result of a decrease in international sales volumes, export from Russia and decline in freight rates abroad, partially offset by the sales volumes growth in the domestic market and the effect of the ruble devaluation to the US dollar.

Compared to the first half of 2017, our expenses for transportation of refined products decreased by 3 billion RUB, or by 3.5%, as a result of the decline in sales volume and freight rates outside Russia, while expenses, in Russia, didn't change significantly.

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.

	Q2	Q1	1st half of	
	2018	2018	2018	2017
		(millions of rubles)		
Labor costs included in selling, general and administrative expenses	16,396	14,072	30,468	29,474
Other selling, general and administrative expenses	24,451	21,544	45,995	45,996
Increase (decrease) in liability related to share-based compensation program	–	190	190	(2,718)
Expenses on provision for doubtful debts	(438)	948	510	2,779
Total selling, general and administrative expenses	**40,409**	**36,754**	**77,163**	**75,531**

Compared to the first quarter of 2018, our selling, general and administrative expenses increased by 3.6 billion RUB, or by 9.9%, that was mainly a result of higher labor costs, assets maintenance expenses and rental costs. At the same time, in the second quarter of 2018, our selling, general and administrative expenses were positively impacted by a reversal of bad debt allowance related to one of our international upstream projects as a result of a repayment of the debt.

Compared to the first half of 2017, our selling, general and administrative expenses increased by 1.6 billion RUB, or by 2.2%. In the first half of 2017, the Group recognized profit in amount of 3.1 billion RUB as a result of accruals within share-based compensation program due to LUKOIL share price fluctuations. Moreover, in the first half of 2017, an allowance for bad debt was accrued in relation to one of our international upstream projects.

Moreover, the dynamics of our selling, general and administrative expenses both quarter-on-quarter and year-on-year was significantly affected by the ruble devaluation.

Depreciation, depletion and amortization

Compared to the first quarter of 2018, our depreciation, depletion and amortization expenses increased by 10 billion RUB, or by 11.3%, due to launching a new gas treatment plant at Kandym project in Uzbekistan and the ruble devaluation. Moreover, this dynamics was also due to the inventory effect.

Compared to the first half of 2017, depreciation, depletion and amortization expenses increased by 20 billion RUB, or by 12.3%, due to the completion of commissioning stage of the V. Filanovsky field at the end of 2017, and commencement of related assets depreciation, and an increase in gas production volumes as a result of launching new production facilities as part of the Gissar and Kandym project in Uzbekistan.

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, an 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.

Our share in income of affiliates increased by 0.9 billion RUB, or by 16.3%, compared to the first quarter of 2018, and by 4 billion RUB, or by 47.7%, compared to the first half of 2017, largely as a result of the increase in income of Tengizchevroil.

Taxes other than income taxes

	Q2	Q1	1st half of	
	2018	2018	2018	2017
	(millions of rubles)			
In Russia				
Mineral extraction taxes	197,634	171,172	368,806	271,039
Social security taxes and contributions	7,080	6,766	13,846	13,288
Property tax	6,182	6,264	12,446	9,609
Other taxes	648	234	882	1,227
Total in Russia	**211,544**	**184,436**	**395,980**	**295,163**
International				
Social security taxes and contributions	1,498	1,465	2,963	2,548
Property tax	227	194	421	406
Other taxes	701	572	1,273	1,205
Total internationally	**2,426**	**2,231**	**4,657**	**4,159**
Total taxes other than income taxes	**213,970**	**186,667**	**400,637**	**299,322**

Our taxes other than income taxes increased by 27 billion RUB, or by 14.6%, compared to the first quarter of 2018, and by 101 billion RUB, or by 33.8%, compared to the first half of 2017. This was largely driven by an increase in the mineral extraction tax rate in Russia resulting from an increase in crude oil prices and fixed factor in the tax calculation formula.

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 special tax regimes).

	Q2 2018	Q1 2018	1st half of 2018	1st half of 2017
		(millions of rubles)		
Decrease in extraction taxes from application of reduced and zero rates for crude oil and gas production	32,561	26,060	58,621	35,568
		(thousands of tonnes)		
Volume of crude oil production subject to:				
zero rates (ultra-high viscosity)	385	377	762	429
reduced rates (tax holidays for specific regions and high viscosity oil)	1,346	1,318	2,664	2,722
reduced rates (low permeability deposits)	119	116	235	150
reduced rates (Tyumen deposits)	179	190	369	290
reduced rates (depleted fields)	3,895	3,940	7,835	7,242
reduced rates (other)	562	557	1,119	1,154
Total volume of production subject to reduced or zero rates	**6,486**	**6,498**	**12,984**	**11,987**

Certain fields and deposits of the Group are also subject to special tax regimes for crude oil production resulting in lower than standard crude oil extraction tax rates. In the second quarter and the first half of 2018, volumes of production subject to such regimes amounted to 1,495 thousand tonnes and 2,860 thousand tonnes, respectively (compared to 1,365 thousand tonnes in the first quarter of 2018 and 2,005 thousand tonnes the first half of 2017).

Excise and export tariffs

	Q2 2018	Q1 2018	1st half of 2018	1st half of 2017
		(millions of rubles)		
In Russia				
Excise tax on refined products	31,330	31,341	62,671	54,900
Crude oil export tariffs	48,127	36,765	84,892	72,566
Refined products export tariffs	9,818	13,534	23,352	23,743
Total in Russia	**89,275**	**81,640**	**170,915**	**151,209**
International				
Excise tax and sales taxes on refined products	48,073	39,473	87,546	73,291
Crude oil export tariffs	(14)	14	–	109
Refined products export tariffs	68	64	132	166
Total internationally	**48,127**	**39,551**	**87,678**	**73,566**
Total excise and export tariffs	**137,402**	**121,191**	**258,593**	**224,775**

Compared to the first quarter of 2018, export tariffs increased by 8 billion RUB, or by 15.1%, as a result of higher volumes of crude oil export and higher export duty rates. The volumes of crude oil export beyond the Customs Union increased by 3.8%. At the same time, the volumes of refined products exports decreased by 22.0%. The increase in excise tax expenses in Russia due to higher sales volumes was offset by a decrease in excise tax rates in Russia from 1 June 2018. Ouside Russia, excise tax expenses increased due to growth in sales volumes and the effect of the ruble devaluation to euro.

Compared to the first half of 2017, export tariffs increased by 12 billion RUB, or by 12.2%. The increase in export duty rates was offset by a decrease in the volumes of crude oil and refined product export beyond the Customs Union. The volumes of export of crude oil and refined products decreased by 5.5% and by 10.9%, respectively. The increase in excise tax expenses in Russia was driven by increase in rates and domestic sales volumes, while outside Russia the excise tax expenses increased as a result of euro devaluation to ruble and increase in sales volumes subject to excise tax.

Foreign exchange gain (loss)

Foreign exchange gains or losses are 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 those currencies. Nevertheless, in the first half of 2018, the Company’s net monetary position in foreign currencies significantly decreased as a result of the change in the structure of intra-group financing.

As a result of the ruble devaluation, foreign exchange gains amounted to 22 billion RUB in the second quarter of 2018 and to 21 billion RUB in the first half of 2018, compared to a foreign exchange losses of 1 billion RUB in the first quarter of 2018 and 16 billion RUB in the first half of 2017.

Other (expenses) income

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

In the second quarter of 2018, the Group recognized an impairment loss for its exploration and production assets in Russia in the amount of 5 billion RUB following the decision to stop exploration works at the East Taimyr block.

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 and application of reduced regional income tax rates in Russia.

Compared to the first quarter of 2018, our total income tax expense increased by 21 billion RUB, or by 89.8%. At the same time, our profit before income tax increased by 79 billion RUB, or by 59.8%. In the second quarter of 2018, our effective income tax rate was 20.7%, compared to 17.4% in the first quarter of 2018. An increase in effective income tax rate in the second quarter of 2018 was a result of a reassessment of deferred taxes related to our projects in Uzbekistan.

Compared to the first half of 2017, our total income tax expense increased by 19 billion RUB, or by 40.3%. Our profit before income tax increased by 95 billion RUB, or by 38.2%. In the first half of 2018, our effective income tax rate was 19.4%, compared to 19.2% in the first half of 2017.

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 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.

	Q2 2018	Q1 2018	1st half of 2018	1st half of 2017
	(millions of rubles)			
Profit for the period	**167,995**	**109,425**	**277,420**	**201,478**
Add back				
Income tax expense	43,868	23,117	66,985	47,757
Financial income	(4,648)	(3,514)	(8,162)	(6,401)
Financial costs	8,279	7,322	15,601	16,237
Foreign exchange (gain) loss	(22,394)	1,432	(20,962)	15,708
Equity share in income of affiliates	(6,104)	(5,249)	(11,353)	(7,685)
Other expenses (income)	10,562	(699)	9,863	(45,341)
Depreciation, depletion and amortization	97,593	87,690	185,283	164,936
EBITDA	**295,151**	**219,524**	**514,675**	**386,689**
EBITDA by operating segments				
Exploration and production	239,699	171,918	411,617	241,364
- in Russia	203,525	144,657	348,182	207,738
- outside Russia	36,174	27,261	63,435	33,626
- including West Qurna-2 project	6,297	5,735	12,032	6,786
Refining, marketing and distribution segment	71,620	46,849	118,469	132,995
- in Russia	52,695	42,299	94,994	93,647
- outside Russia	18,925	4,550	23,475	39,348
Corporate and other	(3,724)	519	(3,205)	1,407
Elimination	(12,444)	238	(12,206)	10,923
EBITDA	**295,151**	**219,524**	**514,675**	**386,689**

Reconciliation of Cash provided by operating activities to Free cash flow

	Q2 2018	Q1 2018	1st half of 2018	1st half of 2017
	(millions of rubles)			
Net cash provided by operating activities	242,949	166,992	409,941	337,901
Capital expenditures	(105,777)	(121,057)	(226,834)	(254,868)
Free cash flow	**137,172**	**45,935**	**183,107**	**83,033**

Liquidity and capital resources

	Q2	Q1	1st half of	
	2018	2018	2018	2017
		(millions of rubles)		
Net cash provided by operating activities	242,949	166,992	409,941	337,901
including increase in working capital	(19,997)	(47,856)	(67,853)	(27,226)
Net cash used in investing activities	(85,912)	(128,400)	(214,312)	(169,886)
Net cash used in financing activities	(136,809)	(70,401)	(207,210)	(124,792)

Changes in operating assets and liabilities:

	Q2	Q1	1st half of	
	2018	2018	2018	2017
		(millions of rubles)		
(Increase) decrease in trade accounts receivable	(76,796)	33,570	(43,226)	27,726
(Increase) decrease in inventories	(15,880)	(24,946)	(40,826)	28,491
Increase (decrease) in accounts payable	51,778	(37,914)	13,864	(127,939)
Increase in net taxes other than on income payable	20,765	5,143	25,908	15,723
Change in other current assets and liabilities	136	(23,709)	(23,573)	28,773
Total increase in working capital	**(19,997)**	**(47,856)**	**(67,853)**	**(27,226)**

Operating activities

Our primary source of cash flow is funds generated from our operations. Compared to the first quarter of 2018 and the first half of 2017, our cash generated from operations increased by 76 billion RUB, or by 45.5%, and by 72 billion RUB, or by 21.3%, respectively, as a result of an increase in profit. In the periods considered, our operating cash flow was adversely affected by an increase in working capital.

In the first half of 2018, the increase in working capital was driven by following factors. Trade accounts receivable increased due to higher volumes of crude oil trading and an increase in realized prices. Our accounts payable increased in line with the growth of crude oil trading. Inventories increased as a result of higher international hydrocarbon prices and inventory build-up at our refineries. The increase in net tax accounts payable was a result an increase in mineral extraction taxes and property tax payable.

Investing activities

In the second quarter of 2018, cash used in investing activities decreased by 42 billion RUB, or by 33.1%, compared to previous quarter. Compared to the first half of 2017, it increased by 44 billion RUB, or by 26.2%. This increase was a result of the recognition of proceeds from sale of our diamond business in the amount of 81 billion RUB in the second quarter of 2017.

Our capital expenditures decreased by 15 billion RUB, or by 12.6%, compared to the first quarter of 2018 and by 28 billion RUB, or by 11.0%, compared to the first half of 2017.

	Q2	Q1	1st half of	
	2018	**2018**	**2018**	**2017**
		(millions of rubles)		
Capital expenditures				
Exploration and production				
West Siberia	32,724	38,189	70,913	69,065
Timan-Pechora	17,689	21,737	39,426	40,679
Ural region	8,673	9,484	18,157	14,156
Volga region	12,341	8,391	20,732	27,399
Other in Russia	1,998	2,228	4,226	6,276
Total in Russia	73,425	80,029	153,454	157,575
Iraq	4,365	4,946	9,311	7,587
Other outside Russia	13,152	14,432	27,584	64,828
Total outside Russia	17,517	19,378	36,895	72,415
Total exploration and production	**90,942**	**99,407**	**190,349**	**229,990**
Refining, marketing and distribution				
Russia	9,252	15,267	24,519	17,200
- refining	5,776	9,588	15,364	10,124
- retail	1,150	2,016	3,166	2,146
- other	2,326	3,663	5,989	4,930
International	4,461	5,785	10,246	6,913
- refining	3,115	4,537	7,652	4,572
- retail	938	924	1,862	2,063
- other	408	324	732	278
Total refining, marketing and distribution	**13,713**	**21,052**	**34,765**	**24,113**
Corporate and other	**1,122**	**598**	**1,720**	**765**
Total capital expenditures	**105,777**	**121,057**	**226,834**	**254,868**

Compared to the previous quarter, our upstream capital expenditures decreased by 8 billion RUB, or by 8.5%. In Russia, the decline was due to payment schedule to contractors and suppliers in West Siberia and Timan-Pechora. An increase in expenditures in Volga region was due to further development of the Yu. Korchagin and V. Filanovsky fields in the Caspian Sea.

In the Russian downstream, decrease in capital expenditures compared to the previous quarter was largely due to payments in the first quarter of 2018 related to previously accrued expenditure. However, expenditures accrued in the current period increased as compared to the first quarter of 2018 due to the commencement of construction of the delayed coker complex at Nizhny Novgorod refinery and modernization of petrol stations in Russia.

Compared to the first half of 2017, our capital expenditures in the exploration and production segment decreased by 40 billion RUB, or by 17.2%, mainly due to lower spending in Uzbekistan after completion of main construction works as part of the Gissar and Kandym projects.

The increase in capital expenditures in our refining, marketing and distribution segment compared to the first half of 2017 was primarily due to payments in the first half of 2018 related to previously accrued expenditures, as well as commencement of construction works at Nizhny Novgorod refinery.

The dynamics of our international capital expenditures was also affected by the ruble devaluation.

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

	Q2	Q1	1st half of	
	2018	**2018**	**2018**	**2017**
		(millions of rubles)		
West Siberia (Yamal)	7,198	5,690	12,888	8,571
Caspian region (Projects in Russia)	11,211	7,371	18,582	25,662
Timan-Pechora (Yaregskoye field)	3,030	2,704	5,734	5 824
Iraq (West Qurna-2 project)	4,002	4,816	8,818	6,958
Iraq (Block-10)	363	130	493	629
Uzbekistan	6,450	9,533	15,983	50,561
Total	**32,254**	**30,244**	**62,498**	**98,205**

Financing activities

In the second quarter of 2018, net movements of short-term and long-term debt generated an outflow of 121 billion RUB, compared to an outflow of 5 billion RUB in the first quarter of 2018. In the first half of 2018, net movements of short-term and long-term debt generated an outflow of 126 billion RUB, compared to an outflow of 39 billion RUB in the first half of 2017.

Other information

Sectorial sanctions against the Russian companies

In July-September 2014, the United States ("US"), the European Union ("EU") and several other countries imposed a set of sanctions on Russia, including sectoral sanctions which affect several Russian oil and gas companies. The US has placed the Company onto the Sectoral Sanctions Identifications List subject to Directive 4. Directive 4 prohibits US companies and individuals from providing, exporting, or re-exporting directly or indirectly, goods, services (except for financial services), or technology in support of exploration or production for deepwater, Arctic offshore or shale projects that have the potential to produce oil in the Russian Federation, or in maritime area claimed by the Russian Federation and extending from its territory.

In August-October 2017, the US expanded abovementioned sanctions to include international oil projects initiated on or after 29 January 2018 that have the potential to produce oil in any location, and in which companies placed on the Sectoral Sanctions Identifications List (subject to Directive 4) have an ownership interest of 33% or more, or ownership of a majority of the voting interests.

The management believes that current sanctions do not have a material adverse effect on the Group's oil projects. At the same time, the Company continues to monitor and evaluate potential risks for its operations in connection with sanctions.

Operations in Iraq

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