

2014

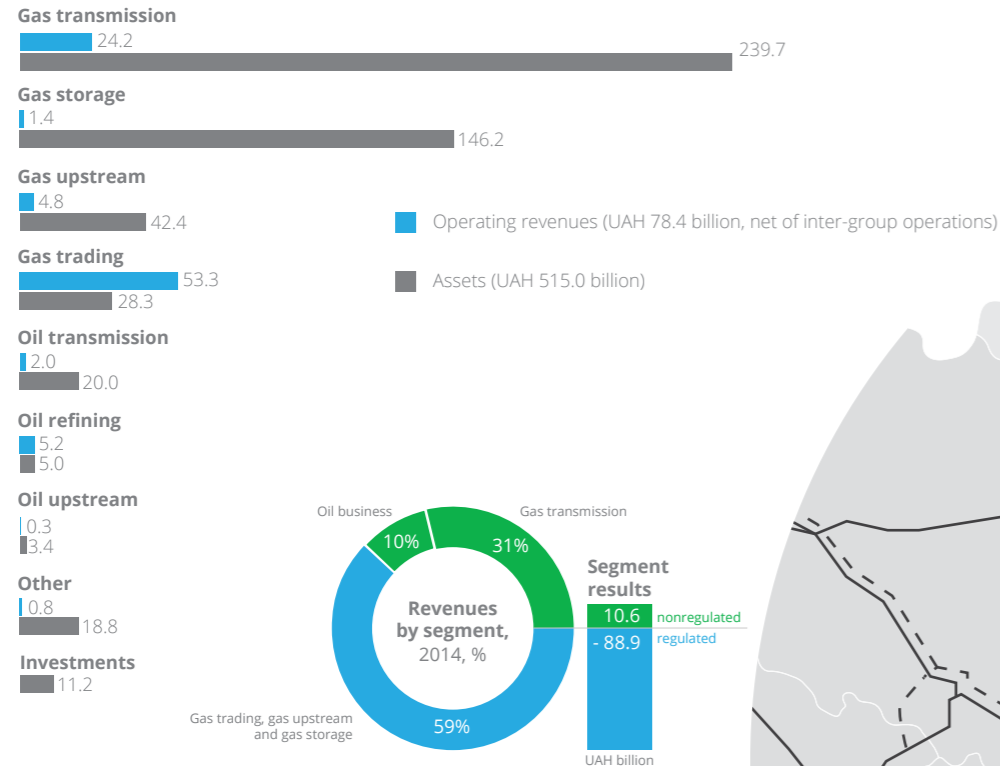
# NAFTOGAZ OF UKRAINE ANNUAL REPORT



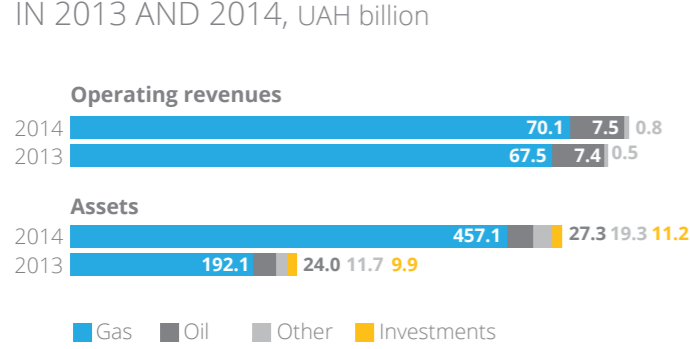
Changing  
for the future

# NAFTOGAZ AT A GLANCE

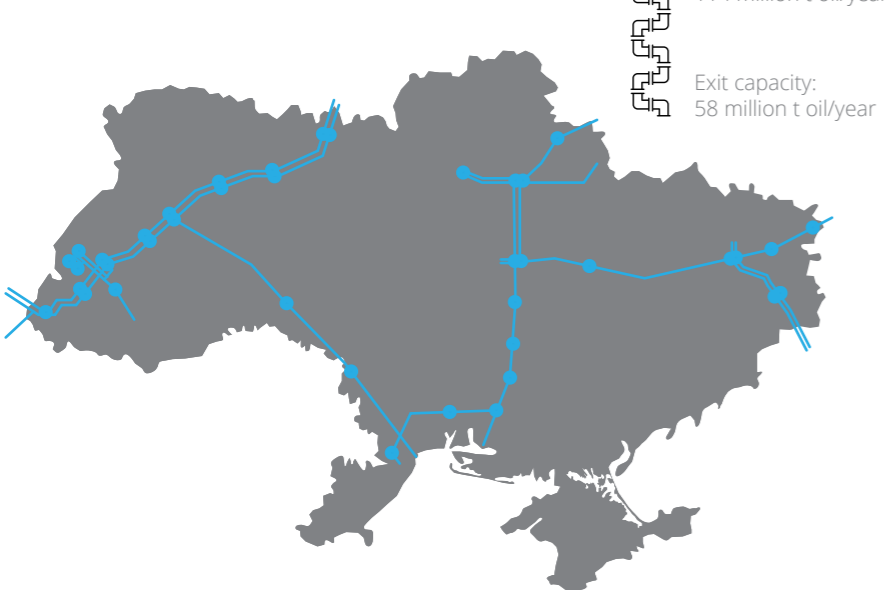
## GROUP STRUCTURE BY SEGMENT, 2014, UAH billion



## OPERATING REVENUES AND ASSETS IN 2013 AND 2014, UAH billion

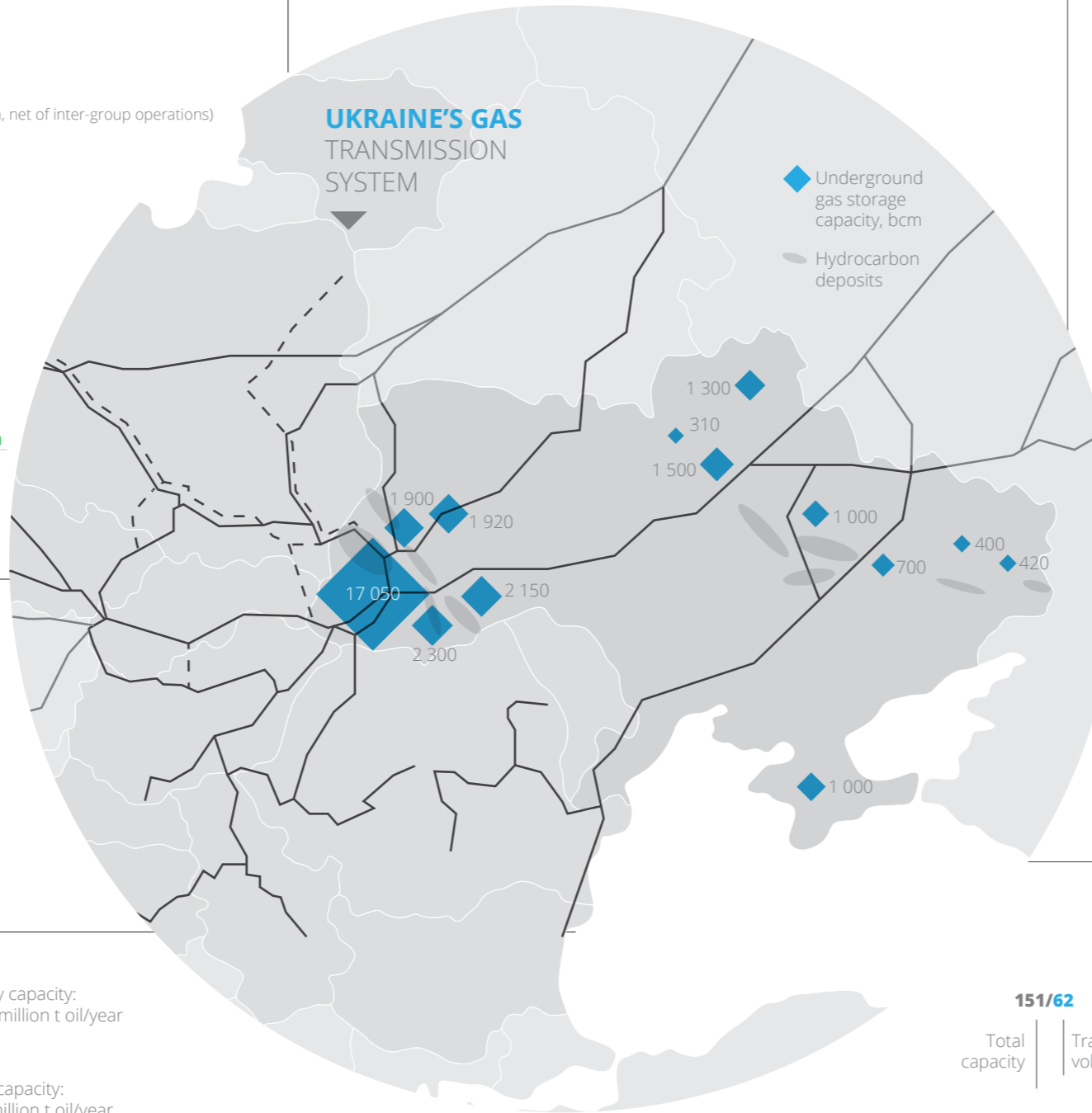


## UKRAINE'S OIL TRANSMISSION SYSTEM

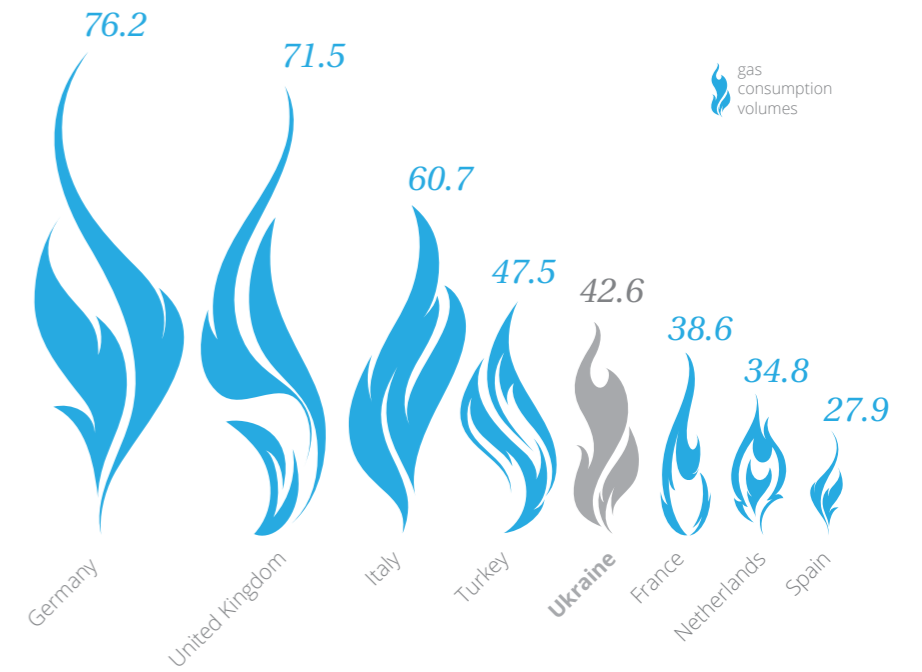


Ukraine's gas transmission pipelines are long enough to circumvent the globe

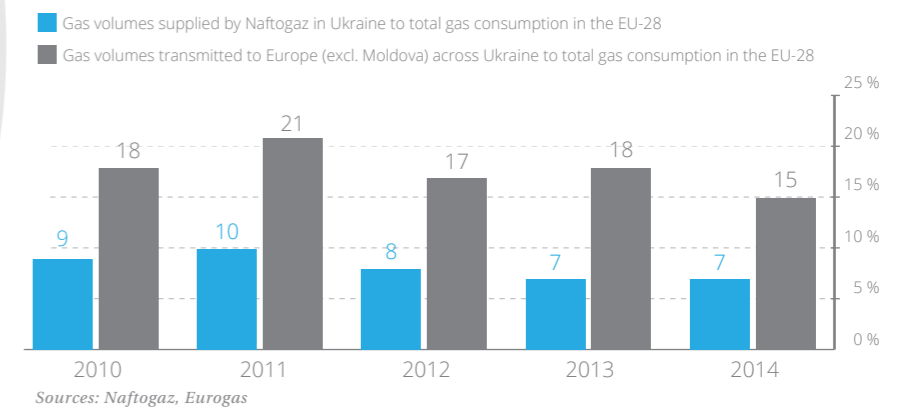
Entry capacity: 288 bcm/year  
Exit capacity in EU direction: 151 bcm/year



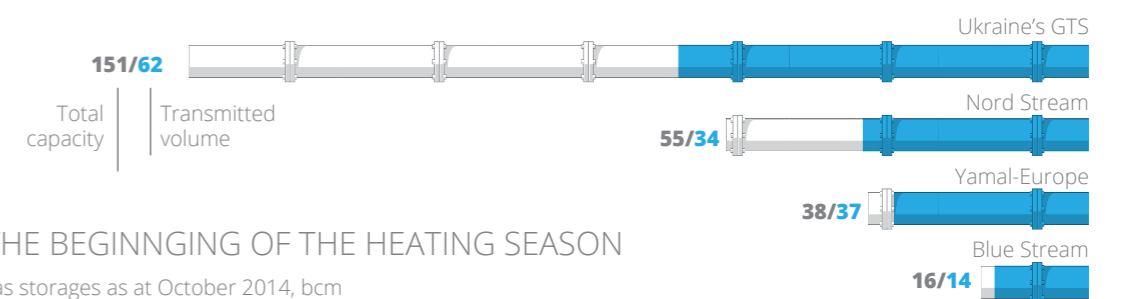
## EUROPE'S LARGEST GAS MARKETS, 2014, bcm



## NAFTOGAZ AND EUROPEAN GAS MARKET, 2010-2014, %

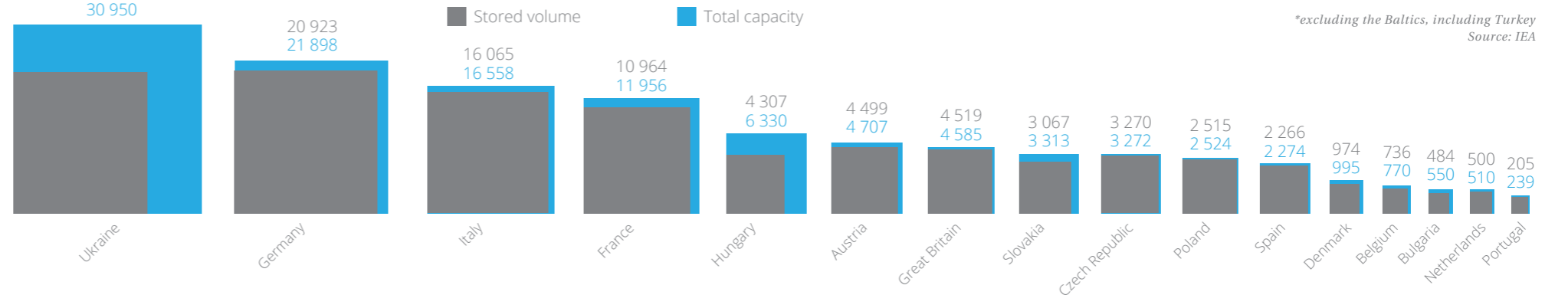


## SUPPLY ROUTES OF RUSSIAN GAS TO EUROPE, 2014, bcm\*



## GAS IN STORAGE AT THE BEGINNING OF THE HEATING SEASON

Volumes stored in underground gas storages as at October 2014, bcm



Source: GIE  
Additional sources: Naftogaz, State Statistics Service of Ukraine

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## MISSION AND VALUES

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### MISSION

Naftogaz sees itself as the driving force behind reform of the Ukrainian gas market and creation of a competitive business environment based on European best practices. The company is committed to ensuring security of gas supply for Ukrainian and European consumers and strives to do it on appropriate terms and in a financially sustainable way

### VALUES

#### Dedication

Naftogaz is the driver of change in Ukraine's gas sector, working to replace the old corruption-prone regulated environment with modern competitive market rules in the entire gas industry, with an inevitable reduction of the company's role from a state monopoly to a regular market participant

#### Responsibility

Naftogaz creates added value for its customers and for the society striving to preserve each of the six capitals (human, social, intellectual, manufacturing, natural and financial)

#### Accountability

Naftogaz is guided in its activities by both strategic long-term and tactical short-term interests of the Ukrainian society as a whole, as the concurrent owner of the group and user of its activities

#### Efficiency

Naftogaz aims to achieve maximum results with minimal resources



## STATEMENT OF CHIEF EXECUTIVE OFFICER

*Andriy Kobolyev*



Dear readers,

Thank you for your interest in our annual report. For a standard corporate report, this is quite an unusual document.

### WHAT YOU WILL FIND IN THIS REPORT AND WHY IT IS SO LONG

This report is not typical because the actual results of Naftogaz in 2014 are only a small portion of what we discuss. The document explains in detail the development strategy we have chosen for Naftogaz and the company's changing role in the overall context of the gas market reform in Ukraine.

Not only do we formally disclose the group's results but also try to present this information to the wider public in a clear and rational way. This document contains concise descriptions of our key markets (upstream, transmission and supply of gas and oil) and explains our place and role in each of these markets.

In this report we present an analysis of the corporate governance system of Naftogaz (what it is and what it should be, in our opinion), discuss recent changes in our human resources policy, our new transparency and disclosure policy, our social initiatives, as well as our strong commitment to follow the highest standards of industrial and environmental safety.

In the last section of the report, you will find consolidated financial statements of Naftogaz for 2014. They were audited by Deloitte and are accompanied by a management discussion and analysis in this document. For the first time since 2009, the group's hydrocarbon reserves and fixed

assets were revalued. We engaged international companies Ryder Scott and EY, respectively, to perform these valuations.

### WHO PREPARED THIS REPORT

At the end of March 2014, I returned to Naftogaz as Chairman of the executive board. I knew the company from within, having previously worked there for eight years, and had no illusions about the challenges the new team was facing.

I knew the strengths of Naftogaz, most notably the professionalism of our technical staff. For many years, sometimes in extreme conditions, these people have been ensuring the stable functioning of Ukraine's gas transportation system. It was crucial to maintain this technological expertise, and we made efforts to retain the best and the most experienced personnel.

*However, I also realized that the deep changes required in Naftogaz were impossible without new people in the company's management*

It was essential to introduce new values and managerial best practices that would turn Naftogaz into the driver of change in the gas sector. My vision therefore was to combine new faces with existing employees, creating a team with the desire and ability to reform, on the one hand, and profound expertise in the oil and gas industry, on the other.

### OUR FIRST STEPS AND RESULTS

We had to address a range of systemic and operational problems immediately. Widespread corruption, an outdated corporate governance model originating in the Soviet era, distorted pricing dictated by political or corrupt goals are just some of them. We also faced a record deficit of UAH 109 billion, were almost entirely dependent on imports from Russia, and had to confront Gazprom's ability to dictate discriminating supply terms to us.

*We did not have the luxury of choosing priorities. We had to deal with all the problems at the same time*

For many years, Naftogaz supplied gas for households at absurdly low prices. This price distortion was the key reason behind the huge deficit of Naftogaz and led to a number of critically adverse effects.

The group gas upstream division experiences stagnation in production. Households had no incentive to use gas and heat efficiently. The resulting losses of Naftogaz were covered by the state budget.

Until the last year, Russia was the key beneficiary of these conditions, as it was practically the only source of imported gas that Ukraine needed, and in huge volumes. Russia charged Ukraine 30% to 50% more compared to the prices paid by other Gazprom clients of in Europe. This drained Ukraine's finances and made it dependent on the Kremlin.

To correct this situation, we immediately set about revising our relations with Gazprom. We engaged the European Commission in our negotiations, filed court claims and opened the new supply route from Slovakia.

In addition to creating alternative supply capacities, we increased the number of our suppliers significantly. We started cooperation with Statoil, Europe's largest gas producer, as well as with most of the leading gas shippers active in the EU gas market.

*For the first time ever, Naftogaz ensured a real diversification of gas imports to Ukraine*

As a result, the share of Gazprom supplies to Ukraine fell from 92% in 2013 to 75% in 2014 and 37% in the first half of 2015. Europe is the main gas supplier for us this year.

Once it was evident that we were able to substitute Gazprom with European suppliers, the Russians revised their offer to match the European prices. Market forces came into play, and gas turned from a political tool into a regular commodity.

Our next challenge is to address the long-term issues within Ukraine and introduce market mechanisms in the local market as well.

### REFORMING NAFTOGAZ AND THE UKRAINIAN GAS MARKET

Changing Naftogaz is inseparable from the ongoing gas market reform that is designed to replicate European rules in Ukraine and make the local market competitive, transparent, and efficient.

*For the market to become competitive, Naftogaz will have to give up its monopoly position, becoming one of many market participants*

This key change is required to complete the reform. The new Law on the Natural Gas Market in Ukraine stipulates that it will take place in the nearest future. In this report, we explain what has been done to make this happen, and what remains to be done.

### PRICE LIBERALIZATION AND DIRECT SUBSIDIES TO LOW-INCOME HOUSEHOLDS IS THE ONLY SOLUTION

A key component of the reform is the transition to the market-based pricing model, where the price of gas is set by supply and demand. In this model, the low-income households are supported by direct subsidies from the state and high-income

consumers pay full market price for gas they consume.

We realize that over the last year and a half the financial position of almost every Ukrainian family has significantly deteriorated. Currency devaluation, inflation of consumer prices, the economic crisis, unemployment and the war have been very real trials for everyone. Against the backdrop of the crisis, the sharp hike in utility prices is certainly very frustrating and seems unfair.

*The trouble is, however, that if the pricing issue is not addressed now, the situation will only get worse*

In this report, we explain why the transition to market-based gas prices accompanied by targeted subsidies for the poor is the only strategy now available to Ukraine.

Such a transition will initiate development and growth in the country. It will create the much needed incentives for investments in energy efficiency and for increasing domestic gas production. It will eliminate opportunities for corruption created by the difference of prices. Gas suppliers will compete for customers offering them better service on better terms. Other sectors where customers are free to choose with whom they do business work this way. The gas market should work this way too.

Our country has a lot to fight for. Unlike most European countries, Ukraine could completely stop importing gas within 10 years. To achieve this, it is necessary to attract investment for improving energy efficiency and boosting local gas production.

To achieve both of these strategic objectives, a market gas price for all consumers is a necessary condition. People who can afford paying the full price for gas they consume should pay it.

Then the state will help those who need assistance covering utility bills, investing in the installation of meters, boilers replacement and buildings insulation. This will lower demand for imported gas and will significantly alleviate the pressure on the hryvnia.

If we want Ukraine to remain on the map as a sovereign state, there is no alternative to this choice; the only question is the pace of this transition. The more time it takes us to switch to market pricing, the more expensive the transition will be for each of us and for the country.

The pricing issue is extremely important for the success of reform, and that is why we have devoted to it a full section in this document.

#### **WHAT WE DID TO GAIN YOUR TRUST**

From the very first days of the new team in Naftogaz, we began fighting corruption in our industry. It is an extremely difficult task as there is hardly a single industrial group in Ukraine which would not have a certain interest in preserving the old structures of a non-transparent gas market.

In just months, we changed almost the entire management team of Naftogaz. We engaged new leaders without a “history” in gas to head divisions where technical expertise in oil and gas was not required. The transformation of management teams now continues in our subsidiaries as well.

Our tender announcements are now published not only on specialized websites but are distributed in the media for the public as well. Recently Naftogaz and our upstream subsidiary Ukgasvydobuvannya joined ProZorro, the new state e-procurement system that offers increased transparency and wide reach to numerous suppliers. Other companies of the group are preparing to join the system as well.

*In some cases, by changing contractors and suppliers, we were able to reduce costs fivefold*

Our strategy of increasing transparency does not only help us to make our local operations more efficient. It has also been a key in building trust and improving our relations with the international community and our Western partners.

Naftogaz now cooperates with counterparts in a normal business way, has got rid of murky intermediaries and has become far more open to the world. Following this operating policy change, we have gained the crucially important support from the West for a closer integration with the EU.

Our current cooperation with Western partners is vital in reforming Naftogaz and Ukraine's gas industry.

We continue to fight for a fair price of imported gas for Ukraine. This work continues not only during commercial negotiations but also in diplomatic and legal dimensions.

Ukraine has wasted a lot of time. Ten years ago, we have proclaimed our European choice but we did not start working toward improving energy efficiency, which is an integral part of the modern European culture. Governments one by one have continued to simulate the old ways to please or to trick the voters. Years of populism and corruption have led Ukraine's gas upstream to a critical condition.

Today we have another chance to carry out the crucial gas market reform that will bring us closer to Europe – both in terms of the rules of the game and, eventually, in the quality of life for each of our citizens.

It would certainly be an exaggeration to say that the process of change is going smoothly and there are no unexpected, sometimes very discouraging, failures. However, it is also impossible to deny that today there are more reform-oriented people in the government and public sector enterprises than ever before.

*We are laying the foundation for sustainable growth in the coming years that will make Ukraine strong and truly independent*

#### **THANKS**

I am grateful to all those who have been and remain involved.

I am grateful to the country's leaders for their trust in me and our team. This trust means that we sometimes have disputes. However, it also reflects

our mutual confidence in pursuing the path of reform. With the available political support, we can plan and execute strategic changes. It is priceless in the current conditions, and I appreciate every manifestation of this support.

I want to thank to the team for their work. Sleepless nights, late meetings, and unexpected challenges – this is our routine. We have a shared vision that justifies sacrificing our personal lives and comfort: our success lies in security and in a chance of a better tomorrow for every Ukrainian.

I appreciate the invaluable assistance we receive from Ukraine's friends and partners in the West. Our fight would be futile without this support.

I am grateful to the activists and experts who criticize and support us.

*The criticism has helped us make balanced decisions. The support has inspired us and was sometimes decisive in overcoming challenges*

I thank our customers for their understanding. Ukraine is as strong as each Ukrainian makes it. Following the rules, efficient energy consumption and paid bills – these are the contemporary manifestations of patriotism and of a genuine love for Ukraine.

Together we can do it!

ANDRIY KOBOLYEV  
**Chairman of the Board,**  
**Naftogaz of Ukraine**

2013

2014



KEY EVENTS IN UKRAINE

**21.11.2013** Ukrainian Government suspends signing the Ukraine-EU Association Agreement; start of the Revolution of Dignity

**17.12.2013** USD 15 billion "Russian Eurobond" agreed, USD 3 billion borrowed by the end of 2013

**16-19.01.2014** Ratification of the anti-constitutional "Dictatorship Laws" and the beginning of active protests

**18-20.02.2014** Tens of protesters are shot in the center of Kyiv

**23-27.02.2014** Power change: parliament appoints a new government

**February-March** Intervention of Russian troops and occupation of Crimea

**21.03.2014** Political provisions of the Ukraine-EU Association Agreement (AA) signed

**26.03.2014** **The Cabinet of Ministers appoints new management at Naftogaz**



DIVERSIFICATION OF GAS IMPORTS: EU INTEGRATION

**14.04.2014** Cooperation agreement updated between Ukrtransgaz and Gaz-System S. A.

**28.04.2014** **MOU signed in Bratislava to enable reverse gas flows from Slovakia to Ukraine, including reverse flow via existing pipelines**

**06.05.2014** Ukrtransgaz joins a leading EU underground gas storage transparency platform AGSI+ of GIE

**02.09.2014** **Commercial launch of Slovakia-Ukraine gas flows via a new pipeline. First direct interconnection agreement (DIA) on the new pipeline signed between Ukrtransgaz and Eustream**

**25.09.2014** Hungary stops supplying gas to Ukraine after Gazprom officials visit Budapest

**October 2014** **Statoil starts supplying gas to Naftogaz**



DIVERSIFICATION OF GAS IMPORTS: RELATIONS WITH RUSSIA

**17.12.2013** Russian gas price for Naftogaz cut to USD 268.5/tcm

**17.03.2014** Occupying government of Crimea confiscates assets of Chornomornaftogaz and creates Crimean Republican Enterprise Chornomor-neftegaz to manage them. The company later reregistered under the jurisdiction of the Russian Federation under the name of "State Unitary Enterprise of the Republic of Crimea Chornomor-neftegaz"

**1-2.04.2014** **Russia unilaterally increased gas price for Naftogaz by 80%+ to nearly USD 500/tcm. European imports cost Naftogaz USD 370/tcm**

**April-May 2014** US Commerce Department places Chornomor-neftegaz on its "Entity List" restricting trading activities; the EU imposes sanctions on Chornomor-neftegaz as well

**28.04.2014** Naftogaz sends Gazprom pre-arbitration notice regarding gas supply contract

**1-2.05.2014** Ukraine-EU-Russia trilateral negotiations commence on terms of Russian gas supply to Ukraine. Nearly ten trilateral meetings held over the following five months

**16.06.2014** **Naftogaz and Gazprom initiate arbitration proceedings regarding gas supply contract at the Arbitration Institute of the Stockholm Chamber of Commerce**

**17-23.06.14** Gazprom unilaterally cancels balancing agreement with Ukrtransgaz that enabled Gazprom to request use of Ukrainian gas to cover demand spikes in Europe



GAS MARKET REFORM

**14.08.2014** **Parliament passes a law opening way to form a partnership with EU and US companies to manage Ukraine's GTS**

**19.10.2014** 16.8 bcm of gas accumulated in Ukraine's UGSs at the start of the heating season

**26.11.2014** Government passes controversial decree #647 setting limitations in the wholesale gas market for three months in order to preserve security of supply to Ukrainian consumers in the emergency situation

**09.04.2015** **Parliament passes a ground breaking Natural Gas Market Law set to reform Ukraine's gas market in full compliance with the 3<sup>rd</sup> Energy Package**



CURBING CORRUPTION AND IMPROVING OPERATIONAL EFFICIENCY

**28.03.2014** Naftogaz makes USD 75.8 million Eurobond coupon payment

**31.03.2014** **Ukrainian regulator NERC brings gas prices for public sector consumers to the level of industrial ones**

**March-August 2014** Changes in Naftogaz management. Number of executive board members reduced from 14 to 5

**10.07.2014** Appointment of new management in Ukrtransgaz

**08.08.2014** Department for Reform and Business Development as well as Energy Efficiency Department are created in Naftogaz

**October 2014** **Naftogaz pays out USD 1.7 billion Eurobond and coupon**

**October 2014** Action plan to bring Naftogaz' corporate governance system in line with OECD standards proposed

**November 2014** Ukrtransgaz starts disclosing daily gas transmission data on the European transparency platform ENTSSOG

2015

**27.03.2014** The UN General Assembly adopts a resolution in support of Ukraine's territorial integrity

**April 2014** Russia's armed aggression in Eastern Ukraine begins

**30.04.2014** USD 3.2 billion received under IMF Stand-By Arrangement (SBA)

**25.05.2014** Ukrainian Presidential elections held

**27.06.2014** Remaining Ukraine-EU AA provisions and DCFTA signed

**August 2014** USD 1.4 billion received under IMF SBA

**26.10.2014** Parliamentary elections held

**21.11.2014** Coalition agreement signed including a provision for structural reform of energy sector and liberalization of gas market

**March 2015** USD 5.0 billion received under a new IMF SBA

**April 2015** The International Support for Ukraine Conference held in Kyiv

**July 2015** The first US-Ukraine Business Forum held in Washington D.C.

**August 2015** USD 1.7 billion received under IMF SBA

**09.10.2014** Government adopts resolution requiring to bring transmission of Russian gas in compliance with the 3<sup>rd</sup> Energy Package

**1-15.12.14** EBRD and EIB agree to provide €300 million to modernize the principal section of Ukraine's GTS. Includes provisions for reforming Naftogaz and Ukrtransgaz, as well as transparent tendering requirements

**17.12.2014** **Ukrtransgaz and Polish Gaz-System sign a cooperation agreement envisaging construction of a new interconnector to expand Poland-Ukraine gas flow capacity 6-fold to nearly 10 bcm/year**

**10.01.2015** Gas flows to Ukraine via Hungary restored

**29.05.2015** Ukrtransgaz and Hungarian FGSZ sign an interconnection agreement fully compliant with 3<sup>rd</sup> Energy Package and newly adopted EU gas network codes

**10.07.2015** In Croatia, 15 EU Member States and Energy Community countries of Central, Eastern, and South-Eastern Europe, including Ukraine, sign a memorandum on gas markets integration and diversification of supply sources

**15.07.2015** European Commission for Energy Union Šefčovič: Russia's plans to abandon transiting gas through Ukraine endangers European energy security and is unacceptable for the EU

**16.10.2014** Naftogaz initiates arbitration proceedings at the Arbitration Institute of the Stockholm Chamber of Commerce to bring the gas transmission contract with Gazprom in line the 3<sup>rd</sup> Energy Package

**31.10.2014** **The Winter Package, a trilateral agreement regulating interim terms for Russian gas supply to Ukraine until 31 March 2015, signed in Brussels**

**November 2014** Naftogaz covers USD 1.45 billion of disputed bills for Russian gas pursuant to the Winter Package

**December 2014** 2014 Naftogaz covers USD 1.65 billion of disputed bills for Russian gas pursuant to the Winter Package, thereby fulfilling all of its obligations

**31.01.2015** Naftogaz submits a Statement of Claim in the gas supply arbitration against Gazprom in Stockholm

**February 2015** **Gazprom announces start of alleged gas deliveries to occupied territories of Donbas through uncontrolled entry points. Naftogaz does not recognize such deliveries as its contractual imports**

**February-March 2015** Gazprom repeatedly breaches the Winter Package by failing to fulfill Naftogaz' prepaid gas supply nominations in full and by violating contractual procedures for raising its transmission nominations. Matter resolved through rapid response mechanisms included in the trilateral Brussels agreements

**01.04.2015** **Naftogaz and Gazprom extend the Winter Package through the end of June 2015. Gazprom offers gas price in line with the European levels**

**30.04.2015** Naftogaz files a Statement of Claim in the gas transit arbitration against Gazprom in Stockholm

**01.07.2015** **Naftogaz stops buying gas from Gazprom until gas supply conditions are agreed. Russian gas transmission to the EU continues in accordance with the contractual terms**

**10.04.2015** 7.6 bcm of gas remain in Ukraine's UGSs at the end of the heating season

**08.05.2015** **The Natural Gas Market Law comes into effect; most provisions come into force on 1 October 2015**

**14.07.2015** Naftogaz and Frontera Resources sign a memorandum of understanding on cooperation in exploration and development of oil and gas in Ukraine and potential implementation of LNG deliveries from Frontera's gas fields in Georgia

**14.07.2015** Trailstone announces its intention to enter the Ukrainian gas market after the new legislation comes into force in October 2015

**January 2015** Tenders for revaluation of Naftogaz' hydrocarbon reserves and fixed assets announced

**March 2015** Naftogaz releases 2012-2013 consolidated financial statements audited by Deloitte

**03.03.2015** **National regulator NERC adopts higher gas prices for households from 1 April 2015 and heat producers for households from 1 May 2015**

**19.03.2015** Parliament reduces shareholder meeting quorum requirement thus paving way for Naftogaz to regain control over Ukrnafta

**April 2015** Appointment of new management in Ukrtransnafta

**14.05.2015** **Parliament adopts a law on stabilizing the financial state of Naftogaz aimed at reducing the company's deficit and improving consumer payment discipline**

**June 2015** Appointment of new management in Ukrnasvydobuvannya; the new CEO appointed through a new transparent nomination procedure

**17.06.2015** Naftogaz joins a new transparent electronic system for state procurement

**24.07.2015** Parliament adopts changes to communal service industry regulations designed to reduce consumer debt to Naftogaz

**July 2015** **Baker & McKenzie and PWC proposed a detailed action plan of Naftogaz' corporate governance system reform based on OECD standards**

**July 2015** General Shareholder Meeting of Ukrnafta votes for a new CEO. The candidate is selected through a transparent public procedure and proposed by a Nomination Committee combined of government representatives and independent experts

## STATEMENT OF DIRECTOR FOR BUSINESS DEVELOPMENT

Yuriy Vitrenko



Dear readers,

Both in our country and abroad the Ukrainian gas sector is firmly lodged in the public opinion as an area plagued by large-scale corruption and uncontrolled theft.

Changing this perception to gain the trust of the society is both extremely important and challenging for anyone involved in reforming Naftogaz and building the gas market in Ukraine.

*Whatever progressive laws may the parliament pass, and whatever positive effects the proposed changes may bring to Ukraine, without the public support, the gas reform will be illegitimate and will never materialize*

### CORRUPTION BREEDING POPULISM

Corruption leads to populism. The previous generation of Ukraine's top-politicians defrauded the country and let the others below them use opportunities to steal — directly or indirectly — in order to secure their own positions.

The public felt the injustice of the government and, as a result, the people did not trust the politicians. This mistrust led the voters to simply demand lower prices for basic commodities and more social benefits. In such a situation, there is no use in explaining the public why the country cannot afford it — because there is no trust in such explanations.

Ukraine was going around in circles: the people elected populists, these populists were usually

corrupt; these corrupt individuals caused public distrust by their actions in the government, and led to the rise of yet another group of populists during the next election.

Incomplete and indecisive attempts of reforms lead to no result. In fact, they only cause irritation and further distrust within the society, and subsequently generate further demand for populism.

Breaking out of this circle is a hefty challenge. I understand that in order to earn trust, we have to talk less about the need to adjust gas prices, and more about the change that we are implementing at Naftogaz.

### INITIAL CHALLENGES AND FIRST RESULTS

The new management team that came to Naftogaz last year has achieved important results in several areas and is progressing in others.

The tasks on which our team works can be grouped into four strategic areas:

1. Reforming the Ukrainian gas market: moving away from excessive administrative control, inefficient monopolies and regulated gas prices set on the basis of political slogans instead of economic rationale — to an efficient market with the non-discriminatory access to the infrastructure for gas suppliers and the ability to freely choose a supplier for gas consumers
2. Ensuring security of gas supply to Ukrainian consumers and across Ukraine to the EU: including full-scale integration with the EU gas market and bringing relations with Gazprom to standard European business practices
3. Improving the operational efficiency of the group: curbing corruption, tackling financial deficit and introducing best governance practices based on OECD standards

4. Achieving gas independence for Ukraine through a combination of raising efficiency of gas consumption and developing domestic upstream sector

2014 was probably the most challenging period in the history of Naftogaz. Several critical threats coincided that year, including:

- unpaid gas bills amounting to UAH billions
- abrupt and politically motivated unilateral increase of Gazprom gas price by more than 80%, almost absolute dependence on Russia for gas imports, and the complete halt of gas supplies from Russia for almost six months
- sizeable loans coming due, including USD 1.6 billion in Eurobonds and associated coupon payments
- no cash for transit services for most of 2014 because of the advances received and spent years ago
- loss of a considerable part of upstream assets because of the Russian aggression
- the rapid devaluation of the hryvnia in a situation when most payments were in dollars and revenues in hryvnia
- the distortion between the purchase and selling gas price for households and the challenge for the authorities to reduce this gap at the time of the economic recession and war
- the political uncertainty and a series of elections which negatively affected the pace and the depth of change
- effects of years of corrupt practices that led to a critical loss of confidence in Naftogaz, both in Ukraine and internationally

*Naftogaz has never been so close to bankruptcy as in 2014*

In fact, bankruptcy was one of the options our team proposed when the decision was made on the new management and the future of Naftogaz.

However, it was essential to prepare for the 2014-2015 heating season in time and to ensure the reliable transit of gas to European consumers. Considering these tasks and following discussions

with international partners and creditors, a decision was made to attempt saving Naftogaz.

The most urgent task following the appointment of the new management team headed by Andriy Kobolyev was to stabilize Naftogaz operations. We had to make sure that the company was able to meet its obligations and accumulate necessary volumes of gas for Ukrainian consumers.

My team was responsible for gas supplies to Ukraine from the West. We negotiated with European suppliers and participated in launching the new interconnector between Ukraine and Slovakia. Now Ukraine's needs of imported gas can almost entirely be covered by supplies from Europe.

### FIXING IMBALANCES AND BUILDING THE FOUNDATION FOR GROWTH

However, the bulk of our work is aimed at bringing the rules of the game for each of our business segments in line with international best practices.

Together with our international partners we are now creating a solid foundation for the development of Ukrainian gas industry and reforming Naftogaz. The issues this cooperation covers include expansion of local gas production, anti-corruption initiatives in gas industry, integration with the European gas market, bringing our relations with Gazprom to normal commercial terms and improving operational efficiency at Naftogaz and its subsidiaries.

When (or if) the proposed legal and operating framework becomes effective, our market will function in accordance with standard EU principles. However, it is important to make these changes comprehensive and sustainable.

*If the reform is fully implemented, it will protect the interests of Ukrainian citizens both as consumers and the ultimate owners of public assets — regardless of who heads the government or manages Naftogaz at any given moment*

The reform of corporate governance system is crucial to ensure the irreversibility of these changes. It is a vital tool for overcoming corruption and improving the operational efficiency of the group. As with any other state-owned enterprise in Ukraine, the corporate governance system at Naftogaz requires urgent revision.

Before the reform start in 2014, executive positions in Naftogaz were often filled based on political loyalty, not professionalism. Control over Naftogaz and its subsidiaries was split among a limited number of interest groups, each trying to maximize their gains during their period of control.

While efficiency and the maximization of profits for the owners' benefit are typical private business objectives, these goals have never before been an official priority for Naftogaz. On the contrary, the permanent losses were expected, because of the paternalistic social contract that guaranteed "cheap gas" for every consumer. The losses were covered by the state budget, i.e. ultimately, by the citizens of Ukraine.

Ukraine's gas industry was governed by a Soviet-style centralized system which implied active state intervention. Given the limited tradition of authorities' accountability to the society and the lack of an established civil service culture, this structure resulted in a classic double agency problem.

At the highest level, the authorities were used to utilizing Naftogaz for their own purposes which most often did not correlate with the interests of the Ukrainian people.

At the lower level, the management of Naftogaz often sought to secure their own interests in addition to serving the interests of those in power at the time, and this did not match the societal interests either. Such a structure created vast opportunities for abuse.

Today Naftogaz has an unprecedented reform-minded team of managers who genuinely believe that their highest priority should be serving the citizens of Ukraine as the ultimate owners of the company. However, there is no guarantee that positive changes will not be halted or rolled back if the political will for reform wanes for any reason or if the management changes.

In the past years, most business functions of Naftogaz were at the discretion of a few people who were not accountable to the Ukrainian society.

*These business functions should be transferred to a much more advanced system of coordination of interests — the free market, where the competition motivates industry participants to create the maximum value using minimum resources*

A civilized and efficient market requires development and implementation of rules that encourage competition and ensure fair dealing by all market participants.

#### **THE NEW GAS MARKET LAW**

Last year, Ukraine's counterparts in the Energy Community proposed a new draft law on gas market that corresponded to the current European energy legislation. The document was drafted in good faith; however it had little chance to pass through the state authorities and the parliament. It infringed on the interests of several industrial groups and was contrary to the regular agenda of populists. The number of educated reformers in the parliament was insufficient for a successful vote.

We took on the job of advocating and defending the provisions of the law. Uniting efforts with the civil society, reform-minded members of parliament and market players, as well as partners from the EU and the US led to a wide public discussion and, eventually, won support for the new law. It was submitted by the Cabinet of Ministers, adopted by the Verkhovna Rada and signed by the President. Starting from 1 October 2015, Ukrainian gas market is to operate according to the new rules.

Under the new system, the national regulator now does not have the authority to set gas prices, except for the standard public service obligations provisions. The regulator sets tariffs for gas transmission (Ukrtransgaz) and gas distribution (regional gas companies) and is responsible for regulating the market, most notably, for safeguarding free competition.

*The new legal framework converts gas from a social benefit, abused and distributed unfairly, to a regular commodity, priced on the basis of supply and demand*

While the state continues to oversee natural monopolies in gas transmission and distribution, each family will now have the right to choose their gas supplier independently of their gas distribution company. This is a major change for the Ukrainian gas market and it finally makes the industry consumer-focused.

The new gas market law has created the necessary legal framework. However, scores of secondary documents needed to be developed and enacted to ensure an effective implementation of the new law and a smooth transition to the new rules. Over the past months, Naftogaz has been actively participating in the development of these documents with a team of European and national experts.

#### **SAFEGUARDING CHANGE: THE CORPORATE GOVERNANCE REFORM**

The history of gas industry transformation in other European countries shows that the chances for a successful reform increase dramatically when the incumbent state company actively supports it.

In Ukraine, Naftogaz is one of the drivers of the reform. Last year we laid the foundation which is now begins to transform the market.

When the reform is fully implemented, the decision-making process in companies that now form Naftogaz group is going to be based on economic rationale rather than political reasoning.

To make the reform irreversible, a new concept of corporate governance of Naftogaz was developed with the support of the EBRD. It is based on the OECD best practices for corporate governance in state-owned companies.

The proposed system creates checks and balances that will ensure coordination of interests of various stakeholders in the decision-making process while avoiding the group paralysis.

*The corporate governance reform we advocate together with Ukraine's international partners provides for an independent supervisory board, which would include independent members with years of professional experience, impeccable reputations and high levels of public trust*

Reforming corporate governance is vital for overcoming corruption and improving the operational efficiency of the group. Through independent supervisory boards the Naftogaz and its subsidiaries will receive the opportunity to implement long-term strategies focused on maximizing value for the public, within their mission and mandate.

#### **THE FUTURE OF NAFTOGAZ**

For a certain period of time Naftogaz will have to stay in its present legal form. The company is needed until retail gas prices for all consumers are deregulated and a competitive market develops. Another reason for Naftogaz to exist is its arbitration with Gazprom where the company disputes billions of dollars excessively paid for Russian gas and demands this money to be refunded.

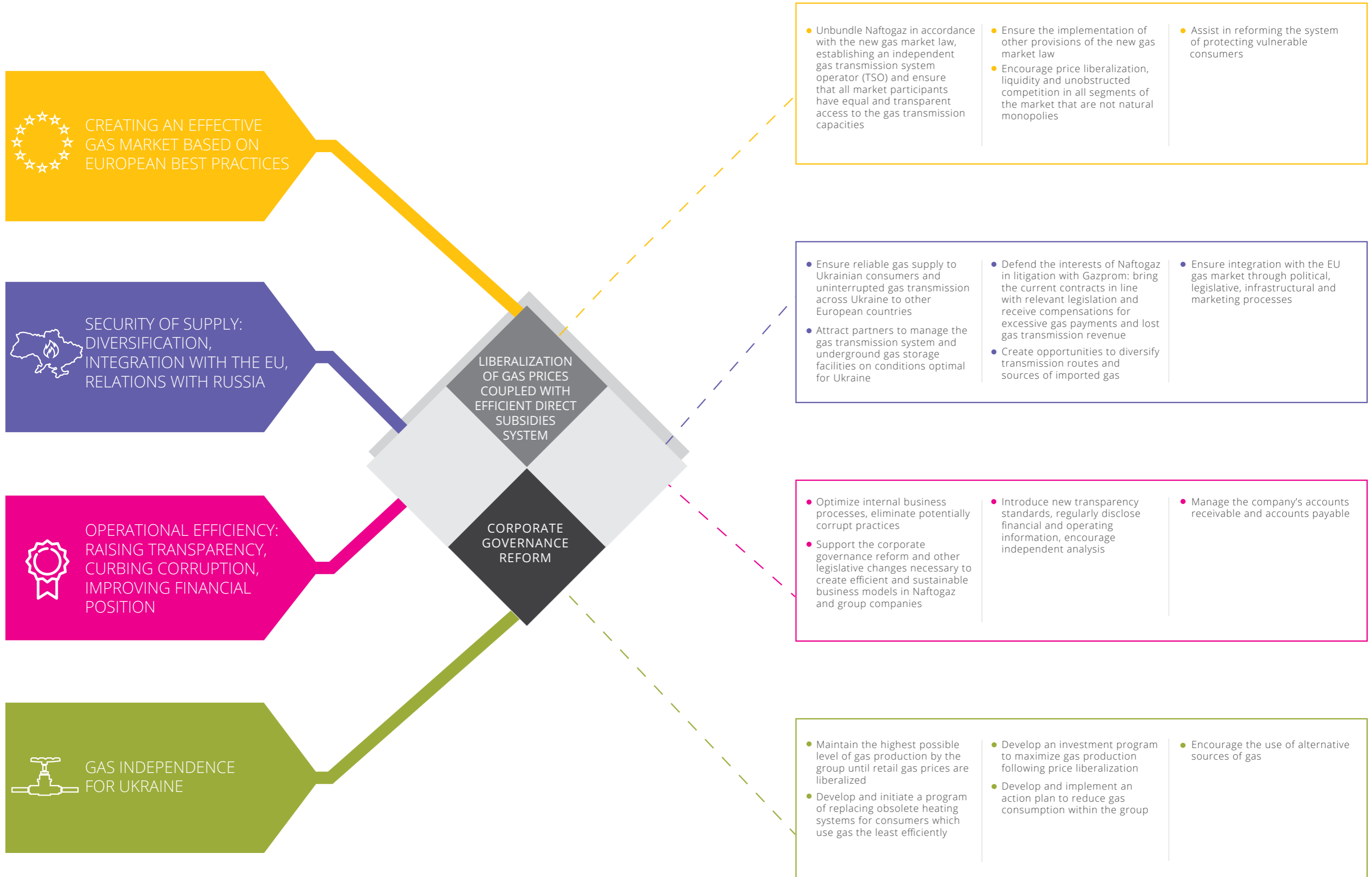
Then, if we do it right, within a few years the present Naftogaz will have evolved into a set of market rules. The Ukrainians will have reliable sources of gas supply at competitive prices and will not have to sacrifice a portion of national sovereignty in return. Our European counterparts will have a transparent partner offering mutually beneficial opportunities for integration and growth.

This is a future worth changing for and fighting for.

YURIY VITRENKO

*Director for Business Development  
Naftogaz of Ukraine*

# STRATEGY OVERVIEW



## STRATEGY SUMMARY

Strategic changes in Ukraine's gas market are not possible without changing Naftogaz itself. In the same time, systemic changes within Naftogaz are impossible without a comprehensive reform of the market. The group's position in Ukraine's gas industry imposes on it a responsibility to **lead the market reform**.

### *The strategic goal of Naftogaz is the development of a competitive gas market in Ukraine*

An efficient market will ensure security of gas supply and competitive gas prices for consumers in a financially sustainable way and will create the necessary conditions to attract investment to increasing local gas production and improving energy efficiency in Ukraine.

The current gas market model with excessive government intervention and inefficient monopolies should be replaced by a competitive market modeled on the

European best practices, with transparent rules of access to the infrastructure for all market participants and freedom for consumers to choose their suppliers.

During the transition period, Naftogaz should continue to perform its functions, specifically to **ensure reliable gas supplies to Ukrainian consumers and stable transmission of Russian gas to European consumers**. An important part of this task is the diversification of routes and sources of gas imports to Ukraine, integration with the EU energy market, as well as bringing relations with Gazprom to European market standards.

Naftogaz also strives to **increase the operational efficiency** of the group companies, which must be transformed under the new market conditions. The key objective is to optimize internal business processes to eliminate potentially corrupt practices and introduce best practices of transparency and financial disclosure. This transformation should also address liquidity and solvency issues of Naftogaz and its subsidiaries.

The long-term goal dependent on the implementation of the gas market reform is to **achieve gas independence**

**for Ukraine**. Naftogaz is taking an active role in promoting legislative and structural changes in Ukraine that will attract investments in upstream to increase local gas production and in energy efficiency to reduce gas consumption.

The implementation of Naftogaz strategy is highly dependent on two key changes in the group operating environment which Naftogaz actively advocates and supports.

Of particular concern is ensuring that gas is available for socially vulnerable households during the transition period. Recognizing the critical importance of **gas prices liberalization** for the reform's success, Naftogaz supports the state subsidy system reform and communication of these changes to the consumers.

Of equal concern is reforming the corporate governance of Naftogaz in line with the OECD standards to ensure sustainability of changes introduced by the market reform. Naftogaz supports the development, discussion and implementation of the **corporate governance reform**.



## CREATING AN EFFECTIVE GAS MARKET BASED ON EUROPEAN BEST PRACTICES

The old ways of the Ukrainian gas market are unacceptable and require change. This understanding unites the Ukrainian public, policy makers, industry experts and market participants.

The goal of the gas market reform advocated and led by Naftogaz is to create conditions for a sustainable development of the industry and improvement of the quality of life for Ukrainian citizens as the ultimate beneficiaries of this development. The new system should eliminate barriers that previously hindered development and led to an opaque and inefficient use of resources.

*The central idea of reform is to introduce transparent rules for all participants based on the EU best practices. As in the EU, consumers' interests are the cornerstone of this reform*

However, the initial implementation of the reform requires socially sensitive and unpopular moves, including the elimination of regulated retail gas prices

cross-subsidized by the state. To address this issue, the transformation will be implemented in stages, alongside the reform of the state subsidies system for vulnerable consumers and development of programs to improve energy efficiency in housing.

Successful implementation of the reform will have several important consequences.

Firstly, competition will appear in all segments of the market. Inefficient companies will be forced to either transform themselves or leave the market.

Secondly, the gas transmission and distribution infrastructure will be independent of gas suppliers. An open market with clear rules on infrastructure access will promote the diversification of suppliers and thus strengthen the security of gas supplies to Ukrainian consumers.

Thirdly, the functions of the market and the state will be clearly separated, protecting the sector from political meddling and graft. The functions of the state which are not typical for a regular business, including support for the socially vulnerable families, will be performed only on the basis of clearly defined conditions within the framework of public service obligations (PSO). The cross-subsidizing of gas for all consumers will be replaced by direct state subsidies for low income families only.

Finally, the transparent rules consistent with the European gas market and immune to political instability, will promote long-term investment in gas production and energy efficiency in Ukraine.

Implementing such reforms is in line with Ukraine's obligations as a member of the Energy Community and with the Association Agreement with the EU.

The first important steps in this direction were made in the spring of 2015, when the Verkhovna Rada of Ukraine passed, and the President approved, a new law on the natural gas market. This legislation was developed and promoted by representatives of the Energy Community Secretariat, Naftogaz and market participants, industry experts, reform-minded politicians and other stakeholders. The law is fully compliant with the 3<sup>rd</sup> Energy Package of the EU.

Most provisions of the new law come into effect on 1 October 2015. This framework document thoroughly changes the rules of the gas market in Ukraine. Its full implementation requires changes and amendments to dozens of existing regulations. During the past months, active work on this secondary legislation was performed by the government, the National Energy and Utilities Regulation Commission, the Energy Community Secretariat, Naftogaz and other industry stakeholders.



## SECURITY OF SUPPLY: DIVERSIFICATION, INTEGRATION WITH THE EU AND RELATIONS WITH RUSSIA

Energy security is a daily challenge not only for Ukraine but also for other European countries. The EU is implementing a new energy security strategy which involves creating a unified gas market and eliminating physical or administrative cross-border barriers to bidirectional gas flows within the framework of the Energy Union.

Diversification of both gas supply routes and sources minimizes a country's political and technological risks and strengthens its energy security. It also inevitably leads to an increased competition among suppliers, higher liquidity and fair gas prices for consumers. In a successfully diversified market, any state should have access to at least three independent sources of gas.

In the short term, removing transmission system bottlenecks and achieving effective diversification of gas supplies may require investments in infrastructure or restrictions to the volume of purchases from a single source. In its policy for security of gas supply Ukraine follows the same strategy.

### DIVERSIFICATION OF GAS SUPPLY ROUTES

Until 2014, Ukraine could import gas from the West via Poland (1.5 bcm/year) and Hungary (5.5 bcm/year). These routes were not sufficient for Ukraine because of their limited and interruptible capacity, and because they lack connection to the liquid gas markets of the Western Europe.

*Thanks to the collaboration between the Ukrainian and Slovak transmission system operators (TSOs) as well as the active support of the European Commission, the Slovak gas supply route to Ukraine was launched in 2014*

The current capacity of the new route is 15 bcm/year. It connects Ukraine to the liquid gas markets of the Western Europe and has been the main route for Ukrainian gas imports in 2015.

Ukraine's current demand for imported gas is estimated at 15-18 bcm/year. Therefore, with the launch of the Slovak route Ukraine has eliminated its critical dependence on Russian gas imports.

However, because gas demand is uneven throughout the year and strongly depends on the weather conditions, it is important to have sufficient transmission capacity to cover not only the total annual demand but also seasonal demand spikes.

If the infrastructure allows for a free movement of large volumes of gas to cover peak demand, security of gas supplies in the region significantly increases. Sufficient transmission capacity allows to reduce the need to store excessive volumes of gas and makes the market more stable and efficient. Creating a well-interconnected



gas transmission system that allows for a quick increase of gas flows is one of the main goals of the EU Energy Union.

Naftogaz and Ukrtransgaz continue to work on unlocking the full potential of the existing interconnectors between Ukraine and the EU. Not only will this work further strengthen Ukraine's energy security but will also benefit other countries of Central and Eastern Europe.

Russia has lost its dominant position in the Ukrainian market and is no longer able to use gas to extort political or commercial concessions from Ukraine. Since April 2015 Russian gas has been offered to Ukraine at prices that generally match prices at which Naftogaz can buy gas in the EU. If the interconnectors between Ukraine and the EU are fully utilized, the same results are possible for other countries of the region which currently significantly depend on Gazprom as their source of gas supply.

In June 2015, a direct interconnection agreement was signed between Ukrtransgaz and FGSZ, the Hungarian TSO. This agreement fully complies with the new European Gas Network Codes. It

is the first step to using the full potential of the interconnector between Ukraine and Hungary, including the virtual reverse flows (see *Gas transmission*).

The ultimate goal of Naftogaz is to sign and implement standard interconnection agreements with TSOs of all the neighboring EU member states, including Slovakia, Poland and Romania. For a full and unobstructed cooperation between the neighboring markets, it is also necessary to normalize relations between Ukrtransgaz, Naftogaz and Gazprom, and adapt Ukrainian legislation appropriately.

Another focus of the group is to increase the physical capacity of the interconnector between Poland and Ukraine. Ukrtransgaz and the Polish TSO GAZ-SYSTEM develop a joint project to build a new gas pipeline that will increase the capacity of the Polish interconnector by 8 bcm/year to 9.5 bcm/year in Ukraine's direction.

### DIVERSIFICATION OF GAS SUPPLIERS

Besides developing alternative gas supply routes, an important element of diversification is increasing the number of suppliers. The most reliable way to

achieve this goal is to implement Ukraine's gas market reform. The reform foresees liberalization of retail gas prices for all consumers and adoption of a new regulatory environment that is consistent with the EU energy legislation. These changes will stimulate entry of new gas suppliers to Ukraine.

The first results of the adoption of the new gas market law are already visible. In July 2015, Trailstone, one of suppliers to Naftogaz in the European market, has expressed its intention to enter the Ukrainian market after the new regulatory environment is introduced. Other European gas traders are preparing to enter the market as well.

*In 2014, Naftogaz significantly expanded the number of its gas suppliers in Europe. In particular, the group started to buy gas from Statoil*



Naftogaz also buys directly from a number of leading European gas traders, including ones from Germany and France. In order to maximize the range of its potential suppliers, Naftogaz has adopted a number of trading tools and principles common for the EU market, including standardized EFET contracts with delivery to the virtual trading point (VTP) and nominated in energy units.

Liquefied natural gas (LNG) could become a potential new source of gas for Ukraine. Given that Turkey currently opposes the passage of LNG-terminals through the Bosphorus, LNG can be sourced by Ukraine from the countries of the Black Sea basin. Alternatively, LNG could be sourced from the terminals in Lithuania and Poland, subject to the development of appropriate gas transmission infrastructure. Naftogaz explores a number of possible options in this regard.

### RELATIONS WITH GAZPROM AND RUSSIA

Relations with Gazprom and the Russian Federation significantly impact the energy security of Ukraine and operations of Naftogaz. Prior to 2014, Gazprom was virtually the only supplier of imported gas

to Ukraine (see *Gas imports and wholesale trading*). Ukraine's gas transmission system is the primary delivery route for Russian gas to the EU, Gazprom's largest export market (see *Gas transmission*). Following Russia's military aggression, Naftogaz has lost control over some of its assets, and Gazprom announced the commencement of unauthorized gas supplies to the occupied territories of Donbas (see *Military aggression of Russia against Ukraine*). Naftogaz aims to bring relations with Gazprom to standard market terms and to minimize political influence on these relations.

There are two contracts between Naftogaz and Gazprom: one covers gas supply to Ukraine and the other — transit of Russian gas to European consumers. Both contracts require revision based on Ukraine's commitments as a member of the Energy Community, newly adopted legislation and changes in the market environment. In addition, both companies have concerns regarding the application of certain provisions of the contracts.

#### Contract for gas supply

Having failed to agree on issues related to the contract for gas supply through

negotiations, Naftogaz and Gazprom initiated arbitration proceedings at the Arbitration Institute of the Stockholm Chamber of Commerce (SCC) in June 2014. The two claims were subsequently combined into one proceeding.

Naftogaz requests a repayment of more than USD12 billion charged by Gazprom above prevailing market prices between 2010 and 2014. Naftogaz refers to its contractual right for a revision of the price to reflect the actual market conditions. Naftogaz repeatedly applied for such a revision over the previous years.

Gazprom requests a payment of approximately USD 26.7 billion by Naftogaz. Approximately USD 2.1 billion of this amount relates to the disputed difference between the justified and contractual prices for gas supplied to Naftogaz in 4Q 2013 and 2Q 2014. The remaining portion of Gazprom's claim refers to the "take or pay" provision and is a demand to pay for gas which was never supplied. Naftogaz insists that the "take or pay" provision combined with other provisions of the contract (including the pricing mechanism and the prohibition of re-exporting the gas) is discriminatory and cannot be applied.

#### Contract for gas transit

The gas transit contract between Naftogaz and Gazprom requires revision as well. Naftogaz has raised this issue repeatedly both in bilateral discussions with Gazprom and during trilateral negotiations involving representatives of Ukraine, Russia and the European Commission. In October 2014 Naftogaz initiated arbitration proceedings in SCC regarding this contract and submitted a statement of claim in April 2015.

In a report of 3 December 2014, the Energy Community Secretariat concluded that the gas transit contract between Naftogaz and Gazprom may be considered non-compliant with European competition and energy law.

In its statement of claim, Naftogaz indicates that a number of provisions of the contract, including tariff

setting provisions, are invalid based on the applicable competition and energy law. These provisions must be replaced pursuant to the contract, with retroactive effect. Naftogaz claims a compensation for incurred losses related to the actually transmitted volumes.

Naftogaz also demands a compensation for Gazprom's failure to supply negotiated gas volumes for transit, given that the transmission tariffs depend on the volume of gas transported. Gazprom has committed to transit no less than 110 bcm per year via Ukraine. Instead, the annual transmitted gas volume in 2009-2013 averaged 94 bcm. In 2014, Gazprom transited just 62 bcm of gas through Ukraine.

Finally, Naftogaz requests that its rights and obligations under the contract are transferred to Ukraine's gas transmission system operator in accordance with the 3rd Energy Package.

The total monetary claims of Naftogaz under this contract exceed USD 11.7 billion. These claims relate to the period prior to 2015 and will be extended to cover losses incurred in 2015.

Naftogaz is ready to continue negotiations on both contracts.

#### Interim agreements on Russian gas supplies to Ukraine

Until the conclusion of the arbitration proceedings, the terms of Russian gas supplies to Ukraine are regulated by interim agreements, which are mediated and monitored by the European Commission. The so-called "winter package" signed in Brussels on 31 October 2014 set out the terms of Russian gas supply till the end of March 2015. The package consisted of a trilateral binding protocol between the governments of Ukraine, Russia and the European Commission, as well as a bilateral supplemental agreement to the contract between Naftogaz and Gazprom. The bilateral agreement was later extended to cover the period until the end of June 2015.

Under the conditions of the winter package Naftogaz has paid USD 3.1 billion for 11.5 bcm of gas delivered by Gazprom in 4Q 2013 and 2Q 2014 at USD 268.5/tcm. The Russian side provided a gas price discount and undertook an obligation to supply up to 114 mcm/day based on Naftogaz' daily nominations on a prepaid basis. The take-or-pay provision did not apply during this period.

The final ruling in the pricing dispute between Naftogaz and Gazprom will be made by the SCC. The Brussels agreements are temporary and do not affect the positions of the parties in court.

The winter package was an important and effective tool which alleviated the risk of interruption of gas supplies by Russia to European consumers during the winter season of 2014-2015. It also gave Ukraine an opportunity to source the necessary volumes of gas to cover its demand. Naftogaz did not buy gas from Gazprom in 3Q 2015. The parties continue negotiations of a similar trilateral package for the 2015-2016 winter season.

### INTEGRATION WITH THE EU GAS MARKET

Ukraine's relations with the European Union and other European countries on gas issues are based on the principle of mutually beneficial partnership.

Ukraine aims to facilitate its own gas industry transformation utilizing the experience gained by all other European countries — from the United Kingdom to Slovakia.

If the reform is implemented successfully and Ukraine is fully integrated with the European gas market, attractive new opportunities will open for Western partners in at least four new markets.

#### Gas supply

Ukraine is one of the largest markets for natural gas in Europe, with imports in 2014 amounting to 19.5 bcm and the consumption to 42.6 bcm. Given Ukraine's desire to diversify gas supplies following the Russian military aggression, European suppliers have an opportunity to increase their market share in Ukraine.

#### Gas transmission and storage

Ukraine's gas transmission system, operated by Ukrtransgaz, remains a reliable transit route for Russian gas to the EU: over 40% of Russian gas delivered to Europe and Turkey in 2014 was transmitted through Ukraine. Ukraine has the largest underground gas storages in Europe with a total capacity of over 30 bcm. The largest of these storage facilities are located at the border of Ukraine and the EU.

Ukraine's gas transmission system can be used to transport gas from suppliers in Western Europe to customers in Central, Eastern and Southern Europe. Ukraine's existing gas infrastructure interconnects otherwise fragmented gas transmission systems of the region and can help to significantly decrease the dependence of these countries on Russian gas supplies.

Ukraine is interested in optimizing the use of its gas infrastructure and invites western partners to jointly operate the Ukrainian gas transmission system and underground storage facilities. Relevant amendments to the legislation enabling such partnerships were passed in 2014.

#### Gas upstream

Ukraine ranks third in proven natural gas reserves in Europe after Norway and the Netherlands. Naftogaz' subsidiary Ukrgasvydobuvannya is the largest player in Ukrainian upstream market. The gas market reform, industry deregulation and liberalization of retail gas prices will open this market for investment. Upstream investment needs in public and private sectors are estimated at approximately USD 5.6 billion over the next 5 years.

#### Energy efficiency

In addition to gas supply, transmission and upstream markets, the proposed reform creates investment opportunities in the market of energy efficiency projects. Ukraine is one of the least efficient gas consumers in Europe. Modern technologies provide a huge energy saving potential for both households and industrial consumers. The market size is estimated between USD 10 to 15 billion over the next 5 years.

## OPERATIONAL EFFICIENCY: TACKLING CORRUPTION, RAISING TRANSPARENCY, ADDRESSING FINANCIAL ISSUES

The gas market reform currently implemented in Ukraine aims to create an efficient competitive environment in each segment of the gas industry. Naftogaz group companies need to adapt to the new conditions by improving their operational efficiency.

### TACKLING CORRUPTION AND RAISING TRANSPARENCY

For a long time, Naftogaz has been synonymous with ubiquitous corruption. To remedy the situation and gain trust of its stakeholders, Naftogaz introduces comprehensive changes in its internal operating policies and procedures. The group management also advocates introduction of European standards and regulatory best practices in all segments of Ukraine's gas market to remove distortions which made Naftogaz unavoidably loss-making and created ample opportunities for corruption.

The negative perception of Naftogaz was formed by both internal and external factors. The group management has varying influence on processes which determine the effectiveness of tackling corruption within Naftogaz and related to Naftogaz.

Some factors are outside of Naftogaz control and relate to the functions of the law enforcement and judicial systems,

especially in matters that concern proving and recovering past losses.

### *Naftogaz cooperates with investigators on a number of cases associated with the past management of the group and ensures full access to related information and documents*

In its strategy for building an effective gas market in Ukraine, Naftogaz takes the responsibility beyond its normal scope of duties and drives the change — in particular, in streamlining the regulatory framework and reforming its corporate governance system.

Naftogaz has also introduced or is implementing changes within its direct control. In particular, the new management has eliminated intermediaries in gas imports and internal gas supply, created conditions that led to reduction of prices of imported gas

for Ukraine, has initiated arbitration proceedings related to old disputes and continues actions to regain control over its key subsidiaries.

Steps are also taken to tackle less prominent manifestations of corruption and abuse. Naftogaz now uses transparent bid solicitation process whereby its tender announcements are widely distributed in local media to maximize the selection of potential suppliers. In 2015, Naftogaz and Ukrgasvydobuvannya joined ProZorro, an e-procurement system for public sector which enables access to a wide range of private sector suppliers and ensures a transparent bidding procedure.

The new management team has taken unprecedented steps to improve disclosure of Naftogaz operating and financial data and introduce new transparency standards. The group has released audited consolidated financial statements for 2012-2013 and 2014. Naftogaz now publishes quarterly audited stand-alone financial results. The management continues to modernize and rationalize the internal reporting systems within the group to enable the preparation of consolidated financial statements on a quarterly basis.

Naftogaz has initiated a public discussion of its strategy and activities both with



internal and international stakeholders. The group now publishes a comprehensive selection of regular operating statistics related to gas imports, production, transmission, storage and consumption. Naftogaz has joined leading European gas infrastructure transparency platforms of GIE and ENTOSOG, whereby it established automated daily updates of gas storage and transmission data.

For the first time Naftogaz has disclosed data on the structure of its executive board and management remuneration. The personnel selection process has become transparent and is now based on professional merits (see *Personnel*).

Thanks to the radical improvements in its transparency and general governance

standards, Naftogaz was able to receive support of the European Commission and to gain trust of the group's partners from Europe and the USA. At the same time, relations with Gazprom have become more pragmatic and business-oriented.

### ADDRESSING FINANCIAL ISSUES

All Naftogaz companies should be managed in the interests of the people of Ukraine, the ultimate owner of the Naftogaz group. The key management objective therefore needs to be increasing the market value of the group's assets. Tailored approaches are required for each assets, with options including development in existing markets, expansion into new markets, restructuring, privatization or liquidation.

Changing the rules of the gas market in Ukraine and reforming Naftogaz corporate governance can aid this process. Historically, Naftogaz has sold gas at below market prices, leading to substantial losses and making the company dependent on state support.

For years, selling price for Ukrgasvydobuvannya gas has been administratively set below market prices. The company has therefore been unable to raise sufficient investments to modernize its production facilities and technologies and to eventually increase its output.

Group companies operating in other sectors of the gas market face similar structural challenges and regulatory distortions. The ongoing gas market reform should create

favorable conditions for the development of these assets.

Another important challenge for the group is managing its vast accounts receivable and accounts payable. Having repaid its Eurobond in 2014, Naftogaz significantly reduced its current obligations. Most of remaining current loans were restructured in 2014-2015 (see *Financial Statements Review*).

At the end of 2014, the accumulated debt of consumers to Naftogaz and its trading subsidiary Gas of Ukraine amounted to UAH 38.7 billion. 60% of this debt dated back to before 2014.

72% of the debt was owed to Naftogaz and Gas of Ukraine by district heating companies

(DHCs), as well as regional gas distribution and supply companies (oblgazes). In this category, the largest accumulated debt is associated with Dnipropetrovsk and Kharkiv regions, the city of Kyiv, the Anti-Terrorist Operation area in east Ukraine, and the occupied Crimea. 18% of debt relates to industrial users, of which 2/3 is from chemical enterprises in the three oblasts of Luhansk, Rivne and Cherkasy. Another 10% of the debt has been accrued by gas traders and other companies, with the largest debtor in this category being the Crimea registered entity GazUkrayina-Commerce.

Between 2010 and 2015, Naftogaz and Gas of Ukraine filed more than 5 000 lawsuits related to debts totaling UAH 38.8 billion

and additional UAH 10.7 billion in penalties and fines

Almost half of the total amount of these claims is related to 21 clients, with each having outstanding debts of more than UAH 0.5 billion. Approximately 100 clients with debts of UAH 0.05 billion to UAH 0.5 billion account for 42% of the total debt owed to the group. The remaining debtors (nearly 2 300 companies with debts of less than UAH 50 million) account for less than 10% of total debt.

During this period, court decisions were made regarding claims which amount to approximately UAH 36.7 billion, with a positive ruling issued regarding UAH 27.7 billion (or 67% of the total amount claimed). However, as of July 2015, only UAH 5.2 billion have been paid.

Solving the issue of gas debts owed to Naftogaz and Gas of Ukraine requires not only active steps by the companies but certain amendments to the legislation. As a guaranteed gas supplier, Naftogaz had the obligation to conclude gas contracts and supply gas to virtually any consumer in Ukraine. However, Naftogaz did not have effective tools to recover debts from delinquent customers. The policy of guaranteed supply led to an increase of Naftogaz deficit and made it reliant on additional support from the state budget.

In May 2015, within the package of bills agreed with the IMF, the parliament voted in favor of legislative amendments aimed to correct the situation and stabilize the finances of Naftogaz. When these amendments are fully operational, Naftogaz will have the right to suspend gas supplies to consumers in arrears and can refuse to enter into contracts and to supply gas to companies that are bankrupt. Additionally, the moratorium on the forced sale of property of district heating companies to cover their gas debts will be lifted, and an improved process for the execution of court decisions will be implemented. Naftogaz will have an opportunity to publicly auction debts owed to it. Full implementation of these changes requires the adoption of certain secondary regulations and rulings by the Cabinet of Ministers.

## GAS INDEPENDENCE FOR UKRAINE

Unlike many countries in Europe, Ukraine could potentially abandon importing gas and fully meet the country's gas demand through domestic production alone. In order to achieve this goal, it is necessary to bring investments to increase both energy efficiency and domestic gas production.

Achieving this goal depends on successfully reforming the gas market and on other steps the government has initiated to create a favorable investment climate in Ukraine. It is estimated that Ukraine needs USD 40 billion of investments into energy saving and gas production in order to abandon gas imports within the next ten years. To put this amount into context, Ukraine paid over USD 80 billion for Russian gas over the past ten years.

Naftogaz management is certain that the most practicable way to achieve gas independence for Ukraine is to fully implement the gas market reform and safeguard unobstructed competitive environment in the country's gas sector.

Naftogaz energy efficiency division is developing programs to increase efficiency of gas use by the group's enterprises, as well as a program to replace old and inefficient boilers for the poorest consumers. Ukrgasvydobuvannya is also currently analyzing the possibility of increasing gas production and evaluating investment needs. Naftogaz supports the use of alternative sources of gas (including biogas) and alternative fuel sources.

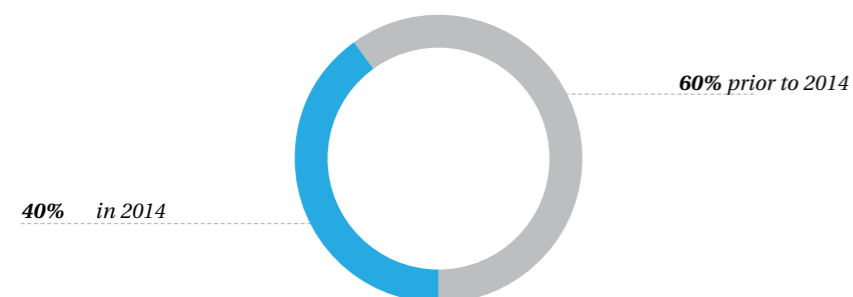


According to Naftogaz estimates, comprehensive energy efficiency measures can decrease households demand from about 22 bcm in 2014 to 10 bcm/year by 2025. According to preliminary estimates, modernization of the heating equipment and networks, installing meters and insulating buildings requires nearly USD 36 billion of investments.

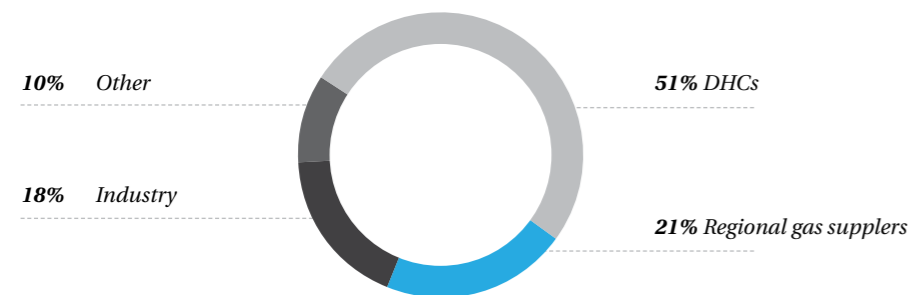
Conventional natural gas reserves in Ukraine are estimated at over 1 trillion

cubic meters and are among the largest in Europe. Ukraine's reserves-to-production ratio is above 30, being the highest in Europe and indicating that Ukraine depletes its resources comparatively slowly. An estimated USD 5.6 billion of investments is required to increase gas production to 12-14 bcm per year by 2020. Taking into account the anticipated depletion of existing wells, it may bring Ukraine's total gas production to 27-29 bcm per year by 2020.

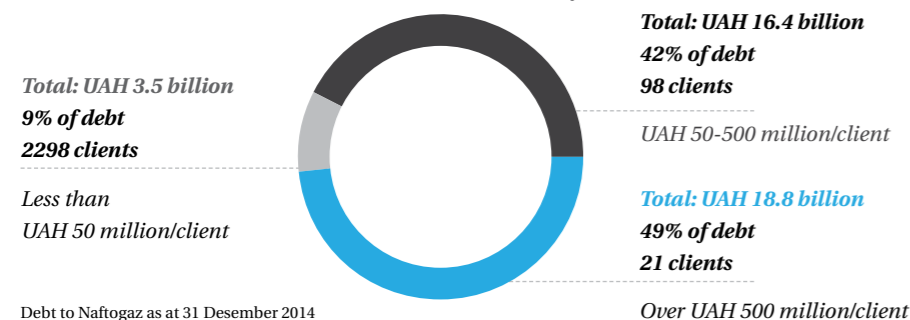
### DEBT TO NAFTOGAZ AND GAZ OF UKRAINE, BY ORIGATION DATE



### DEBT TO NAFTOGAZ AND GAS OF UKRAINE, BY CONSUMER CATERGORY



### DEBT TO NAFTOGAZ AND GAZ OF UKRAINE, BY AMOUNT OWED



Debt to Naftogaz as at 31 Desember 2014

## REFORM RISKS AND CHALLENGES

The proposed market reform is not limited to Naftogaz itself; it encompasses the entire Ukrainian gas industry. The reform requires significant changes in the industry governance in general, shifting the government policy from control to regulation.

The proposed changes are designed to encourage more efficient business models focused on longer term strategies by the gas market participants.

A successful implementation of the reform will also result in a shift to more energy conscious behavior for millions of Ukrainians. The most challenging part of the reform is the need to move the center of responsibility for efficient energy use from the top to the bottom, creating an environment where citizens are responsible for making better energy consumption choices.

Naftogaz sees three key challenges which can hinder the reform process, namely, demand for paternalism, poor coordination between various governmental bodies implementing the reform and corruption-induced resistance to change.

### PATERNALISTIC EXPECTATIONS OF THE PUBLIC

A significant number of Ukrainians still have paternalistic expectations originating from the Soviet system. During the Soviet era, the citizens had no effective instruments to influence the governance of the state or their communities. In the result, avoiding individual responsibility has become a common behavioral pattern. Basic commodities subsidized by the state traded off for selective justice and the non-accountability of the authorities were components of the paternalistic culture that evolved over many decades.

The European choice that the Ukrainians have proclaimed requires a completely different model of behavior. The transition to this model is a challenge for millions of Ukrainians. Some citizens reject the necessity to invest in energy efficiency and to take the full financial responsibility for their energy consumption. For others the transition is complicated because it requires evaluation of different consumption patterns and forecasting of future consumption — tasks never done before. This shift is particularly difficult against the backdrop of a struggling

economy. The situation is complicated by the fact that Ukrainians rely on the state but do not trust it.

Social surveys of confidence in institutions show single-digit levels of trust to the state institutions. At the same time, the speed with which reforms are taking place and the uncertainty generated by the lack of, and often contradictory, government communication on the reform process and its goals, creates a confusing environment for the public, leading to stress and distrust.

Populist political leaders oppose reforms, using a chance to increase their political influence. By opposing the gas sector reform in general or some of its elements, they can undermine the integrity of the changes Naftogaz seeks to implement.

However, the Ukrainian society is not entirely paternalistic. The reforms initiated by Naftogaz enjoy the support of many within Ukrainian civil society.

### *The 2013-2014 Revolution of Dignity has demonstrated that Ukrainians are willing and able to take responsibility for changing the country*

An effective communications strategy, together with the support of the ruling parliamentary coalition, should help to reduce public anxiety. The 2015-2016 winter will likely be the most challenging and decisive period for the reform success and will show how the country adapts to the new conditions.

### LACK OF COORDINATION AMONG THE REFORMERS

The lack of coordination among various entities and governmental bodies that participate in the implementation of the reform poses a major threat to the reform process. At least one member of the ruling coalition openly opposes the currently implemented reform. The vision of the gas market reform and its elements is not unified across various participants responsible for its



implementation. The process of constitutional separation of powers between the parliamentary coalition, the government and the President has not been finalized. Meanwhile, the ongoing decentralization reform adds to the confusion, creating ambiguity over the levels of responsibility the local authorities are going to assume.

The participation of internal and external stakeholders is extremely important to resolve these challenges. The Ukrainian civil society now actively monitors the government decisions and actions. Ukraine's foreign creditors and international partners have clearly articulated the terms of their support, with special emphasis placed on the previously failed attempts to reform the energy sector. An unreformed energy sector in Ukraine presents a potential security risk, both for the EU and for Ukraine. Given the lack of resources and time constraints, reforming the market requires determination of all parties involved.

*In order to address this challenge, the Ukrainian authorities have launched a number of joint initiatives that bring together representatives of different ministries and organizations involved in the reform process to improve coordination between them*

Of particular importance in moving the reform forward is the National Reforms Council established by the President of Ukraine, which unites representatives of the parliament, the government and the presidential administration, as well as relevant NGOs and experts.

Another important cross-ministerial group was formed by the government to coordinate the development and implementation of state-supported energy efficiency programs as well as the reform of the system of utility subsidies for low-income consumers.

### CORRUPTION-INDUCED RESISTANCE FROM THE MARKET

The third key challenge to the gas market reform is corruption. Energy sector is associated with significant capital flows and is an effective way of securing political leverage and influence. Therefore, control over this sector

of economy has always been an important priority for those who engaged in corrupt practices.

Through the energy sector, corrupt groups have influenced the political, economic and social development of the country for many years. Large-scale overpriced gas imports from Russia and heavily subsidized gas for households have served as instruments of power and created a corruption-prone system. Without control over Naftogaz and its subsidiaries, the old groups of influence lose their competitive advantage against more effective private sector players.

The array of tactics deployed to hinder the reform include defamation, sabotage, blocking changes through court decisions, lobbying legislation that undermines the reform integrity and even using threats of physical violence against individuals responsible for the reform implementation.

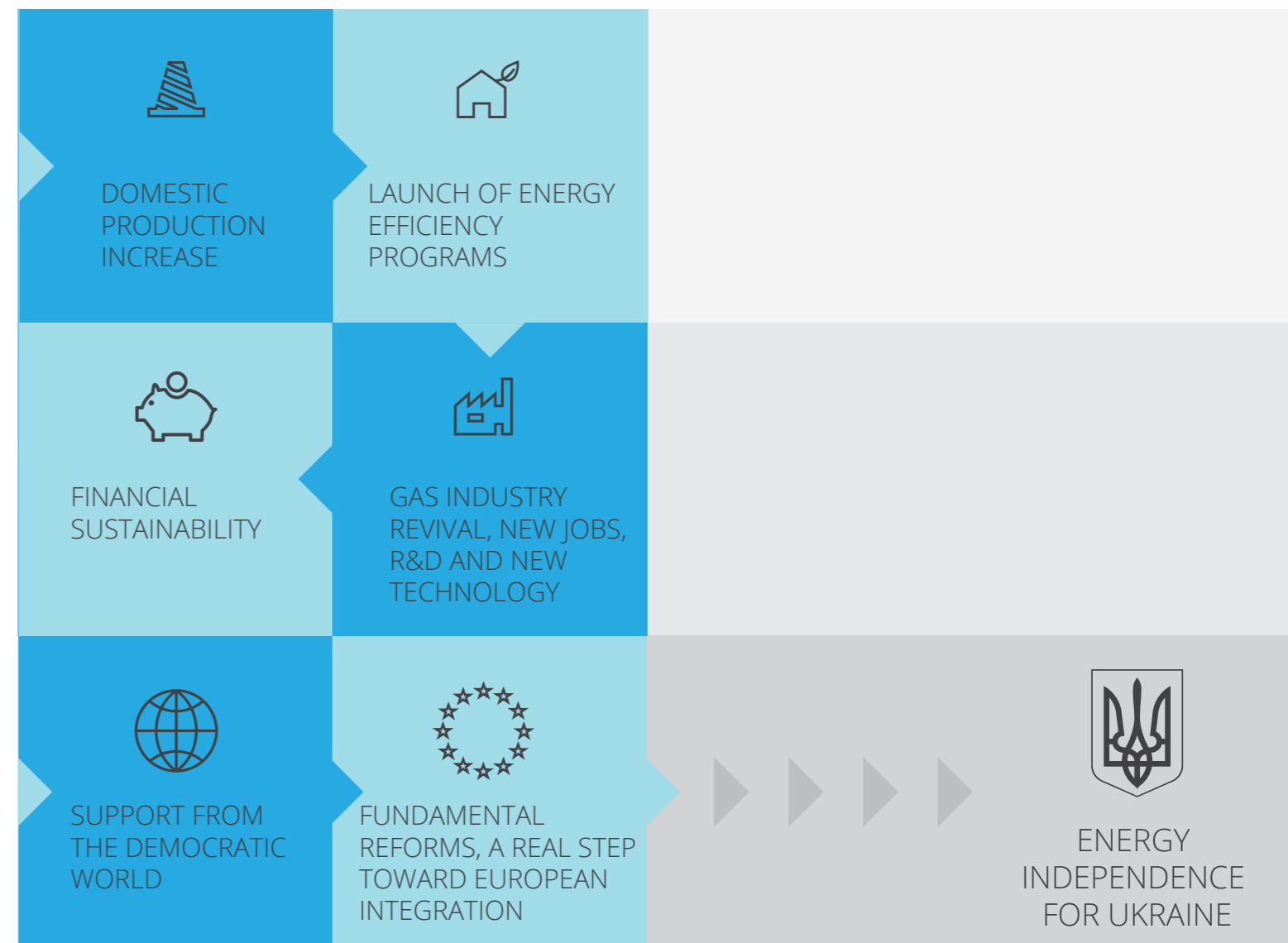
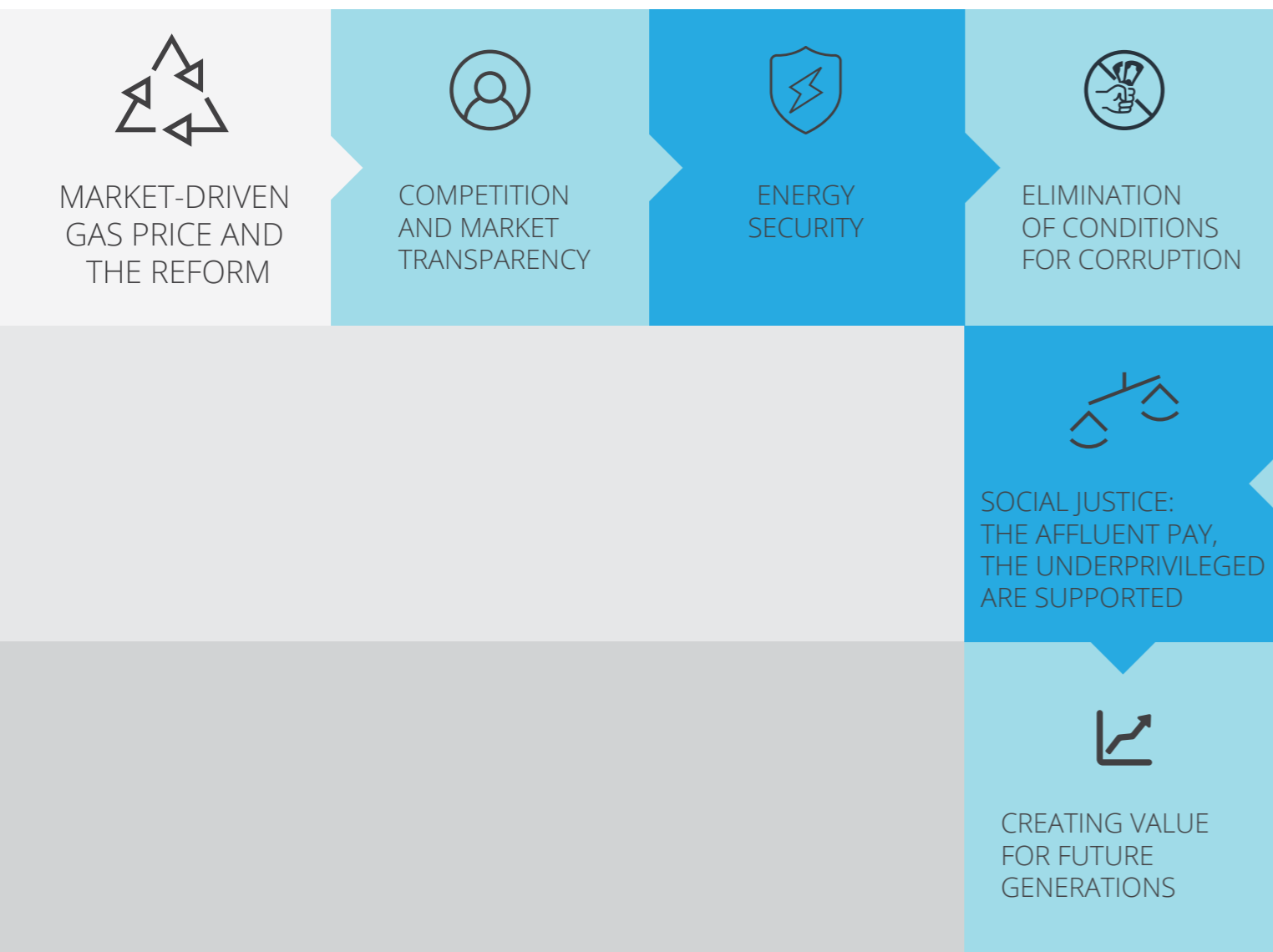
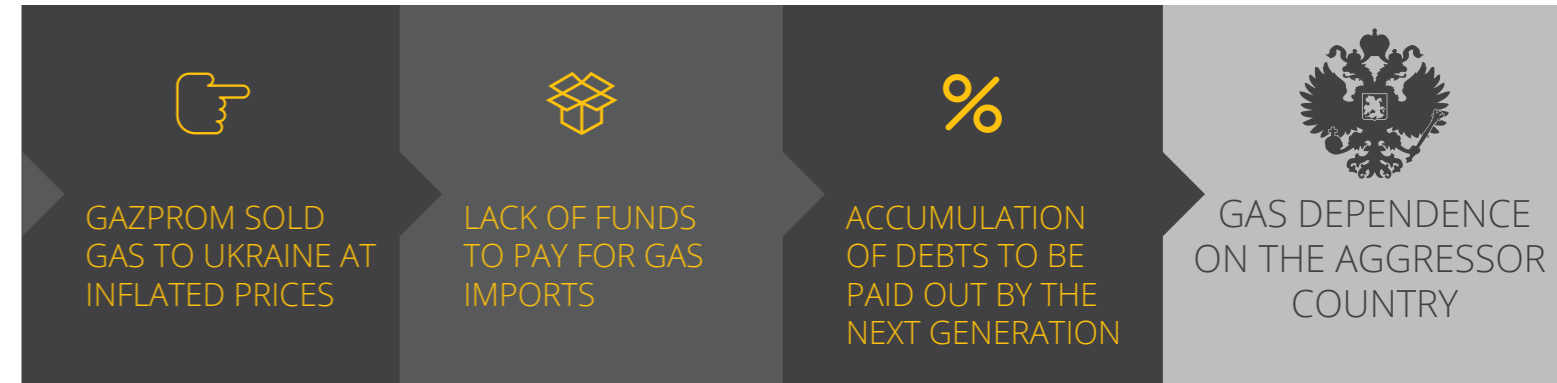
As long as Ukraine's public institutions are weak and the public support for the unpopular changes is limited, the alliance of corrupt interests and paternalistic expectations can pose a threat not only to the gas market reforms, but to the country as a whole. Communicating these threats to the society and explaining the logic behind the reform process are therefore crucial steps.

*The strong political will within Ukraine and the voice of Ukraine's Western partners are critical for moving the reform forward. The increased role of the Ukrainian civil society helps to curb corruption and block decisions aimed to stop the reform implementation*

Naftogaz believes that the corporate governance reform based on OECD best practices for public sector companies is one of the most effective ways to combat corruption in the energy sector. In particular, an independent supervisory board in Naftogaz needs to be formed to protect the company from potential political meddling, safeguard against nepotism, improve control over the group's finances and guarantee that management decisions reflect the interests of all Ukrainians as the ultimate owners of Naftogaz, not of a limited group of individuals.

# WHY GAS SHOULD BE SOLD AT MARKET PRICE

Gas market reform results



## HOW MUCH SHOULD UKRAINIAN HOUSEHOLDS PAY FOR GAS?

The price of gas is one of the most hotly debated topics in the Ukrainian society. This debate is complicated by populist politics and by a lack of public awareness about the economic realities underpinning the gas market. Expectations for unrealistically low gas prices have served as a barrier to true energy independence of Ukraine for decades. The artificially low, administratively capped prices have damaged Ukraine's wider national interests and stunted the country's economic development.

Ukrainians have long been dissatisfied with the lack of transparency in the country's domestic gas sector, which is widely viewed as a source of corruption and a key factor behind inadequate public services. For many households, gas and heat consumption meters remain the exception rather than the rule.

The sale of gas at prices below the market rate has necessitated a policy of state subsidies that has drained funds and prevented Naftogaz from addressing other strategically important issues. Years of underfunding have also resulted in a decrease in the volume of gas produced by Naftogaz.

Ukraine's energy sector requires urgent and fundamental reform. Naftogaz is currently carrying out far-reaching reforms designed to introduce European standards to the domestic gas market. Key goals include establishing a framework for reliable and economically sustainable gas

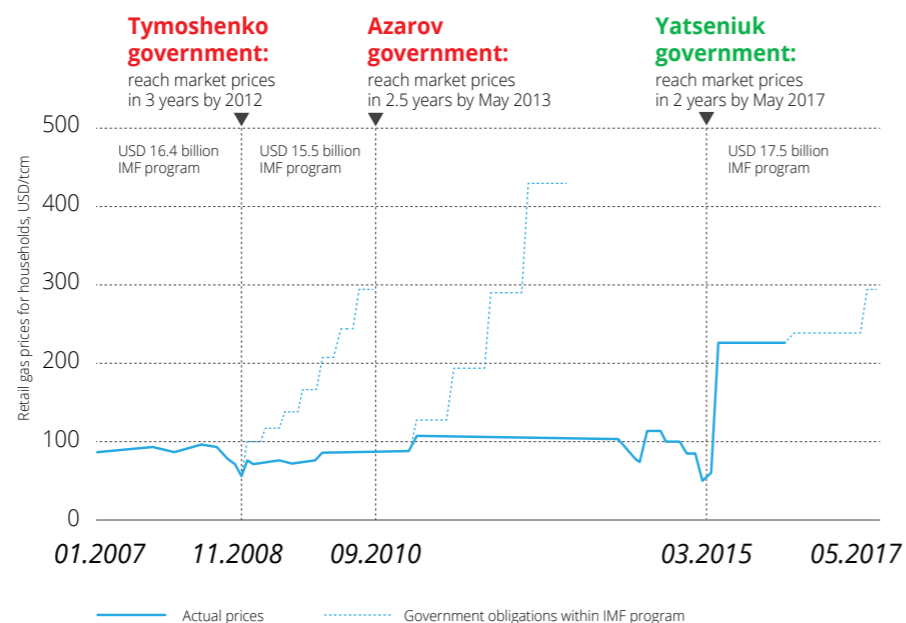
supplies to domestic consumers, reducing opportunities for corruption, and creating the conditions for greater domestic gas production (see *Creating an effective gas market in Ukraine*).

This reform process is far from painless. For Naftogaz, it should result in a significant reduction in its role in the domestic gas market. Other gas market participants will have to adjust to greater transparency requirements and a more competitive marketplace. The reform process will also force the Ukrainian government to abandon non-market tools as a way of finding temporary solutions to socially sensitive energy sector challenges.

*From Ukrainian consumers, except the low-income households, a successful implementation of the reform requires paying market prices for gas they consume*

This transition to market rates must take place in a timely fashion. Previous attempts have failed, in large part due to the populist

### BRINGING RETAIL PRICES TO MARKET LEVEL: PROMISES NO LONGER WORK



policies of the country's political parties and the paternalistic expectations among significant segments of the population. Instead of market rates, a sliding scale of cross-subsidized retail prices has been the norm, creating an environment where corruption has flourished.

Despite all the difficulties, the chances of a successful Ukrainian gas sector reform are now greater than ever. It is crucial to properly inform the public about the issues at stake. Ukrainians need to realize that they are already paying more than the market rate for gas in numerous indirect ways, due to the fallacy and inefficiency of the current cross-subsidy system and the burdens this places on the national budget. Funds which could otherwise be used to cover the financing of schools, hospitals, roads and other vital infrastructure are being diverted to cover the difference between subsidized and market gas prices for both low-income families and the affluent consumers.

Gas sector reform does not mean abandoning support for the most vulnerable people. Those in need will continue to receive support directly from the state. However, public funds must not be used to help consumers who are quite capable of paying market rates for gas they consume.

Introducing market rates to the domestic gas market will not only kick start the development of the entire industry — it will also help to eradicate corruption and prevent suppliers such as Gazprom from using energy prices as a political weapon.

There are two constituents to determining what the retail gas price should be. First, it is hardly debateable that the price of gas should cover the cost of its purchase and delivery to the consumer. The first section of this chapter looks at these costs and explores the expenditures and revenues of Naftogaz related to the supply of gas to households.

The second constituent in determining fair gas prices for households is the notion that the price should be set by supply and demand, provided that all suppliers have a non-discriminatory access to the

infrastructure. This means that retail price for gas produced domestically should be in line with the cheapest rates available for imported gas. In the second part of this chapter, factors that drive domestic gas production are explained.

### GAS SUPPLY FOR HOUSEHOLDS: COSTS AND REVENUES

For over 10 years, Naftogaz paid more to purchase gas than the price it received from consumers. Even if 100% of consumer energy bills were paid, Naftogaz would still have required additional funds in order to finance the purchase of gas for the needs of households.

Over the past decade, the negative difference between the price paid for gas consumed by Ukrainian households (using gas either directly or through centralized heating), and the actual cost of purchasing the gas, has exceeded USD 20 billion. The issue has been further complicated by the below-100% payment rate.

The citizens of Ukraine have covered this difference through the taxes they paid to the state budget, and they will continue covering it while Ukraine pays out the loans raised to cover this difference in the past years. This burden on the state budget and the society will continue until the practice of non-market pricing is ended.

### HOW MUCH NAFTOGAZ SPENDS AND WHAT IT RECEIVES FOR SUPPLYING UKRAINIAN CONSUMERS

Naftogaz covers 100% of gas needs of Ukrainian households, including gas for individual use and gas for centralized heat production for households supplied to district heating companies (DHCs).

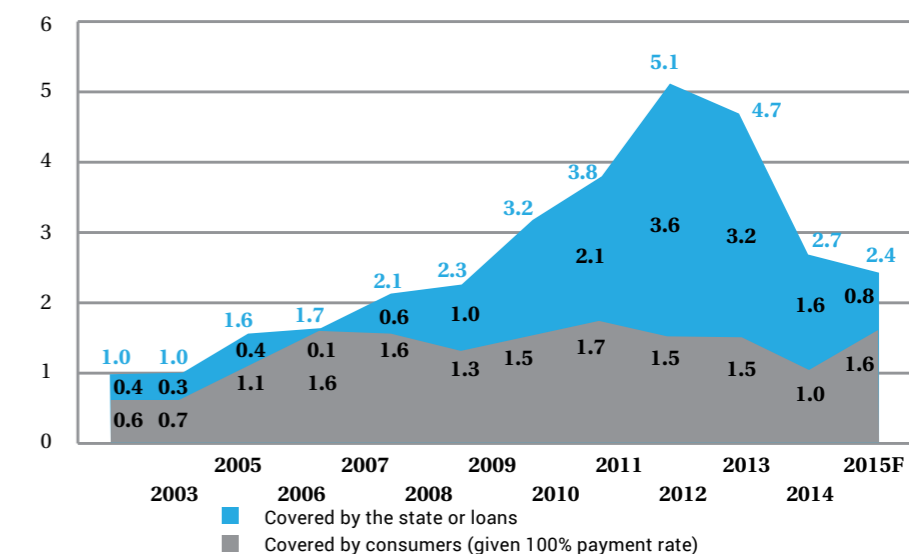
About 60% of the required volumes is gas produced in Ukraine, which Naftogaz buys from its subsidiary Ukgasvydobuvannya (UGV) at a reduced price. Supplying this gas results in a minor positive difference for Naftogaz.

### GAS SUPPLY FOR HOUSEHOLDS: COSTS\* AND REVENUES, 2014

	bcm	Revenues, UAH billion	Cost of sales, UAH billion	Revenues-cost, UAH billion
Ukrainian gas	13.9	6.7	4.9	1.8
Imported gas	8.2	6	26.5	-20.5
Total	22.1	12.7	31.4	-18.7

\*does not include adjustments according to IAS 2

### GAS FOR HOUSEHOLDS: HOW MUCH CONSUMERS COVERED, USD BILLION



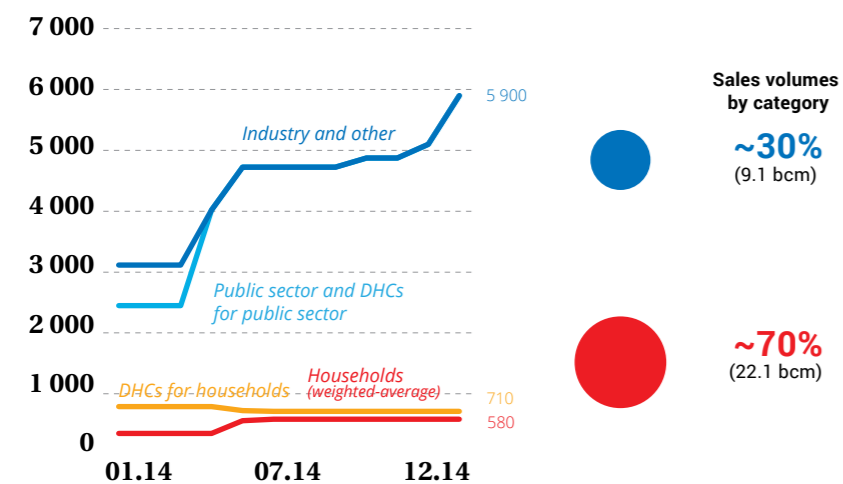
**GAS SUPPLY FOR HOUSEHOLDS: COSTS AND REVENUES, 1Q 2015**

	bcm	Revenues, UAH billion	Cost of sales, UAH billion	Revenues-cost, UAH billion
Ukrainian gas	3.2	1.1	1.9	0.8
Imported gas	5.4	22.9	3.6	-19.3
Total	8.6	24.0	5.5	-18.5

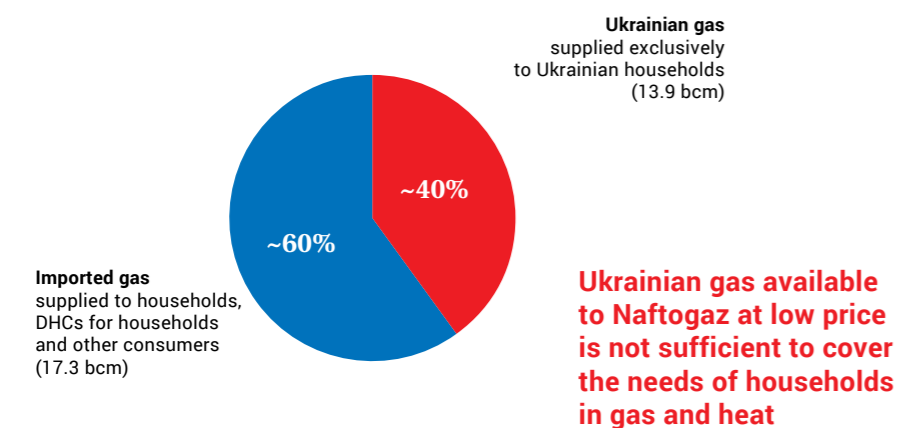
**FINANCIAL RESULTS OF SUPPLYING GAS FOR HOUSEHOLDS IF 10% OF GAS WERE SOLD AT MARKET PRICE, 1Q 2015**

	bcm	Revenues, UAH billion	Cost of sales, UAH billion	Revenues-cost, UAH billion
Gas sold at subsidized prices, 90% of the total volume	19.9	28.3	11.4	-16.8
Gas sold at market price, 10% of the total volume	2.2	3.1	11.2	8.1
Total	22.1	31.4	22.6	-8.8

**RETAIL GAS PRICE (NET OF TRANSPORTATION, DELIVERY AND TAXES), UAH/TCM, 2014**



**GAS SOURCES FOR NAFTOGAZ**



The company's deficit is formed by supplying the remaining 40% of gas for households. This gas is imported at market rates. By selling it to consumers at a discounted price, Naftogaz loses more than it earns in trading Ukrainian gas. In 2014, for Naftogaz the negative difference between the cost of sales and revenues related to supplying gas for households, amounted to UAH 18.7 billion. The deficit caused by supplying imported gas to this category of consumers was 11 times greater than the positive difference from trading gas produced in Ukraine.

Gas supplied directly to households and to DHCs for producing heat for households account for nearly 70% of Naftogaz gas sales by physical volume. In 2014, retail gas prices for these categories were up to 10 times below the market price.

Naftogaz uses foreign currency to import gas and sells it in hryvnia. Therefore, when the hryvnia depreciated and the retail prices set by the regulator were not adjusted accordingly in time, Naftogaz losses significantly increased. In 1Q 2015, when the national currency was extremely volatile, the deficit of Naftogaz from supplying gas to households amounted to USD 18.5 billion and almost matched the deficit for the entire 2014.

If just 10% of gas for households were sold to the richest consumers at full market price, and the remaining 90% continued to be subsidized, Naftogaz revenues from this segment would increase by more than UAH 10 billion. This would cover more than half of the deficit. It is estimated that subsidies may be necessary for nearly 45% of households.

The volume of gas Naftogaz sources from UGV at administratively capped prices covers only 40% of the company's total traded volume. The positive balance related to UGV gas does not cover the losses related to imported gas for Naftogaz.

Other categories of consumers (industry, public sector and other institutions) pay prices that cover the cost of imported gas. Naftogaz has a positive balance with these consumers but it is not sufficient to fully

offset the losses incurred in supplying gas to households.

Gas is Ukraine's largest type of imports by value, and it is a significant factor affecting the country's balance of payments. The foreign exchange reserves of the National Bank of Ukraine in January-February 2015 dropped to a 10-year low. The hryvnia reached a rate of UAH 30 per USD. Ukraine faced an acute risk of underfunding not only essential gas purchases but also other budget expenditures, including public sector salaries and pensions. Naftogaz deficit became comparable to the state budget deficit. In this situation, raising gas prices for households — the largest consumer of gas in Ukraine — was unavoidable.

In February 2015, Ukraine secured international funding necessary to cover the urgent budget needs and to stabilize the hryvnia. The government managed to negotiate with the creditors the mildest possible terms for the pace of the gas prices deregulation.

Ukraine committed to a three-stage process of moving from cross-subsidies for all households to unregulated retail gas prices combined with direct subsidies to the vulnerable consumers who cannot afford market prices for gas.

In spring 2015, gas prices for households were raised to cover nearly 60% of the market rate on average.

In April 2016, gas prices for households will be set to cover nearly 75% of the market level. This will make gas trading for Naftogaz deficit-free but the price for UGV gas will still be capped below the market rate.

Finally, in April 2017, the prices should become completely unregulated in all segments of the market. This will make supplying gas to households financially attractive for non-state traders. Naftogaz will face the competition in this market from other suppliers from Ukraine and abroad. At the same time, UGV will be able to sell its gas at market prices, invest in increasing production, and become one of the largest taxpayers in Ukraine.

**WHAT IS INCLUDED IN RETAIL GAS PRICE FOR HOUSEHOLDS?**

Naftogaz receives from 60% to 70% of the post-tax total gas prices paid by Ukrainian households.

In the current gas year (from 1 April 2015 to 31 March 2016), Naftogaz is selling gas for households (for direct use and centralized

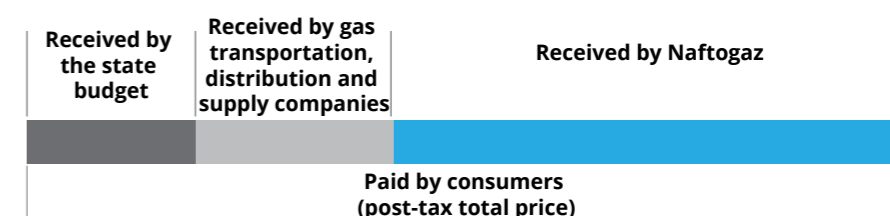
heating) at the weighted average price of UAH 2 834/tcm or USD 131/tcm.

The weighted average purchase price of imported and Ukrainian gas for Naftogaz is forecasted at UAH 3 120 or USD 144/tcm. The price for UGV gas is set at UAH 1 590/tcm and covers nearly 60% of the total needs of households. The price of imported gas is forecasted at USD 250/tcm or UAH 5 424/tcm at UAH 21.7 per USD.

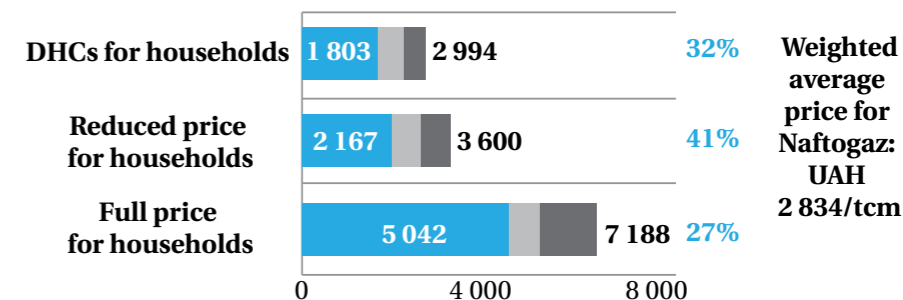
**GAS DEMAND BY UKRAINIAN HOUSEHOLDS**

It is estimated that the households will consume nearly 21.3 bcm of gas for heating and cooking in the gas year from 1 April 2015 to 31 March 2016. Naftogaz expects to purchase 12.8 bcm of this volume domestically at a price below the market rate, and to import the remaining 8.5 bcm at market prices.

**POST-TAX TOTAL GAS PRICE VS. GAS PRICE RECEIVED BY NAFTOGAZ**



**PRICE RECEIVED BY NAFTOGAZ AND POST-TAX TOTAL PRICE, STARTING FROM 2Q 2015**



**STRUCTURE OF RETAIL PRICES FOR GAS FOR HOUSHOLDS, UAH/TCM**

	Full price	Reduced price	Price for DHCs for households
Post-tax total price	7 188	3 600	2 994
incl. 20% VAT	1 198	600	499
incl. 4% special tax to the state budget	202	87	36
incl. costs of transportation, delivery and supply to the consumer	746	746	656
Price of gas received by Naftogaz (UAH/tcm)	5 042	2 167	1 803
Share of total gas sold for households at each rate	27%	41%	32%

### HOW MUCH GAS WILL HOUSEHOLDS NEED?\*

#### Consumption volumes

Households	DHCs	Total
14.5	6.8	21.3

#### Sources of gas

Ukraine	Import	Total
12.8	8.5	21.3

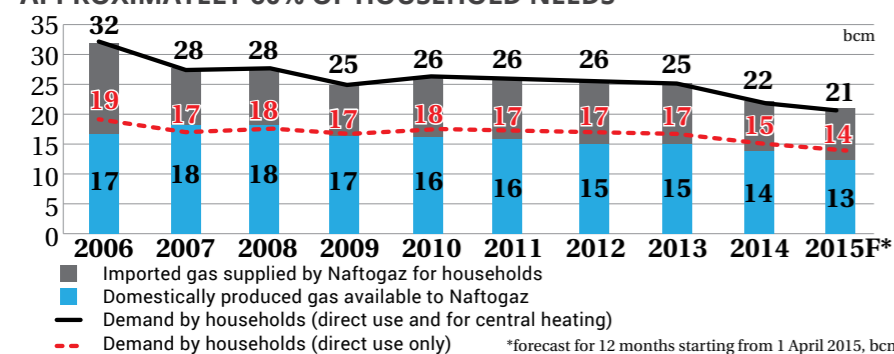
\*forecast for 12 months starting from 1 April 2015, bcm

### WHY DOES UKRAINE NOT USE ALL OF ITS DOMESTICALLY PRODUCED GAS TO MEET THE NEEDS OF HOUSEHOLDS?

In accordance with Article 13 of the Ukrainian Constitution, Ukraine's subsoil belongs to the people of Ukraine. In order to take advantage of these resources and deliver them to end consumers, investments are required. The state provides gas producers with the right to develop mineral resources in the form of licenses, and, in addition to the ordinary income tax, it also charges royalties. This royalty is transferred to the state budget and is then spent on social needs such as pensions, wages and defense. The royalty level for UGV is currently set at 70% of revenues.

*By paying the royalty, gas producers pay the people of Ukraine for the use of the subsoil. Gas produced in the result of these activities belongs to the gas producers*

### DOMESTICALLY PRODUCED GAS AVAILABLE TO NAFTOGAZ COVERS APPROXIMATELY 60% OF HOUSEHOLD NEEDS



According to the Ukrainian legislation, any company in which the state directly or indirectly owns 50% must sell all of its marketable gas monthly to Naftogaz in order to meet the needs of the Ukrainian households. Before the new gas market legislation comes into effect, the sales price for each such producer are established by the National Energy and Utilities Regulatory Commission.

Marketable gas is defined as total produced gas less the volumes used in production and maintenance of the gas producer (within norms) as well as volumes of gas used for refinery and processing.

In the result of the occupation of the Crimea, Naftogaz does not currently receive marketable gas from Chornomornaftogaz. In 2015, all marketable gas for households was delivered by UGV only.

A separate note is required for gas produced by Ukrnafta. According to legislative amendments adopted in June 2011, Ukrnafta has no marketable gas to sell to Naftogaz for resale to households. Instead, some of the gas produced by Ukrnafta is designated as gas used for processing in production of ammonia at the leased facilities of Dnipro Azot. The use of this gas for households would require changes to the current legislation.

Naftogaz and Ukrnafta have varying opinions regarding the proper execution of the transfer and payment for 10.1 bcm of marketable natural gas produced by Ukrnafta and consumed by the households between 2006 and 2011. According to

Naftogaz, the price of this gas is UAH 3.75 billion, a figure which is reflected in the financial statements of Naftogaz for 2012-2013 and 2014. This assessment is based on prices set by the national regulator for the relevant period. Since the beginning of 2012, Naftogaz is not buying gas produced by Ukrnafta.

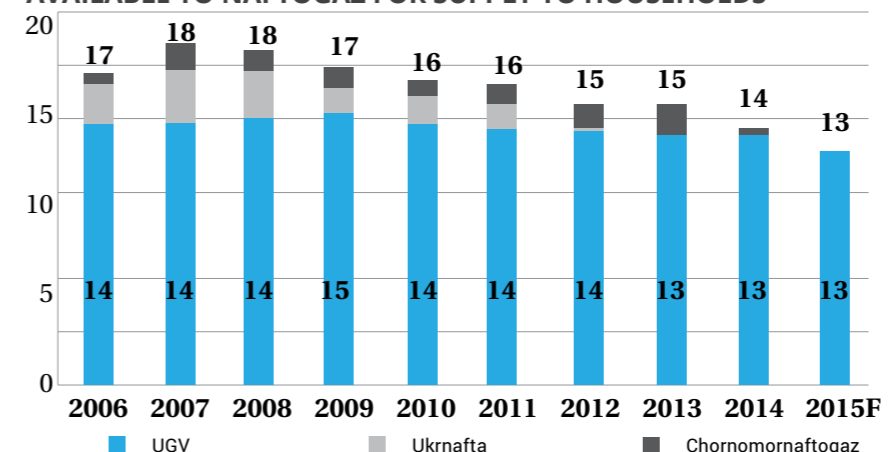
In the first years of Ukraine's independence, all gas was produced by state companies. Since 2000, some state gas assets have been sold or transferred to private producers in return for commitments to invest. Naftogaz can now buy only about 2/3 of gas produced in Ukraine at reduced prices for the needs of the households. The remaining volumes are produced by private companies, who sell this gas at market prices to industrial consumers.

This change occurred for two reasons. The first factor, hardly doubted by the public, was corruption. It is likely that some of the proven deposits discovered by the state companies passed into private hands at a price much lower than the fair market value. Furthermore, the beneficiaries of such arrangements still have their representatives in the Ukrainian parliament and can hinder market reform through them. The solution to this problem is the adoption of a law that will force the final beneficiaries to reveal themselves, as well as independent investigations of all suspicious cases of gas asset transfers from the state to private producers.

The second reason is less obvious to the public. Extraction of gas requires constant investment. In the past decade, because of the populist, and sometimes corrupt, policy of keeping the retail gas price at artificially low levels, state enterprises were unable to invest enough money in gas production.

To stimulate gas extraction in Ukraine, some fields were sold to true investors, often foreign, who have been investing into the development of these assets for many years and have achieved a significant increase in gas production. In many cases these were geologically complex fields with high extraction costs.

### CONTRACTION OF VOLUMES OF DOMESTICALLY PRODUCED GAS AVAILABLE TO NAFTOGAZ FOR SUPPLY TO HOUSEHOLDS\*



\*According to Ukrainian gas market legislation

Because of the need to keep the sales price for domestic state-owned producers low in order to ensure low gas prices for the households, the state had no money to extract this gas. This gas cannot be simply taken away from private producers and given to the Ukrainian citizens at low cost. If such measures were attempted, Ukraine would lose not only gas which is too expensive for the state companies to extract, but also the support from the international community.

*For many years prior to 2014, the policy of providing "cheap" gas to all households while subsidizing it via the state budget has been too heavy a burden for Ukraine. However, the old government lacked the political will to publicly admit this and begin to reform the market — because it would require fundamental changes in the government itself*

### IS IT POSSIBLE TO FINANCE THE PURCHASE OF GAS FROM OTHER SOURCES?

The limit on prices is set by the state, so the difference between the real cost of gas and its price for consumers is, by law, covered by the state budget of Ukraine.

Historically, this compensation was not always timely received from the state, so Naftogaz often had to search for other sources of money to buy gas for households. The deficit also accumulated in the form of foreign currency loans raised by Naftogaz over a number of years. The company had to pay out most of these international loans, including Eurobonds with interest, in 2014, resulting in cash outflow of more than UAH 20 billion.

Another method used to finance the purchase of gas for households during the past years was receiving advance payments of transit fees from Gazprom. This method was used in 2010 and 2012, and the money was spent for the purchase of gas from Gazprom in the same periods. As a result, in 2014 Naftogaz did not receive cash payments for the transit of Russian gas to Europe until October.

As a result of these practices, the illusion of "cheap" gas for households was generated by spending future

revenue. In 2014, Naftogaz had to find sources to both finance gas purchases for the next winter and cover its maturing loans.

### IS IT POSSIBLE NOT TO PAY FOR GAS IF FUNDING IS DIFFICULT TO FIND?

It is technically possible, but eventually the payment must be made in some alternative way. Conscious of the fact that Ukraine had no choice but to buy gas from Gazprom, Russia periodically allowed Naftogaz to receive gas "on credit". As a result, Ukraine was often confronted by excessive gas bills at prices that were sometimes two times higher than the price at which Gazprom sold gas to its European customers.

Knowing that the Ukrainian authorities had driven themselves to a standstill, Russia used this situation to secure political dividends such as the prolongation of the agreement allowing Russian military forces to remain on Ukrainian territory, forcing Ukraine's rejection of the European integration, and the transfer of a portion of Ukrainian sovereignty under the terms of the customs union with Russia.

Instead of investing billions of dollars in replacing boilers, installing meters and insulating buildings, for years Ukraine paid Gazprom. This situation must change. Those who can afford to pay the full market price for gas must pay it.

### WOULD THE DEFICIT PROBLEM BE SOLVED BY THE LIQUIDATION OF NAFTOGAZ?

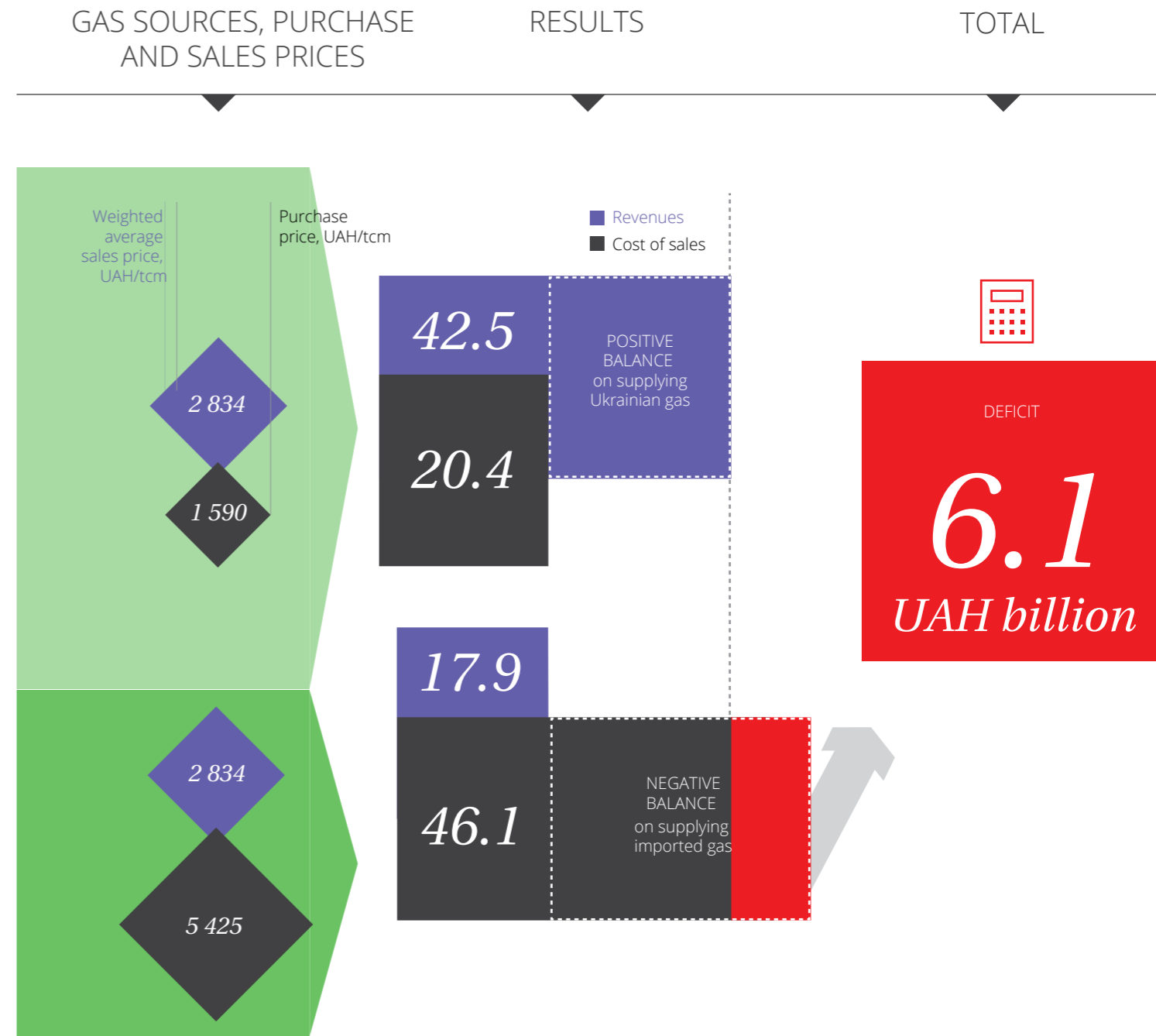
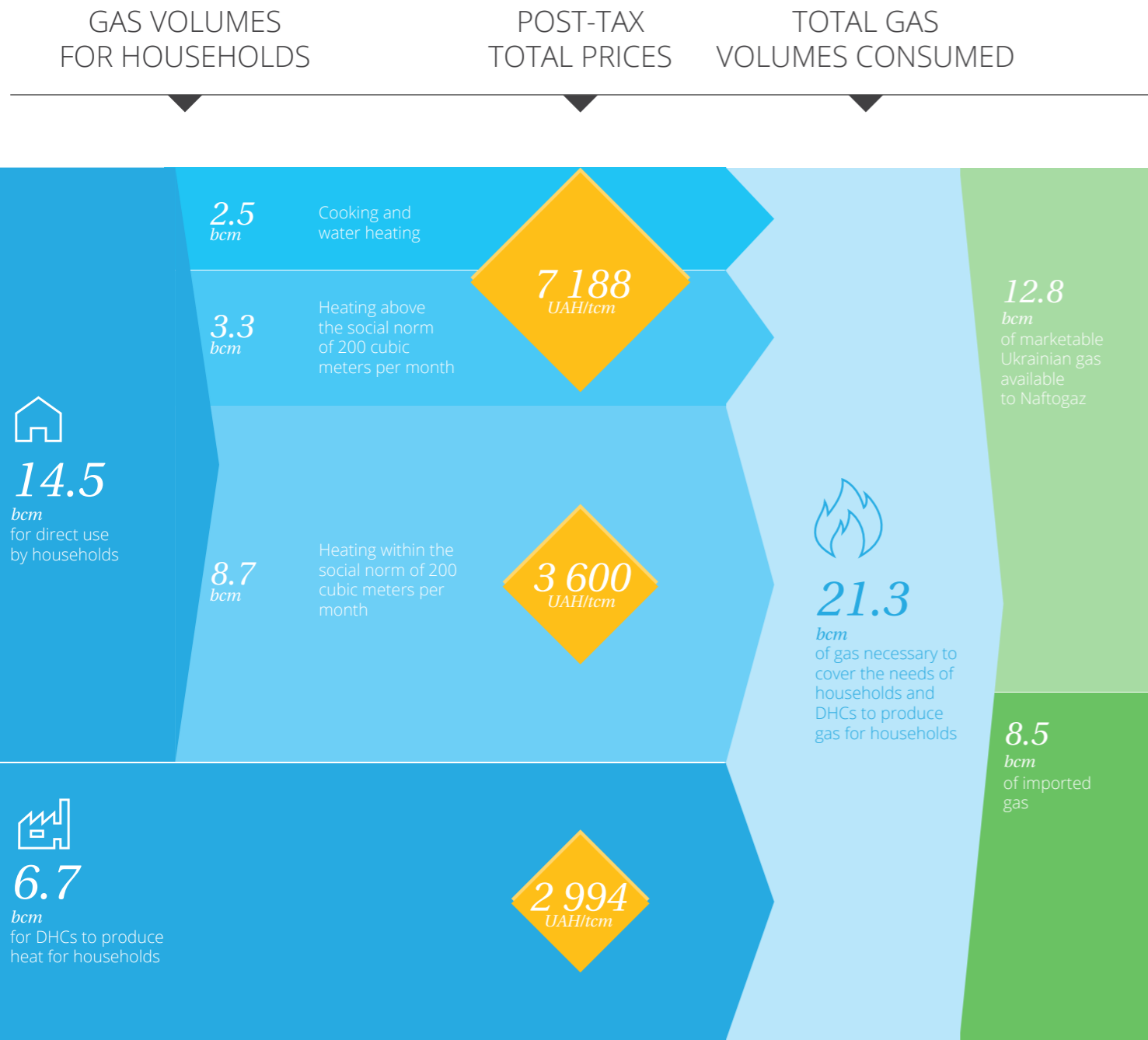
In 2014, Naftogaz administrative costs including salaries of employees, the cost of international legal support, audit and valuation services, rental costs, utilities and other expenses amounted to nearly UAH 0.5 billion. This amount corresponds to approximately 12 hours-worth of gas consumed by Ukrainian consumers in January 2015.

Despite the devaluation of the hryvnia in 2014, administrative expenses of Naftogaz remained at the same level as

# GAS SUPPLY FOR HOUSEHOLDS

Forecast for the period from 1 April 2015 to 31 March 2016\*

Current retail prices do not fully cover Naftogaz costs to supply gas for households



\*Assumptions: USD 250/tcm weighted average price for imported gas; UAH 21.7 per USD exchange rate. Abbreviations: UAH/tcm — hryvnia per thousand cubic meters

in the previous year. This is a significant achievement, taking into account the fact that in 2013 the company did not pay for the international audit or for legal services in arbitration with Gazprom.

In the overall structure of Naftogaz expenses as a stand-alone company in 2014, the administrative costs amounted to less than 0.32% of cash spent. In 2014, 66% (UAH 119 billion) of cash payments was spent on buying

gas for the consumers. Additional 21% (UAH 39 billion) was spent on payments on debt generated in the previous years. Approximately 6% (UAH 11 billion) of funds was spent to pay for gas transmission, and another 6%

(UAH 11 billion) on taxes (see *Management review of financial statements*).

Liquidating Naftogaz without the implementation of the gas market reform and deregulation of retail prices

would neither bring any noticeable savings to consumers nor improve the situation.

As long as the state subsidizes gas for households, Naftogaz or another similar

structure will need to exist in order to buy gas at market prices and sell it at cheaper rates to the households, receiving compensation from the state budget to purchase gas at market prices again.

## MARKET-BASED PRICING FOR UKRAINIAN GAS

If retail prices in effect since spring 2015 were introduced at the time when the exchange rate was nearly UAH 11 per USD, the current prices would cover the full market price of gas, including gas produced by UGV. By this time, new suppliers would be competing in gas supply to households and the state-owned gas producer might well be discussing terms with international investors.

At the current exchange rate of nearly UAH 22 per USD, gas prices for households cover just over a half of Naftogaz expenses associated with the purchase of this gas. The price paid for UGV gas, after 70% royalties and other taxes, hardly covers the company's operating expenses and does not allow for the exploration of new deposits.

If Ukrainian gas is sold at market rates, several important benefits arise for Ukrainian citizens. Firstly, UGV will be able to modernize and expand its production which will lead to an increase in output in 2-3 years. Therefore, the need for imported gas will decrease. This in turn will lead to a reduction in the demand for foreign currency to pay for the imported commodity. As a result, the pressure on the exchange rate will be reduced.

The money that Naftogaz pays for Ukrainian gas remains in the country and continues to benefit the Ukrainian economy. The state budget receives a portion of this money in the form of royalties and taxes which, in turn, can be used to finance subsidies, install gas meters and fund energy efficiency programs.

The remainder of the money is spent by the producers to create jobs in Ukraine,

expand production, and procure goods and services from the local economy.

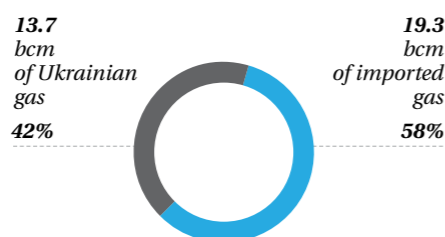
The state can regulate the portion of revenues it extracts from national gas producers balancing its current financing needs with longer-term investment plans of the companies. For instance, in 2014, the royalties amounted to 20% of the selling price, while in 2015 they were increased to 70% for UGV in order to provide the state budget with a guaranteed source of funding to

finance utility subsidies following the price increase. In the case of imported gas, Ukraine cannot collect royalties from foreign gas producers; the money paid for this gas leaves Ukraine.

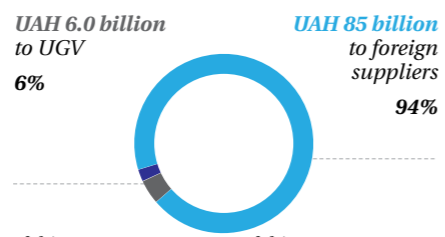
Another positive effect of charging market prices for Ukrainian gas is the redistribution of wealth from wealthy citizens to the vulnerable through targeted state subsidies. Citizens whose financial means allow them to pay market prices for gas they consume will

### WHAT WOULD CHANGE IF UKRAINIAN GAS WERE SOLD AT MARKET RATES IN 2014?

#### IN 2014 NAFTOGAZ BOUGHT



#### NAFTOGAZ PAID FOR THIS GAS



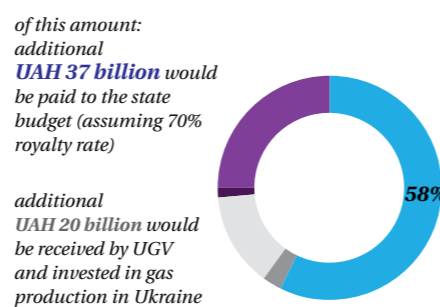
of this amount: UAH 2 billion returned to the state budget of Ukraine as royalties and taxes

of this amount: UAH 0 returned to the state budget of Ukraine as royalties and taxes

UAH 4 billion was spent by UGV in Ukraine to cover its expenses

UAH 85 billion was paid abroad and will not benefit Ukraine's economy

#### IF THE UKRAINIAN GAS WAS PRICED AT MARKET RATES IN 2014, NAFTOGAZ WOULD PAY UAH 51 BILLION MORE TO THE LOCAL PRODUCER

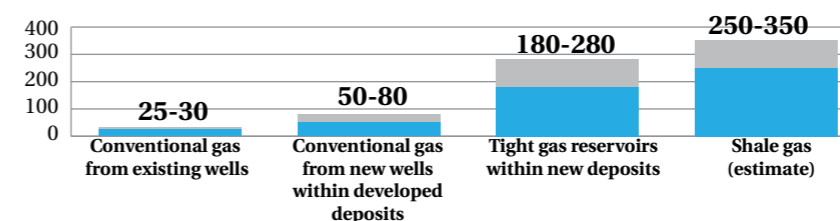


#### RESULTS:

- Affluent citizens support the disadvantaged: the state budget receives additional funding to finance subsidies, pensions and other social needs
- Growth of local gas production and reduction of gas imports share within 2-3 years of new investment
- The state regulates the share of revenues paid as royalties: 20% in 2014, 70% in 2015

Note: less than 1% of the total retail price is directed to cover Naftogaz expenses other than gas purchase

### COST OF GAS PRODUCTION DEPENDS ON WELL TYPE, USD/TCM



enjoy the benefits of more reasonable government spending and of the economic growth, including the growth of the gas industry.

By moving from cross-subsidies for all households to targeted direct subsidies for the underprivileged, the government will be able to increase funding for other important projects, for instance, ensuring 100% gas and heat metering, as well as energy efficiency programs. If this shift is accepted by the society, it will have a legitimate reason to demand improvements in the quality of state governance at all levels.

### COST OF GAS PRODUCTION IN UKRAINE

There is a common belief in Ukraine that retail price of gas should be linked to its production cost rather than determined by supply and demand. In reality, the average cost of production ultimately depends on the expected selling price of the extracted gas. The higher the expected selling price net of taxes, the more money is available to invest in production, and the more gas is subsequently extracted.

In a competitive market where a portion of gas is imported, the price of domestically produced gas is limited by the lowest price of imported gas. Should a domestic producer set the price above that of imported gas, consumers will purchase imported gas.

Similarly, in a competitive market, if a consumer offers to pay less than other buyers, the supplier will sell its gas to consumers who are willing to pay more. In this way, the price is ultimately set at a compromise level acceptable for both consumers and suppliers.

Market mechanisms thus determine the price of gas, resulting in the maximum economically justified level of gas production within the country and reducing the share of imported gas to the minimum reasonable level.

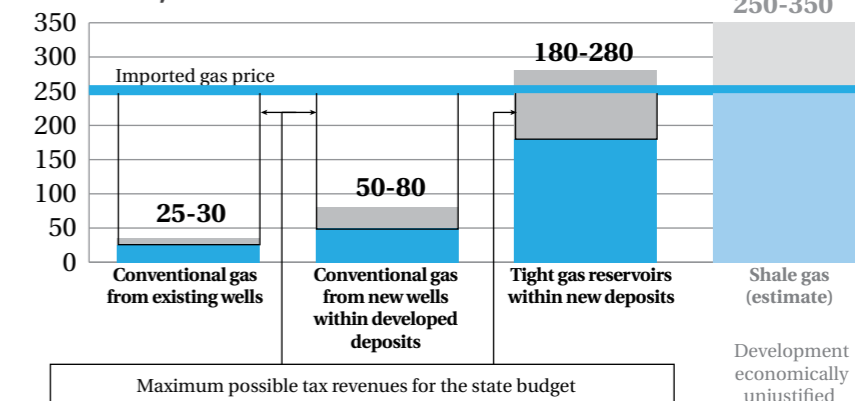
Costs associated with extracting gas differ depending on deposit and well types.

Extracting conventional gas from existing wells does not require substantial capital investment: USD 25-35/tcm may cover the associated costs. However, these wells have a limited operating period as the rate of extraction declines over time.

In order to increase output of such a well, the producer may install a compressor station to pump the gas from the underground deposits or implement other measures, all of which require additional investment. Eventually the well will be depleted to such a degree that additional measures aimed at increasing production are no longer economically justified.

When this happens, the only way to maintain the production volumes is switching to new wells. To have such wells available in time, a company must invest in

### OPTION 1: PRICE FOR DOMESTIC GAS AT THE LEVEL OF IMPORTED GAS PRICE, USD/TCM



obtaining relevant licenses, exploration and drilling 2 to 3 years prior the anticipated start of production at the well. Not every drilled well is productive, even if research has determined that chances are reasonably high. Some newly drilled wells will not be successful.

To drill new wells, the company has to invest appropriately. The investment needs depend on the type of the field, the depth of the productive strata, and other geological and technical conditions. The company management decides if they should acquire new licenses, explore and drill wells depending on the forecasted price at which this gas will be sold.

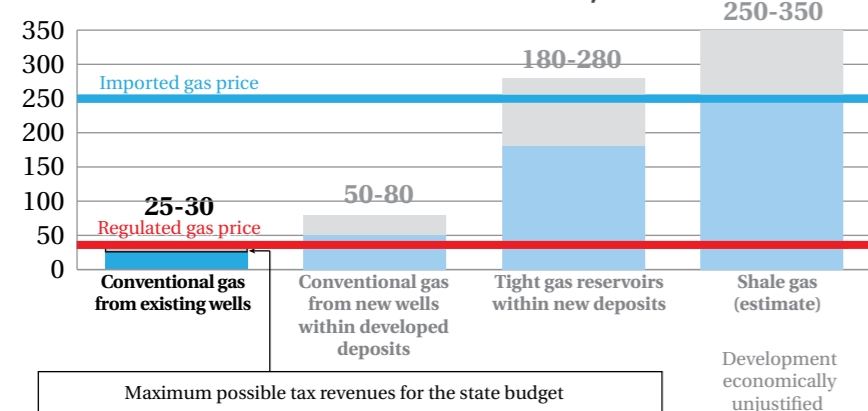
A higher sales price allows producers to go after gas with higher extraction costs. This, in turn, increases gas production volumes.

It is considered economically justifiable for a country that imports gas to develop fields where extraction costs are even USD 1 less than the cost of imported gas. The excess earnings generated from low-cost extraction can be redirected to the state budget by means of licensing fees, royalties or other taxes and fees.

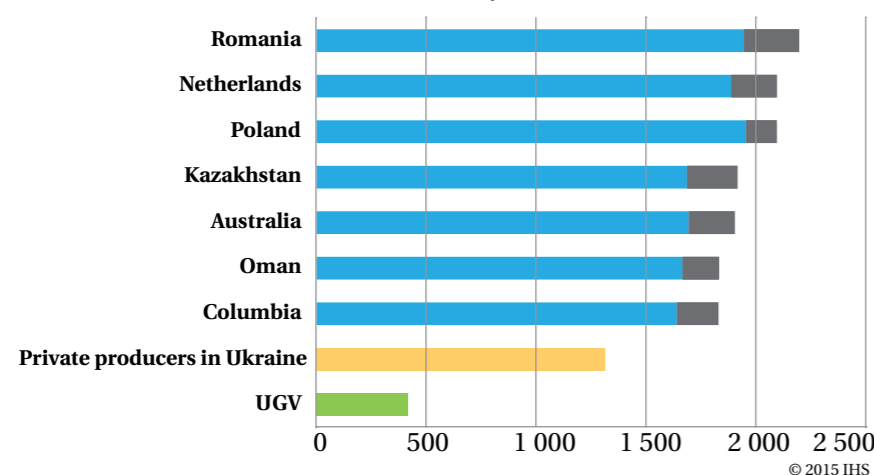
Deregulation of prices for gas stimulates the development of the maximum number of fields where extraction is economically justified, and thus maximizes tax revenues to the state budget.

Limiting domestic gas prices at around the cost of extraction from existing wells will negatively impact decisions to drill new wells, despite the fact that the gas

**OPTION 2: PRICE FOR DOMESTIC GAS AT THE LEVEL OF EXTRACTION COST FROM EXISTING WELLS, USD/TCM**



**COST BENCHMARKING: WELL DRILLING, USD/M**



production costs are times lower than those of private enterprises working in similar geological conditions.

UGV cost of drilling — one of the largest cost factors in gas production — is three times lower than the average among private gas producers in Ukraine and 4.6 times lower than that of producers in other European countries.

It takes UGV 9 months to drill a 4 500 m well with the obsolete and unreliable equipment currently available to the company. Private Ukrainian gas producers drill such wells in 3 months and foreign companies can drill to similar depths in 1.5 months.

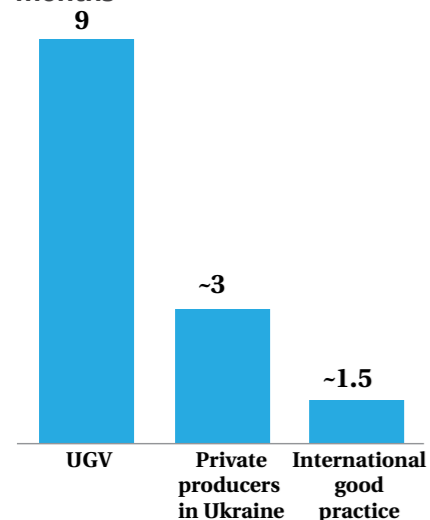
UGV's selling price net of 70% royalty is slightly higher than USD 20/tcm. Such revenues can hardly cover the operating costs associated with the functioning wells. Private gas producers receive up to USD 130/tcm net of royalties for their gas. Even at this level, most of the private companies have announced a reduction in their investment programs. For comparison, in the second quarter of 2015 Ukraine imported gas at about USD 268/tcm.

If pricing and taxation policies for the largest gas producer in Ukraine are not revised, the development of new fields by UGV will be impossible. Without investments, the total production volume of UGV (including its joint ventures) will decrease from about 15 bcm in 2014 to 10 bcm in 2020. The weighted average cost of extracted gas will remain low but Ukraine will spend much more money on purchasing imported gas than it could have done.

**“CHEAP” GAS FOR EVERYONE IS TOO EXPENSIVE FOR UKRAINIANS**

Over the years, the illusion of cheap Ukrainian gas was touted by populist politicians, while at the same time they drained the state budget and took on billions of dollars in loans to cover the difference between the actual cost of gas and the prices people saw in their bills.

**DRILLING TIME FOR A 4 500 M WELL months**



extracted from them would be cheaper than imported gas. As a result, the state loses a significant amount of tax revenue and spends more money on gas imports.

**THE LOW UGV COSTS SET ALARM BELLS RINGING**

For a certain period of time, a company's costs can be kept down if it relies exclusively on existing wells and does not make necessary investments to prepare new wells. However, within a few years, such a policy will inevitably lead to a decrease in production.

Because gas prices for households in Ukraine were kept absurdly low, UGV, Ukraine's largest gas producer, has been compelled to implement such a detrimental policy for years. Its

These loans and associated interest will have to be paid back by the current generation of Ukrainians and their children. Strikingly, the same populists who are campaigning for cheap gas have earned huge fortunes in gas trading, often serving as intermediaries between Ukraine and Gazprom.

**WHO BENEFITS MOST FROM CHEAP GAS?**

A World Bank report shows that the richest Ukrainians receive on average twice as much state aid in the form of cheap gas as the poorest. According to research and data of Naftogaz, this gap may in fact be much larger.

Average Ukrainian families live in homes up to 100 square meters large and consume an average of 2 500-3 000 cubic meters of gas per year. The difference between the full price of gas and the prices that were seen on household bills before 1 April 2015, averaged UAH 21 000 per year (marked in blue on the chart).

When the transition is made to the full market prices, low-income families become eligible for the same amount of targeted subsidies from the state (marked in green on the chart).

Wealthy people tend to live in much larger properties, and their large estates can use over 30 000 cubic meters of gas per year. Accordingly, through cheap gas these affluent consumers receive nearly 10 times more of state aid than the average consumer.

In addition, wealthy families sometimes own several properties, which exponentially increases the amount of state aid they receive. After the transition is made to full market prices for gas, wealthy consumers will not be eligible for subsidies and will have to cover the full value of gas they consume.

When the reform is fully implemented, the state support will only be provided to those people who cannot afford paying the market price. The remaining funds should be allocated to modernize heating systems, insulate buildings and boost gas production in Ukraine.

**STATE ASSISTANCE TO AN AVERAGE HOMEOWNER**

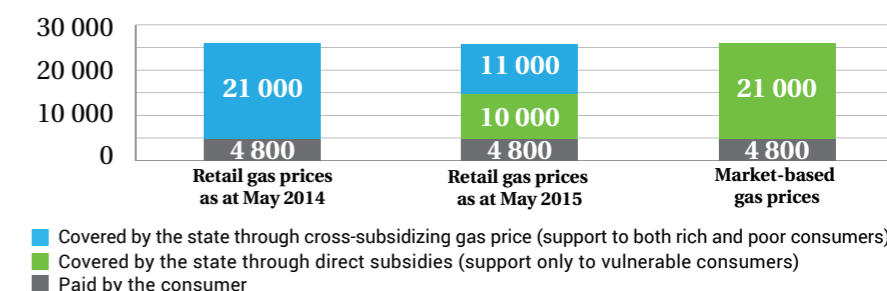
**ASSUMPTIONS:**

Heated area, square meters:	90
Number of residents:	4

**Consumption norms**

Heating, cubic meters of gas per 1 square meter of heated area per month:	3.6
Cooking and warming water, metered, cubic meters of gas per 1 person per month:	9
Consumed volumes per year, cubic meters:	2 700

**GAS EXPENSES, UAH PER YEAR**



**STATE ASSISTANCE TO A LARGE PROPERTY OWNER**

**ASSUMPTIONS:**

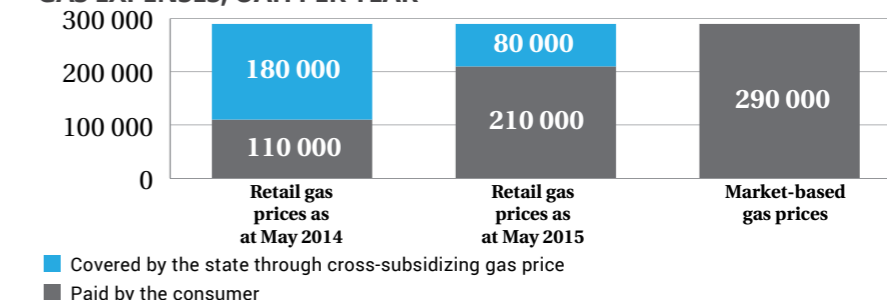
Heated area, square meters:	588
Number of residents:	6

**Consumption norms**

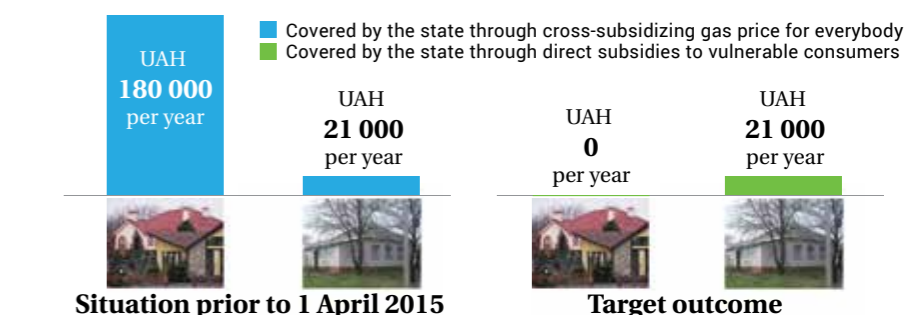
Heating, cubic meters of gas per 1 square meter of heated area per month:	7
Cooking and warming water, cubic meters of gas per 1 person per month:	18

**Consumed volumes per year, cubic meters:** 30 108

**GAS EXPENSES, UAH PER YEAR**



**STATE ASSISTANCE TO RESIDENTS OF A LARGE PROPERTY VS. AN AVERAGE HOME**



**RAISING RETAIL PRICES FOR ALL AND PROVIDING DIRECT SUBSIDIES FOR THE UNDERPRIVILEGED IS NECESSARY SO THAT THE STATE DOES NOT SUPPORT THE RICH AT THE EXPENSE OF THE REST**

## CORPORATE GOVERNANCE OVERVIEW

2014 was a transformational year for Naftogaz. Changes in the company's activities were mainly the result of the dedicated professionalism of the new management, who took on the responsibility for solving the numerous challenges that have accumulated at Naftogaz during many years.

However, the current format of corporate governance is far from perfect: the national reform of the gas market requires clear and transparent mechanisms of interaction between the company, the ultimate owners (Ukrainian citizens), and their representatives (the Cabinet of Ministers and related ministries).

Taking into account the social and economic importance of Naftogaz operations, it is essential that the group's management and supervisory board are appointed and operate independently based on professional merits rather than their affiliation with political groups.

The reform of the Ukrainian gas market is possible only with an adequate transformation of Naftogaz as its largest player. Therefore, improving the system of corporate governance of the company is a key element in efforts to reform the entire market.

The current management team of Naftogaz is aware of the need for change, and is prepared to implement it together with other subjects of reform — the Cabinet of Ministers, the Verkhovna Rada and other government agencies and international institutions.

### CORPORATE GOVERNANCE: CURRENT STATUS AND CHALLENGES

The current system of corporate governance at Naftogaz is a legacy of the past, when the company was used as a tool to provide social benefits and redistribute state budget funds. It was also an instrument of political influence. Since the founding of Naftogaz, a significant share of both internal and external issues related to the group's operations is directly regulated by the parliament and the government.

#### Owners of Naftogaz

Naftogaz is a national joint-stock company, and the people of Ukraine are, in essence, the ultimate shareholders (owners) of Naftogaz. In turn, the Cabinet of Ministers and the Ministry of Energy and the Coal Industry (the Energy Ministry) are the government agencies that are responsible for representing the citizens' interests in the company. However, in practice, these two public bodies act as owners of Naftogaz and, for management of Naftogaz, they act as direct superiors.

In the statutory documents of Naftogaz, the Cabinet of Ministers is formally defined as the founder, while the Energy Ministry is defined as a shareholder of the company. However, the governance functions are not clearly divided between these two bodies. The Cabinet of Ministers has certain exclusive rights including the right to amend constituent documents of the company, the share

capital and to approve important transactions (including transfer of assets). Furthermore, within the framework of the government, the Cabinet of Ministers formally has superiority over the Energy Ministry. As a result, decisions regarding Naftogaz activities have often been based on orders and exposed to the political influence of the Cabinet of Ministers.

The current vagueness in the definition of the ownership structure raises the risk that management of Naftogaz will act in the interests of the government and, consequently, certain political groups, instead of acting in the interests of the Ukrainian people. In fact, the citizens of Ukraine have no direct impact on the operations and strategy of the company because they cannot participate in general shareholder meetings or influence the supervisory board in any meaningful way.

#### General meeting of shareholders

The general meeting (GM) of shareholders is responsible for approving the strategy of Naftogaz, appointing and dismissing board members and management, as well as approving the annual report and budget of the company. In practice, the Energy Ministry performs the functions of the GM.

In addition, the annual budgets of Naftogaz and its subsidiaries also require approval by the Finance Ministry. This provision duplicates some of the key functions of the GM and provides an additional mechanism of direct influence of the state on the company management.



#### Supervisory board

The function of monitoring the activities of Naftogaz is formally assigned to the supervisory board. However, since 2005 this body has been controlled by the Energy Ministry. The supervisory board is comprised of three officials from the Energy Ministry, seven employees from six other ministries, and a representative of the State Property Fund.

This structure makes the supervisory board dependent on the political influence and prone to conflicts of interest. The regulatory or social functions these ministries perform in the government may contravene business goals of Naftogaz or the interests of the citizens of Ukraine as the ultimate owners of the company.

In addition to these structural concerns, the supervisory board of Naftogaz is currently not operational. The current composition of the board was approved in August 2013. Most of its members, including the chairman, have since been dismissed from their positions in the government. As a result, no supervisory board meetings convened in 2014 or 2015. Recently, issues within the responsibility of the board have been resolved in practice by the GM.

The management of Naftogaz has applied to the Energy Ministry with a request to terminate the current supervisory board and elect a new board following the implementation of the OECD principles of corporate governance in Naftogaz, in accordance with the action plan of the gas industry reform approved by the government in March 2015.

#### Revision commission and audit

A combination of the public mistrust and populist political decisions has resulted in numerous ad-hoc and ongoing inspections of Naftogaz by various government agencies. These inspections and audits often overlap and duplicate each other. The state, through the State Financial

Inspection (SFI) service, conducts control over the activities of Naftogaz on a daily basis. The company has allocated separate permanent rooms for officials of the SFI within its offices.

According to the statutory documents of Naftogaz, the examination of the company financial and operating activities should be carried out by the revision commission appointed by the GM for a term of five years and consisting of five members. The current members of the revision commission were appointed in October 2013. The commission is comprised of representatives of the Energy Ministry, the National Energy Regulation Committee, the SFI and the Ministry of Revenues and Duties. Because the head of the revision commission has been dismissed from the Energy Ministry, meetings of the commission cannot be held at present time.

The management of Naftogaz has applied to the Energy Ministry with a request to terminate the current revision commission and reform this function in Naftogaz in line with the OECD principles of corporate governance, in accordance with the action plan of the gas industry reform approved by the government in March 2015.

To improve internal controls over its operating activities, Naftogaz has established a new internal audit department, subordinate directly to the Chairman of the executive board (Chief Executive Officer, CEO). To ensure independent review of the company activities, the management has conducted an open tender and engaged Deloitte to conduct regular reviews of stand-alone and consolidated financial statements of Naftogaz. The company now issues audited stand-alone financial reports on a quarterly basis.

#### Management and the executive board

Operations of the company are managed by the CEO and seven top executives responsible for different functional areas.

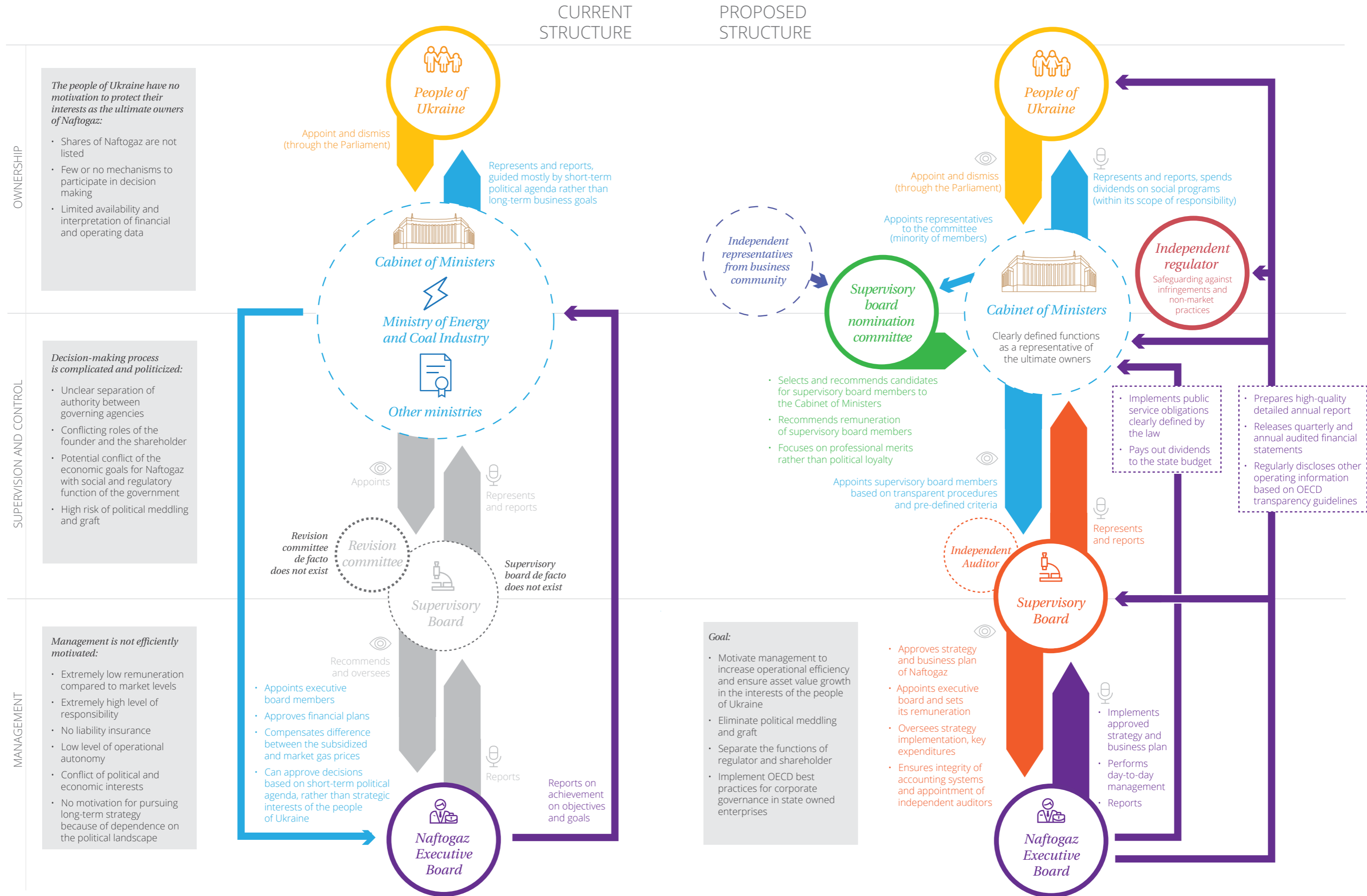
Three of them have been approved by the Energy Ministry and formally appointed as members of the executive board by the Cabinet of Ministers. The other four top managers have responsibilities similar to those of the board members. However, they have not been appointed to the executive board.

Engaging top managers who possess skills and qualifications required to deal with the issues now facing Naftogaz is a major challenge for the group. The matter is further complicated by the fact that currently Naftogaz cannot offer a competitive remuneration comparable to that in the private sector to executive board members and other senior managers. Following the Revolution of Dignity, the group succeeded in attracting a number of executives and other highly qualified employees who are motivated by the desire to implement the much-needed reforms in the Ukrainian gas market. However, there is a high risk that Naftogaz will not be able to retain these employees, especially if the government forgoes its commitment to conducting fundamental reforms.

Approving contracts with the executive board members and determining their remuneration is the exclusive competence of the supervisory board of Naftogaz. The terms of contracts with the current members of the executive board have not been approved. The terms of the employment contract with the CEO have been approved by the Energy Ministry.

The Cabinet of Ministers and the Energy Ministry have the ability to influence day-to-day management of Naftogaz. The appointment of the top management of Naftogaz subsidiaries depends on the Cabinet of Ministers as well. This governance structure increases the risk of political meddling and can cause a revision of the operating strategy of Naftogaz and group companies based on politically motivated factors.

# CORPORATE GOVERNANCE SYSTEM



OWNERSHIP

SUPERVISION AND CONTROL

MANAGEMENT

## EXECUTIVE BOARD STRUCTURE AND REMUNERATION

The executive board of Naftogaz changed radically in 2014. In the first quarter of 2014, the executive board consisted of 14 members. After the dismissal of Yevhen Bakulin, the previous CEO of Naftogaz, and the appointment of Andriy Kobolyev as the new CEO in March 2014, all members of the previous board except Yuriy Kolbushkin were dismissed and left the company.

In the second quarter of 2014, Ihor Prokopiv, Sergiy Konovets and Oleksandr Todiychuk (passed away in March 2015) joined the executive board. In August 2014, Ihor Prokopiv moved to head Ukrtransgaz, and his position in Naftogaz executive board was subsequently filled by Sergiy Pereloma.



**Andriy Kobolyev**  
Chief Executive Officer (Chairman of the executive board) since 25 March 2014

Andriy began his career at the international audit and consulting group PriceWaterhouseCoopers (PWC), where he specialized in issues of strategic management and corporate transformation. From 2002 to 2010 he

### Previous executive board

**Chairman:** Y. Bakulin  
**Board members:**

V. Franchuk, O. Lopushansky, A. Katsuba, D. Mormul, V. Trikolich, V. Chuprun, G. Yuriev, V. Vinokurov, R. Zahorodniy, P. Polishchuk, E. Shvydkyy, S. Vinokurov, Y. Kolbushkin

### New executive board

**Chairman:** A. Kobolyev  
**Board members:**

I. Prokopiv (April to August 2014), S. Pereloma (since August 2014), S. Konovets, Y. Kolbushkin, O. Todiychuk\*

\*To the great regret of the staff of the company and the wider professional community of the oil and gas industry Oleksandr Todiychuk passed away on 3 March 2015.

worked at Naftogaz, rising from a chief specialist to Adviser to the Chairman. Following the appointment of Yevhen Bakulin as Chairman of the executive board in 2010, he left the company. After leaving Naftogaz, Andriy co-founded AYA Capital investment banking group where he focused on debt and equity capital

raising, debt restructuring and corporate reorganizations of large enterprises and holdings.

Andriy holds a master's degree in international economic relations with honors from the Institute of International Relations at Kyiv Shevchenko National University.



**Ihor Prokopiv**  
First Deputy Chairman from April to August 2014

For many years Ihor worked in management positions

in industrial enterprises, commercial structures, and enterprises of housing and communal services in Ivano-Frankivsk region. He headed Ivano-Frankivsk district heating company, Ivano-Frankivskgaz, and other industrial enterprises. On joining Naftogaz, Ihor managed divisions responsible for gas sales, asset management and procurement. In August 2014 he was appointed as head of Ukrtransgaz.

Ihor studied engineering at the Ivano-Frankivsk Oil and Gas Institute and economics in the Ternopil Academy of National Economy.



**Sergiy Pereloma**  
First Deputy Chairman since August 2014

Sergiy has more than 13 years experience in the oil

and gas industry and manages divisions responsible for transit and supply of natural gas, customs clearance, gas sales and gas balancing. He has extensive experience in finance, banking and insurance sectors. Sergiy is Chairman of the Supervisory Board of the Odessa Port Plant.

Sergiy graduated from the Institute of International Relations at Kyiv Shevchenko National University.



**Sergiy Konovets**  
Deputy Chairman since April 2014

Sergiy is responsible for financial management in Naftogaz. The

scope of his responsibilities includes budgeting, investment analysis, financial and management reporting. Sergiy has 20 years of professional experience in strategy development, business development, finance and audit. He worked for a number of leading international companies including Boston

Consulting Group, Bunge, Deloitte and EY.

Sergiy holds an MBA degree from the International Institute for Management Development (IMD) in Lausanne, Switzerland.



**Yuriy Kolbushkin**  
Member of the executive board since February 1999

Yuriy has worked at Naftogaz since the company was

founded. He is responsible for taxation, pricing policy, budgeting and economic relations. Before moving to oil and gas industry, he worked for 15 years in the Finance Ministry of Ukraine.

Yuriy graduated from the Kyiv Institute of National Economy, holds a doctoral degree in economics and is a member (academic) of the Ukrainian Academy for Oil and Gas.



**Oleksandr Todiychuk**  
Deputy Chairman from April 2014 to March 2015

A recognized expert in oil and gas industry with more than

35 years of professional experience, Oleksandr worked at the Institute of Oil Transportation, was appointed special

envoy of Ukraine for the realization of the Euro-Asian Oil Transport Corridor and served as an adviser to the State Secretary of the President of Ukraine. He also held the position of Coordinator for the Realization of the Ukraine-EU Energy Memorandum (INOGATE) and was a member of the Expert Council of the World Economic Forum.

In his role as Deputy Chairman of Naftogaz, Oleksandr was in charge of the production division and security of gas and oil transmission. He and was also responsible for capital investment programs, international cooperation, research and industrial safety. Previously Oleksandr headed Ukrtransnafta for five years.

He received a degree in business administration at the Kyiv International Institute of Management.

Oleksandr passed away on 3 March 2015.

### REMUNERATION OF BOARD MEMBERS

In 2014, the total remuneration of Naftogaz executive board members, including salaries and bonuses, amounted to UAH 6.2 million before taxes. Of this amount, UAH 3.3 million was the remuneration of executive board members who had worked at Naftogaz at the beginning of 2014 and were subsequently dismissed during the year. UAH 2.9 million is the total remuneration of the members of the new executive board.

## OTHER SENIOR MANAGERS



**Yuriy Vitrenko**

**Director for Business Development since April 2014**

Yuriy is responsible for strategic development and reform of Naftogaz

and for the diversification of gas supplies to Ukraine.

He has cooperated with Naftogaz as a staff member or external advisor since 2002, and was responsible for international debt capital raising and debt restructuring.

Yuriy began his career in the international audit and consulting group PriceWaterhouseCoopers (PWC), where he advised major Ukrainian companies on financial management.

He has 12 years of experience in investment banking and finance in Ukraine, Russia, and the UK.

Yuriy headed the international investment fund Amstar Europe, and worked for Merrill Lynch investment bank in London (UK). He is a co-founder and partner AYA Capital investment banking group.

In 2004 Yuriy graduated from the MBA program at the INSEAD Business School (France, Singapore).

He holds a master's degree in International Business Management from Kyiv National Economic University, and is an Associate of the London Securities and Investment Institute (ASI).



**Andriy Pasishnyk**

**Executive Director, Acting Deputy Chairman of the executive board since July 2014**

Andriy is responsible for issues related to Naftogaz assets in the oil industry.

He also oversees asset management and investment divisions.

Andriy is an oil business professional and has experience in crisis management in large corporations, economic security matters, financial controlling and quality management.

Prior to joining Naftogaz, he worked in management positions at WOG RETAIL and Zolotiy Ekvator.

Andriy started his career at Ukrtatnafta, where he worked for 10 years.

He holds a degree with honors in Business Administration from the Institute of Economy and New Technologies and in Chemical Fuel and Hydrocarbon Materials Technology from the Ukrainian State Chemical Technology University.

He also holds a degree in Organic Substances Production from the Chemical Technology College of Dneprodzerzhinsk State Technical University.



**Yaroslav Teklyuk**

**Director for Legal Affairs and Government Relations since April 2014**

Yaroslav is responsible for legal matters and

government relations. He has 15 years of professional experience in legal practice. Yaroslav has provided legal advice and represented corporate clients in banking, financial, and telecommunications sectors. Prior to joining Naftogaz he spent eight years at Vasil Kisl and Partners, a leading Ukrainian law firm, including four years as a partner.

Yaroslav has graduated in International Law from the Institute of International Relations at Kyiv National Shevchenko University.



**Vitaliy Shcherbenko**

**Director of Energy Efficiency and Procurement since April 2015**

Vitaliy heads the energy efficiency and

procurement divisions in Naftogaz. He has more than 20 years of experience in senior management positions in the financial sector. Prior to joining Naftogaz Vitaliy held various executive positions, including the position of the president of an insurance company.

Vitaliy studied Economics at Kyiv National Economic University.

## CORPORATE GOVERNANCE REFORM

The current structure of corporate governance of Naftogaz has a number of significant flaws:

- The people of Ukraine, as the ultimate owners of Naftogaz, are currently represented by government agencies that have a direct influence on daily operations of the group. This structure does not guarantee that the group is governed in the interests of the ultimate owners. Instead, it may be influenced by political interests. Any change of the government means a de facto change of Naftogaz shareholder.
- Governance functions of the Cabinet of Ministers, the Energy Ministry, the Finance Ministry and other government agencies are not clearly defined, and their areas of responsibility often overlap or intersect. This problem is particularly evident in the functions of internal audit and revision commission.
- Some functions that should be performed independently are in fact performed by the same body. In particular, the Energy Ministry acts as a shareholder at the GM and also controls the supervisory board (which must be

independent and accountable to the GM).

- There is no transparent procedure for nomination and election of the supervisory board members. There are no mechanisms and instruments in place that would enable engaging highly qualified professionals with an impeccable reputation to the board. The professional requirements for supervisory board members are minimal, and so is the level of remuneration. The current procedure does not allow for the establishment of a qualified and independent supervisory board.
- There is no procedure for approval and revision of Naftogaz strategy focused on the business goals of the company and the interests of its ultimate owners (the people of Ukraine).
- Decisions on appointing, dismissing and remunerating management of Naftogaz and its subsidiaries are executed by the government agencies and not by independent boards, which results in a conflict of interest and can affect management decisions.

### REFORMING THE CORPORATE GOVERNANCE SYSTEM

In March of 2015, the Cabinet of Ministers approved the gas industry reform plan which requires that the corporate governance of Naftogaz and its subsidiaries be aligned with the OECD principles of corporate governance. This requirement is also a condition precedent for the European Bank for Reconstruction and Development (EBRD) and European Investment Bank (EIB) loans for the modernization of the Urengoy-Pomary-Uzhhorod pipeline.

With the EBRD support, Baker & McKenzie and PWC have performed a review of the current state of corporate governance at Naftogaz and developed a new model of corporate governance compliant with the OECD best practices for state-owned enterprises. The reform plan includes recommendations for:

- an efficient corporate structure
- establishment of the supervisory board, the composition of which would include a majority of independent directors



- the introduction of committees within the supervisory board
- the distribution and balancing of powers among the governance bodies at all levels

The reform is aimed at bringing the current system in line with international standards in the areas described below.

#### POLITICAL INSULATION

Naftogaz must adopt the best practices of companies in the global oil and gas industry. This implies:

- establishing mechanisms that would ensure that Naftogaz is protected from political interference

- clearly delineating the roles and responsibilities of the Cabinet of Ministers as the legitimate representative of the ultimate owners — the people of Ukraine
- clearly defining the areas of influence of other government agencies and, ideally, restricting this influence

#### EXERCISING OWNERSHIP RIGHTS

According to the developed model, the role of the owner must be performed by a single government body.

The exercise of the rights of the ultimate shareholder should be ensured through:

- providing abroad mandate for the independent supervisory board and management of Naftogaz
- developing and implementing a transparent nomination policy for supervisory board candidates
- setting up an effective supervisory board and establishing supervisory board committees, including an audit committee and a nomination and remuneration committee, as well as a corporate secretary section
- strengthening internal control by establishing risk management, compliance and internal financial control units

- concluding a contract between Naftogaz and a state government agency (the Cabinet of Ministers and/or the Energy Ministry) that will define the responsibilities of Naftogaz; in particular, this should address the execution of certain state functions (such as gas supplies for social needs at regulated prices)
- establishing clear success performance indicators and for Naftogaz management

In order to ensure the independent and objective nomination and appointment of supervisory board members, a board nomination committee should be set up. The committee shall be independent of the government agencies, the current supervisory board and the executive board. Its mandate should include:

- nominating and presenting recommendations on the supervisory board candidate members to the Cabinet of Ministers for review, at least during the transitional phase
- proposing remuneration for supervisory board members

Based on the recommendations of independent consultants, members of the supervisory board nomination committee shall be elected for a term of two years. Most members of the committee should be professionals with experience in investment banking, finance, audit or similar fields, and only a minority, during the transition phase, can be government representatives.

The supervisory board members should be nominated according to transparent procedures and clear criteria disclosed well in advance.

#### FULLY EMPOWERED AND INDEPENDENT SUPERVISORY BOARD

The newly established supervisory board will have the following functions:

- review and approve Naftogaz strategy, risk management policy, business plans and annual budgets

- control the effectiveness of Naftogaz governance and adapt it according to the best practices of similar companies
- define success indicators for Naftogaz management and monitor their achievement
- carry out monitoring of spending, purchases and sales strategic in terms of volume and nature of counterparts
- nominate and appoint executive board members of Naftogaz
- define the objectives and remuneration of the Naftogaz management according to the long-term interests of the company and the people of Ukraine
- manage potential conflicts of interest of executive board members

- assume responsibility for the integrity of accounting and financial reporting, including the independent audit of Naftogaz
- ensure the planned and transparent work of appropriate control systems (including risk management, financial and operational control, and their compliance with laws and standards)
- carry out other work for increasing the level of trust in the company and facilitate cooperation with national and international partners

During the transitional phase of approximately one and a half to two years, it is proposed that the supervisory board should be composed of a majority of independent members, as well as one representative of the President of Ukraine, one representative of the Cabinet of Ministers, and one representative of the trade unions.

#### REGULATORY AND SOCIAL POLICY

The corporate governance reform of Naftogaz and its subsidiaries can only succeed if an independent national regulator of the industry safeguards equal conditions for all market participants. In

order to ensure that the industry regulator performs this function, it is necessary to develop and implement appropriate legislation.

At the same time, the Cabinet of Ministers can meet its social obligations and can incorporate Naftogaz into this activity by specifically listing relevant measures and instruments (for example supplying gas to the utilities sector).

In other words, the government should perform its social policy through a clear public service obligation mechanism. During the transition period, the government should gradually switch over from the model, in which subsidies are indirectly provided to all households through below-market prices, to a free market pricing, at the same time providing direct subsidies to low-income households.

The following three factors have a significant impact on the success of the corporate governance reform:

- the engagement of a sufficient number of reform-motivated professionals, both within and outside the company (potential new members of the supervisory board, of the board nomination committee, government representatives)
- the political will of government bodies and international institutions to implement reforms
- the continuous work and dedication of people implementing the reform throughout its expected completion in the end of 2017

The current Naftogaz management is fully aware of the corporate governance reform importance for the overall industry restructuring process and will continue to take all the steps within their power to have the proposed plan approved and implemented.

The management hopes for the same dedication from other participants in the oil and gas sector reform. Above all, this means the commitment of the government authorities and the support of international partners.

## TRANSPARENCY AND DISCLOSURE POLICY

An integral part of the reform proposed by Naftogaz is ensuring a high level of transparency and accountability of the company. In line with the strategic objectives of the new management team, Naftogaz has already significantly changed its approach to transparency and disclosure.

The ultimate owners of Naftogaz are the citizens of Ukraine, and the activities of the company significantly influence the energy security of Ukraine. Therefore, Naftogaz management is aware of its duty to fully inform the public about the activities within the scope of its responsibilities in a timely manner.

The management is voluntarily implementing a disclosure policy the key principles of which are based on the disclosure requirements for public companies listed on major European stock exchanges. Thus, in its disclosure and other policies, Naftogaz is implementing the OECD best practices.

### DISCLOSURE CRITERIA

Information that meets the following criteria is subject to public disclosure:

1. Information that is subject to mandatory disclosure under Ukrainian law. This includes financial and statistical reports, information regarding the procurement of goods and services above specified thresholds, data subject to disclosure under the legislation on access to public information, etc.; or
2. Information not subject to public disclosure, voluntarily disclosed by Naftogaz:
  - Information about activities or events that have a material effect on operating

income or assets of the group (which may lead to more than 10% change in the operating income or assets of the group based on the latest released consolidated annual financial statements)

- Information about decisions or events which, in the opinion of the management, have or may have a material impact on the implementation of any of the key areas of the strategy of the holding company or its subsidiaries
- Regular statistical information about the company, its subsidiaries and the oil and gas market in Ukraine (either in aggregated or expanded form, as decided by management), including information on the gas reserves in underground storage facilities, transmission of gas through the territory of Ukraine, gas production volumes, the volumes and cost of imported gas, gas sales volumes and the dynamics of gas payments from consumers, etc.
- Information about transactions for procurement of goods or services with related parties, which are defined as entities that are not subsidiaries of Naftogaz, and whose owner or owners are board members in Naftogaz or its subsidiaries, except when such transactions are concluded following a public tender or a tender through the e-procurement system ProZorro
- Information about changes in the composition of the executive board of Naftogaz or its subsidiaries whose value exceeds 5% of the value of the group assets according to the most

recent published annual consolidated statements

- The annual declaration of property and income of the CEO of Naftogaz
- Information that is not material to the financial performance of the company or the implementation of its strategy, but is believed by the management to be of significant public importance

Information that is not subject to public disclosure includes:

1. Information that is defined as confidential under the terms of agreements with counterparties. In particular, data concerning the names of counterparties, disaggregated information on prices and volumes of gas purchases or sales by individual counterparties, except in situations where such disclosure was officially permitted by the counterparty. The company discloses the necessary information to supervisory and statistical agencies as required by law
2. Other information that is not required for publication under the law and the disclosure of which, in the reasonable opinion of the management, would prejudice the interests of the company in the process of negotiations or business activities

### INFORMATION QUALITY GUIDELINES

Naftogaz provides information to and solicits feedback from the civil society, representatives of government, professional, scientific and expert communities, involving them in this manner in the analysis and discussion of its strategy and decisions.

Accordingly, information on the company's development strategy and significant events that affect the implementation of this strategy or activities of the group must be timely, accurate, objective and complete.

The management of Naftogaz endeavors to ensure the presentation of this information in a manner that is concise, visual and easily understood by the general public.

### DISCLOSURE CHANNELS

#### Own resources

Naftogaz discloses information on its corporate websites as well as through its official Facebook and Twitter accounts. Official information is also regularly distributed to subscribers from the press service e-mail address [press@naftogaz.com](mailto:press@naftogaz.com).

Official information is also included in annual reports, financial statements issued according to IFRS standards, and other periodic reports and materials which are published on the corporate website of Naftogaz and distributed by Naftogaz to the media and other stakeholders.

The group cautions against using information obtained from other sources without making an inquiry to the company. Naftogaz is subject to numerous ongoing and ad-hoc inspections by a number of agencies. To meet their specific requests, the group may prepare reports presenting information in line with assumptions and requirements set by such agencies. The resulting reports may not be complete and representative, unlike the officially released audited financial statements prepared in line with the IFRS. The management is ready to provide comments on data related to Naftogaz in order to avoid possible distortion of facts and ensure an objective interpretation in the appropriate context.

#### Mass media and NGOs

The mass media is the key channel of communication for Naftogaz. Cooperation with NGO's is also gaining increasingly more importance. Authorized representatives of Naftogaz and its subsidiaries regularly explain the group strategy and other important issues in their interviews with leading print and online media both in Ukraine and

## During 12 months from March 26 2014 (appointment of new management team), Naftogaz:

**released 216 press statements and interviews (during the preceding 12 months: 35)**

**participated in 25 press conferences or television programs (during the preceding 12 months: 1)**

**launched a new website with data for analysis: [www.naftogaz-europe.com](http://www.naftogaz-europe.com)**

**opened official accounts in social networks: [www.facebook.com/NaftogazUA](https://www.facebook.com/NaftogazUA), [twitter.com/NaftogazUkraine](https://twitter.com/NaftogazUkraine)**

**initiated quarterly audited IFRS reporting**

**launched quarterly reports on import prices and volumes**

**started daily disclosure of gas balances in UGS and gas flows**

**started publication of spot gas prices in European hubs**

**disclosed its constituent documents**

**disclosed the declaration of property and income of the CEO**

**disclosed the composition of executive board and information about senior managers**

**restarted disclosure of data on debtors (was abandoned in 2012)**

abroad, conduct press conferences and participate in relevant television and radio programs. When working with the media, the company focuses on the demographic structure of the audience of each media, the relevance of a particular message for such audience, and the format of the publication or program.

Naftogaz respects the professional duties of journalists and attempts to create appropriate working conditions

for media representatives at its events. It is unacceptable for representatives of Naftogaz to make insulting comments or remarks regarding representatives of mass media and/or NGOs, nor to express unsubstantiated criticism of published materials.

In turn, Naftogaz expects objective, substantiated and fair representation in the publications or materials of the media, expert community or NGOs. Naftogaz also expects to be granted the opportunity to comment on information relating to the company or the reform of the gas market of Ukraine.

### Cooperation with the professional community and transparency industry platforms

Naftogaz participates in conferences relevant to the development of Ukraine's oil and gas markets and/or attracting investment to these sectors.

In May 2014, Ukrtransgaz joined AGSI+, the leading European platform for transparency of underground gas storage facilities operated by Gas Infrastructure Europe (GIE). GIE is a major association of European operators of gas transmission systems, underground storage facilities and liquefied natural gas systems. The association publishes information on residual gas volumes in underground storage facilities in Europe on its platform. Ukraine became the first non-EU member country to voluntarily publish data on residual gas volumes in its underground storage facilities. This information is updated on a daily basis and is available online at <https://transparency.gie.eu>.

In November 2014, Ukrtransgaz also started to disclose data at the transparency platform of the European Network of Transmission System Operators for Gas (ENTSOG). Information on this platform enables tracking gas flows from the point of entry into Ukraine through to the point of exiting Ukraine's gas transportation system. This data is also updated daily and is available online at <https://transparency.entsog.eu>.

Naftogaz is open to joining other leading transparency platforms associated with the activities of the company or its subsidiaries.

## LETTER OF FIRST DEPUTY CHAIRMAN: OPERATIONS

*Sergiy Pereloma*



Dear readers!

The past year and a half was the time of hard work at Naftogaz. When I joined the new management team, the company was in a desperate state. Naftogaz had suffered huge financial losses. Almost all the gas we bought was coming from Russia, despite the fact that they had already occupied

Crimea, and we were seeing events rapidly unfolding in the Donbas. Naftogaz did not speak with one voice: the interests of the management of the company and its subsidiaries diverged. The situation was further complicated by the distorted regulatory environment in which the company operated for many years.

The situation demanded quick and decisive action. With the support of the government of Ukraine and its Western partners, the company began a complex transformation.

We are moving in two directions simultaneously. On the one hand, we are working to ensure that consumers pay the full cost of the gas they consume – either independently or with the support of targeted subsidies from the state. On the other hand, we are working hard to lower gas prices so that Ukraine does not overpay for its gas as had been the case for years before.

We can already see the first result: a drastic reduction in dependence on Russia. In 2013, Russia supplied 92% of our imported gas. In 2014, that number dropped to 74%. In the first half of 2015, only 37% of our imported gas came from Russia. This result required hard work from the entire team to enable the transmission of gas from Slovakia

to Ukraine, and to convince our partners in the EU of the importance and feasibility of this step.

### *We opened the Slovak reverse flow in five months after the new team took over management of Naftogaz*

The new transmission route and the ability to choose gas suppliers have made it possible to achieve a substantial reduction in the price of imported gas for Ukraine. From the beginning of April 2014, and until the signing of the trilateral agreements in Brussels in late October 2014, Russia was demanding that we pay a price that was 25-30% higher than the price at which we bought gas in Europe. Now Gazprom is pricing its gas for us at the level at which we buy gas in Europe. We initiated arbitration proceedings in Stockholm, where one of our conditions is setting a fair price for gas for Ukraine based on European prices minus transportation cost from the border between Ukraine and Russia to European gas hubs.

### *Concurrently with the work to reduce the imported gas price for Ukraine, we have stepped up actions on the huge debt of Ukrainian consumers to Naftogaz*

One of the critical operational challenges for Naftogaz is the far from 100% level of payments for the consumed gas. The losses of Naftogaz arose not only because the expensive imported gas was sold below cost. A large portion of major consumers abused the flaws in the regulations and did not pay for the gas they consumed at all. Naftogaz had no legal right to cease supply or require a collateral.

Now, thanks to the recent changes in legislation, we have more opportunities to influence debtors. We will be able to disconnect them, and file claims for the seizure and sale of their property to recover the amount in arrears. In the near future, we should see debt auctions, where we should be able to sell our debt for others to collect. Thus, Naftogaz expects to replenish its working capital and to be able to settle its own obligations.

We began reforms in Ukraine by starting with ourselves, in changing the tone of the relationship with the rest of the market participants, making integrity one of the most important cooperation criteria for ourselves and our partners. As a result, the avalanche of complaints toward Naftogaz ceased, and we can now better communicate our position to our partners in Ukraine and the West.

Over the past year and a half, Naftogaz has significantly improved relationships with its own subsidiaries. Ukrtransgaz, Ukrtransnafta and Ukgasvydobuvannya already have new leaders who share the values of the new Naftogaz. We hope to be able to normalize the situation with the management of Ukrnafta soon.

### *The key objective of the new leaders of our subsidiaries is, first and foremost, boosting operational efficiency of the companies as well as improving their accountability and transparency*

All of our key subsidiaries are strategic players in their respective markets. Ensuring that these companies are managed on the grounds of integrity and professionalism will help Ukraine to quickly strengthen its energy security. More transparent management should also ensure that resources are used rationally and help improve the financial performance of these companies.

Naftogaz is a very active advocate of the Ukrainian gas market reform which is based on the European standards. The group

management promotes changes that will inevitably lessen the role of Naftogaz in this market. Only a handful of vertically integrated state giants in Europe have actively supported a similar de-monopolization of the market. We understand that this reform is critical not only for consumers, who will be able to choose their suppliers and receive the highest quality of service. It is also necessary for the energy security of Ukraine.

Market reforms are important for us as well. In recent years, Naftogaz practically lost its position in the market of gas supply for industrial customers because of legislative distortions. In summer, when demand for gas is the lowest, private traders attract industrial clients with tangible discounts. Before the introduction of the new market rules, Naftogaz could not compete for these customers, as it risked investigation for selling gas at prices below those set by the regulator.

Starting from 1 October 2015, the market regulations change. Naftogaz will enjoy the same rights as other market participants. Following the implementation of the new legislative framework, the state will intervene in our activities only through the clearly defined public service obligations mechanism, for instance, in supplying gas to households.

### *The everyday work of Naftogaz is developing a clear vision of what the new market should be, and the implementation of civilized European rules in Ukraine*

For us this has meant numerous meetings — and sometimes fierce discussions — with the diverse groups in the Parliament, with representatives of the Cabinet of Ministers and the Presidential Administration, as well as with international organizations and European governments. In addition to promoting the legislative changes, we make efforts to see new instruments of cooperation in the gas industry. The gas exchange and the gas spot market have finally begun to take shape. The first steps have been taken. We go forward.

SERGIY PERELOMA

*First Deputy Chairman of the executive board,  
Naftogaz of Ukraine*

## OPERATING ENVIRONMENT OF NAFTOGAZ

### ECONOMIC OUTCOMES OF 2012-2013

In 2012-2013, the Ukrainian industry entered a recession period. The subsequent contraction of the external trade and growth in the government spending have predetermined the devaluation of the national currency.

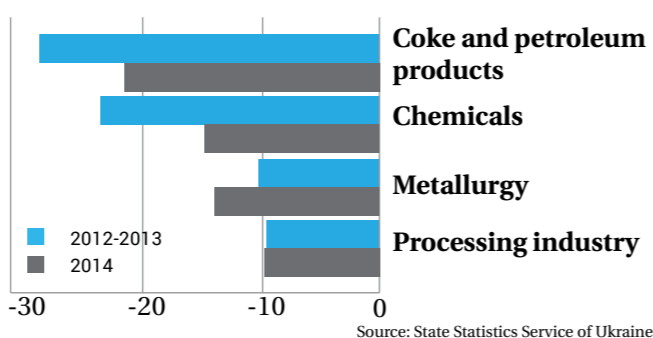
By the end of 2013, Ukraine's economy had been in recession for six consecutive quarters, and the decline in the production index of basic industries had continued for 17 consecutive months. The output volume of the processing industry decreased by 9.2%, and the fall in the chemical industry, traditionally large-scale consumer of gas, amounted to 22.5%. These factors led to a substantial reduction in Naftogaz revenues.

The external trade significantly deteriorated during this period. The slowdown in economic growth of the emerging markets resulted in a reduction of Ukrainian exports. At the same time, the cost of energy for Ukraine remained high, and the so-called trade wars with Russia began.

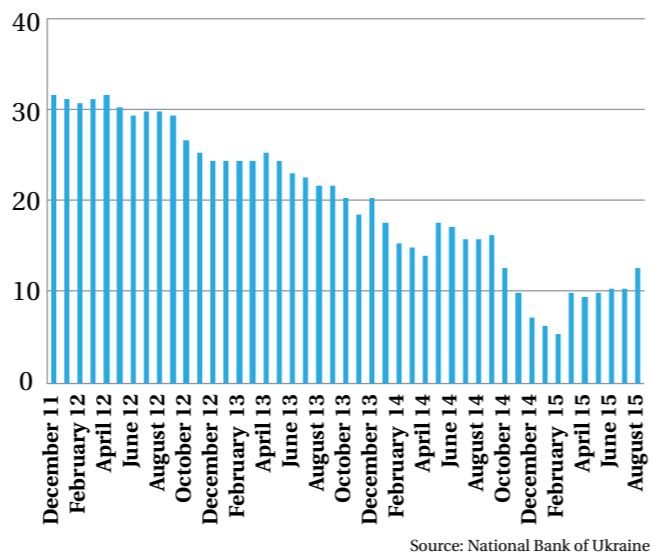
These factors aggravated the devaluation pressure which reached its climax in 2014 and 2015. The deterioration of the external trade led to an increase in the current account deficit to over 9% of GDP. In turn, the unfavorable business climate and the bleak prospects for the economic growth resulted in a drop of the net foreign direct investment to less than 2% of GDP.

This combination of factors caused a significant balance of payments deficit, boosted devaluation expectations and drained the reserves of the National Bank of Ukraine (NBU), which made numerous interventions to keep the exchange rate unchanged. The country's foreign exchange reserves declined by 35% over 2012-2013.

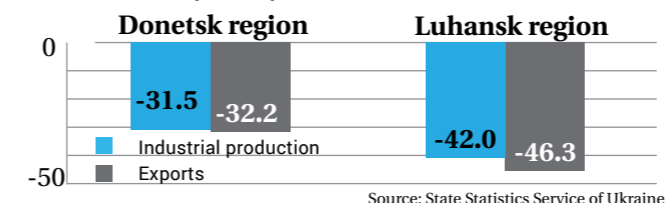
### INDUSTRIAL PRODUCTION INDICES CHANGE, %



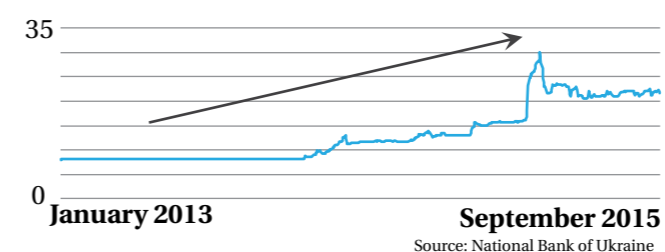
### NBU FOREIGN EXCHANGE RESERVES, 2012-2015, USD BILLION



### NEGATIVE CONSEQUENCES OF THE MILITARY AGGRESSION, 2014, %



### WEIGHTED AVERAGE INTERBANK EXCHANGE RATE, UAH PER 1 USD



### CHALLENGES OF 2014-2015

The inevitable adjustment of the accumulated economic imbalances combined with the Russian military intervention in 2014 caused an unprecedented financial crisis in Ukraine.

In 2014, the pace of the decline in GDP accelerated to 6.8%. According to the IMF forecasts, the GDP decline will continue into 2015 and will reach 9%.

The Russian occupation of the Autonomous Republic of Crimea (Crimea) and the hostilities in the Donbas deepened the recession, which in turn negatively affected domestic demand for natural gas. The decline in production in the processing industry in 2014 amounted to over 9%, resulting in a further reduction in demand for natural gas by industrial customers.

Because of the occupation of a portion of Ukraine's territory, Naftogaz lost a part of its resource base, including the prospective reserves in Crimea. The sharp devaluation of the national currency had a detrimental effect on the finances of the group.

The recession and currency devaluation, together with the blow to the overall economy caused by the armed conflict, made internal and external capital markets inaccessible to Ukrainian companies. This factor has greatly limited the possibilities of Naftogaz to refinance its debt and increased its dependence on the state funding.

In order to overcome the economic crisis, Ukraine needs deep structural reforms which are partially reflected in the measures agreed between the government of Ukraine and the International Monetary Fund (IMF). The reform of the gas market and Naftogaz itself constitute an important part of these undertakings.

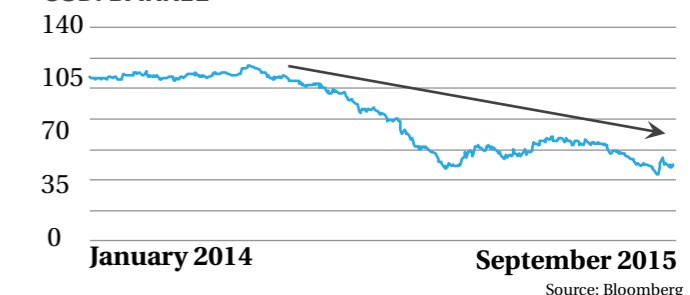
### 2014-2015 DECLINE IN GLOBAL ENERGY PRICES

As an importer of gas into Ukraine, Naftogaz benefited from the reduction of global energy prices in 2014. The negative impact of the oil price correction was only felt in the oil extraction and refinery projects of UGV and Naftogaz projects in Egypt. However the result of these divisions had little impact compared to the overall positive effect on other businesses of the group.

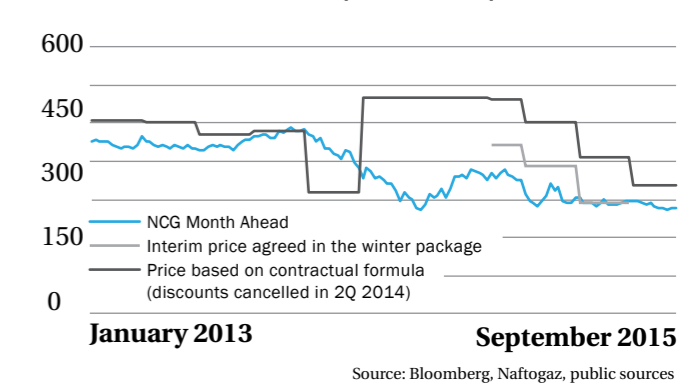
At the same time, terms of the existing contracts with Gazprom, prevented Naftogaz from taking the full advantage of the decline in global oil prices for most of 2014. Having occupied Crimea, Russia unilaterally raised the price of gas for Naftogaz by USD 100/tcm. Protracted negotiations on pricing and other terms of Russian gas supplies to Ukraine resulted in the initiation of an arbitration between Naftogaz and Gazprom. The interim terms of supply of the Russian gas are regulated by the so-called "winter package" – a set of trilateral and bilateral agreements with the participation of Ukraine, Russia and the European Commission.

Naftogaz eventually managed to take advantage of a drop in global energy prices by significantly expanding the volume of gas purchases from the EU starting from September 2014. This development has helped the company to reduce its working capital financing requirements.

### 2014-2015 BRENT OIL PRICE DYNAMICS, USD/BARREL



### GAS PRICES IN EUROPE AND GAZPROM'S PRICES FOR NAFTOGAZ, 2013-2015, USD/TCM



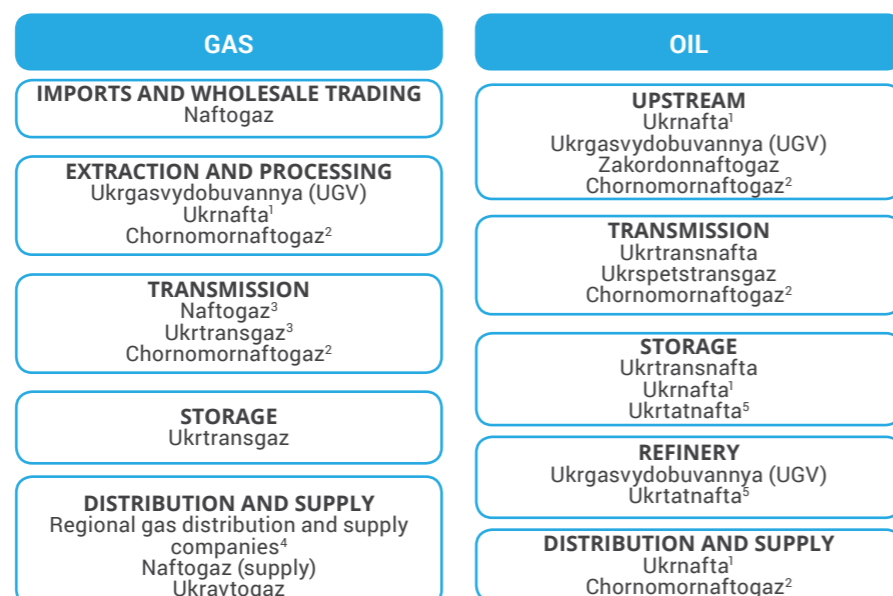
## BUSINESS STRUCTURE

Naftogaz is a vertically integrated group whose activities span from gas extraction, import and supply through gas transmission and storage. The companies in which Naftogaz owns shares are major players in the gas and oil markets.

Nearly 90% of Naftogaz assets and revenues are related to the gas business. Separate subsidiaries operate in each market segment.

- In 2014, Naftogaz supplied to the Ukrainian market gas volumes which are equivalent to 7% of Europe's total consumption
- Ukrtransgaz operates a major gas transportation system (GTS) with the entry capacity of 288 bcm/year and the exit capacity of 151 bcm/year in the direction of the EU. The annual volume of gas transmitted to Europe in 2014 was 62.2 bcm
- Ukrtransgaz also operates Europe's largest system of underground gas storage (UGS) facilities. It consists of 12 separate facilities with a total capacity of about 31 bcm (over a quarter of the EU-28 UGS capacity) and the injection capacity of 280 mcm/day
- Ukrasvydobuvannya (UGV) is Ukraine's largest company in gas upstream and second largest in oil upstream. In 2014, the company produced nearly 14 bcm of gas, accounting for 2/3 of the market

### KEY BUSINESS DIVISIONS



- Naftogaz is one of the largest groups in Ukraine by a number of parameters, including asset value and revenues. Naftogaz is the largest taxpayer in Ukraine

<sup>1</sup>Naftogaz owns 50%+1 share of Ukrnafta but did not exercise control over the company in 2014 and started to recover it in 2015

<sup>2</sup>As a result of the occupation of Crimea by Russia in 1Q 2014, Naftogaz currently does not control assets in Crimea

<sup>3</sup>Naftogaz is a party to the contract with Gazprom on of gas transmission to

European consumers. This contract violates the requirements of the 3<sup>rd</sup> Energy Package currently implemented by Ukraine. Naftogaz has initiated an arbitration to bring this contract into accord with relevant national legislation, Ukraine's international commitments and the standard market practices of the Energy Community of which Ukraine is a member

<sup>4</sup>Naftogaz owns minority stakes in some of regional gas distribution and supply companies, except for Kirovohradgaz where Naftogaz owns 51% of shares

<sup>5</sup>Naftogaz owns a minority stake

### SUMMARY OF OIL AND GAS RESERVES OF NAFTOGAZ, AS AT 31 DECEMBER 2014 (EXCLUDING CRIMEA)

	Oil and condensate (million t)	Natural gas (bcm)	Oil and condensate (million barrels) <sup>1</sup>	Natural gas (million boe) <sup>2</sup>	Total all products (million boe)
<b>Proven oil and gas reserves</b>					
<b>Proven developed</b>					
in Ukraine (excl. Crimea)	3.62	256.03	26.35	1 514.94	1 541.30
Ukrasvydobuvannya	3.52	255.70	25.60	1 513.02	1 538.62
Naftogaz	0.10	0.33	0.75	1.92	2.67
in Egypt	0.47	0.30	3.40	1.75	5.16
<b>Total proven developed</b>	<b>4.09</b>	<b>256.32</b>	<b>29.76</b>	<b>1 516.70</b>	<b>1 546.45</b>
<b>Proven undeveloped</b>					
in Ukraine (excl. Crimea)	0.40	11.14	2.94	65.91	68.85
Ukrasvydobuvannya	0.18	11.13	1.30	65.88	67.18
Naftogaz	0.23	0.00	1.64	0.03	1.67
in Egypt	0.35	0.12	2.57	0.69	3.26
<b>Total proven undeveloped</b>	<b>0.76</b>	<b>11.26</b>	<b>5.51</b>	<b>66.60</b>	<b>72.11</b>
<b>Proven developed and undeveloped</b>					
in Ukraine (excl. Crimea)	4.02	267.16	29.29	1 580.85	1 610.15
Ukrasvydobuvannya	3.70	266.83	26.90	1 578.90	1 605.81
Naftogaz	0.33	0.33	2.39	1.95	4.34
in Egypt	0.82	0.41	5.97	2.44	8.41
<b>Total Proven developed and undeveloped</b>	<b>4.84</b>	<b>267.58</b>	<b>35.27</b>	<b>1 583.30</b>	<b>1 618.56</b>
<b>Probable oil and gas reserves</b>					
in Ukraine (excl. Crimea)	2.16	24.07	15.70	142.43	158.13
Ukrasvydobuvannya	0.59	23.91	4.32	141.45	145.78
Naftogaz	1.56	0.16	11.38	0.98	12.36
in Egypt	0.31	0.19	2.27	1.11	3.38
<b>Total not proven probable</b>	<b>2.47</b>	<b>24.26</b>	<b>17.97</b>	<b>143.54</b>	<b>161.51</b>
<b>Total Proven and probable</b>					
in Ukraine (excl. Crimea)	6.18	291.23	45.00	1 723.28	1 768.28
Ukrasvydobuvannya	4.29	290.74	31.23	1 720.36	1 751.59
Naftogaz	1.89	0.49	13.77	2.92	16.69
in Egypt	1.13	0.60	8.24	3.55	11.79
<b>Total proven and probable</b>	<b>7.31</b>	<b>291.83</b>	<b>53.24</b>	<b>1 726.83</b>	<b>1 780.07</b>

### SUMMARY OF OIL AND GAS RESERVES OF NAFTOGAZ IN CRIMEA, AS AT 31 DECEMBER 2013<sup>3</sup>

	Oil and condensate (million t)	Natural gas (bcm)	Oil and condensate (million barrels) <sup>1</sup>	Natural gas (million boe) <sup>2</sup>	Total all products (million boe)
Proven developed	0.43	14.02	3.11	82.99	86.10
Proven undeveloped	4.27	13.25	31.07	78.43	109.50
<b>Total proven</b>	<b>4.70</b>	<b>27.28</b>	<b>34.18</b>	<b>161.41</b>	<b>195.60</b>
Probable	1.39	14.20	10.14	84.01	94.15
<b>Total proven and probable</b>	<b>6.09</b>	<b>41.48</b>	<b>44.32</b>	<b>245.43</b>	<b>289.75</b>

<sup>1</sup>Oil/condensate volumes are converted to barrel using a factor of 7.28 bbl per 1 t

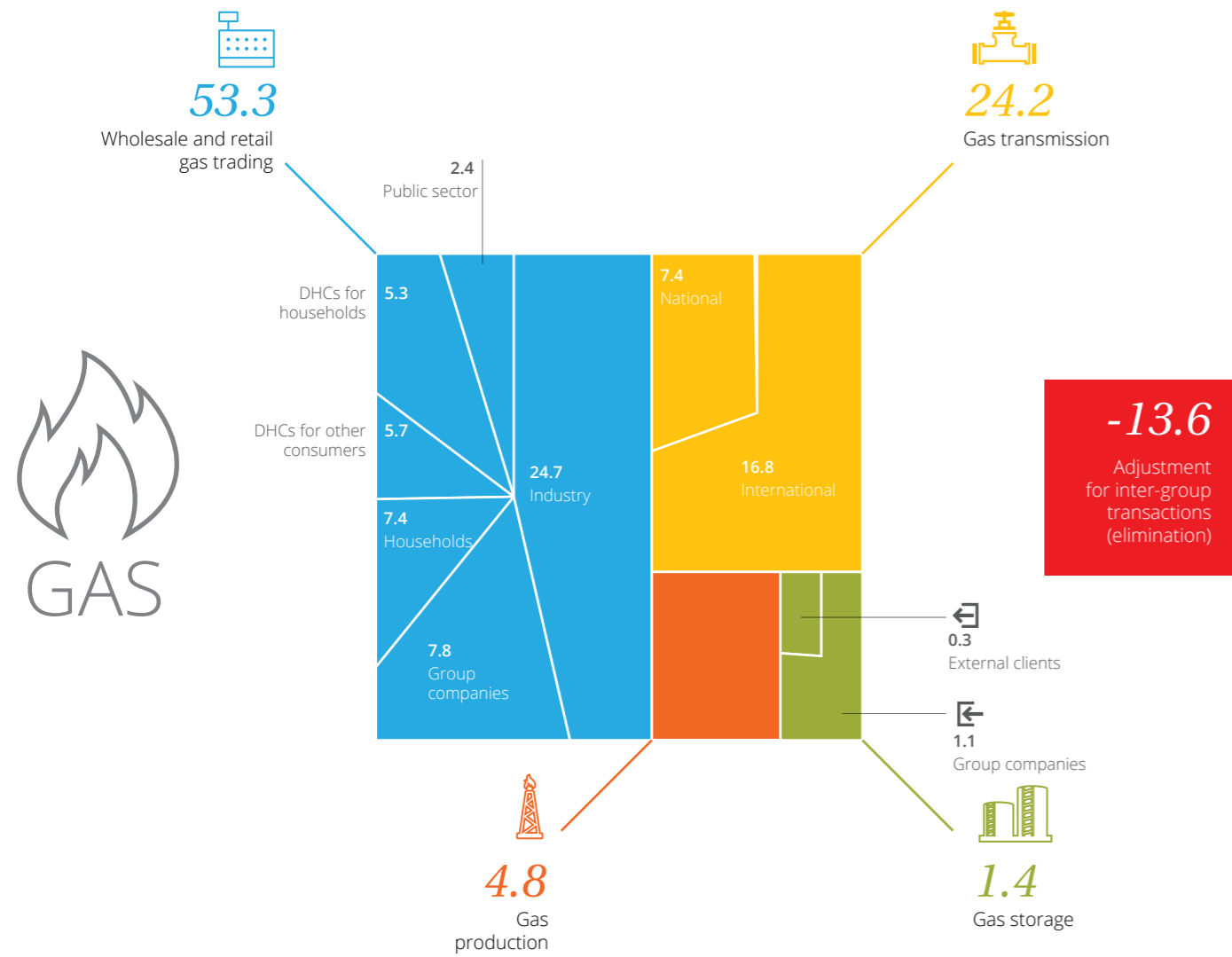
<sup>2</sup>Natural gas volumes are converted to oil equivalent using a factor of 169 cubic metres per 1 bbl

<sup>3</sup>Estimation of reserves in Crimea as at 31 December 2014 was impossible because of the Russian occupation of the peninsula  
Source: Report on estimation of Naftogaz proven, probable and possible hydrocarbon reserves (SPE-PRMS) by Ryder Scott Company

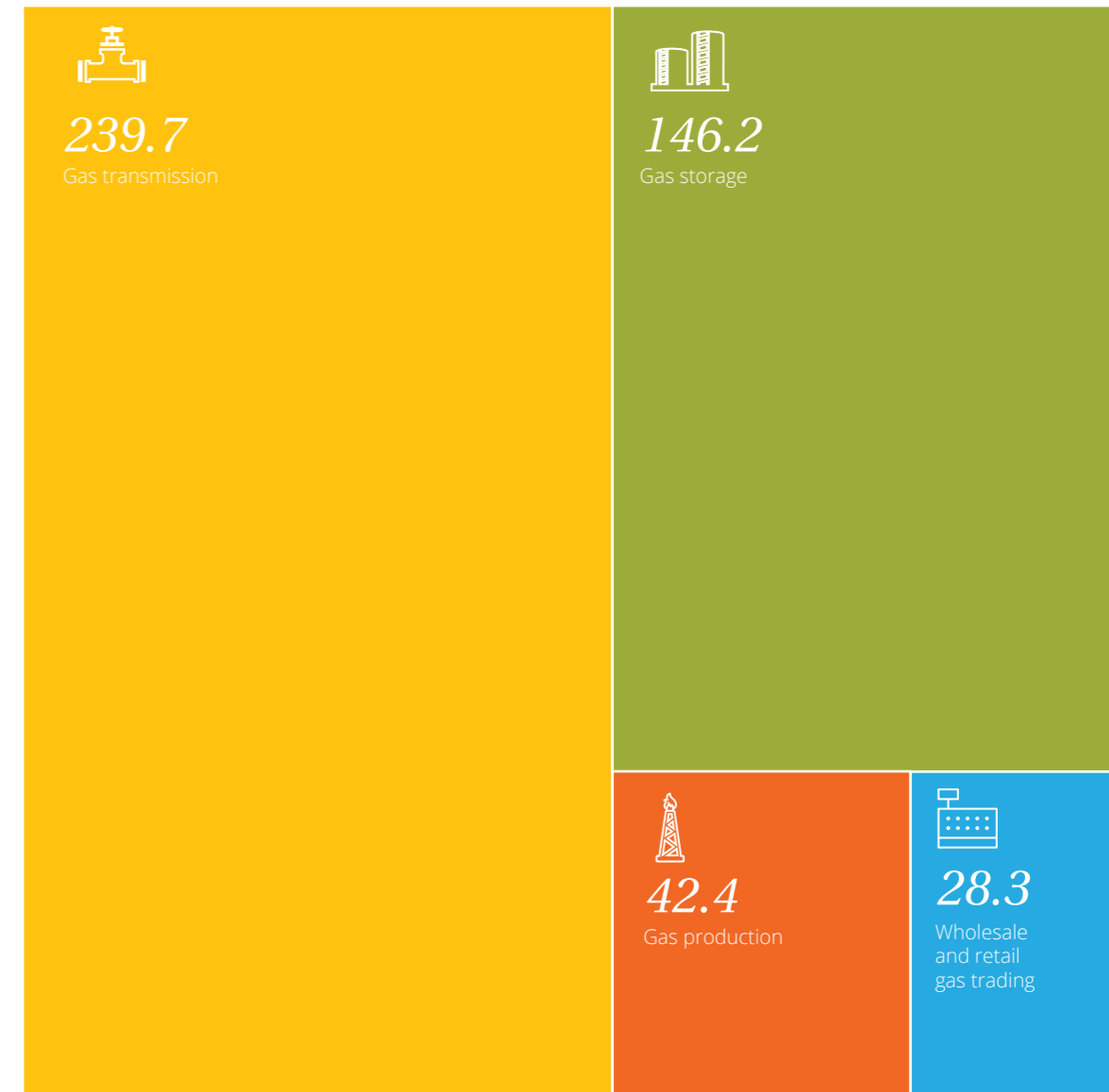
# GROUP STRUCTURE BY OPERATING REVENUES AND ASSETS

2014, UAH billion

## OPERATING REVENUES



## ASSETS



## OTHER<sup>2</sup>

0.8

30.0

<sup>1</sup>Does not include Ukrnafta

<sup>2</sup>Segment assets include administrative and non-core assets, investments (including Naftogaz share in Ukrnafta) and assets of auxiliary subsidiaries

## UKRAINIAN GAS MARKET HISTORY: FROM EXPORTS TO IMPORTS

The development history of the Ukrainian gas industry and related sectors helps to understand the current structure of the market and the challenges the industry is facing now.

From the 1950s until the mid-1970s, Ukraine was one of the leading gas producing countries in the region and an exporter of gas. It was the golden age of the Ukrainian gas industry. Gas produced in Ukraine was used to satisfy the local demand as well as supply to consumers in the current Russian Federation, Belarus, Moldova, the then Czechoslovakia, Austria, Hungary, Romania, Bulgaria, and Poland. In 1975 the total volume of gas extracted from fields in western and eastern Ukraine and in the Crimean region reached a historic high and totaled 68.1 bcm.

Alongside the rapid development of the Ukrainian gas production, industries that intensively use natural gas, like chemicals and metallurgy, evolved as well. Gas was also made widely available to individual consumers – in this regard, Ukraine is still one of the European leaders. Almost 60% of Ukrainian households have access to gas, while less than 40% of households

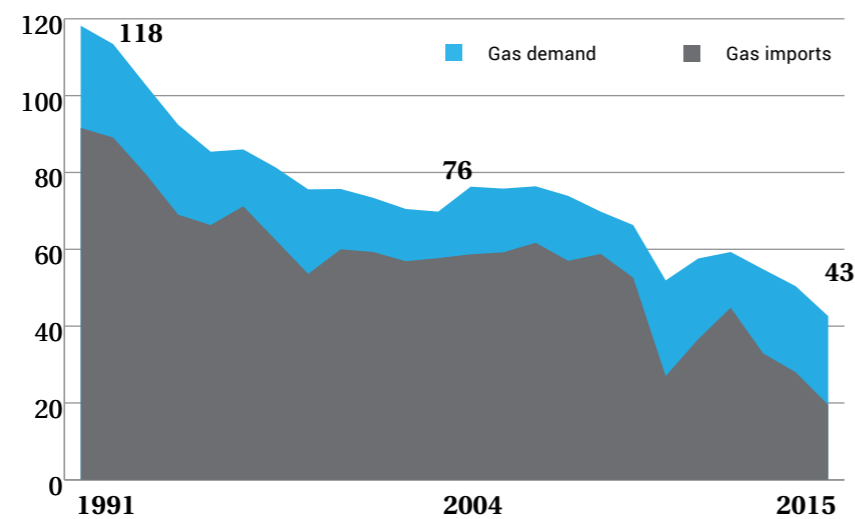
on average have access to gas in the EU member states.

As a result of the rapid development of the industrial and household segments of the market, Ukraine turned into one of the largest gas consumers in the world. By the end of the Soviet era, Ukraine ranked third in gas consumption globally after Russia and the USA, with

gas demand peaking at almost 119 bcm in 1990.

By the late 1970s, the majority of gas fields were depleted and production started to decline rapidly. The demand for gas, on the contrary, continued to grow. Thus Ukraine gradually transformed from an exporter to an importer of gas. This change coincided

**GAS DEMAND AND IMPORTS IN UKRAINE, BCM**



with the active development of gas production in what is now Russia and in Central Asia, as well as with the construction of the supersized gas transmission pipelines from these deposits to Central and Western Europe.

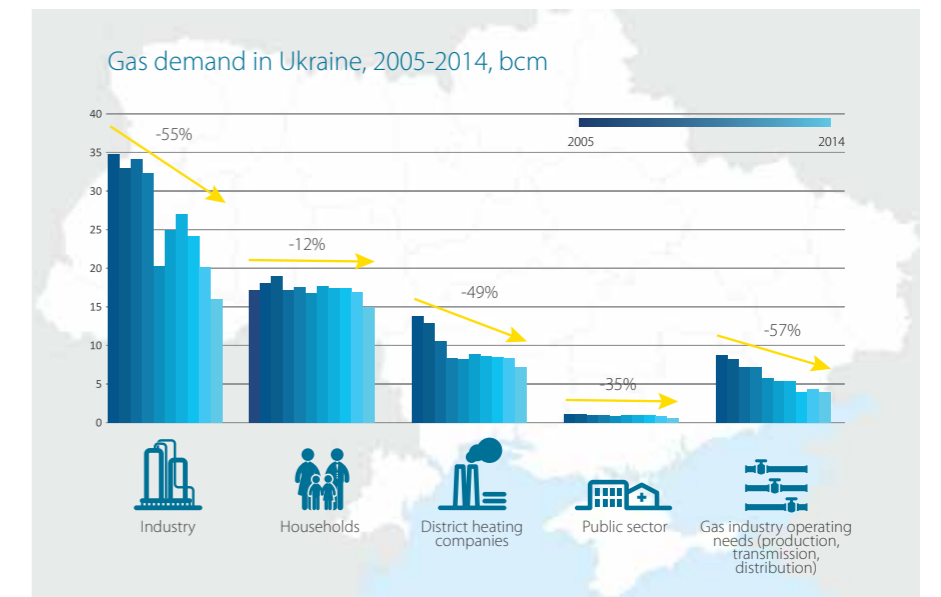
The powerful pipelines crossed the territory of Ukraine and made it a key transit country for Russian gas to Europe. In the same time, they also provided Ukraine with an opportunity to buy virtually unlimited volumes of gas at any time. Gas consumption continued to grow, and the country became increasingly dependent on gas imports. By the time when the Soviet Union collapsed, Ukraine's own gas production covered only about 20% of the national demand.

During almost 25 years of Ukraine's independence, the consumption has dropped by about three times, primarily due to structural changes in the economy. Gas demand from the households declined at a significantly slower pace, and now more than half of gas consumed in the country is used to satisfy the needs of the residential sector.

Unfortunately, because of the abundant availability of gas for decades, a large portion of the society believes that gas is a very inexpensive and a virtually unlimited resource.

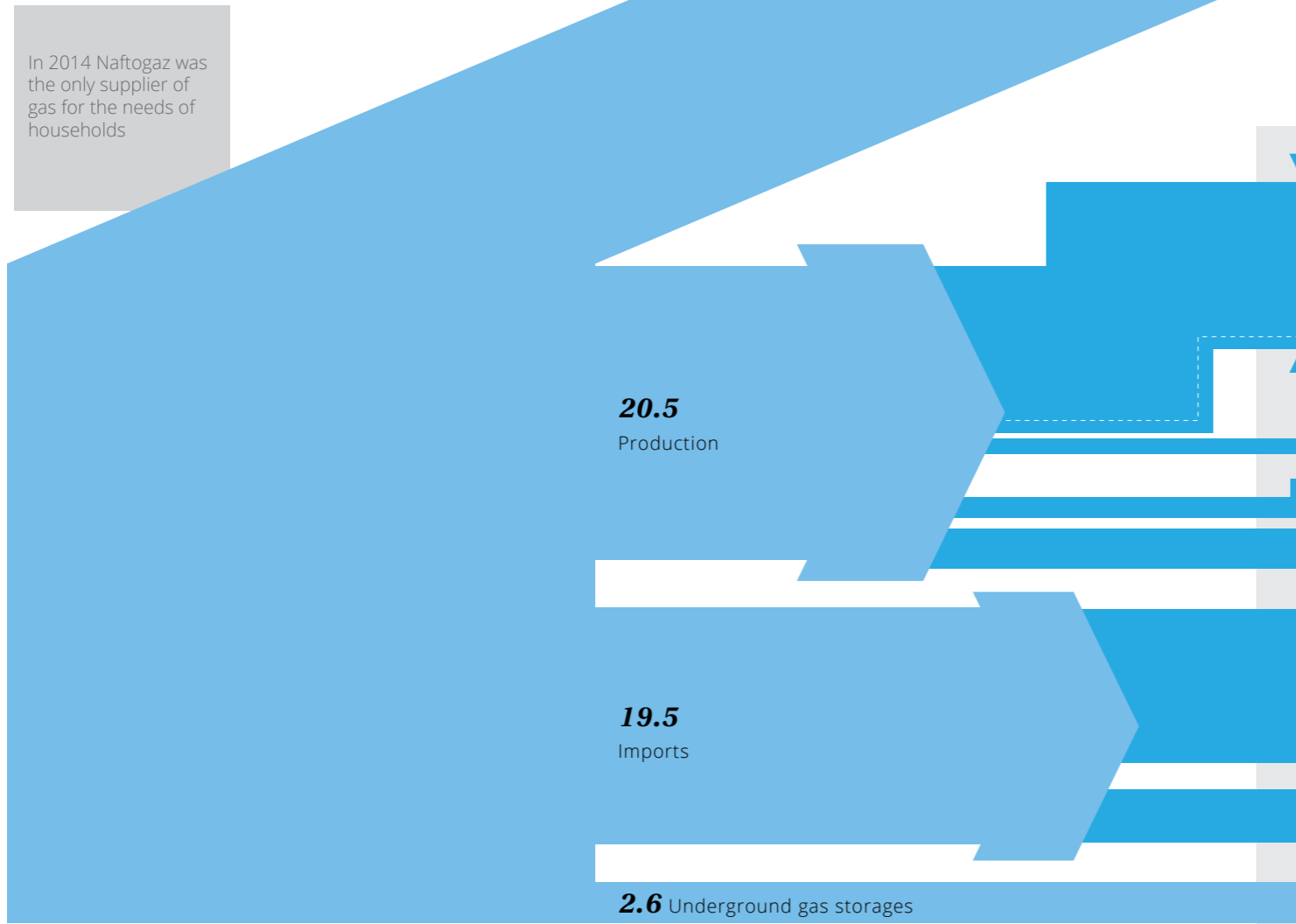
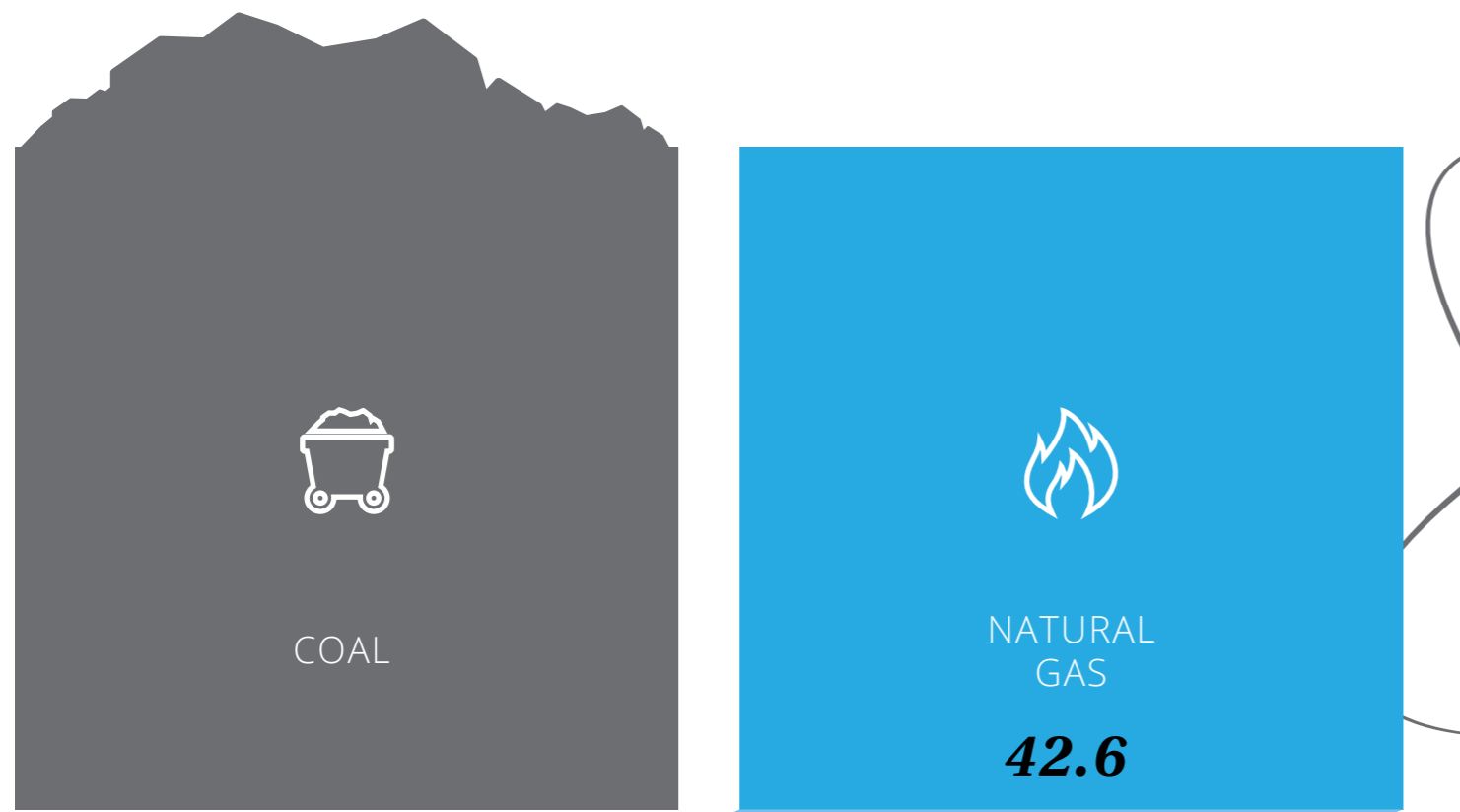
Both the industrial and residential sectors of the Ukrainian economy have evolved in an environment of gas abundance. This fact underlines the depth of the challenges that Ukraine must overcome

on the path to energy efficiency and frugal consumption. Ukraine still has considerable gas resources and can regain its former status as a net exporter if it manages to create an environment necessary to attract investments into gas production. The gas market reform that involves the deregulation of retail gas prices is a prerequisite for achieving gas independence for Ukraine.

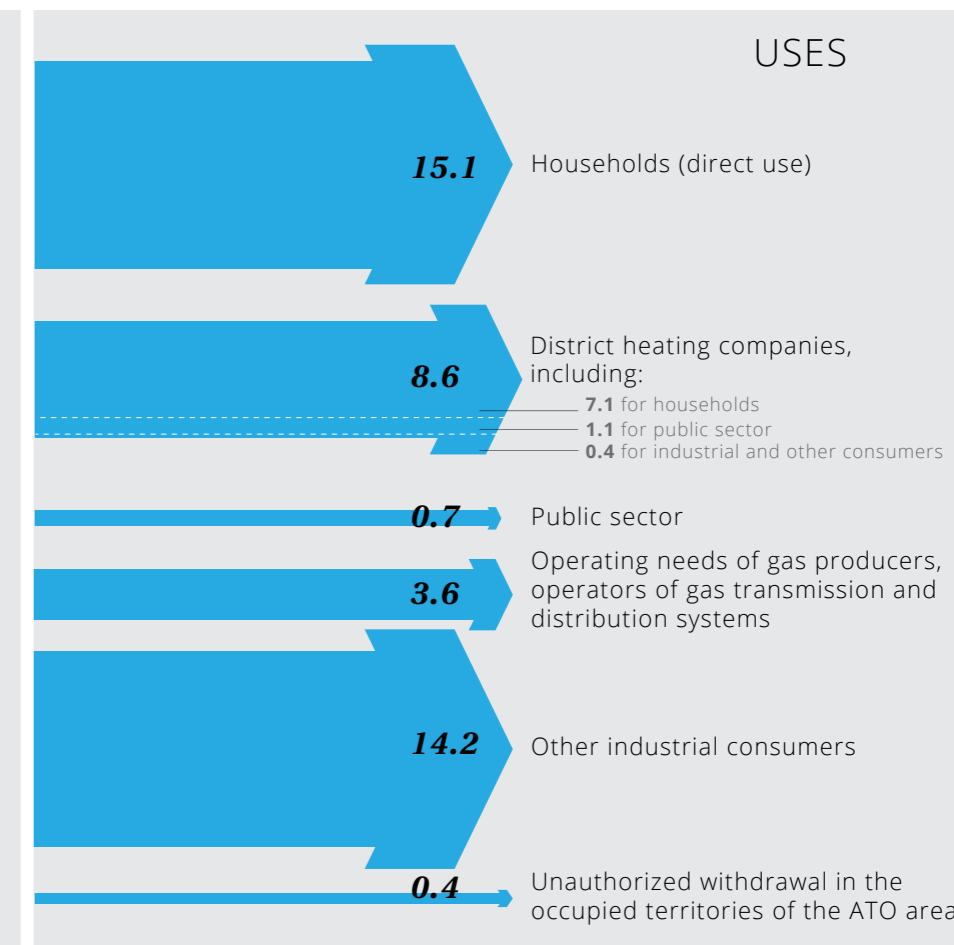
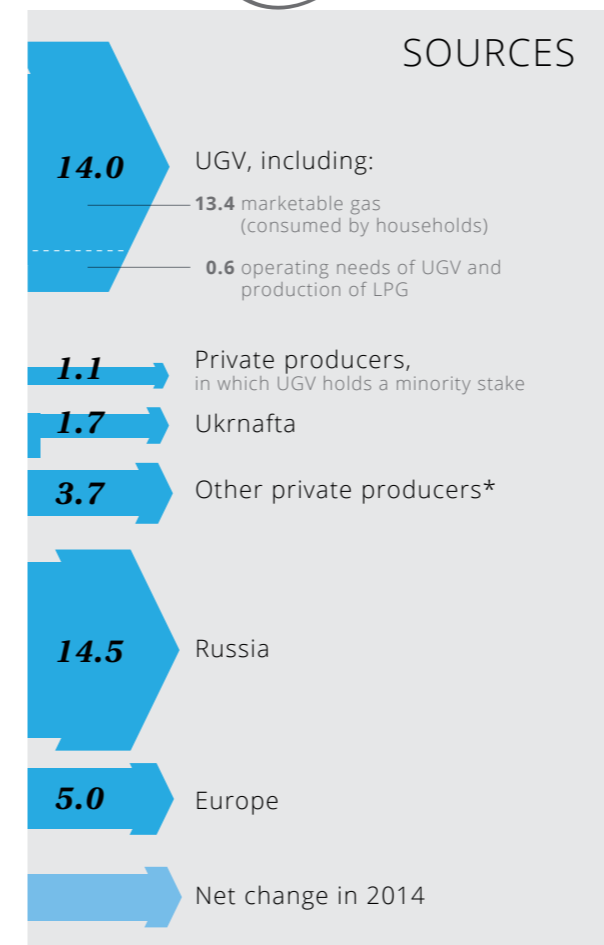
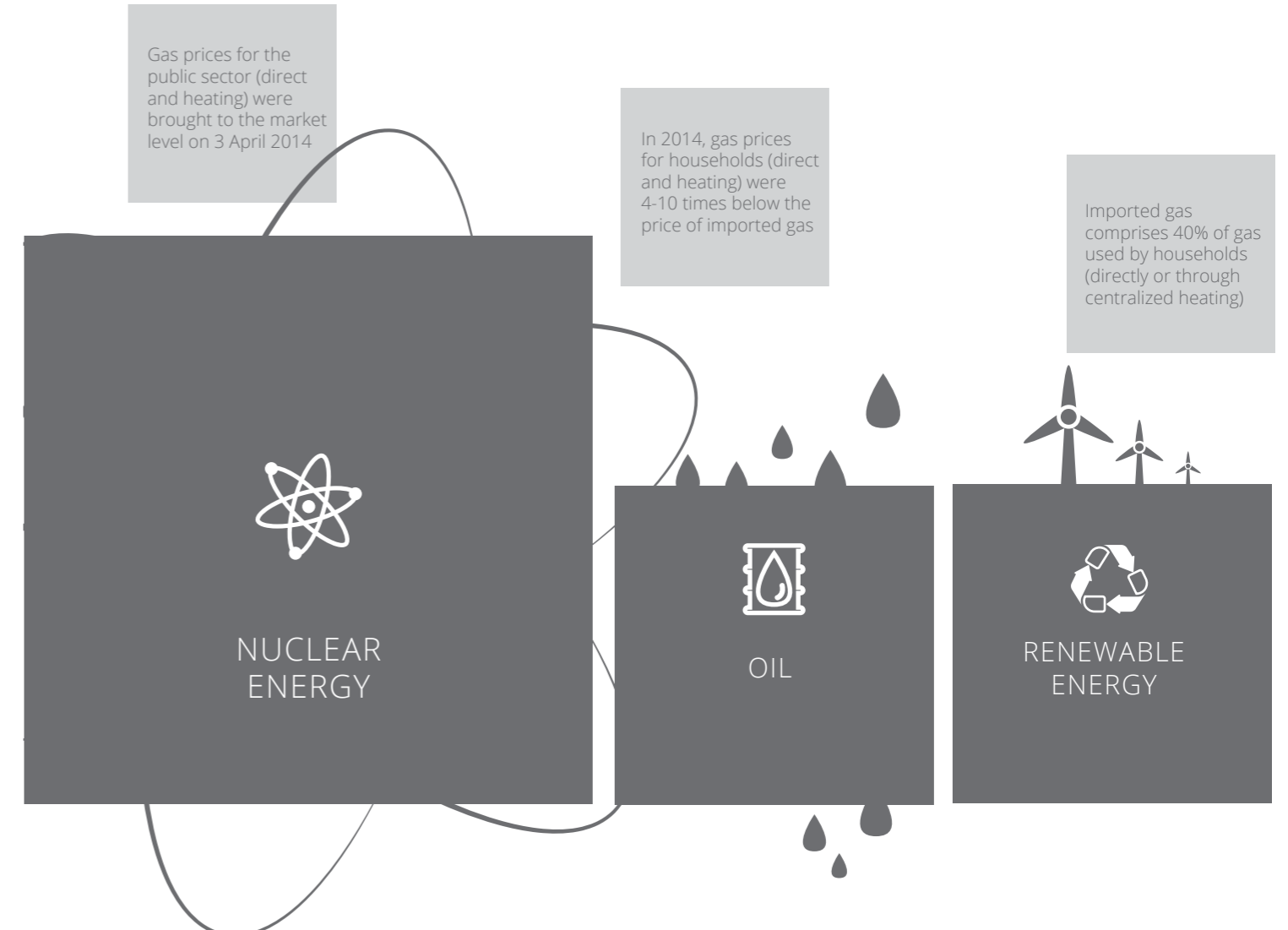


# UKRAINE'S GAS BALANCE IN 2014

bcm



In 2014 Naftogaz was the only supplier of gas for the needs of households

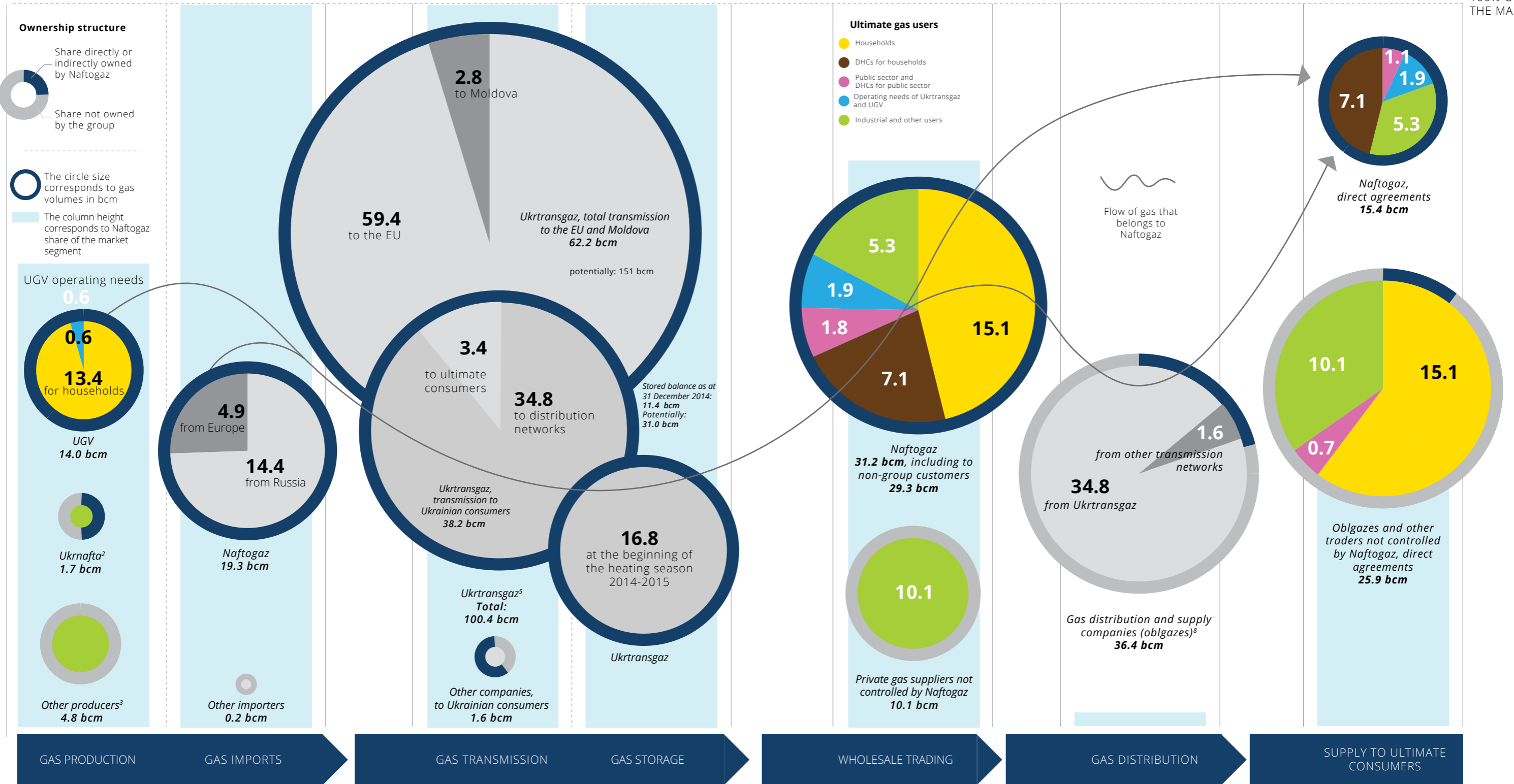


Numbers may not add up due to rounding  
\*including 0.3 bcm from Chornomornaftogaz before the occupation of Crimea

# UKRAINE'S GAS MARKET IN 2014<sup>1</sup>

bcm

100% OF THE MARKET



## TOTAL BY SEGMENTS

bcm



<sup>1</sup>Includes data on Crimea prior to the occupation <sup>2</sup>Naftogaz did not exercise control over Ukrnafta in 2014 <sup>3</sup>Including 1.1 bcm produced by companies where UGV holds a minority stake; including 0.3 bcm of gas produced by Chornomornaftogaz prior to the occupation and sold to the households in 2014 <sup>4</sup>0.9 bcm of gas used by gas producers for their own operating needs and for production of LPG did not enter external transmission systems and was not traded

<sup>5</sup>Ukrtransgaz spent an additional 1.8 bcm of gas for its operating needs; indicated volume includes 0.4 bcm of gas illegally withdrawn in the ATO area <sup>6</sup>2014 maximum level prior to the start of the heating season in October 2014<sup>7</sup> Excludes 0.4 bcm of gas illegally withdrawn in the ATO area; not accounting for possible secondary market <sup>8</sup> Naftogaz holds minority stakes in some obligates (25%+1 share or less excluding Donetskoblغاز (39%) and Kirovohradgaz (51%); additional 0.9 bcm of gas used for operating needs of obligates; transmission volume includes 0.4 illegally withdrawn in the ATO area.

Abbreviations: UGV – Ukrgasvydobuvannya, DHCs – district heating companies  
Numbers may not add up due to rounding

## GAS IMPORTS AND WHOLESALE TRADING

Ukraine ranks fifth among the largest gas consumers in Europe (including Turkey). In 2014, Ukrainian consumers purchased 42.6 bcm of gas. Nearly half of this amount (19.5 bcm) was imported. In 2014, public and private companies in Ukraine produced about 20.5 bcm of gas. The balance was covered by reserves in underground storage facilities.

Naftogaz accounts for the majority share in almost every segment of the gas market in Ukraine, except for gas distribution and retail supply (see *Ukraine's gas market in 2014*).

Naftogaz is the major importer of Russian and European gas to Ukraine. All marketable gas produced by UGV is purchased by Naftogaz to form gas resources for households.

Naftogaz sells this and imported gas to regional gas distribution and supply companies (oblgazes) to be sold on to households and public sector institutions. Naftogaz also sells gas to district heating companies (DHCs) and

industrial consumers through direct contracts.

### MARKET CONTRACTION IN 2014

In 2014, gas demand in Ukraine decreased by 15% to 42.6 bcm from 50.4 bcm in 2013. Excluding data from Crimea for the entire 2013 and two months of 2014, the demand shrank by 14% compared to 2013. The demand fell in all regions of Ukraine and across all consumer categories.

Excluding gas consumption in Crimea, the largest reduction in demand (20%) occurred among industrial customers because of the hostilities in the industrial area of Donbas and the overall deterioration of the economy. The significant reduction in national and transit gas transmission volumes resulted in a 10% reduction of gas volumes used by gas transmission and distribution system operators for their operating needs.

In 2014, residential consumers (excluding Crimea) used 8% less gas

than in the previous year: 14.9 bcm vs. 16.2 bcm. This is the first substantial reduction in consumption in this category over the last 10 years. DHCs (excluding Crimea) have reduced the use of gas to produce heat for all categories of consumers by 14% over the same period. Considering that the winter of 2014 was not significantly warmer than 2013, this decrease in consumption might be explained by an increased efficiency.

### GAS IMPORTS

The contraction of the domestic demand resulted in a reduction of gas imports. Compared to 2013, gas imports in 2014 decreased by almost a third, from 28 bcm to 19.5 bcm. In the same time, the volume of imports from Europe increased almost 2.5 times: from 2.1 bcm in 2013 to 5.0 bcm in 2014. Gas imports from Russia decreased by almost 50%: from 25.8 bcm to 14.5 bcm.

In 2013, Ukraine imported 92% of its gas from Gazprom with the rest coming from European suppliers. The

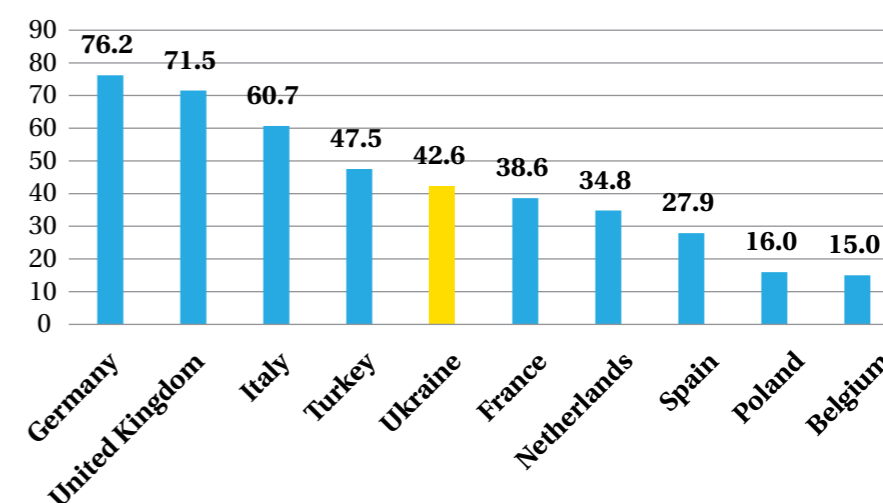


excessive reliance on a single supplier made gas an instrument of political and economic pressure on Ukraine. Being charged inflated prices compared to the European levels for several years, Naftogaz overpaid billions of dollars to Gazprom. In 2014, Naftogaz has taken this claim to court.

In December 2013, following years of negotiations and on the backdrop of mass public protests in Ukraine over the previous government's decision to sacrifice Ukraine's ambition of the European integration for a tighter alliance with Russia, Gazprom agreed to bring the gas price to a justified level.

Following the change of the government in February 2014, Ukraine officially resumed the process of the European integration. Consequently, the price of Gazprom gas for Ukraine was unilaterally increased by Russia in 2Q 2014 by 80% to a level that was 25-30% higher than the price at which Naftogaz bought gas in Europe in the same period. After Naftogaz refused to cover the inflated bills, Gazprom stopped supplying gas to Ukraine for almost six months.

### LARGEST MARKETS IN EUROPE BY GAS CONSUMPTION, 2014, BCM

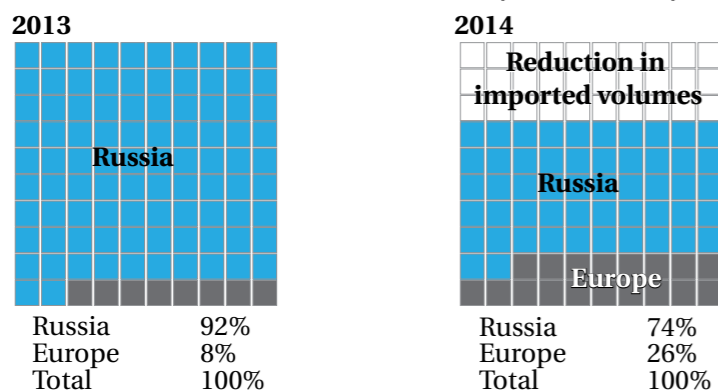


Sources: Eurostat, Naftogaz

### GAS DEMAND REDUCTION IN UKRAINE, BY CONSUMER CATEGORY

	2013	2014	%
Total gas demand in Ukraine	50.4	42.6	-15%
<b>Total gas demand in Ukraine (excluding Crimea)</b>	<b>48.7</b>	<b>42.1</b>	<b>-14%</b>
Households	16.8	15.1	-10%
<b>Households (excluding Crimea)</b>	<b>16.2</b>	<b>14.9</b>	<b>-8%</b>
DHCs (all categories)	10.2	8.6	-16%
<b>DHCs (all categories excluding Crimea)</b>	<b>9.8</b>	<b>8.4</b>	<b>-14%</b>
Industrial consumers	18.2	14.2	-22%
<b>Industrial consumers (excluding Crimea)</b>	<b>17.6</b>	<b>14.0</b>	<b>-20%</b>

**ORIGINS OF GAS IMPORTED INTO UKRAINE, BY VOLUME, %**



In 2014, following the launch of the Slovak gas transmission route in September 2014, gas imports from Russia fell to 75% of the total. In the first half of 2015, the share of Russia contracted to 37% of Ukraine's gas imports.

Determined to diversify sources of gas imports to Ukraine, in October 2014 Naftogaz started buying gas from Europe's largest gas supplier, the Norwegian Statoil. Furthermore, in 2014 Naftogaz adjusted its trading operations to become compatible with the established European market rules and standards. In particular, the company started using EFET contracts and trade on the VTP. These transformations helped Naftogaz to significantly expand its range of suppliers in Europe and buy gas for Ukraine under increasingly favorable terms.

In the second quarter of 2015, Gazprom offered to supply Russian gas to Naftogaz at a price which matched those of Ukraine's European suppliers.

In 2014, Naftogaz share in the total volume of imported gas to Ukraine amounted to 99% (19.3 bcm). Another 0.2 bcm were imported into Ukraine by private suppliers. Naftogaz continues actions aimed at expanding the share of private suppliers and end consumers in gas imports to Ukraine.

**WHOLESALE GAS TRADE**

In wholesale gas trade, the share of Naftogaz in 2014 was nearly 75%.

Almost 70% of total gas volume sold by Naftogaz was priced at a level that did not cover the weighted average cost of purchasing this gas.

Naftogaz was the only supplier who covered the needs of Ukrainian households (15.1 bcm for individual use and 7.1 bcm for DHCs to produce heat for households). Naftogaz received only 13.9 bcm from Ukrainian state-owned producers at a regulated price set below the market level. To cover the remaining needs of households, Naftogaz imported about 8.2 bcm of gas at market prices in 2014.

Naftogaz supplied another 7.2 bcm of gas to other categories of customers (industry, DHCs, public sector and others).

In 1Q 2014, the gas price for public sector entities was nearly 20% below the price charged to industrial consumers. In April 2014, the National Energy and Utilities Regulatory Commission brought

gas prices for this category to the level of prices for industrial consumers.

In 2014, the volume of gas sold to consumers that paid full market prices and were not members of Naftogaz group amounted to nearly 15.4 bcm. The share of Naftogaz in this market was below 35% (5.3 bcm). Other suppliers sold 10.1 bcm of gas to these customers.

Naftogaz sold a further 1.9 bcm to its group companies to cover their operating needs, specifically to Ukrtransgaz for transporting gas to Ukrainian and European consumers. This gas was priced at the industrial rate.

**GAS TRADING IS A LOSS-MAKING SEGMENT FOR NAFTOGAZ**

In 2014, Naftogaz was entitled to buy marketable gas from state-owned gas producers to create gas reserves to cover the needs of households. The balance of these needs not covered by gas produced by state-owned companies is covered by imported gas. In order to minimize the compensations from the state budget to Naftogaz, the regulator priced the marketable gas produced by state-owned companies significantly below its market value.

In this way, Ukraine's largest gas producer UGV sold its gas at a price that was more than ten times below the price of imported gas in 2014. Because of the low selling price, UGV was not able to increase production at the rate of private gas producers. Moreover,

the long-term underfunding of capital investments in UGV may lead to a rapid output decline in the coming years.

*Despite the low price of locally produced gas, supplying gas for households is the most loss-making business segment for Naftogaz*

These losses are caused by the obligation of Naftogaz to sell large volumes of imported gas at prices significantly below the cost of this gas. The losses are not covered by the positive result achieved from supplying locally produced gas to households.

In 2014, the situation further deteriorated because of the occupation of Crimea. In previous years, Naftogaz bought marketable gas produced by Chornomornaftogaz at a low regulated price. A portion of this gas was used to supply to households in Crimea. The rest was used by Naftogaz to cover the needs of households in other regions of Ukraine. Because this resource was not available in 2014, Naftogaz was forced to import 1.3 bcm of additional gas in order to meet the needs of households.

DHCs use only imported gas to produce centralized heating for households but the price of this gas is capped below the market. In 2014, the Naftogaz sold this gas more than 5 times cheaper than it had paid to acquire this gas.

Trading locally produced gas results in a positive difference. In 2014, it amounted to UAH 1.8 billion. However, this profit covers only 9% of the losses incurred from selling imported gas for households, which in 2014 amounted to UAH 20.5 billion. In this way Naftogaz lost UAH 18.7 billion from supplying gas for households. These losses could not be fully offset by the profit Naftogaz made supplying commercial users.

Prior to the introduction of the new market rules starting from 1 October 2015, the national regulator set maximum gas prices for other consumers. In most cases, these prices covered the costs associated with the gas purchase but the prices were nonetheless regulated.

Because of the particularities of the interpretation of the Ukrainian legislation by certain controlling bodies, Naftogaz could not sell gas to industrial consumers at a price below the established maximum. This significantly weakened Naftogaz position in the commercial gas market and led to a reduction of the company share in this profitable market sector.

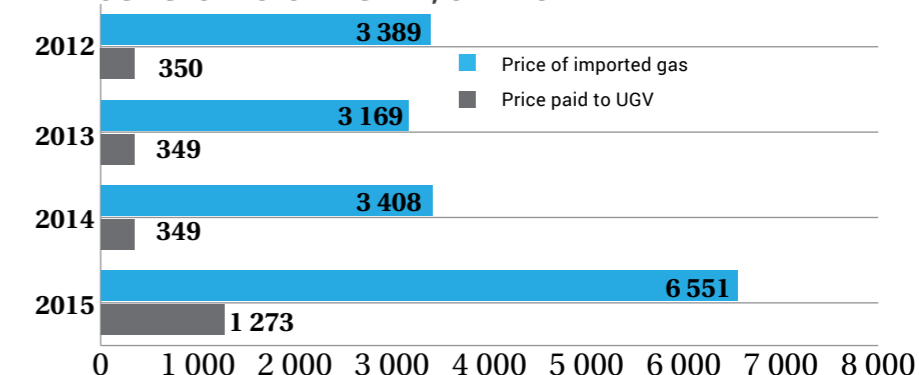
Following the implementation of the new gas market law in October 2015, gas prices for industrial consumers will

no longer be regulated. This change in regulations will allow Naftogaz to compete in this sector on transparent market conditions.

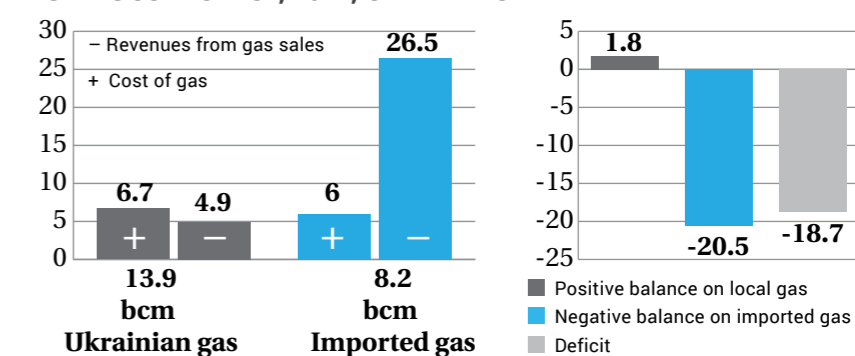
The recent legislative changes help to resolve another distortion in Naftogaz operating framework. In 2014, legislation was in force which required Naftogaz, as the guaranteed supplier, to sell gas to virtually any buyer, regardless of their financial status or payment history.

The regulatory amendments approved in 2015 will allow Naftogaz to assess client financial status, reject signing new contracts with indebted customers and increase the efficiency of debt recovery. These measures are designed to reduce Naftogaz losses, stabilize the company's financial condition and lessen the need for the state support.

**AVERAGE PURCHASE PRICES PAID FOR IMPORTED GAS AND UGV GAS EXCLUDING VAT, UAH/TCM**



**REVENUES AND EXPENSES RELATED TO GAS SUPPLY FOR HOUSEHOLDS\*, 2014, UAH BILLION**



\* excluding adjustment in line with IAS 2

## GAS TRANSMISSION

The Ukrainian gas transmission system (GTS) is one of the most powerful in the world. Its entry capacity is above 288 bcm/year and the exit capacity in the European direction is over 151 bcm/year. Ukraine's GTS links the systems of the neighboring Russia, Belarus, Poland, Slovakia, Hungary, Romania and Moldova, and through them it is integrated into the wider European gas network.

The operator of Ukraine's GTS is Ukrtransgaz, which is 100% owned by Naftogaz. According to the 3<sup>rd</sup> Energy Package and Ukraine's current legislation, the transmission system operator (TSO) must become legally and organizationally independent from other activities in the gas market which are not related to gas transmission. The new gas market law requires for the unbundling of the TSO and Naftogaz by June 2016.

### UKRTRANSGAZ

The pipelines that comprise the Ukrainian GTS are 38.6 thousand kilometers long. The system consists of 72 compressor stations, 1 458 gas distribution stations

and 702 gas pumping units with a total capacity of 5 448 MW.

Ukrtransgaz has implemented an integrated quality management and environmental control system in accordance with ISO 9001, OHSAS 18000 and ISO 14001.

Since November 2014, Ukrtransgaz publishes daily disaggregated data on transported gas volumes at the ENTSOG transparency platform. The data is publicly available at [transparency.entsog.eu](http://transparency.entsog.eu).

In 2014, the volume of gas transited through Ukraine decreased by 25%, from 86.1 bcm in 2013 to 62.2 bcm in 2014. Because of a declining domestic demand for gas, the internal transmission volumes decreased as well, to nearly 40 bcm.

Despite the decline of the transmission volumes in 2014, the capacity utilization of the Ukrainian GTS is higher than that of a number of European gas transmission systems and is comparable to the French TIGF.

Most of the maintenance work is performed in-house. In particular, the internal divisions of Ukrtransgaz:

- operate, maintain and renovate pipelines, compressors and other system components
- diagnose, test and certify the equipment
- construct and install high and low pressure gas pipelines
- conduct research, engineering and design works related to gas transmission and storage

Despite of the large amount of maintenance work done internally, the operating costs of Ukrtransgaz per unit of transmitted gas are below those of neighboring European counterparts.

### GAS IS MEASURED ON ENTRY AND EXIT

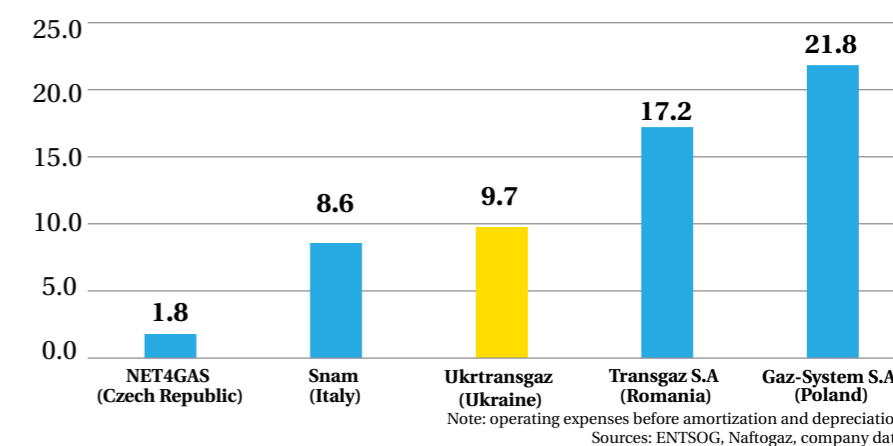
Gas volumes entering the Ukrainian GTS as well as the physical and technical characteristics of this gas are carefully measured. Similarly, the volume and



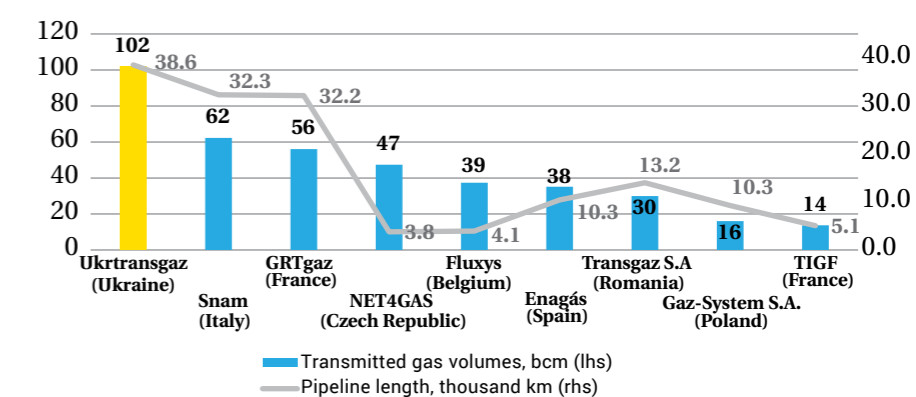
quality of gas is monitored at all points where it exits the Ukrainian GTS and enters the transmission systems of the neighboring European countries. The measurements are carried out at gas metering stations (GMS) at the eastern and the western borders of Ukraine. Each GMS is equipped with high-precision automatic devices for gas flow measurement and quality control.

The measurement of volumes and quality of gas entering the Ukrainian transmission system is conducted by employees of Ukrtransgaz at GMS located in Russia close to the Ukrainian border. Ukraine recognizes delivery of only those volumes of gas which are measured at GMS where Ukrtransgaz has its permanent representatives. This allows for control of the volume and quality of the delivered gas. Because there are no Ukrtransgaz representatives at Platove and Prokhorivka GMS, the quality and quantity of gas allegedly supplied by Gazprom to the occupied territory in eastern Ukraine cannot be verified. Ukraine does not recognize any such alleged deliveries within the framework of the existing gas supply contract between Naftogaz and Gazprom.

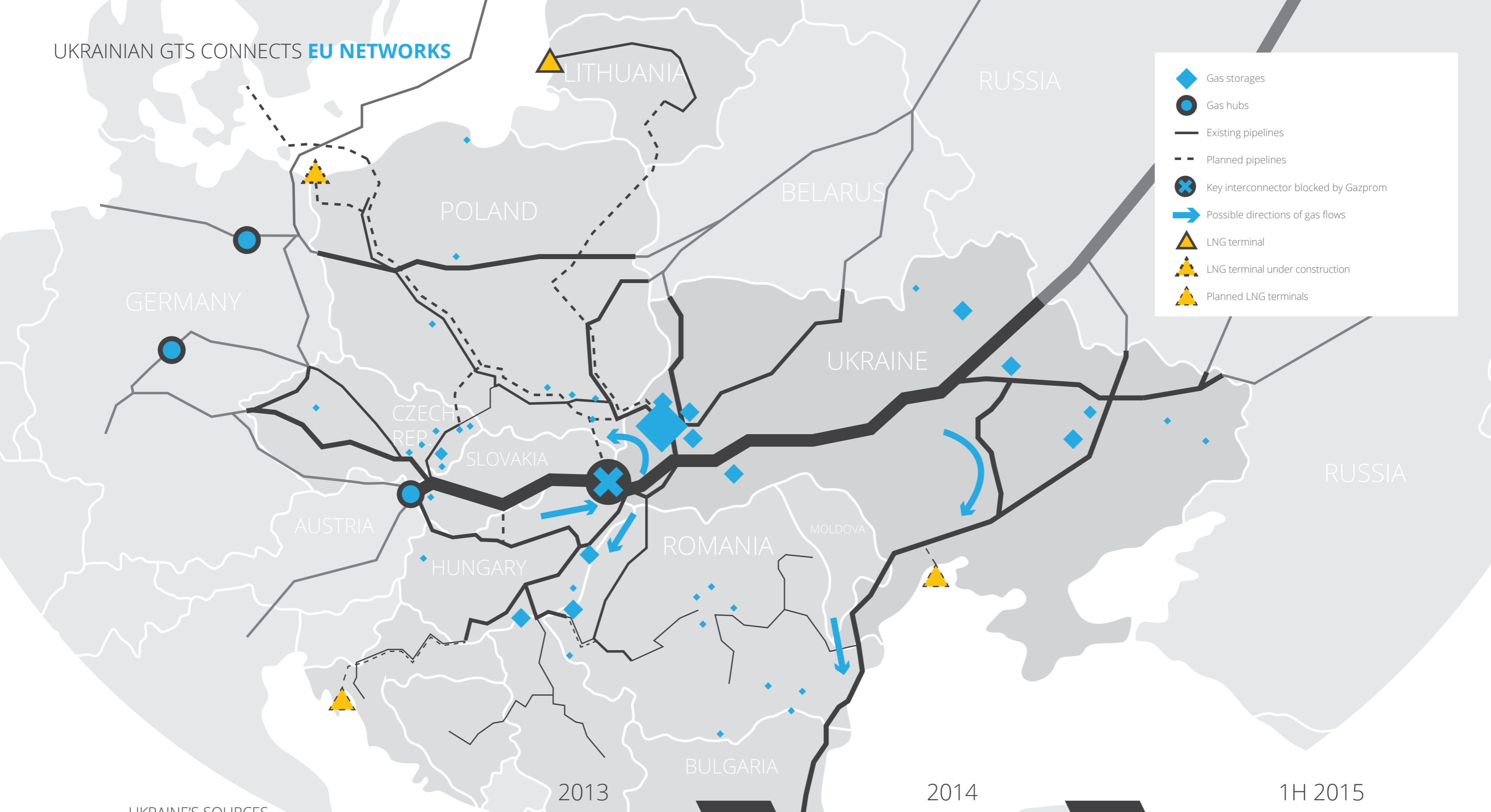
### OPERATING EXPENSES PER VOLUME OF TRANSMITTED GAS, USD/TCM



### CAPACITY UTILIZATION OF SELECTED GAS TRANSMISSION SYSTEMS: PIPELINE LENGTH VS. 2014 TRANSMISSION VOLUMES



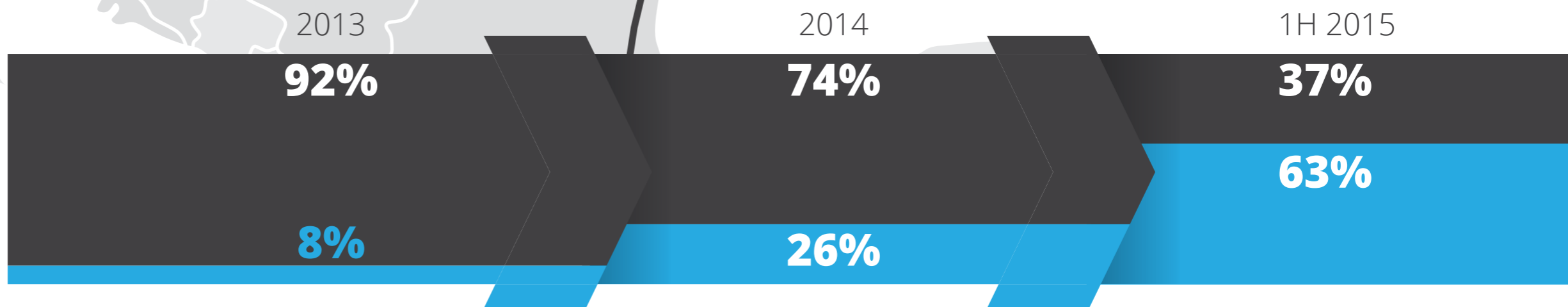
UKRAINIAN GTS CONNECTS EU NETWORKS



UKRAINE'S SOURCES OF IMPORTED GAS

RUSSIA  
single supplier

EUROPE  
several suppliers



### UKRAINE DIVERSIFIES SUPPLY ROUTES OF IMPORTED GAS

Given Ukraine's dependence on gas supplies from Russia and the non-market terms at which this gas was supplied, launching the new powerful gas delivery route via Slovakia was a top priority for the new Naftogaz management team in 2014. The Slovak GTS is the shortest and the most powerful link that connects Ukraine with liquid gas hubs of the Western Europe.

On 28 April 2014, Ukrtransgaz and Eustream, the Slovakian TSO, signed a memorandum of understanding facilitated by the European Commission. The document set out the intention of the parties to enable unrestricted bidirectional gas flows between Slovakia and Ukraine, including physical and virtual gas flows at all pipelines interconnecting the two countries.

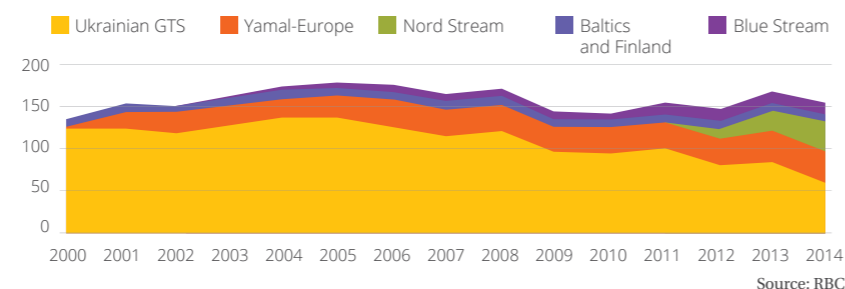
On 2 September 2014, a new gas pipeline for physical supply from Slovakia to Ukraine was launched. Over the next few months, its capacity was increased from the initial 8 bcm/year to 10 bcm/year. Finally, starting from January 2015, the capacity of the new route reached 15 bcm/year. This route can therefore cover up to 90% of Ukraine's annual gas imports needs.

Naftogaz continues to work on creating additional gas transmission routes and expanding those currently used by Ukraine.

In particular, Naftogaz pursues commercial, diplomatic and legal routes to enable full and unrestricted bidirectional gas flows at the interconnection point between Ukraine and Slovakia as well as at the cross-border points between Ukraine and other EU member states.

An expansion of the physical cross border gas transmission capacities is also on the agenda. In December 2014, Ukrtransgaz and GAZ-SYSTEM S.A., the Polish TSO, signed a cooperation agreement to integrate the gas transmission systems of the two countries. The implementation

### RUSSIAN GAS TRANSMISSION ROUTES TO EUROPE, BCM, 2000-2014



of the agreement would result in an increase of gas flow capacity from Poland to Ukraine by 8 bcm/year to 9.5 bcm/year. The agreement also covers the intention of the parties to store European gas in Ukraine's underground gas storage facilities and to deliver this gas to consumers in the EU.

### GAZPROM'S BYPASS PIPELINES THREATEN EUROPEAN SECURITY OF SUPPLY

For almost 50 years the Ukrainian gas transmission system has been the main route for transporting natural gas from Ukraine and Russia to European countries. In the 1980s, new transit pipelines were built to transport gas from Western Siberia and Central Asia to Central and Eastern Europe. The Ukrainian gas transmission system has a low rate of accidents is robust and flexible. It remains the optimal route for supplying gas from Russia and Central Asia to Europe and Turkey.

In December 2014, Ukrtransgaz signed loan agreements with the EBRD and the EIB for a total amount of EUR 300 million earmarked for the modernization of the Ukrainian section of Urengoy-Pomary-Uzhhorod pipeline. This funding will help to improve the energy efficiency of this key component of Ukraine's gas transmission system, and will further increase the competitiveness of this route.

Driven by political rather than economic considerations, Russia has been reducing the volume of gas transmitted to the

EU through Ukraine since 2011. To this end, Gazprom built the bypass route Nord Stream and continues to attempt two other projects that would do little more than duplicate the capacity of the Ukrainian GTS. Russia explains the alleged need to build excessive gas transmission routes by the need to diversify European gas supplies. However, in the same time, it has effectively blocked the supply of Central Asian gas to Ukraine and the EU.

There is no doubt that the construction of bypass gas pipelines reduces the importance of traditional transit countries for Russian gas, such as Ukraine, Slovakia and Poland.

However, the main threat of the excessive transmission capacity from a single source is that European buyers are not able to choose their preferred delivery route for Russian gas. If these Gazprom controlled pipelines are built, Russia will have a stronger negotiating position and will be able to command terms to its customers.

The Ukrainian gas transmission system is a direct, reliable and competitive route for delivering Russian gas to the EU. It is also the only delivery route for Russian gas to the EU that is not controlled by Gazprom.

### UNLOCKING THE INTERCONNECTORS BETWEEN UKRAINE AND THE EU WILL INCREASE SECURITY OF SUPPLY IN THE REGION

Decades ago, Soviet gas was sold to Europe through a purchase agreement made with the Soviet state company.

Accordingly, buyers received the purchased gas at the USSR border. After the collapse of the Soviet Union, Europeans started buying gas from Russia, but continued to receive it, as before, on the border of the former Soviet Union — that is, on Ukraine's border with the EU. Therefore, the European buyers of Russian gas do not control the gas they have purchased until it exits Ukraine.

Gazprom does not provide Ukraine with the so-called shipper codes, the data about the individual gas shipments that are transported through Ukraine. At the gas metering stations on Ukraine's western border the entire volume of gas is transferred to Gazprom's subsidiary Gazprom Export. This company then transfers the gas to the TSOs of the neighboring countries, revealing the shipper codes to them.

In this cooperation with the European TSOs, Gazprom performs a number of important TSO functions, which violates the EU energy legislation. The existing arrangement hinders the cooperation between operators of the neighboring countries of the Energy Community.

### The existing scheme at Ukraine's western border artificially obstructs bidirectional cross-border gas flows between Ukraine and the EU, including virtual reverse flows

Currently, European clients of Gazprom cannot choose the delivery route for gas they purchase from Russia. They are also unable to use gas they bought while it crosses Ukraine. This deprives the European companies of the opportunity to benefit from the largest underground storage facilities in Europe and limits their ability to trade in Ukraine.

Naftogaz aims to minimize the influence of politics both in the domestic gas market and its relations with foreign partners. To achieve this goal, the company works on bringing its relations with neighboring TSOs into accord with the 3<sup>rd</sup> Energy Package.

### Launching unobstructed bidirectional cross-border gas flows between Ukraine and the EU will enable gas trade between the Western Europe and the countries of Central, Southern and Eastern Europe

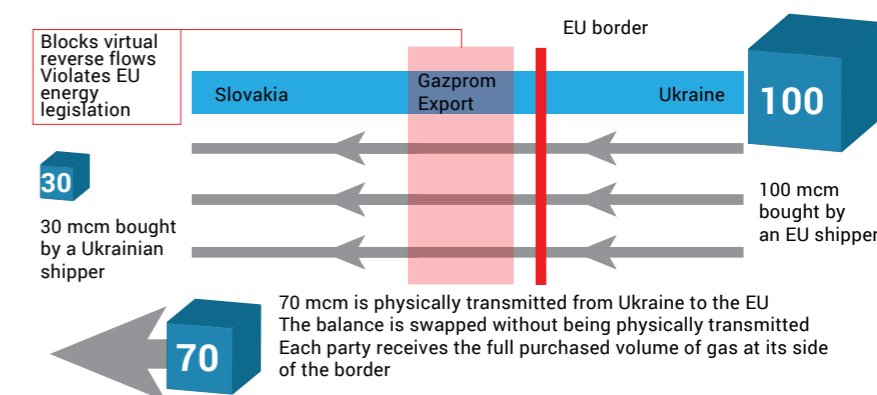
In particular, Bulgaria, Greece, Romania, Hungary, Bosnia, Macedonia and Serbia will be able to buy gas in the Western European market. Suppliers from Germany, France, Norway and other countries will have access to European markets now dominated by Gazprom. The implementation of this project does not demand any additional investment in infrastructure: the Ukrainian GTS is technically prepared to function in this manner. This solution does not require European consumers to make any changes to their existing contracts with Gazprom.

In May 2015, Ukrtransgaz and FGSZ, the Hungarian TSO, signed a direct interconnection agreement. It was the first agreement between the TSOs of Ukraine and an EU member state which fully complies with the EU energy legislation. This agreement is the first step for Ukrtransgaz to establish the comprehensive and unobstructed cooperation with its neighboring TSOs.

Direct interconnection agreements are the only legal basis for cooperation between TSOs in the Energy Community. On the basis of these contracts, the neighboring TSOs exchange information on gas flows, their direction, volume, timing, gas owners and recipients, etc. In the absence of the standard interconnection agreement, this information is not exchanged. Naftogaz continues preparations to sign similar agreements with Slovak, Polish and Romanian TSOs.

In addition to carrying out commercial and diplomatic negotiations on this issue, in October 2014 Naftogaz initiated proceedings with the Arbitration Institute of the Stockholm Chamber of Commerce on its current gas transmission contract with Gazprom. Naftogaz requests that the relations between the parties be brought into compliance with the national legislation that implements the 3<sup>rd</sup> Energy Package in Ukraine and with the international obligations of the country as a member of the Energy Community.

### UNBLOCKING THE INTERCONNECTOR ENABLES VIRTUAL GAS FLOWS



## UNDERGROUND GAS STORAGE

Ukrtransgaz operates Europe's most powerful system of underground gas storages (UGS) which comprises ten depleted gas fields facilities and two aquifer facilities with a total active capacity of nearly 31 bcm. The total capacity of the facilities operated by Ukrtransgaz equals to nearly a quarter of the EU-28 total UGS capacity.

An additional underground gas storage facility with the capacity of 1 bcm is located in Crimea and was operated by Chornomornaftogaz prior to the occupation of the peninsula by Russia.

In May 2014, Ukrtransgaz started to provide disaggregated data on gas balances in its UGS facilities at AGSI+, the transparency platform operated by Gas Infrastructure Europe. The information is updated daily and is available at [transparency.gie.eu](http://transparency.gie.eu).

Because the total capacity of Ukraine's UGS facilities is so large, the country can offer almost 15 bcm of spare capacity to European consumers.

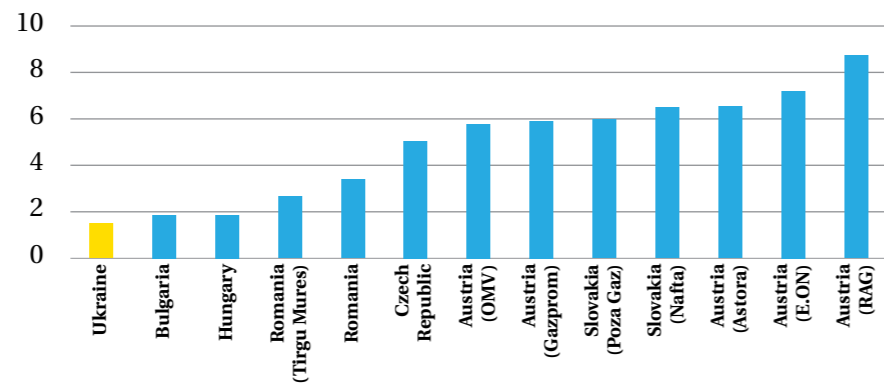
Ukrtransgaz offers gas storage services for both gas suppliers and consumers. Five major facilities are located at the western border of Ukraine at the key intersection of gas pipelines which connect Poland, Slovakia, Hungary and Romania. Most of gas delivered from Russia to the Western Europe passes this strategic pipeline intersection.

Ukraine has proposed to use this powerful gas transmission and storage

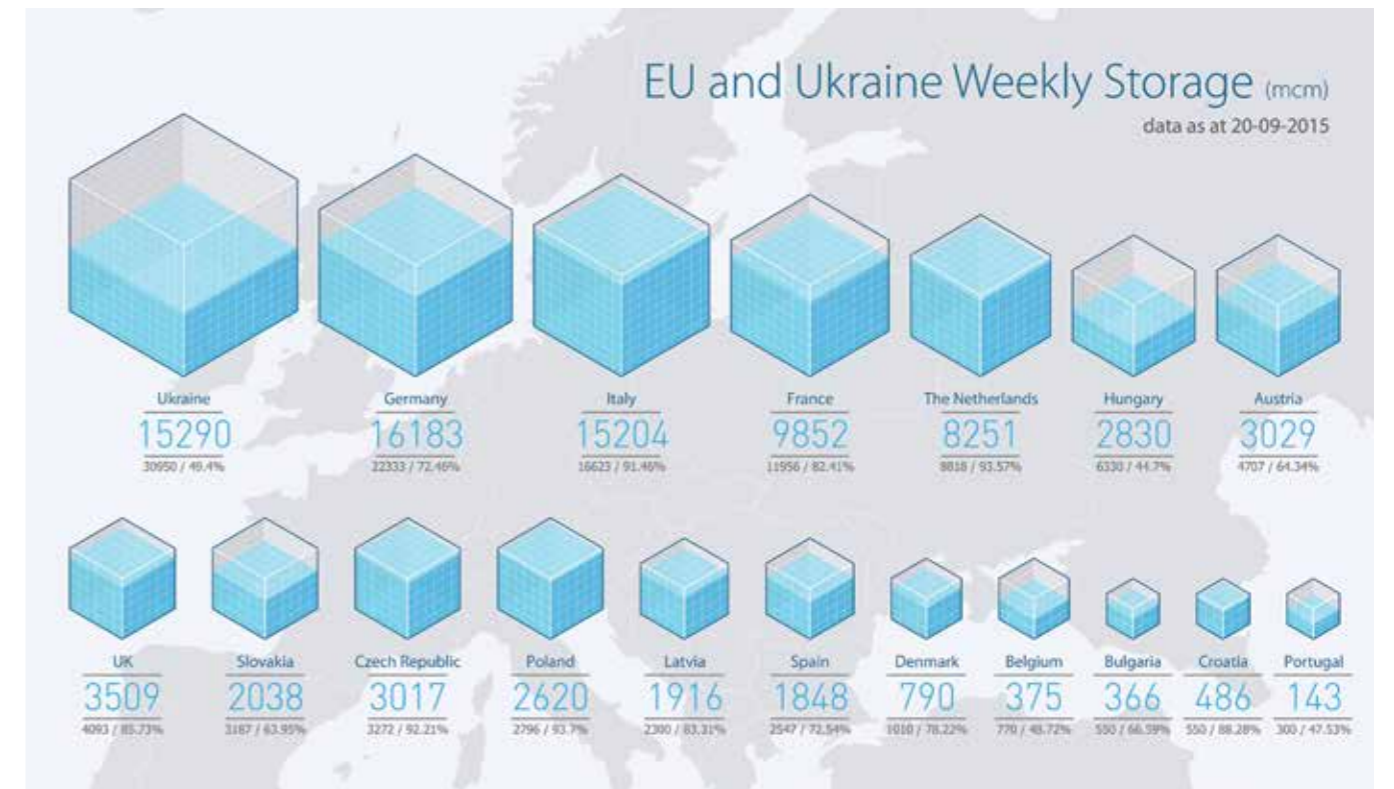
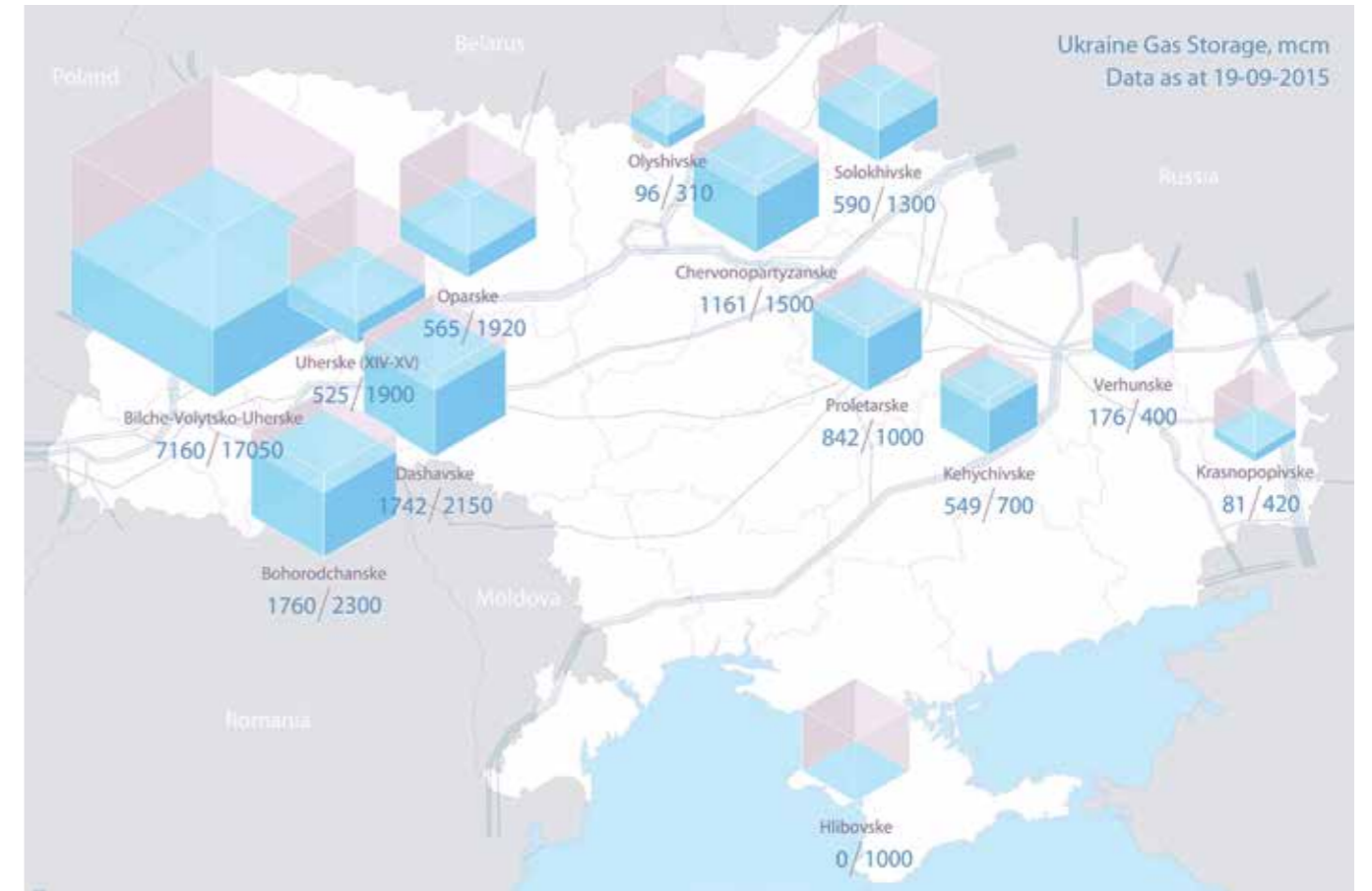
agglomerate as a foundation for an Eastern European gas hub. This project is being discussed with various stakeholders, and is included into the cooperation agreement between Ukrtransgaz and GAZ-SYSTEM S.A. signed in 2014.

Ukraine offers not only the largest storage capacity but also the most competitive storage rates in Europe.

### GAS STORAGE COST IN EUROPEAN UGS FACILITIES, 2012, EURO/MWH



Source: REKK, company and regulator data



## GAS PRODUCTION

In 2014, Ukraine ranked fourth in Europe by volume of produced gas. Ukraine also ranks third in Europe, after Norway and the Netherlands, by proved gas reserves. By increasing the efficiency of gas consumption and the volume of its production, Ukraine has the opportunity to eliminate the need to import gas completely.

However, to extract gas abundant in the Ukrainian subsoil, gas producers have to actively explore deposits, drill new and intensify existing wells. Each well has its own capacity and is gradually depleted. Therefore, keeping production at a stable level requires constant investment.

Selling prices for gas produced by state-owned companies in Ukraine were historically capped below market rates. Setting discriminating price limitations for state-owned gas producers served as an additional tool to cover the deficit resulting from supplying imported gas to households for less than its market value.

As a result, major gas producers in Ukraine, including Ukgasvydobuvannya, were not able to finance their investment program in full, which led in turn to a gradual reduction in output by state-owned companies. In many cases, the technologies to which these companies are constrained are morally and technically obsolete, and the exploration activities have slowed down.

*State companies lose gas production market share to private ones, which operate in more liberal conditions and can sell their gas at market rates*

The underinvestment of production programs is reflected in the company financial results. Compared to other gas producing companies both in Ukraine and in other countries, Naftogaz invests much less capital per unit of extracted product.



### UKRGASVYDOBUVANNYA (UGV)

UGV is the largest gas production company in Ukraine. It also ranks second in oil and condensate production and is the largest producer of liquefied petroleum gas (LPG) in the country.

Proven oil and gas reserves of UGV amount to 1 606 boe (including 1 579 boe of proven gas reserves). By this parameter the company is one of the largest gas producers in Europe.

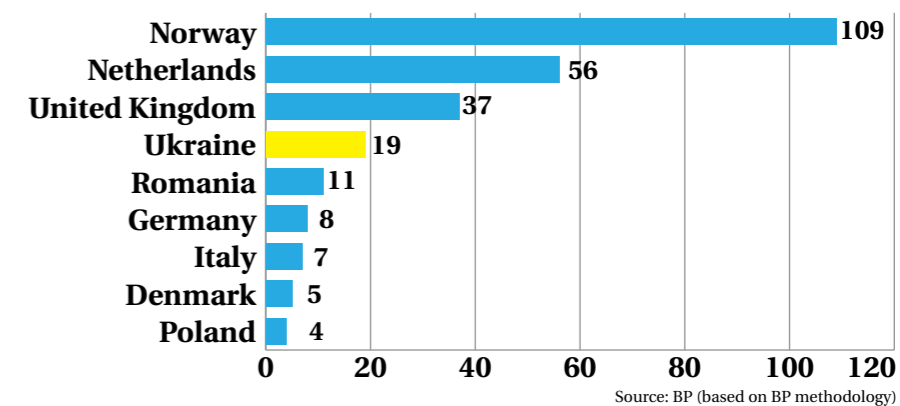
As of the beginning of 2015, the company's operational assets included 2 441 gas wells and 194 oil wells, and 82 drilling rigs. The company develops over 130 fields.

The depletion of the company's initial recoverable reserves at existing fields is estimated at almost 72% in gas, 21% in oil and 63% in condensate (for more information on non-gas business segments of UGV, see section *Extraction of crude oil, condensate and LPG*).

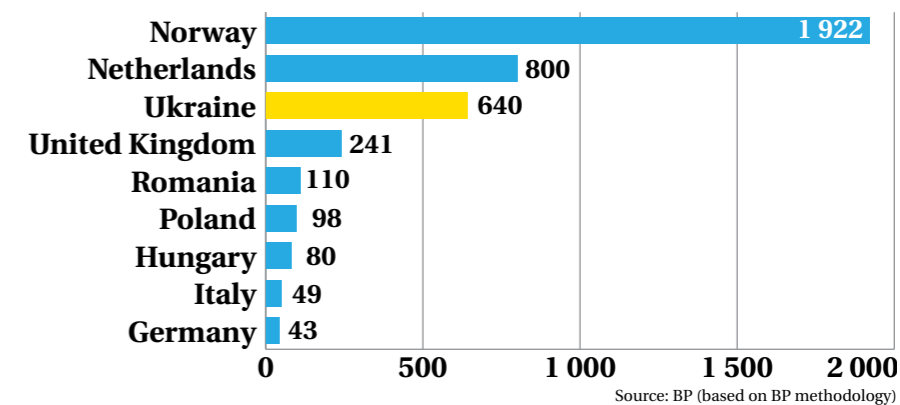
#### Financing of exploration, drilling and intensification

For a number of years, UGV was unable to fund exploration, drilling and intensification operations at required levels.

### GAS PRODUCTION VOLUMES IN EUROPE, 2014, BCM



### PROVEN GAS RESERVES IN EUROPE, BCM



Consequently, the company estimates that in 2015 it will be able to produce at least 0.4 bcm of gas less than in 2014. Purchasing this volume of gas abroad will cost Ukraine nearly UAH 3 billion. This amount is half of what UGV received for 13.4 bcm of gas it sold to Naftogaz in 2014 at prices set by the state (for more detail see section *Market-based pricing for Ukrainian gas*).

The company management expects to be able to raise sufficient investment as retail prices are gradually liberalized by April 2017.

**Taxation and decline in oil prices**

In March 2015, the Verkhovna Rada adopted the Law "On Amendments to the Tax Code of Ukraine." This decision raised royalty rate for UGV from 20% in 2014 to 70% of revenue in 2015. The royalty hike was adopted to provide the government with a guaranteed source for financing utility subsidies following the substantial gas price increase for households.

Under the new regulations, UGV receives UAH 477/tcm net of royalties (nearly USD 22/tcm) for its gas. This amount is hardly sufficient to cover the company's operating expenses and rules out capital investments in the development of new deposits.

The company's finances were further negatively affected by the decline in oil prices during 2014-2015. The oil segment is unregulated, and UGV income from its non-gas business is used to cover the company's administrative and financing expenses.

The combination of the regulated gas prices, the increased royalty rate and the decline of prices for oil and petroleum products results in an extremely challenging operating environment for UGV.

**Other factors influencing operations: special permits, land allocation, losses related to military actions**

The pace of exploration activities at UGV also depends on obtaining new special

permits (licenses) for subsoil use. From 1999 through 2007, the company received an average of 14 new licenses per year. During the period of 2007 to 2013 the company obtained only four special permits.

Only in 2014 did the number of new licenses start to increase. Last year UGV received nine new licenses, and in 2015 it expects to receive 21 licenses.

The exploration drilling is further complicated by the lengthy and complicated land allocation procedures for gas companies which have obtained special permits for subsoil use. UGV and other gas producers make efforts to promote a rationalization of the land allocation procedure for permit holders.

Because of the armed conflict in Donbas, UGV lost gas production facilities with a total capacity of nearly 200 mcm/year.

**Estimated production volumes in 2016**

If UGV is not able to secure investments in drilling new wells and intensification of existing wells, the amount of gas extracted in 2016 will be set to fall. The rate of this reduction is estimated at 1.2 bcm of gas per year.

UGV has launched a comprehensive performance audit of its wells and fields in order to determine the most cost- and time-efficient ways of increasing the output. UGV intends to use the results of this research to defend minimum sales prices that would enable the company at least to stabilize the output.

According to the preliminary estimates, the minimum amount UGV should retain, after the deduction of all taxes and subsoil charges, is approximately UAH 3 000/tcm (nearly USD 135/tcm). The resulting revenue stream should enable the company to secure necessary funding for its urgent investment programs.

**Future development**

In June 2015, Naftogaz appointed a new management at UGV. The new

team's strategy focuses on two primary goals. Firstly, they should develop and implement measures to stabilize gas production and establish conditions for output growth. Secondly, they should modernize UGV, creating a transparent and efficient company able to attract international investments.

The new management team pursues the following goals:

- **Stabilize and gradually increase gas production.** This task includes renovation of existing fields and wells, intensification of the extraction, hydro-fracturing, installation of new compressor stations as well as active exploration of new deposits
- **Conduct operational diagnostics.** A comprehensive diagnostic study is currently ongoing to identify the most efficient modernization projects in terms of output increase per unit of invested funds
- **Upgrade efficiency measurement policy.** Success of extraction activities should be measured by the effect on gas volumes extracted relative to the costs incurred, rather than on the number of drilled meters
- **Implement new transparent procurement procedures.** Procuring goods and services in a transparent and cost efficient manner in line with international best practices is a matter of survival for the company given its current resource constraints. Making steps to implement this goal, UGV has recently joined the newly developed e-procurement system ProZorro.
- **Improve financial management.** The work is in progress to enable the preparation of IFRS-based financial statements on a quarterly basis. Implementation of this goal also requires standardization and unification of accounting policies across the UGV group, conducting a revision of the group's assets and liabilities, as well as reforming

financial management system within UGV

- **Maximize income from non-gas segments.** Petroleum products and LPG sales account for approximately 30% of the group's revenues
- **Promote deregulation and necessary legislative changes.** UGV intends to initiate amendments to the Land Code to streamline land allocation procedures for holders of special permits and tackle corruption related to the land allocation
- **Raise investments to modernize production.** Realization of this goal is contingent on the ongoing price liberalization for households and the amendments to laws regulating royalty rates. However, the preliminary analysis and appropriate transformation of UGV internal business practices need to be started in advance
- **Build a strong and qualified team.** UGV focuses on upgrading personnel recruitment and development policy, supporting relevant research, developing a system of internal communications, creating a full-scale research division, which would i.a. analyze the competitiveness of prices for goods and services offered to UGV
- **Increase operational safety.** The group makes efforts to improve informational security and workplace safety at its industrial sites.

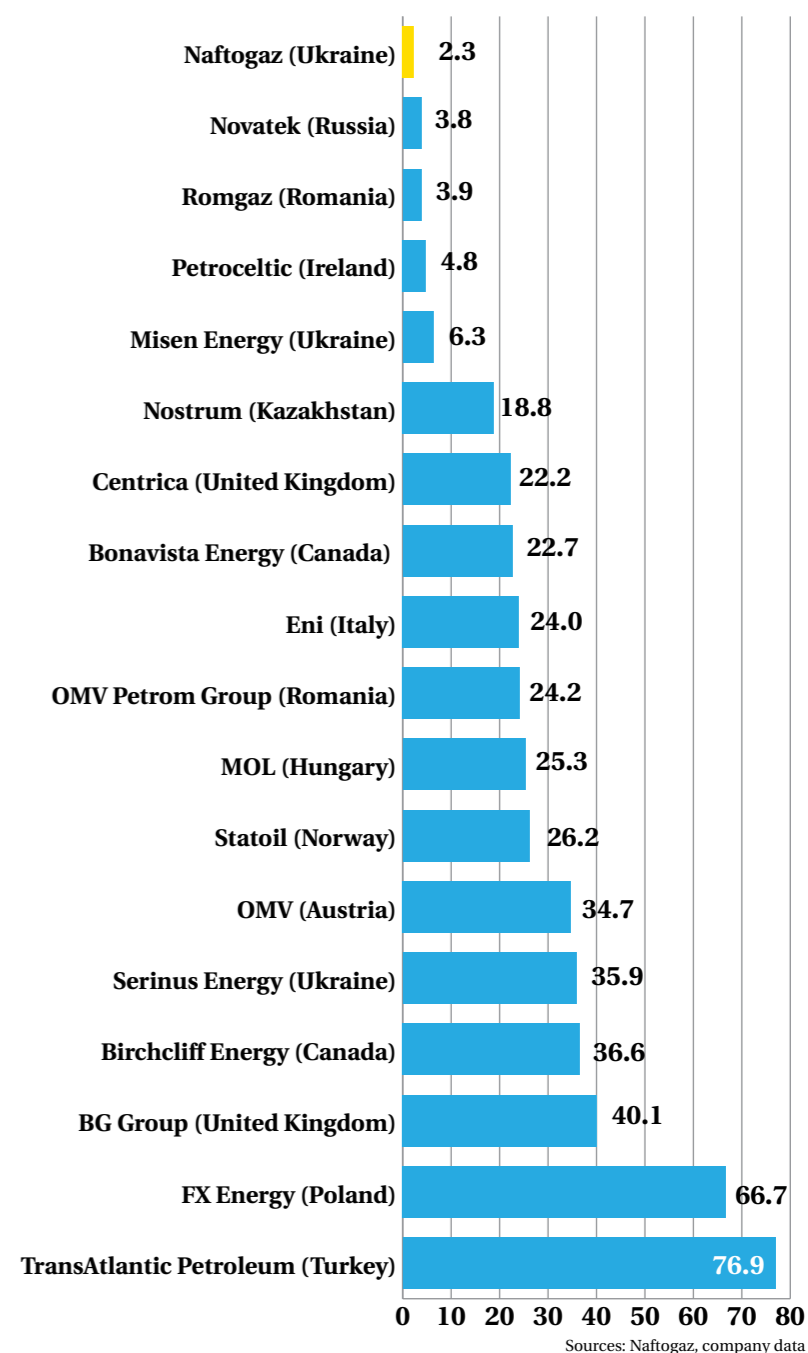
**CHORNOMORNAFTOGAZ**

In 2014, Naftogaz lost control over the assets of Chornomornaftogaz in Crimea because of the Russian occupation of the peninsula. It was expected that the company produces approximately 2 bcm of gas in 2014. Proven oil and gas reserves of Chornomornaftogaz as at 31 December 2013 were estimated at almost 200 million boe, or approximately 10% of total proven reserves of Naftogaz.

**UKRAVTOGAZ**

The company produces compressed natural gas and distributes it via its

**CAPITAL INVESTMENTS, USD PER PRODUCED BOE**



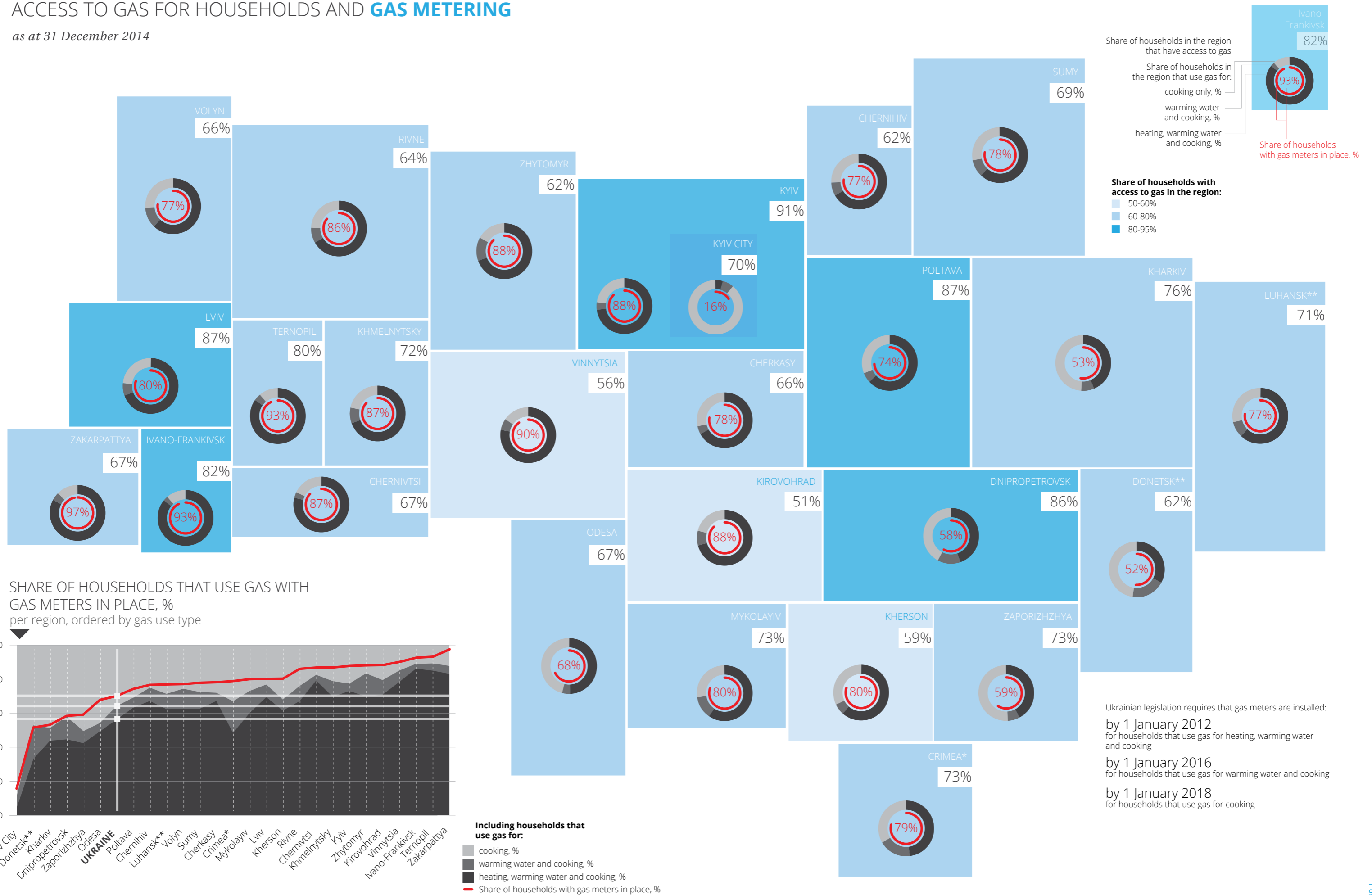
network of 90 filling stations (including 9 stations located in currently occupied territories). Naftogaz owns 100% of Ukravtogaz.

In 2014, the company sold approximately 97 mcm of gas as fuel for motor vehicles, which represents nearly a third of compressed gas sales in Ukraine, and

approximately 0.2% of the country's total gas consumption. The sales volume declined by 26% in 2014 compared to 2013. The UAH-denominated market prices for gas used by Ukravtogaz increased sharply in 2014 and have negatively affected the competitiveness of compressed gas compared to other fuel types.

# ACCESS TO GAS FOR HOUSEHOLDS AND GAS METERING

as at 31 December 2014



\*As at 1 March 2014  
\*\*As at 1 July 2014

Sources: Ministry of Energy and Coal Industry, Ministry of Regional Development, Construction and Housing and Communal Services, State Statistics Service, regional gas distribution and supply companies, Naftogaz

## GAS DISTRIBUTION AND RETAIL SUPPLY

Following the privatization of regional gas distribution and supply companies (oblgazes) Naftogaz is no longer a significant player in the gas distribution market. Naftogaz continues to own minority stakes in a number of oblgazes (25%+1 share or less, except for Donetskoblgaz where it owns 39%). The only gas distribution and supply company consolidated in Naftogaz group is Kirovohradgaz, where Naftogaz owns 51% of shares. The share of Kirovohradgaz in the gas distribution market was less than 1% in 2014.

Prior to 2011, Gas of Ukraine (a Naftogaz subsidiary) sold gas purchased by Naftogaz to end consumers. Today, Gas of Ukraine's main function is debt recovery. As of the end of 2014 the total amount of debt of consumers to Gas of Ukraine including the accumulated fees and penalties amounted to nearly UAH 10 billion.

Now Naftogaz sells gas directly to the following consumers:

1. District heating companies and heat and power plants for:

- producing heat for the households
- producing heat for the public sector
- producing electric power

2. Industrial consumers

3. Transmission and distribution system operators to cover their operating needs

In addition, Naftogaz sells gas to the oblgazes that then in turn sell this gas to:

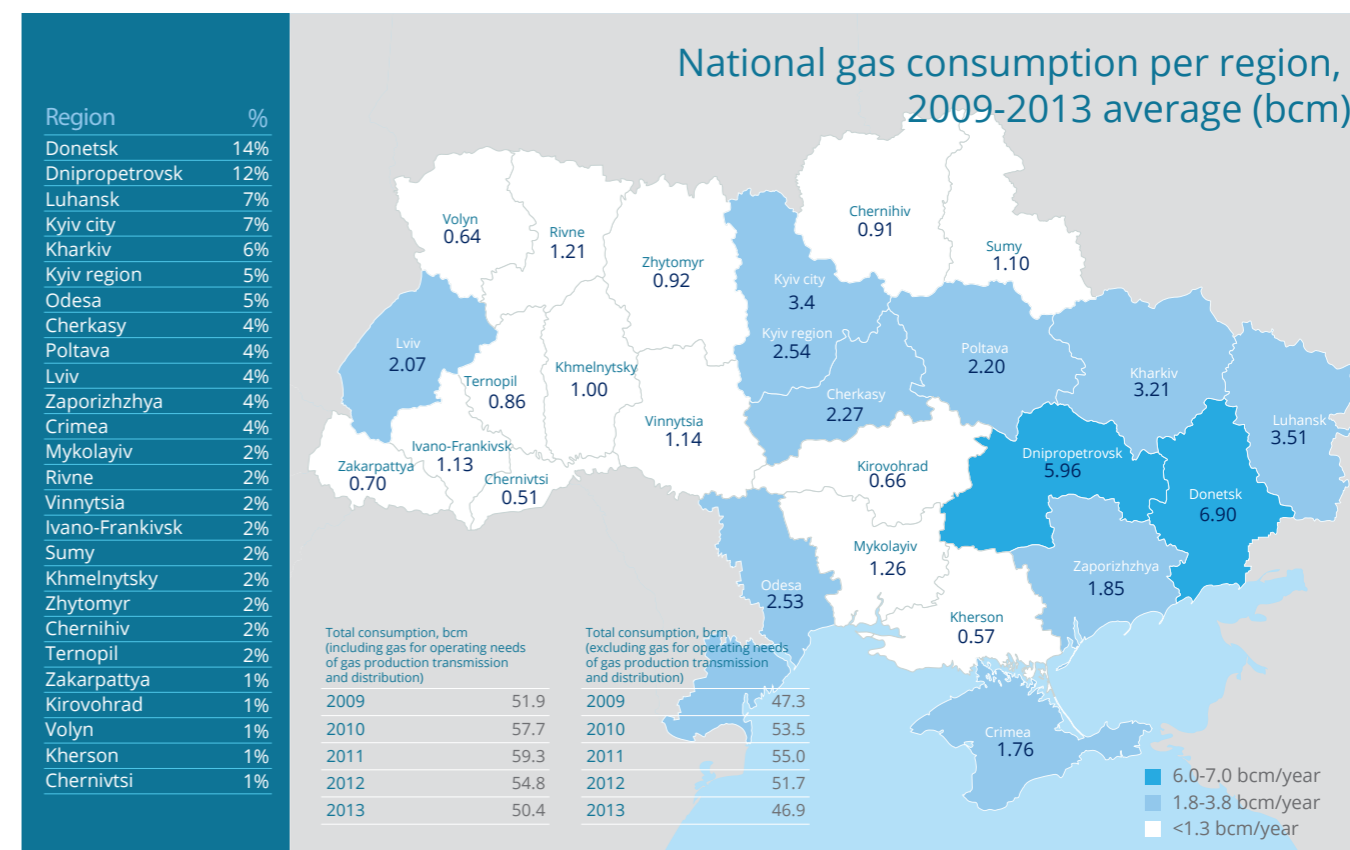
- Households
- Public sector and religious organizations
- Certain industrial consumers and district heating companies

Other private gas traders supply gas to industrial consumers directly as well.

The Ukrainian legislation required the regional gas distribution companies to create new companies that will supply gas to consumers and unbundle this business by 1 July 2015. The oblgazes will continue to deliver gas to end consumers. New supply companies can be part of vertically integrated companies, but should be legally and organizationally separated from functions related to the distribution of gas.

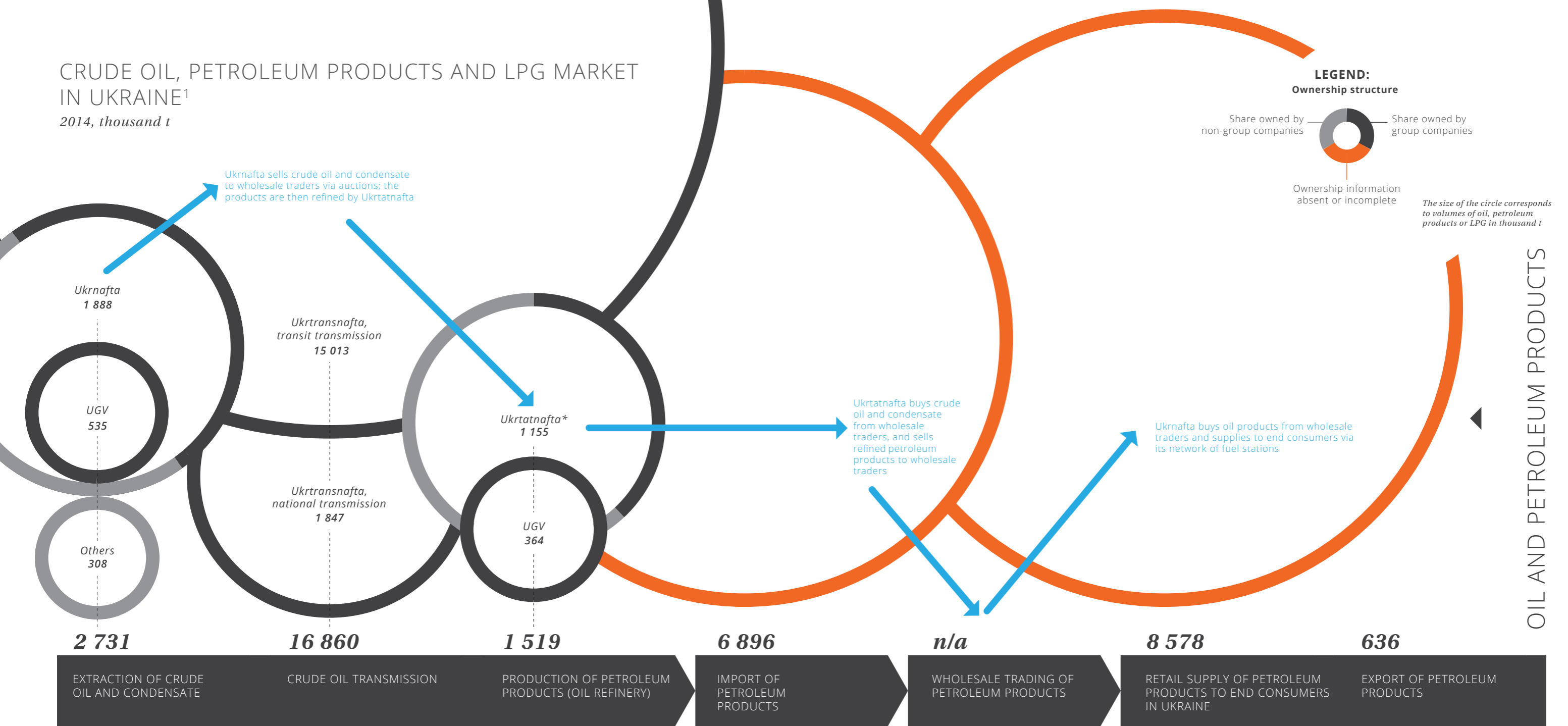
This unbundling was introduced to create conditions that would encourage competition among retail suppliers of gas. The new legislation enables Ukrainian consumers to buy gas from any supplier they choose. The liberalization of gas prices for households expected to complete in April 2017 is going to bring competition and improved level of service into this market.

Naftogaz is considering an entry into the market of retail supply for households in the future.

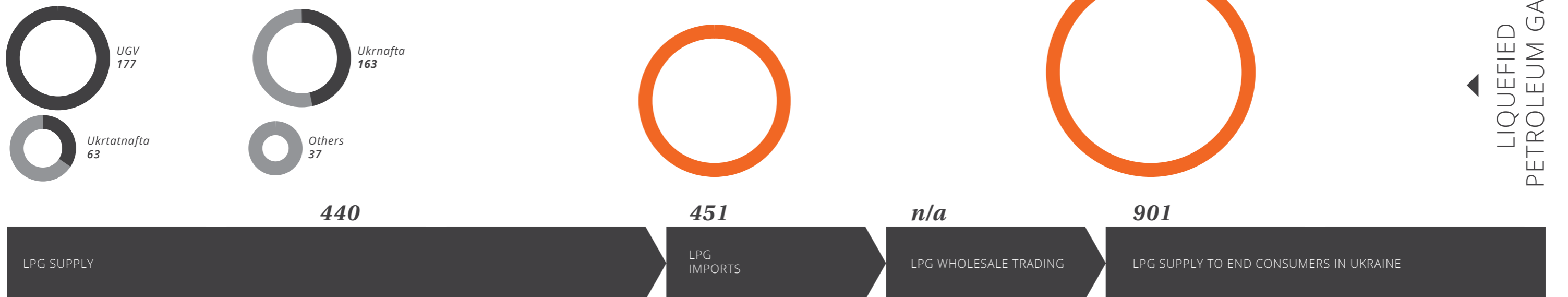


# CRUDE OIL, PETROLEUM PRODUCTS AND LPG MARKET IN UKRAINE<sup>1</sup>

2014, thousand t



\*Total capacity at Kremenchuk refinery:  
**18.6 thousand t**  
of crude oil per year

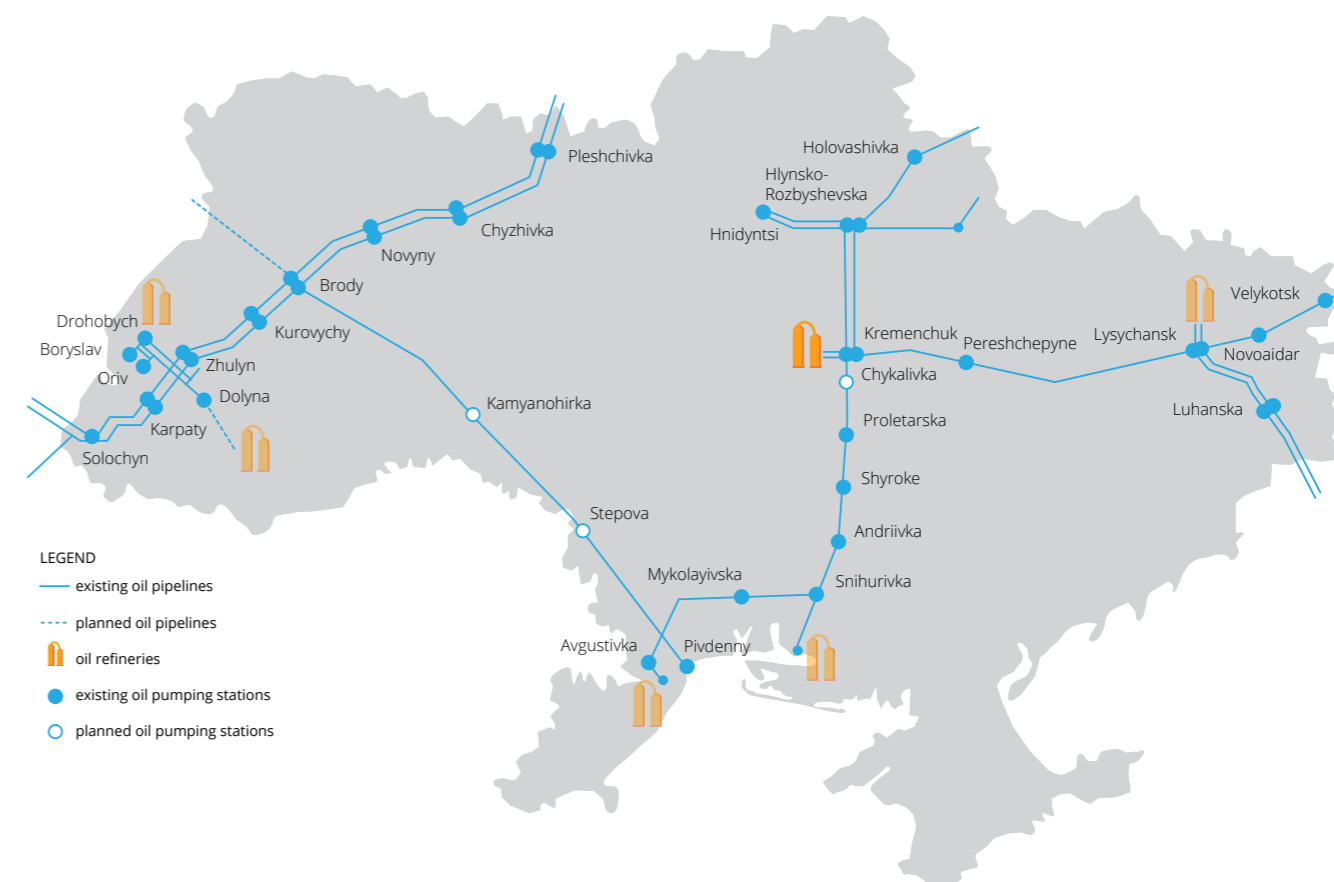


<sup>1</sup>Excluding Crimea;  
n/a – data not available

Sources: Naftogaz, Ministry of Energy and Coal Industry, State Statistics Service, specialized media, company data, Ukrainian LPG association

## CRUDE OIL TRANSMISSION

### OIL TRANSMISSION SYSTEM OF UKRAINE



### UKRTRANSNAFTA

Ukrtransnafta operates the 4 700 km long Ukrainian oil transmission network. The company is a 100% subsidiary of Naftogaz. Ukrtransnafta comprises three affiliates: Prydniprovsky Main Oil Pipelines (central and eastern regions of Ukraine), Druzhba Main Oil Pipelines (northern and western regions of Ukraine), as well as Southern Main Oil Pipelines (southern regions of Ukraine).

Ukraine's oil transmission system delivers Russian oil to Central and Western Europe. Transit deliveries account for



approximately 90% of transported volumes. In addition, the oil transmission network transports locally produced crude oil from oil fields to the Kremenchuk Refinery. This segment accounts for nearly 10% of the volumes transmitted in 2014.

#### KEY OPERATING CHALLENGES

##### Decline in demand for oil transmission services

The biggest challenge for Ukrtransnafta is the 50% decline in demand for oil transmission services in recent years, as well as the failure of the previous management

of the company to generate a timely and adequate response to these systemic changes in the operating environment.

Since 2009, the volume of oil transported through the Ukrainian system decreased from almost 40 million t to nearly 17 million t, including the oil transit, which decreased from 29 to 15 million t over this period. The drastic decline in transit volumes was a result of the redirection of export flows of Russian and Kazakh oil toward alternative transmission routes.

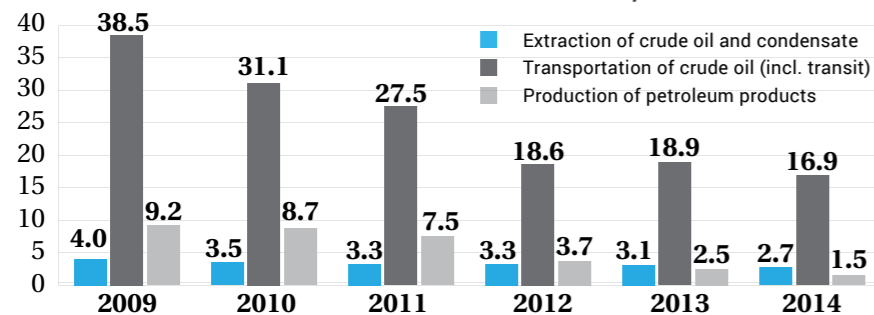
Russia has adopted and implemented a strategy aimed at minimizing the role

of transit countries in its oil business. Instead, Russia focuses on promoting the development of its own networks and maximizing use of marine export terminals. The consequences of this strategy have already been felt by transit countries such as Belarus, Poland, Ukraine and Lithuania.

The internal demand for oil transmission services contracted as well primarily because of the reduction of oil production and refinery levels in Ukraine. Currently only the Kremenchuk Refinery continues to operate in Ukraine, and only 10% of its capacity was used in 2014.

The oil refinery market in Ukraine was hit by the competition from Russian and Belarusian refineries. Belarusian refineries process Russian Urals oil and achieve higher level of refining depth compared to most facilities in Ukraine. In addition, Russian and Belarusian refineries enjoy favorable customs conditions. Before the customs restrictions were lifted by Ukraine in 2005, Ukrainian refineries processed more than 22 million t of crude oil per year, and a portion of produced petroleum products was exported.

### VOLUME OF PRODUCTION AND TRANSMISSION OF CRUDE OIL AND OIL PRODUCTS IN UKRAINE MILLION T, 2010-2014



Source: Ministry of Energy and Coal Industry of Ukraine

Ukrtransnafta and the Ukrainian refinery businesses were so far unable to effectively address the systemic changes in the market. All but one oil refineries in Ukraine suspended their operations. More than 1300 km of oil transmission pipelines were transferred to the standby mode. More than 600 thousand t of technological oil was pumped out of the pipelines. In particular, one of the two lines of the Mozyr-Brody pipeline, Ukraine's primary oil transit route, was put on hold.

#### Insufficient funding of capital investment programs

Another challenge for Ukrtransnafta is the insufficient funding of the required maintenance works to ensure safe and reliable operation of the network. This situation continued for several years before the management was changed in 2015.

Instead of investing in the system maintenance and repair, the previous management placed the company cash in term deposits in banks.

During the past years, 22 oil reservoirs with a nominal capacity of 225 tcm were put on standby. With these reservoirs not ready for operation, in 2014 and 2015 the previous management of Ukrtransnafta concluded contracts for storage of the company's technological oil at the facilities of third parties at prohibitively high costs. The outcomes of the past strategy resulted in unjustified expenses for Ukrtransnafta.

#### Transparency and operational efficiency issues

An important issue the new team of Ukrtransnafta has to deal with is making the company more transparent and accountable to regain confidence of the company's partners, potential employees, the public and other stakeholders. In particular, Ukrtransnafta intends to initiate regular preparation of IFRS-based financial statements audited by a reputable international firm. The company also needs to deal with retaining its most qualified personnel and rebuilding its reputation of an attractive employer.

#### CURRENT GOALS

In the spring of 2015, Naftogaz succeeded in changing Ukrtransnafta management. The new management is addressing the challenges that the company now faces and aims to achieve a number of short- and long-term goals:

##### Analyze opportunities to increase demand

- Develop and adopt Ukrtransnafta strategy till 2020 to reflect changes in the operating environment
- Increase the oil transit capacity to the EU by re-launching the Mozyr-Brody pipeline section which is currently in standby mode
- Market Ukrtransnafta transit capacities to potential clients outside of Ukraine

#### Ensure secure and stable system operation

- Develop and approve an investment plan for Ukrtransnafta till 2020
- Complete the renovation of oil reservoirs with the capacity of 110 tcm
- Return technological oil from storages back into the pipelines
- Promote legislative changes to improve protection of the oil transmission network from unauthorized access
- Develop and implement investment program to improve safety and security at oil facilities, including technologies for early detection of unauthorized access

#### Improve operational efficiency

- Initiate the publication of annual IFRS financial statements
- Develop and adopt new tariff setting system for oil transmission, improve the efficiency of internal oil transportation routes
- Suggest changes to the legislation necessary to improve the operating environment of the company
- Raise the level of public confidence through regular and timely communications
- Develop and implement a modern personnel selection and development policy

#### UKRSPETSTRANSNAFTA

The company transports liquefied petroleum gas (LPG) by rail using its own railway wagons from manufacturers to consumers in Ukraine and abroad. Ukrspetstransgaz is 100% owned by Naftogaz.

In 2014, the company shipped 240 thousand t of liquefied gas, which is 28% less than in 2013. The reduction in LPG transportation volumes is caused by a corresponding decrease in LPG production and consumption in Ukraine.

Ukrspetstransgaz is the only provider of LPG railway transportation services for LPG producers in Ukraine.

## EXTRACTION OF CRUDE OIL AND CONDENSATE, PRODUCTION OF PETROLEUM PRODUCTS AND LPG

Naftogaz owns shares in Ukrnafta, Ukrigasvydobuvannya (UGV) and Ukrtatnafta which operate in the Ukrainian market for oil, petroleum products and liquefied petroleum gas (LPG). In addition, Chornomornaftogaz owns the rights to a number of assets in oil upstream in Crimea. The company does not currently have access to these assets because of the occupation of the peninsula.

#### UGV

##### Oil and condensate extraction

UGV is the largest gas production company in Ukraine and second in the production of oil and condensate: in 2014 the company's share in the total gas production was 68%, and it had a 20% share in crude oil and condensate extraction in Ukraine.

As of the beginning of 2015, the company's operational assets included 2 441 gas wells, 194 oil wells, and 82 drilling rigs. There are presently 139 hydrocarbon fields under development, located in Kharkiv, Poltava, Sumy, Donetsk, Dnipropetrovsk, Luhansk, Lviv, Ivano-Frankivsk, Volyn, Chernivtsi and Zakarpattya regions.

The depletion of the company's initial recoverable reserves at existing fields is estimated at almost 72% in gas, 21% in oil and 63% in condensate.

In March 2015, the parliament increased the royalty rate for oil and gas companies, and for UGV it was set at 70% of revenues to ensure the state has sufficient reserves to finance utility subsidies for households following the gas price hike. The increased royalty rate, albeit introduced for plausible reasons, negatively affects the finances and production rate of UGV and, if extended for a long period of time, can lead to a sharp reduction in the production of oil and gas in Ukraine.

#### Refinery

UGV largest refinery facility is Shebelynsky Refinery. In addition, the company has the following refinery capacities: LPG producing Yuliyivska and Tymofiyivska facilities for the advanced extraction of hydrocarbons, the Bazylivschyna plant producing LPG and stabilized gas condensate, the Yabluniv division producing LPG and dry gas, and the Orhovyska plant, which produces bitumen.

UGV is the largest producer of LPG (a mixture of propane and butane) in Ukraine. In 2014, the company produced 187 thousand t of LPG, a 17% reduction compared to 2013. The company also produced 206 thousand t of gasoline (30% less than in 2013), and 118 thousand t of diesel fuel (21% less than in 2013). The production decrease was caused by the reduced extraction of key raw materials.

##### Petroleum products supply

UGV covers nearly 4% of the total demand for petroleum products and nearly 21% of the total LPG demand in Ukraine.

The company has a network of 15 filling stations in the Kharkiv region. In 2014, this network sold 5% of the petroleum products produced by UGV. The remaining oil products were sold by the company at public auctions or through direct contracts.

Between June 2015 and April 2016, oil products produced by UGV will be sold through its retail network of filling stations, at public



auctions, or through tenders where it will exclusively supply the Defense Ministry, Interior Ministry, Security Service, Foreign Intelligence Service and other government agencies responsible for the military operation, or as prescribed by decrees of the Cabinet of Ministers of Ukraine.

### UKRNAFTA

Naftogaz is the major shareholder in Ukrnafta, holding a 50% + 1 stake in the company. However, in 2014 Naftogaz did not exercise control of the company and Ukrnafta was not consolidated in the financial statements of the group for 2012-2013 and 2014. The share of Naftogaz in Ukrnafta operations is reflected in the consolidated financial statements under 'Investments in associates'.

On 10 October 2014, an extraordinary meeting of the shareholders of Ukrnafta approved the distribution of the company profits for 2011-2013. The dividend share of Naftogaz should have been transferred to the state budget. However, the executive body of the company has not fulfilled this decision as of October 2015.

In March 2015, the Verkhovna Rada adopted the law 'On Amendments to the Law of Ukraine On Joint Stock Companies', which reduced the requirements for a shareholder quorum to 50%. Naftogaz is currently examining how this reduction will influence the group's ability to regain control of and, therefore, the consolidation of Ukrnafta.

### Oil and condensate extraction

Ukrnafta is one of the largest oil and gas companies in the country. In 2014, the company share in oil and

condensate extraction was 69%, and it accounted for 6% of gas produced in Ukraine.

As of the beginning of 2015, Ukrnafta operated 1 949 oil wells and 185 gas wells and 58 drilling rigs. The company has extraction facilities in Poltava, Chernihiv, Sumy, Kharkiv, Dnipropetrovsk, Lviv, Ivano-Frankivsk and Chernivtsi regions.

The depletion of the company's initial recoverable reserves at existing fields is estimated at almost 83% in oil and 81% in gas.

In 2014, the volume of oil and condensate extracted by Ukrnafta decreased by 7% compared to 2013, and amounted to 1 888 thousand t. Production of oil gas reached 449 million cubic meters, which is 7% more than in 2013.

### Refinery

By law, Ukrnafta sells crude oil and condensate it extracts through public auctions. Kremenchuk Refinery, which belongs to Ukratnafta (43% owned by Naftogaz), is now the only oil refinery operating in Ukraine.

Because of distorted regulations, in 2014, Ukrnafta crude oil was sold with a de facto discount factor, reducing the selling price of

oil by 15%. This problem was corrected in January 2015 when the Cabinet of Ministers made appropriate changes to auction regulations.

Ukrnafta produces LPG at three processing plants: Kachaniv, Hnidyntsiiv and Dolyzna. In 2014 a total of 163 thousand t of LPG was produced, which is 4.8% less than the previous year.

### Petroleum products supply

Ukrnafta owns one of the largest networks of filling stations in Ukraine, with more than 500 facilities in most of the regions across the country.

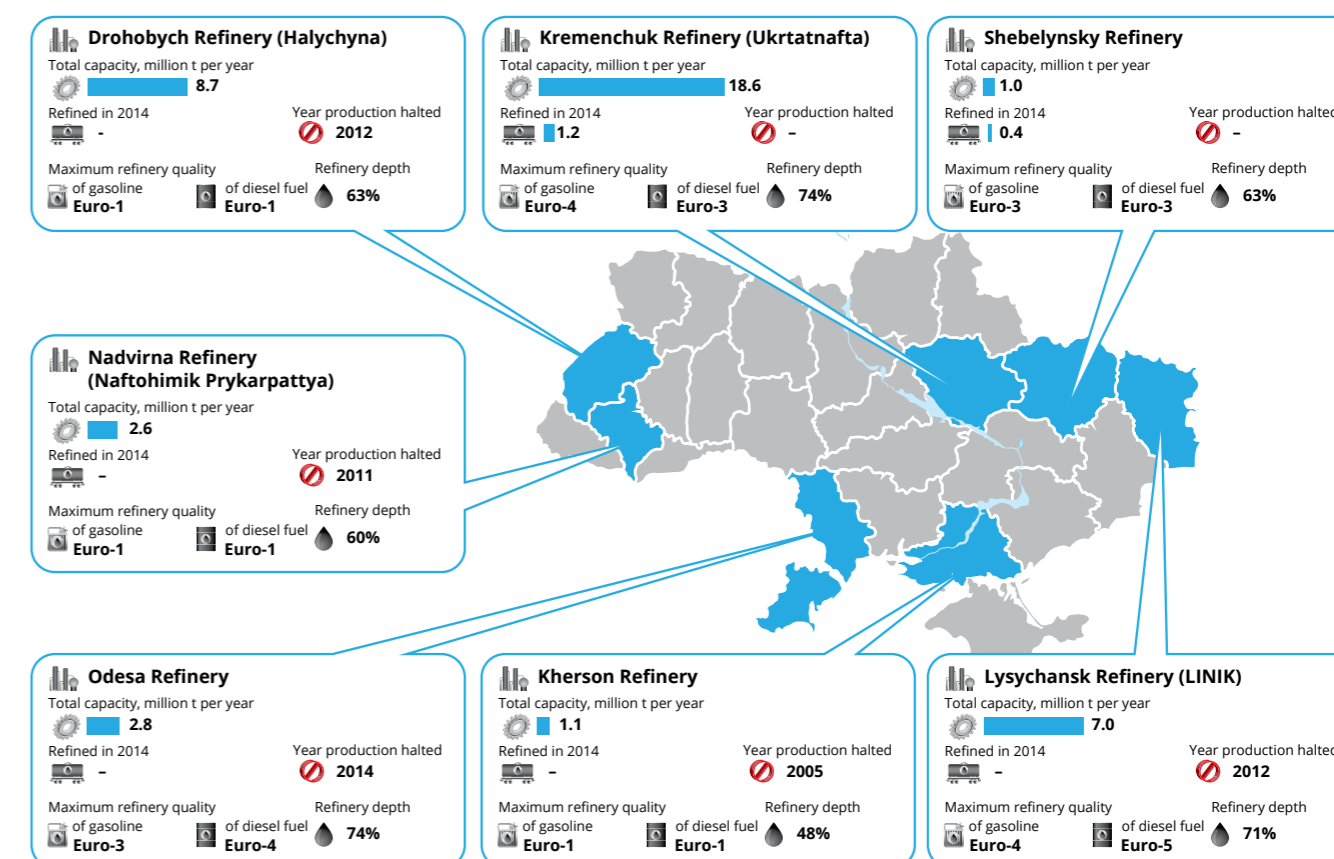
The share of Ukrnafta filling stations in the total sales of gasoline and diesel fuel in Ukraine in 2014 reached 15%, and the network had an 18% market share in LPG sales in Ukraine.

LPG Ukrnafta sells is mostly of its own production. In supplying gasoline and diesel fuel, the company uses products from external suppliers. The Ukrnafta audit committee discovered that in 2014 Ukrnafta suffered UAH 800 million in losses in this market segment, primarily because it was buying gasoline and diesel fuel above the market rate.

## EXTRACTION OF CRUDE OIL AND CONDENSATE, PRODUCTION OF PETROLEUM PRODUCTS AND LPG BY COMPANIES WHERE NAFTOGAZ OWNS SHARES, 2014

Company	% owned by Naftogaz	Crude oil and condensate		Petroleum products (gasoline, diesel, fuel oil)			LPG		
		thousand t	% of total extraction in Ukraine	thousand t	% of total production in Ukraine	% of total consumption in Ukraine	thousand t	% of total production in Ukraine	% of total consumption in Ukraine
UGV	100%	533	20%	378	25%	4%	187	42%	21%
Ukrnafta*	50% + 1 share	1 888	69%	-	-	-	163	36%	18%
Ukratnafta*	43%	-	-	1 155	75%	14%	63	14%	7%
Total	-	2421	89%	1533	100%	18%	413	92%	46%

\*not consolidated in the financial statements of Naftogaz for 2014



Source: Ministry of Energy and Coal Industry of Ukraine

## OIL AND GAS PRODUCTION IN EGYPT

In 2014 and 2015, Naftogaz continued to develop its overseas investment projects in Egypt, namely the Alam El Shawish East project in the Western Desert and projects South Wadi El-Mathareeth and Wadi El-Mathareeth in the Eastern Desert.

### ALAM EL SHAWISH PROJECT

The project was started in 2007 under a concession agreement to conduct oil exploration and extraction between Naftogaz, the Arab Republic of Egypt, and the Egyptian General Petroleum Corporation. The project is realized by Petrosannan company. This joint venture was created by Naftogaz and the Egyptian General Petroleum Corporation, with the two parties having equal shares.

In 2014, Naftogaz invested USD 43 million in this project and it generated revenues of USD 69 million, resulting in a positive cash flow of USD 26 million.

Eight wells were brought online in 2014. Average daily oil production from the project increased by 26% compared to 2013, amounting to 6 354 barrels per day compared to 5 043 barrels per day in 2013. In total, during 2014 1.93 million barrels were produced compared to 1.73 million barrels in 2013.

As at July 2015, 44 wells were drilled from the start of the project, of which 33 are productive. 6.5 million barrels of oil were extracted, including 1.1 million barrels extracted in 1H 2015.

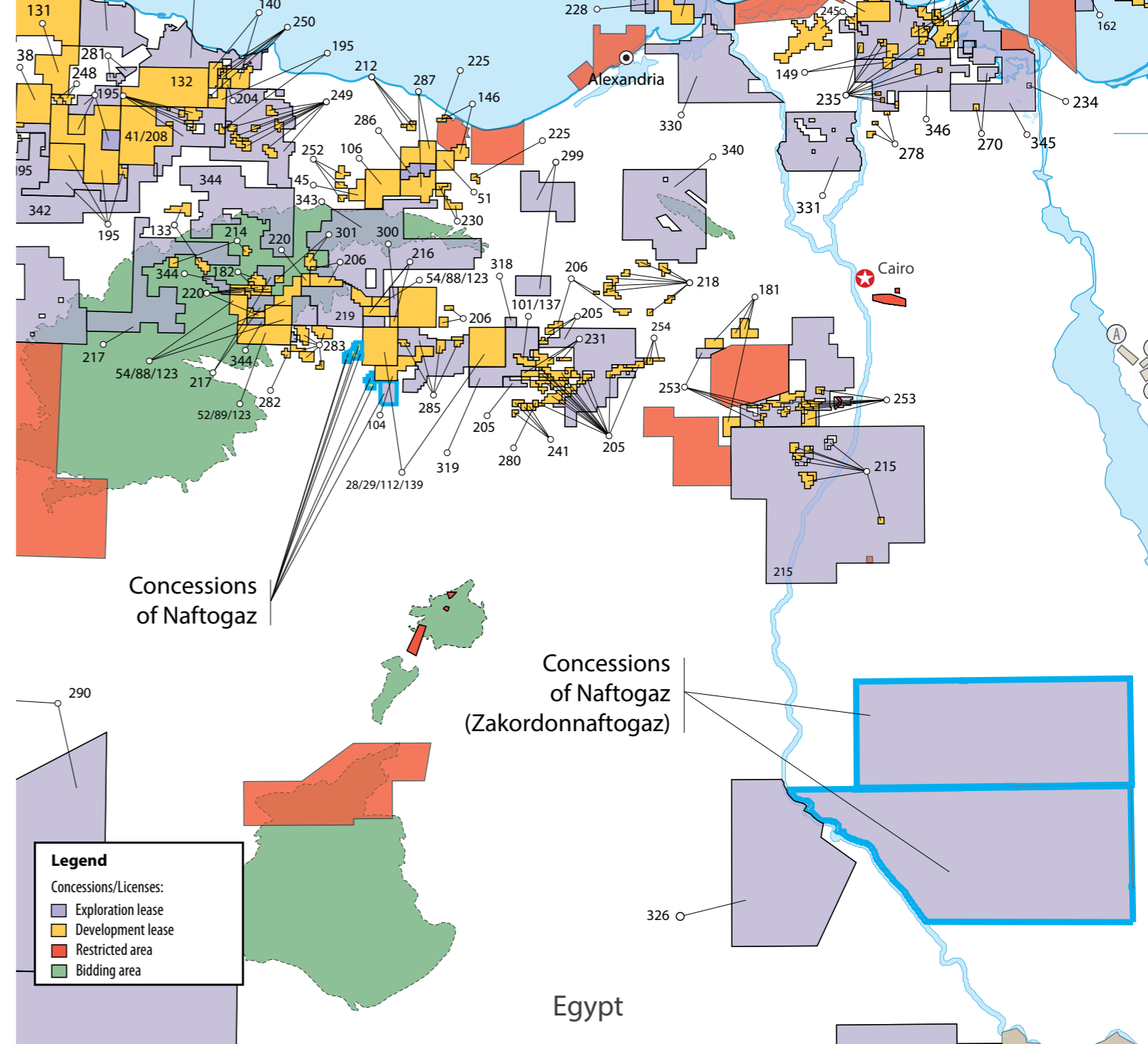
Following the construction of a pipeline that connected the project with the T-aria (GPC) point and the launch of gas preconditioning facility at the Karima field, the project started to produce natural gas and condensate in September 2014. In addition, a pipeline was built to the Tammam deposit and Tammam-1 gas and condensate well was launched.

As at July 2015, the project produced 146 mcm of gas.

### SOUTH WADI EL-MATHAREETH AND WADI EL-MATHAREETH PROJECTS

These projects are implemented under concession agreements signed in 2012 between Naftogaz subsidiary Zakordonnaftogaz, the Arab Republic of Egypt, and the state-owned Egyptian Petrochemicals Holding Company. These agreements cover a period of 28 years.

The initial exploration period is currently underway, and equipment for a 2D seismic study has been mobilized. The project team has laid 1 125 linear km of seismic profiles, conducted geodetic research on 1 840 linear km and prepared 2 472 linear km for seismic profiling. Seismic exploration continues in 2015.



### OTHER ACTIVITIES

On 25 December 2012, Naftogaz and China Development Bank (CDB) signed a general loan agreement to finance projects aimed towards the substitution of natural gas for domestically produced coal. Under the terms of the agreement, signed between the Ministry of Finance and CDB, Ukraine issued sovereign state guarantees for the amount of the loan, which can amount up to USD 3.65 billion.

In 2012, Vuhlesyntezhaz Ukraine, a 100% subsidiary of Naftogaz, was created as a dedicated project entity to invest the funds granted under this loan. Initially, the parties agreed to focus on two

investment areas, namely construction of coal gasification facilities and modernization of heat and electricity producing facilities in Ukraine, including combined heat and power plants. No funds have been drawn so far.

In early 2015, Ukraine confirmed its willingness to continue the cooperation under the CDB loan. Now the government and Naftogaz negotiate an expansion of project types where these funds can be applied. Ukraine suggested using the loan to finance more urgent projects in the oil and gas industry, including additional gas interconnectors between Ukraine and the EU, natural gas production or energy efficiency projects in Ukraine.

## EMPLOYEES

### PERSONNEL STRUCTURE

Naftogaz is one of the largest employers in Ukraine. The group (including its consolidated subsidiaries and Ukrnafta) employs more than 80 thousand people. Including regional gas distribution companies where Naftogaz holds minority shares, this number reaches more than 100 thousand employees.

On 25 March 2014, the Cabinet of Ministers appointed Andriy Kobolyev as Chief Executive Officer of Naftogaz. Key strategic goals of the new management include reforming Naftogaz and the broader Ukrainian gas market based on European best practices, as well as ensuring security of natural gas supply to consumers in Ukraine and in the EU.

With the appointment of the new management and the adoption of the new strategy, the company's HR policies underwent fundamental changes as well. A new HR strategy has been developed. It is based on the principles of increasing organizational efficiency, building lean HR processes, improving management practices and raising the level of motivation and engagement of employees.



### ORGANIZATIONAL EFFICIENCY

During 2014, Naftogaz was reorganized to reflect its new strategic goals. Fifteen departments underwent profound revision or were established, including the newly created departments for energy efficiency and energy saving, for business development and reforms, and for business, industrial and informational security and risk management.

More than fifty positions were eliminated following the reorganization. The number of the executive board members reduced from fourteen to five, of which four members joined the company after the management change took place in March 2014. In total, approximately 2/3 of senior executives and division managers have been replaced.

In order to improve the management efficiency and prevent potential corruption, Naftogaz hired experienced executives from other sectors to head functions that do not require specific technical knowledge in oil and gas. Senior managers responsible for finance, legal issues, property management, procurement, communications and internal audits have been hired on this basis. The company succeeded in engaging graduates of top-tier Western institutions with valuable international experience.

Specialized internal divisions are headed by specialists with long employment records in their respective fields who have been selected on the criteria of professionalism and reputation.

The company continues to optimize its organizational structure, business processes and the management system.

### RECRUITMENT POLICY

For the first time in the history of Naftogaz, transparent policies are used in personnel selection and recruitment, guaranteeing equal opportunities to all interested candidates. Vacancy announcements are posted on the company's website and specialized recruitment resources. Selection of new employees is carried out based on interviews, assessment of professional qualifications and competences of candidates. During 2014, approximately thirty professionals were recruited to the holding company via publicly announced selection, including nearly twenty at senior executive positions.

Naftogaz cooperates with professional associations and international initiatives to select and recruit employees. The most prominent addition to the team in this sense was Sergiy Konovets, the CFO and Deputy Chairman, who was recommended by the Professional Government platform which unites Ukrainians who have graduated from leading foreign universities. This is one of the top positions a participant of this initiative has ever filled.

Transparent and competitive recruitment procedures are also implemented in Naftogaz subsidiaries. The goal of Naftogaz is to develop the group in the interests of the people of Ukraine. A core prerequisite for this is attracting experienced professionals motivated to be leaders of change in their units.

### COOPERATION WITH THE INTERNATIONAL PROFESSIONAL COMMUNITY

In view of the resource constraints and the scope of challenges now facing Naftogaz, the group actively cooperates with the international community in developing action

plans, reform concepts and legislation drafts. Several projects with the European Bank for Reconstruction and Development (EBRD), the World Bank (WB), the European Commission and other international donors have already been implemented.

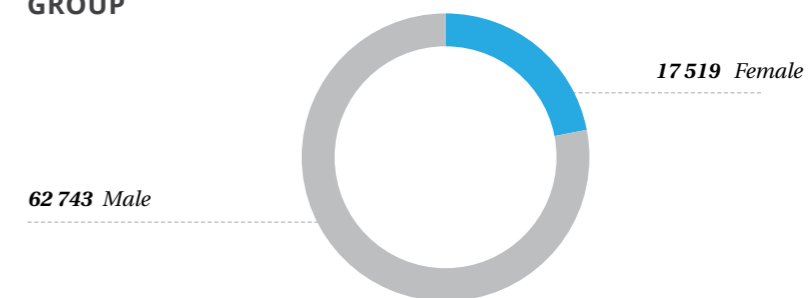
This cooperation provides access to knowledge and practices which have proven to be effective in other countries that have successfully implemented similar reforms in the past. It allows Naftogaz to develop efficient initiatives in areas where Ukraine currently lacks qualified personnel. This interim measure allows Naftogaz to ensure a high quality of the developed solutions and to expand cooperation with the international community.

### EMPLOYEE ENGAGEMENT

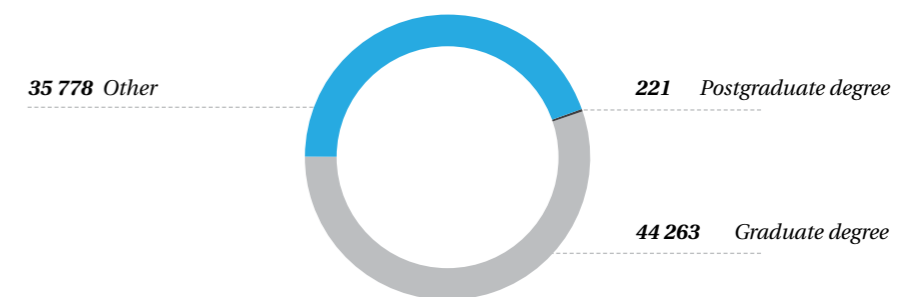
Motivated, engaged and highly professional personnel is a prerequisite for top-quality performance of Naftogaz and thus of the value maximization for the company ultimate owners — the people of Ukraine. The code of conduct adopted in 2014 sets out the group strategy, mission, values, norms of business conduct, basic principles and professional standards for all Naftogaz employees. The code of conduct is a guideline for all company employees regardless of their position.

Continuous efforts are made to establish vertical communication and open dialogue between staff and management. The goal of this work stream is to ensure efficient

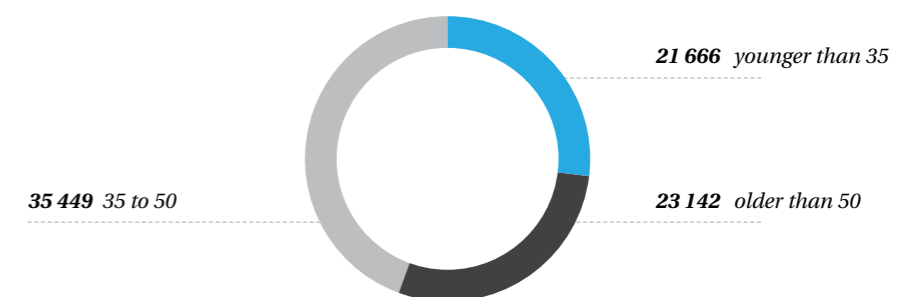
### NUMBER OF EMPLOYEES AND GENDER COMPOSITION OF THE GROUP



### EMPLOYEE STRUCTURE BY EDUCATION

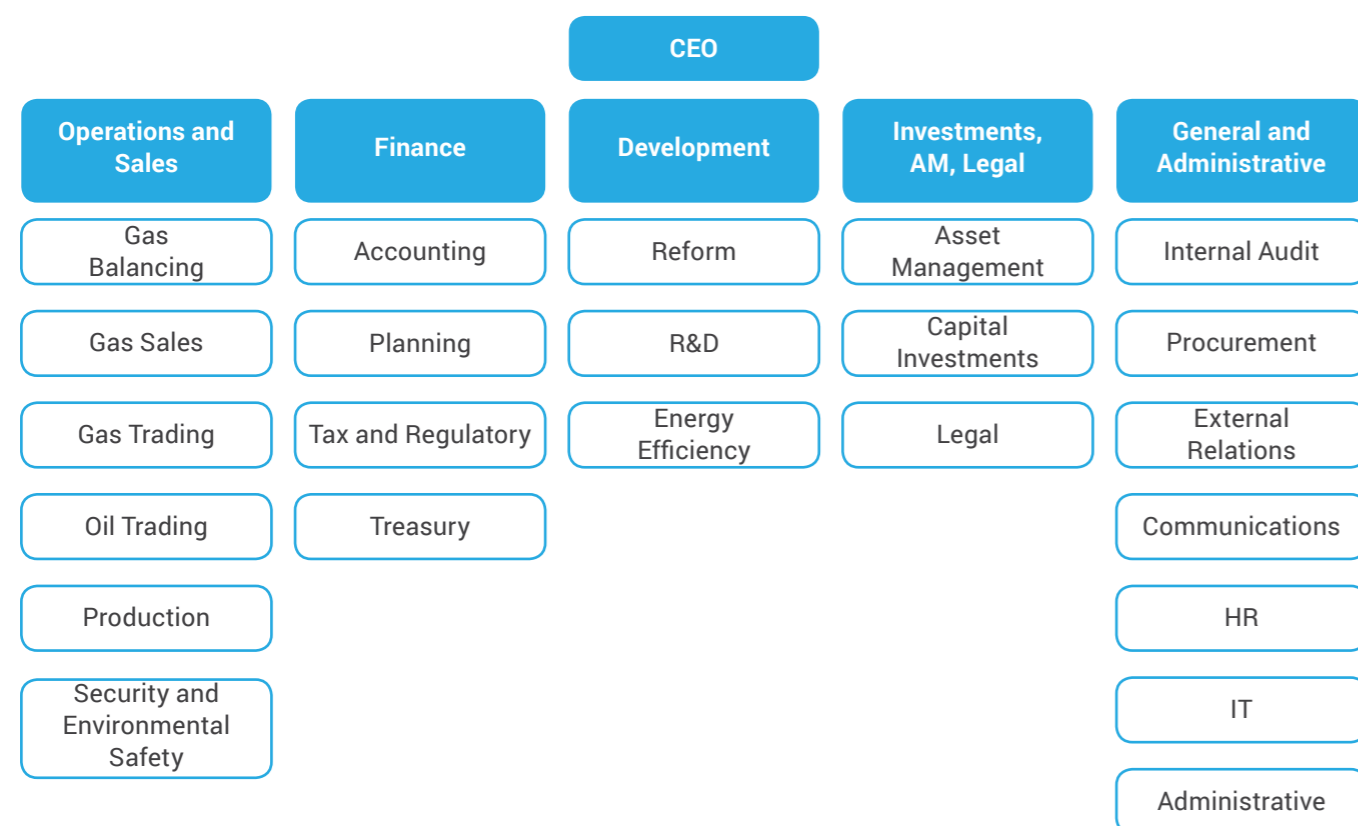


### EMPLOYEE STRUCTURE BY AGE



Number of employees, as at 31 Desember 2014

## FUNCTIONAL STRUCTURE OF NAFTOGAZ HEADQUARTERS



information exchange within the company and to engage all employees in developing and implementing the group strategy.

During 2014, a number of development and training programs were offered to unlock the internal potential and to develop professional qualifications of employees. These programs focused on:

- professional orientation for recent graduates, attracting top students and graduates of leading universities
- cooperation with universities and other academic institutions in training faculty members by providing hands-on understanding of oil and gas production processes, equipment and technologies, as well as participation of Naftogaz employees in diploma and thesis committees
- acceleration of the adaptation process for new employees through special guidance at the early stages of employment

Employees of Naftogaz and its subsidiaries have the opportunity to improve their professional qualifications in specialized centers of extended education. The company views engaging qualified and proactive personnel as key to implementing its strategy.

Naftogaz continues developing professional training initiatives, corporate programs for learning English and employee engagement programs.

#### SOCIAL PROTECTION OF EMPLOYEES

Efficient operations depend on a good team spirit which itself depends on safe and comfortable workplace conditions, relevant remuneration levels and adequate social protection of staff members. In addition to the monetary remuneration, Naftogaz provides the following social benefits for its employees:

- meal subsidies
- tuition coverage

- recreational programs for workers and their children
- special support for pensioners, veterans and disabled employees
- support of disabled children and orphans
- other social benefits

Naftogaz group has thirty two recreational centers for staff members and their families, including three child health care centers. During 2014, 3 247 staff members and 4 360 children benefited from recreation and rehabilitation programs sponsored by the group.

In April 2015, Naftogaz ranked fifth among the most attractive employers for professionals in technical and scientific fields, according to a study conducted by HeadHunter, a leading regional recruitment portal. This result is a valuable recognition of the company's efforts to modernize its personnel management policies and corporate governance.

## CORPORATE CODE OF CONDUCT

One of the main priorities in reforming Naftogaz is the implementation of modern corporate governance standards. The company believes the corporate ethics is integral to the quality of organizational management. Ethical norms in governance establish a framework for proper business conduct. Contemporary standards of the corporate ethics allow companies to be more effective in achieving their targets and create possibilities for self-actualization based on merit, which positively impacts both motivation and the productivity of employees.

Citizens, partners and local authorities, media and other external stakeholders are entitled to expect ethical business conduct from Naftogaz. Despite a complicated history, the current management of Naftogaz seeks to build relationships with its stakeholders on the principles of legality, professionalism, integrity, mutual trust and adherence to contractual obligations.

By implementing modern corporate ethics standards, Naftogaz seeks to bolster the reputation of the company so that its employees could take pride in their personal achievements, the overall company results, as well of the means by which these results were achieved. It is important for Naftogaz to be a respected employer in order to preserve the unique competencies of workers and to attract new highly qualified professionals.

In 2014, Naftogaz developed and approved a corporate code of conduct in order to outline rules for interaction between

employees, partners, competitors, the state and the society. This code determines reliability, professionalism, responsibility and development as core values of cooperation.

Under the new code of conduct, Naftogaz undertakes to respect personal freedoms, rights and dignity, and forbids any form of harassment or behavior that could be seen as offensive and unacceptable. Management is obliged to act in a way that respects the human dignity of all staff members.

Discrimination on the basis of origin, social or economic status, race, nationality, age, sex, language, political opinion, religion, occupation, sexual orientation, place of residence or other circumstances is unacceptable at Naftogaz.

Qualifications, professional skills, actual professional achievements and other criteria associated with professional merits of a person are the core criteria for personnel selection. Naftogaz supports and encourages proactiveness and creativity among its employees, and supports the development and implementation of the skills and abilities of individual staff members.

Naftogaz also considers corporate social responsibility an important element of cooperation of the group with the society, the state and the business community. The company aims to institute socially responsible practices toward its employees and members of their families, the residents of localities where it operates, and the society in general.

## ENVIRONMENT AND SAFETY

OCCUPATIONAL  
SAFETY SPENDING,  
2014, UAH MILLION

87.2

### OCCUPATIONAL HEALTH AND SAFETY

The code of conduct of Naftogaz includes a special section dedicated to occupational safety. This section incorporates the Seven Golden Rules of occupational safety management widely implemented in the European Union.

Special regulations on occupational health are at the moment being developed by the companies of the group. These will be based on the national standard of Ukraine DSTU OHSAS 18001:2010 Systems for Occupational Health and Safety Management: Requirements (OHSAS 18001: 2007, IDT) and international norms (such as the Seven Golden Rules and the Zero Accident Vision).

The main objectives of the health and safety regulations at Naftogaz are:

- the implementation of international best practices in occupational health and safety management
- staff training
- unconditional adherence to approved health and safety standards, including proper organization of operations and work places
- adequate funding for occupational safety
- mandatory medical examinations of workers
- effective support of company health care facilities
- cooperation with international organizations in issues of occupational safety in order to implement international best practices

In 2014 investment in occupational health programs amounted to UAH 87.2 million. The funding of occupational safety programs of its subsidiaries amounted to the equivalent to 1.58% of the group total payroll for 2013. All employees of Naftogaz and its subsidiaries are employed on the basis of an employment agreement (contract) and insured against accidents at work and occupational health hazards. The company also implements a five-tier operating system for monitoring occupational health and safety measures, including regular inspections of production units and work places.

Employees are the core asset of Naftogaz and their safety and well-being are of utmost importance to the group.

### ENVIRONMENTAL PROTECTION

The business practices of Naftogaz are designed to meet European environmental protection policies and basic safety standards in radiation and environmental protection. The code of conduct adopted in 2014 contains a section on environmental protection.

The basic principles of the environmental policy of the group are:

- responsibility and awareness
- balance between economic, environmental and social interests
- effective environmental management
- implementation of modern environmentally safe technologies



- prevention measures
- improving environmental education and culture
- open access to information and transparency of decisions

In 2014, the combined emissions of pollutants at all production facilities of Naftogaz did not exceed the maximum allowable levels established by relevant permits, and the total emissions of the group companies decreased by 19%. In the first period of the Kyoto Protocol, the emissions of all group companies fell by more than 20 million tons of CO<sub>2</sub> equivalent which enabled additional investment in the modernization of the technological equipment.

*Each company within the group considers ecological safety in and around the workplace as its core obligation.*

Group companies use safety measures for equipment containing ionizing radiation sources (IRS). All IRS equipment is used for the purpose prescribed by relevant sanitary certificates and is

stored in specifically designed guarded facilities with alarm systems and duly marked by radiation hazard signs. Naftogaz companies have obtained licenses for conducting operations with IRS issued by the special agency of ecology and natural resources of Ukraine, while the state committee for nuclear regulation has also issued licenses to undertake nuclear waste transportation. Naftogaz group operates decontaminating and sanitizing facilities for personnel safety.

Group does not operate radioactive waste storages. Waste and sources of ionizing radiation (tubing, equipment, etc.) are temporarily stored in specially equipped facilities (5 operating units at Ukrnafta; and one at UGV). These items are periodically transported by special purpose certified vehicles for long term storage, recycling or disposal at SSD Radon in Kharkiv.

Naftogaz considers the environmental protection of all work places extremely important. The group's activities are undertaken in strict compliance with environmental protection requirements and standards.



## RESPONSIBILITY TO CONSUMERS

One of the major roles of Naftogaz is to ensure a reliable and stable supply of natural gas to consumers. Military actions in the Donbas have significantly complicated the performance of this function. During 2014 and 2015, employees of Naftogaz in the region have put their health and lives at risk on numerous occasions to perform their duties and ensure safe and stable gas supplies to Ukrainian households and industrial consumers.

### SAFETY AND SECURITY OF SUPPLY

Because of the abrupt loss of assets in Crimea and military actions in eastern Ukraine, 2014 was a year of tremendous technological challenges for Naftogaz. As a result of deliberate attacks or collateral damage caused by the hostilities, there have been

three instances of category one emergency situations on gas pipelines and several hundred smaller scale emergencies to deal with.

In response to these significant security challenges, Naftogaz created a division of industrial security within the department of economic, industrial and information security and risk management in

October 2014. This division was tasked with the following functions:

- development of a policy for resolution of complex issues related to technical supervision and industrial safety
- supporting the Unified State System for the prevention and early response to emergencies

- monitoring the implementation of regulatory norms for technical supervision, industrial safety, civil protection and fire safety, and prevention and handling of emergency situations
- developing and implementing training systems for emergency repair teams, emergency dispatcher services, and linear-operational services for targeted missions
- coordinating and implementing training programs in civil defense

Naftogaz companies regularly conduct training sessions to prepare professionals for possible emergencies on gas pipelines.

For instance, in September 2014, Ukrtransgaz held anti-terrorist training exercises in cooperation with the Ministry of Internal Affairs and the State Emergency Service of Ukraine, with participation of international observers, at the Oparske underground storage facility. In accordance with the training plan, participants were required to localize and neutralize an unauthorized intervention at one of the facility's gas storage wells.

### GAS QUALITY MONITORING

Another area of responsibility of Naftogaz is to ensure continuous monitoring of

gas quality supplied to distribution networks and to international consumers at Ukraine's borders. The gas delivered by the group must meet state standards as well as the technical requirements established in supply contracts with domestic distribution companies and in transit contracts. Quality control takes place at every stage of gas transmission, from the entry into the gas transmission system of Ukraine, either from non-Ukrainian or from local producers, up until the point where gas leaves the system outside of Ukraine, or enters local distribution networks for supply to consumers in Ukraine.

Starting from March 2015, Ukrtransgaz releases monthly measurements data on the quality of gas in the transportation system broken down by region of Ukraine. Depending on the proximity of the wells from which gas is extracted, to entry points for imported gas and to the underground storage facilities, the calorific value of gas, being one of the key quality indicators, fluctuates in the range of 7.950 to 8.600 kilocalories per cubic meter depending on the region, but in any event the quality meets the state standard of calorific value set at the level of 7.600 kilocalories per cubic meter (based on the lower calorific value).

In May 2015, Ukrtransgaz held a dedicated event in Uzhhorod to familiarize mass media and expert community with quality control processes at the gas transmission system. The company is preparing further steps to build public awareness and trust in gas quality control measures employed by the group.

### MEDIA COVERAGE AND PUBLIC AWARENESS

The implementation of Naftogaz strategy largely depends on fostering greater understanding of gas market principles amongst consumers and other stakeholders of the company. To this end, one of the key areas of informational activities of Naftogaz is encouraging the media, market experts and the public to participate in events discussing changes in the oil and gas market of Ukraine and raising public awareness.

In addition to general communications activities, group companies operate a number of gas industry museums aiming to raise public understanding in the way the industry operates. Regular guided tours to operational facilities are offered as well to help media and other stakeholders understand the history, principles and challenges of the oil and gas industry in Ukraine.

## ENERGY EFFICIENCY

Improving energy efficiency is an important pillar of the gas market reform in Ukraine. Naftogaz actively implements energy efficiency improvements at its companies and subsidiaries. The group focuses its efforts on the development of energy saving solutions in two key areas:

- extraction, processing, storage and transportation of hydrocarbons
- consumption of natural gas for thermal energy production (heating and hot water supply) by individual households and heat producing companies

In August 2014 the company established a new department for energy efficiency and energy saving with the following objectives:

- to create conditions for the sustainable use of energy resources by consumers
- to implement measures improving energy efficiency and promoting the use of alternative energy sources in Naftogaz, its subsidiaries and related entities
- to develop and implement a unified investment policy for the company

aimed at rationalizing the use of energy, promoting the energy efficiency and increasing the use of alternative energy sources

- to monitor and analyze payments for and the use of thermal energy
- to create incentives for producers of thermal energy to implement energy efficient technologies and facilitate alternative and renewable energy sources
- to develop similar processes for subsidiaries of Naftogaz engaged in the delivery of energy services



## TEN MONTHS AFTER THIS DEPARTMENT WAS ESTABLISHED:

- The heat distribution system reform concept has been developed targeting to improve the system's energy efficiency and security
- The use of energy resources by the group companies in 2014 declined by 200 thousand t of fuel, including 152 mcm of natural gas, 24 million kWh of electricity and 87 thousand Gcal of thermal energy

- The Naftogaz energy efficiency program for 2015-2020 has been developed
- Internal rules on minimization of natural gas consumption by Naftogaz production units have been developed and implemented
- Naftogaz has also initiated development of a system of energy management within the company.

Energy profile questionnaires have been compiled to help determine the most energy-consuming production processes and to develop measures to increase energy efficiency

- Energy audit and energy saving assessment standards have been updated. The establishment of the new energy service subsidiary is in process. Its activities will be focused on the installation of solid

fuel boilers replacing natural gas operating devices in households. It is anticipated that this subsidiary will be funded by Naftogaz, dedicated loans, grants and other resources

- Cooperation has been improved within the framework of a number of international energy efficiency initiatives including the USAID Program 'Energy efficiency:

restructuring the gas transmission system and increasing the professional skills of Ukrainian specialists', the GIZ project (energy efficiency in the communities), the International Financial Corporation project 'Energy efficiency in the residential sector of Ukraine', and the INOGATE project 'Support for energy market integration and sustainable energy (SEMISE)'.

## RUSSIAN MILITARY AGGRESSION AGAINST UKRAINE

Naftogaz group incurred significant losses as a result of Russia's military intervention in Crimea, Donetsk and Luhansk regions. In 2014 these losses amounted to over UAH 26 billion, as reflected in the consolidated financial statements of the group. These losses included the loss of property and inventories as well as net differences between accounts receivable and accounts payable.

The occupation of Crimea resulted in losing natural gas stock amounting to approximately 1.4 bcm. The expected volume of gas production by Chornomornaftogaz in 2014 was 2.1 bcm, 0.7 bcm of which should have been supplied to households in Crimea, and the remaining 1.4 bcm to households in other regions of Ukraine. The loss of this resource forced Naftogaz to replace these volumes with imported gas at much higher prices.

In addition to these losses, the group lost a portion of income in 2014 due to the Russian intervention in Crimea and eastern Ukraine. Prior to the Russian aggression, the aggregate gas demand of consumers located in Donetsk and Luhansk regions (including the territories currently controlled by the government of Ukraine) and Crimea amounted to approximately 25% of the total consumption in Ukraine (14%, 7% and 4% per year on average over the period of 2009-2013, respectively). Compared to 2013, sales in these regions fell in aggregate by 38% in 2014 (including 26% in Donetsk, 40% in Luhansk and 71% in Crimea). The group discontinued supply

of natural gas to consumers in Crimea after the peninsula was occupied by Russian military in 1Q 2014.

The abrupt loss of control over a part of the company's assets created significant issues for the group, including the challenge of maintaining the integrity of the gas transportation system of Ukraine. Thanks to the dedicated work of the group employees, as well as the structural reliability and flexibility of the Ukrainian gas transportation system, Naftogaz has been able to ensure the uninterrupted transit of Russian gas to European consumers as well as stable supply to consumers in Ukraine in practically all locations now controlled by the Ukrainian authorities.

### RELIABLE SUPPLY IN A CHALLENGING ENVIRONMENT

The employees of Naftogaz operating gas facilities near the frontlines in the Donbas faced extreme challenges. Throughout 2014 and 2015, these professionals repeatedly risked their lives to perform their duties and ensure stable gas supply to consumers.

As a result of the armed conflict in the region, gas supplies in the area of the Anti-Terrorist Operation controlled by Ukrainian authorities were cut off in 501 locations. Naftogaz employees have been able to restore supplies to 486 of these locations as at July 2015.

The management and staff of Naftogaz express deep gratitude to the employees

of Ukrtransgaz, Ukgasvydobuvannya, Ukrtransnafta and other subsidiaries who faced and resolved these emergency situations for their dedicated work and heroism. They succeeded in renewing damaged gas infrastructure and restoring supplies to consumers in the toughest conditions imaginable.

### AIDING THE CASUALTIES OF MAIDAN AND SUPPORTING THE UKRAINIAN MILITARY

In February 2014, Naftogaz employees unanimously agreed to support the families of the fallen heroes of the Heavenly Hundred (protesters killed during anti-government rallies at Maidan) by collecting approximately UAH 360 000 in donations and directing this money to the families of the deceased.

As the hostilities unraveled in the eastern Ukraine, Naftogaz employees began to regularly donate a portion of their income to support the Ukrainian Army. As of July 2015, Naftogaz staff have donated more than UAH 4.3 million to the needs of the national military. The company and trade union also provide financial support to employees who have joined the Ukrainian Armed Forces.

In February 2015, Gas of Ukraine, a subsidiary of Naftogaz, donated 174 vehicles to the Ministry of Infrastructure and the Security Service of Ukraine for use in the area of the Anti-Terrorist Operation, including passenger cars and cargo vehicles, excavators, gasoline stations, radio stations and other technical products equipment.



## CRIMEA

### RUSSIAN OCCUPATION OF CRIMEA

In late February 2014, the Russian Armed Forces began their undeclared invasion of Ukraine and deployed troops across the Crimean peninsula. On 16 March 2014, Russia staged a hastily prepared and unconstitutional "referendum" on the status of Crimea. The voting was held with significant violations of both electoral law and the rights of voters. In particular, citizens of Russia who have never resided in Crimea, were allowed to participate in the voting. On 18 March 2014, the Russian authorities declared the annexation of Crimea and Sevastopol.

Ukraine and the international democratic community treat Crimea as a temporarily occupied territory of Ukraine. The status of this territory is regulated by a special law of Ukraine. Under section 9 of this law, all authorities and their officials operating in the temporarily occupied territory are considered illegal, if these authorities or officials were established, elected or appointed in violation of the laws of Ukraine. Any act (decision, document) issued by these authorities and/or officials is null and void.

### LOSS OF CONTROL OVER ASSETS IN CRIMEA

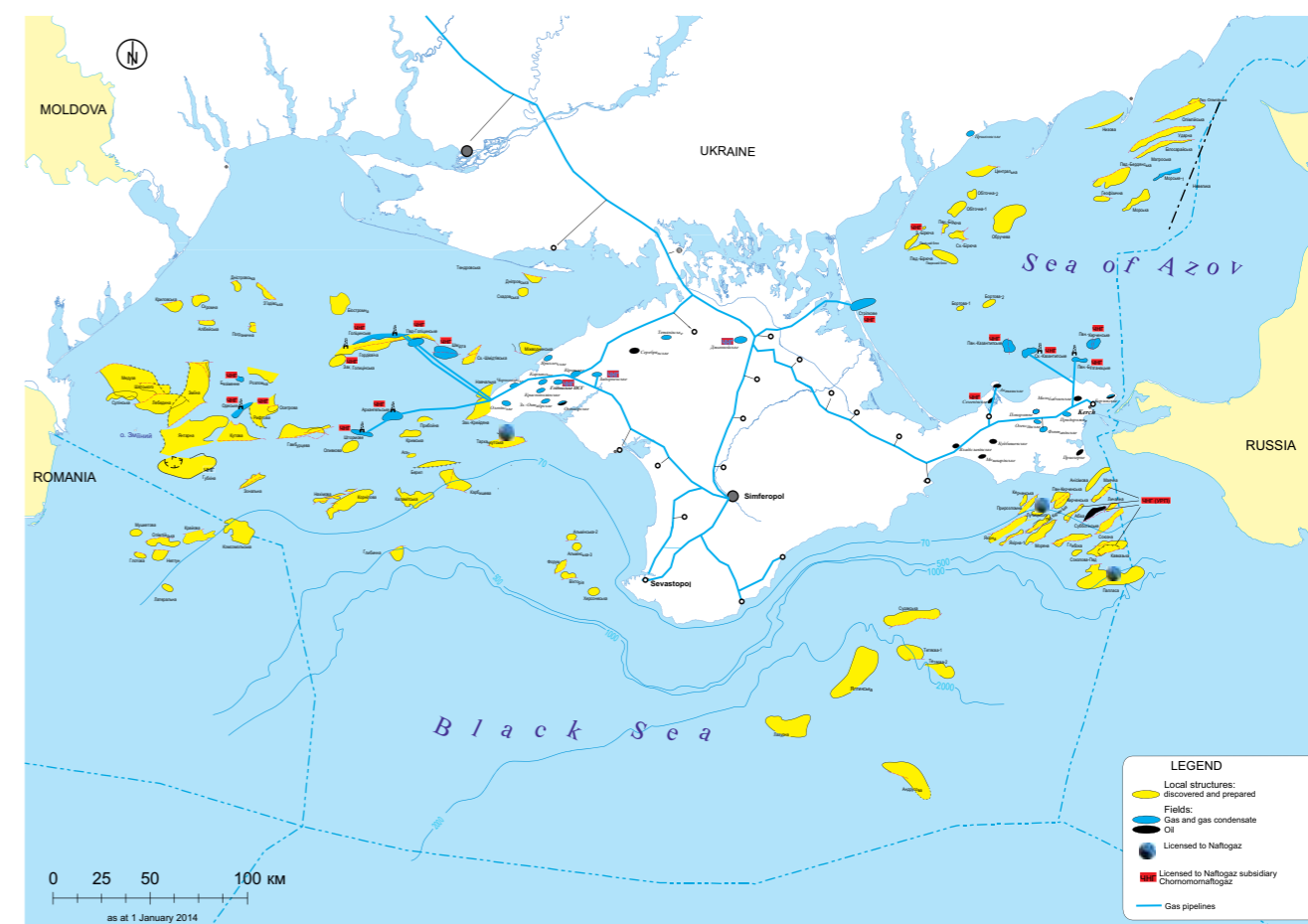
On 17 March 2014, the occupation forces in Crimea announced the nationalization

of the property of Chornomornaftogaz in Crimea and its transfer to the share capital of a newly founded Crimean Republican Enterprise Chornomorneftegaz. On 2 December 2014, the company was re-registered in the Russian Federation and changed its name to State Unitary Enterprise of the Republic of Crimea Chornomorneftegaz.

The nationalization of Chornomornaftogaz assets by the occupation forces of Crimea was and continues to be a violation of international law.

The newly founded Chornomorneftegaz was included in the list of persons and entities sanctioned by the United States

### OIL AND GAS RESERVES AND PROSPECTIVE RESOURCES OF THE UKRAINIAN SECTOR OF THE BLACK SEA AND THE SEA OF AZOV



Department of Commerce in April 2014. This company was also the first on the list of persons and entities sanctioned by the EU starting from May 2014.

At the same time, the PJSC National Joint Stock Company Chornomornaftogaz, a subsidiary of Naftogaz, was re-registered in Kyiv. As of August 2015, this company controls the Strilkove gas field located near the village of Strilkove in the Henichesk district of Kherson region (control was regained in December 2014).

Chornomornaftogaz is currently working on restoring its legal documentation, re-registration of its special permits for subsoil use on the peninsula and adjacent shelf, re-registration of its marine vehicles in Odesa commercial sea port, and is engaged in numerous litigation processes.

On 10 October, 2014, the Prosecutor General of Ukraine made a record in the Unified Registry of Prejudicial Investigations for the illegal appropriation of Chornomornaftogaz property on

the grounds of a criminal offense specified by clause 3 of article 206 of the Criminal Code of Ukraine and for illegal extraction of natural gas by officials of Chornomorneftegaz on the grounds of a criminal offense specified by clause 2 of article 240 of the Criminal Code of Ukraine. In particular, Chornomornaftogaz planned to extract 2.4 bcm of natural gas, 58.5 thousand tons of gas condensate and 7.2 thousand tons of oil during 2014.

The European Court of Human Rights is considering a claim filed by the Ministry of Justice of Ukraine against Russia. This claim concerns recognition of the occupation of Crimea as illegal, and seeks compensation for damages caused by the occupation and violation of the constitutional rights of citizens by the seizure of power in Crimea by the Russian Federation and by further activities of the occupation forces. The claim identifies damages inflicted against 4 000 business entities including Chornomornaftogaz.

### CRIMEAN ASSETS IN CONSOLIDATED FINANCIAL STATEMENTS

Considering the temporary inability to control the assets of Chornomornaftogaz in Crimea and in order to conservatively reflect the current status of the Naftogaz group, the management decided to transfer the net assets related to Chornomornaftogaz to discontinued operations as at 1 January 2014. For this reason, in 2014 Naftogaz recorded losses from these discontinued operations of UAH 13.8 billion. In addition, the group recognized the impairment of other assets (property and receivables) located in Crimea amounting to UAH 5.8 billion in other operating expenses in 2014.

Nevertheless, Naftogaz continues to undertake all possible legal and diplomatic actions aimed at both regaining control over the assets in Crimea and receiving reimbursement for losses incurred.

## DONBAS

### MATERIAL LOSSES IN EASTERN UKRAINE

Naftogaz group recognized losses resulting from the occupation of parts of Donetsk and Luhansk regions and the military actions ongoing in these regions since the spring of 2014 in amount of UAH 7.2 billion in its consolidated financial statements for 2014. Naftogaz created a provision to reflect conservatively the uncollected revenues from customers in the occupied territories. Naftogaz also recognized a loss of approximately 400 mcm of gas in 2014, which was illegally taken out of the gas transportation system in the occupied territories.

14 gas pipelines, 4 compressor stations, three gas distribution stations and the Verhunske underground gas storage facility were damaged as a result of the armed conflict, and 3 gas distribution stations were cut off from electricity. In June 2015, the gas pipeline that delivers gas to the eastern part of Zaporizhzhia and Donetsk regions was severely damaged by shelling.

*Mariupol, Berdiansk and other settlements in the region could have faced a prolonged disruption in gas supplies*

The coordinated efforts of the Ukrtransgaz team, the Ukrainian Army, the local authorities and consumers enabled the timely repair of the critically damaged pipelines. An emergency termination of gas supply, which would require months of work to restore gas flows, was avoided.

As a result of the conflict, the Severodonetsk site for the extraction of gas and condensate partially suspended operations of 6 gas processing plants: Vilhivska, Lobachivska, Kondrashivska, Markivska, Kruzhylivska and West Verhunska. Shebelynkagasvydobuvannya's losses in extraction of natural gas incurred as a result of the hostilities as of July 2015 amounted to 636 tcm of gas per day.

The infrastructure of oil pipelines of the Dnipro Main Oil Pipelines branch (Vovchoyarivka, Popasna district, Luhansk region) was also hit. Technological and auxiliary equipment, buildings and structures, and vehicles of the Lysychansk linear supply control station were damaged.

Illegal armed groups captured nine vehicle gas filling compression stations of Naftogaz subsidiary Ukravtogas, namely: Donetsk-2, Donetsk-3, Horlivka-1, Horlivka-2, Makiyivka-1, Makiyivka-2 Amvrosiyivka, Yenakiyev and Luhansk. 47 vehicles

belonging to this entity have been stolen since the beginning of the hostilities.

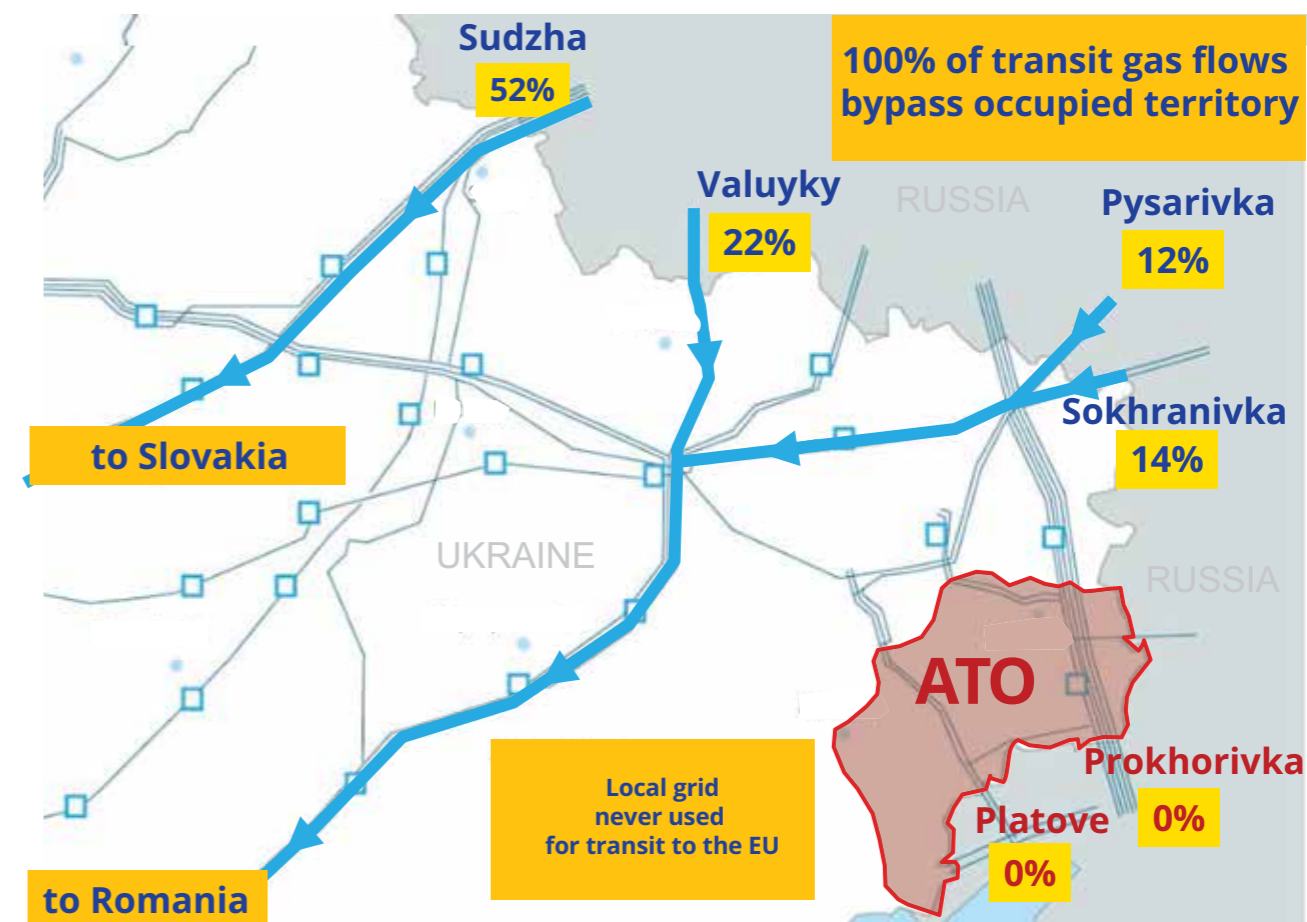
### ILLEGAL SUPPLIES TO THE OCCUPIED TERRITORIES BY GAZPROM

Neither Naftogaz nor Ukrtransgaz have personnel at gas metering stations (GMS) in the Anti-Terrorist Operation (ATO) area. Because of the occupation of the southern Donbas and the ongoing hostilities, the group is unable to ensure the presence of technical experts at gas pipelines in the area as this would pose a risk to their lives. As a result, there are no authorized representatives of Naftogaz at Prokhorivka GMS and Platove GMS to verify the volumes and quality of gas which Gazprom claims to supply to the occupied territory.

The contract between Naftogaz and Gazprom specifies that technical operators Ukrtransgaz and Gazprom agree on the scope and terms of gas supply. In this regard, Gazprom sends its total transit volume nomination to its Ukrainian counterpart indicating gas volumes it would like to receive at specific exit points. Ukrtransgaz then indicates specific entry points where the nominated volumes of gas for both transit and use in Ukraine (if any) should be directed by Gazprom for entry into the Ukrainian gas transmission system.

Starting from February 2015, Gazprom claims to allegedly supply gas through

### RUSSIAN GAS SUPPLY ROUTES



GMS that have not been approved by the operator of the Ukrainian gas transportation system in breach of the contract. Such supplies would rely on infrastructure located in the military action zone and may lead to catastrophic outcomes. No adequate maintenance can be guaranteed in the occupied area because of the shelling, asset seizure and damage inflicted by illegal armed groups.

Naftogaz is not in a position to accept the delivery of such supplies because they were not nominated and are neither certified nor controlled by the group's authorized personnel.

### GAS FLOW FROM RUSSIA TO EUROPE: UKRAINE CONTINUES TO BE TRANSPARENT AND RELIABLE PARTNER

Naftogaz continues to ensure uninterrupted gas flow to Europe despite the Russian aggression against Ukraine.

Ukraine is committed to be a reliable partner for the European Union.

At the same time, Naftogaz would like to bring to the attention of the international community a risk related to the unauthorized gas supplies by Russia to the occupied territories of Donbas.

Naftogaz is concerned that the Russian counterparty may declare that it has sent certain volumes of gas destined for transit to its European clients through the uncontrolled territories. Such a claim would pose a serious threat to the stability of gas flows to Europe since Naftogaz would not be in a position to retrieve such volumes of gas from the territories occupied by the illegal armed groups.

Gas supplied for transit to Moldova and the EU has never passed through the region now occupied in Donbas. Existing routes of gas flows from Russia to the EU

via the Ukrainian territory have proved secure for decades. There is no reason to use the longer route that passes the military actions area for supplying gas to the EU.

Such unauthorized supplies would violate the contract as well. Nevertheless, considering Gazprom's readiness to deviate from the contract in its alleged supplies to Donbas, the situation when Russia claims supply of gas for transit through the occupied region, announces unauthorized withdrawals by Ukraine and completely terminates supplies on this ground, cannot be ruled out.

Directing gas flows nominated for transit to the EU via territories that are not controlled by the Ukrainian authorities, specifically, through Prokhorivka GMS and Platove GMS, is unreasonable, economically inefficient and threatens the security of supplies to European consumers.

## STATEMENT OF DEPUTY CHAIRMAN

Sergiy Konovets



Dear readers!

I would like to address the financial aspects of the operations of Naftogaz and its subsidiaries.

Like most of my colleagues who took the responsibility to lead Naftogaz, I joined the company in early April 2014. I learned of the opportunity via the Professional Government initiative of Ukrainians who have graduated from Western universities.

The new management team took over a strategic company, and along with this great responsibility we have also inherited a legacy of accumulated challenges and problems. In the aftermath of numerous years of unresolved issues, the Naftogaz group faced huge losses (UAH 88.4 billion) and an enormous deficit (UAH 108.6 billion) in 2014.

To address the group's challenges related to finance, we are taking steps in three main areas:

- eliminating the reasons behind systemic losses of Naftogaz
- ensuring the sustainable solvency of the group and restoring its liquidity
- securing the group's transparency and improving its operational efficiency

### TRANSFORMING THE LOSS-MAKING BUSINESS MODEL

The main underlying factor behind the systemic losses of Naftogaz is the populist policy of previous governments to maintain below-the-market retail gas prices for certain categories of consumers. Instead of the conventional model of developed countries, where targeted subsidies are provided by the state only to vulnerable consumers, Ukrainian politicians subsidized all consumers through low gas prices.

*Such a system skews the very principle of social justice: the government subsidies in the form of low gas prices are obtained not only by the poor, but also by those who are financially secure*

This model has led not only to shifting actual expenditures of the state budget to Naftogaz, but also served as a stimulus for corruption in the gas sector.

*As a result of this unsustainable practice, for many years Naftogaz has been selling imported gas to consumers for less than its cost, thus requiring more and more compensations from the state budget and accumulating multi-billion dollar debts*

In particular, in 2014 the imported gas used for production of heat for households cost Naftogaz from USD 270/tcm to USD 380/tcm while its selling price during the same year decreased from USD 95/tcm to USD 48/tcm because of the devaluation of hryvnia. The total negative difference between the purchase price of gas for Naftogaz and the sale price of the same gas for the needs of households in 2014 amounted to tens of billions of hryvnias.

Over the last five years, financial results of Naftogaz have also deteriorated because the selling price of Ukrainian gas produced by Ukrgasvydobuvannya (UGV), a subsidiary that provides about 60% of gas for households, was administratively set at a level more than 10 times lower than fair market price. In 2014, the administratively set price was only UAH 349/tcm.

As a result, UGV has been unable to invest in the development of its own production for years and the need for imported gas has remained consistently high.

Global energy prices rose rapidly for several years, and Ukraine had to pay a high price for imported gas due to a combination of dependence on one supplier (Gazprom) and various schemes with intermediaries built in the past around the purchase of Russian gas.

At the same time, retail gas prices for households remained almost unchanged, which resulted in growth of Naftogaz losses from year to year. In 2007, the negative difference between the purchase and sale prices of gas for households in Ukraine was USD 300 million, or 0.2% of GDP, while in 2012 it grew to USD 3.6 billion, or 2% of GDP.

*For many years, the accumulation of operational losses of Naftogaz was an inherent feature of the business model of the group. This business model, in our view, is inefficient and should be changed*

The issue of systemic losses should be resolved in three ways:

1. **Bringing the purchase price of imported gas down to fair market levels.** Throughout 2014, the group's management demonstrated not only the intent to do so, but also an ability to significantly reduce the cost of imported gas.

Unlike in April 2014, when most of Ukraine's needs in imported gas could only be met by importing gas from Russia, at a price 30% higher than European customers were paying, today we have the opportunity to purchase significant volumes of gas from EU countries. As a result, Gazprom now offers us gas at a price level comparable to the prices at which we are able to buy from European suppliers.

2. **Increasing domestic production by raising the selling prices of gas produced by UGV** to a level that would ensure sustainable levels of investment. Starting from April 2015, the sale price of gas produced by UGV was increased by 4.6 times. However, much of this increase has been offset by a simultaneous increase in royalty rates associated with hydrocarbon extraction from 20% to 70% of the gas price. In April 2016, the gas price for UGV will be increased to accommodate necessary investments in production growth.
3. **Gradual bringing of retail prices for all categories of consumers to a fair market level.** Even with the decrease of the prices of imported gas to market levels and domestic production growth, the only way to ensure Naftogaz operating profitability is to allow the group to sell gas at market prices.

This task is one of the key elements of the gas market reform initiated by the government and strongly supported by Naftogaz. The reform process foresees the gradual shifting of retail gas prices towards fair market levels.

*This is the beginning of the transition from the existing practice of multi-billion injections by the state budget to cover Naftogaz losses towards direct state assistance to the vulnerable categories of consumers through effective and transparent targeted subsidies mechanism*

Successful implementation of these steps will allow Naftogaz, for the first time in many years, to break even. As a consequence, the company's activities will ensure sufficient tax payments to the state budget to finance targeted subsidies programs.

## ADDRESSING LIQUIDITY AND SOLVENCY ISSUES

The second challenge for the efficient management of the group's finances is restoring liquidity, both in terms of the group's ability to pay to external and internal creditors, and financing sufficient levels of working capital.

*By the beginning of 2014, Naftogaz had accumulated multi-billion dollar liabilities, mostly denominated in foreign currency, consisting of loans and outstanding invoices for imported gas*

Because of the prepayments for gas transmission services Naftogaz received from Gazprom and spent in 2010-2012, we started to receive cash from this segment only in late 2014. There were also unresolved issues regarding the terms of supply of gas from Russia after 1Q 2014.

Economic and political developments in Ukraine in 2014 also negatively affected the performance of the group. Because of hryvnia devaluation and the loss of gas production capacities in Crimea and in the area of the Anti-Terrorist Operation (ATO) in eastern Ukraine, Naftogaz cash outflows increased by more than UAH 47 billion.

*Under these conditions, the deficit of the group in 2014 could have amounted to UAH 142 billion. To address this extreme liquidity crisis, the new Naftogaz management team implemented a number of measures which resulted in a 24% reduction of the deficit*

After numerous rounds of trilateral negotiations involving Ukraine, the Russian Federation and the EU, an agreement with Gazprom was reached on the reduction of Russian gas prices. Furthermore, Naftogaz also secured supply of imported gas from Europe at market prices, implemented certain measures to improve cash collection from domestic customers, and restructured some existing loans.

The remainder of the deficit (UAH 108.6 billion) was covered by attracting loans totaling UAH 12 billion and through funding by the state budget totaling UAH 96.6 billion. The latter funds were

transferred to Naftogaz share capital in the form of domestic government bonds.

For many years the state did not fully compensate Naftogaz for the difference between the purchase and sale prices of gas consumed by households. As a result, the group covered the deficit by accumulating loans and other liabilities. The time to pay these bills eventually came in 2014.

*Addressing the issue of the Naftogaz deficit through direct support from the state budget is an unsustainable and irrational strategy. It could only be justified in emergency cases, like the one Naftogaz faced in 2014*

This decision to provide the record volume of state support to Naftogaz was difficult. However, it was necessary to guarantee sufficient gas supplies to Ukrainian consumers during the winter of 2014-2015 and the stability of gas transmission to the EU. In addition, most of the accumulated past liabilities of Naftogaz were guaranteed by the state.

*The funds received from the state in 2014 allowed us to purchase the necessary volumes of imported gas (both from Russia and from Europe) to make sure that Ukrainians have gas and heat during the winter season*

Along with addressing the issue of debt repayments, an important challenge for our team has always been and still remains securing sufficient working capital. The business model developed before 2014 (where the imported gas was paid for upon delivery, the operations were financed through advances, and consumers were allowed to accumulate huge debts) changed dramatically in 2014. In particular, Naftogaz had to prepay any gas it imports.

The timely repayment of Eurobonds and the restructuring of other debt has significantly improved the solvency of the group. This allowed Naftogaz to start negotiations on the working capital financing with international financial institutions, at interest rates much lower than at the domestic market.

## ENSURING TRANSPARENCY AND OPERATING EFFICIENCY

The third challenge for the efficient management of the group's finances, in addition to addressing the loss-making business model and the liquidity crisis, is overcoming the consequences of corrupt practices, lack of transparency and inefficient corporate governance, form which the group has suffered for years.

*One of the most striking examples of the poor governance is the fact that before we joined Naftogaz, independent audits of the group's financial statements had not been conducted for two consecutive years*

It is highly possible that the main reason for such a delay in preparation of financial statements could be a reluctance of the previous management to reveal certain decisions and activities to the public.

In particular, in the notes to the consolidated financial statements for 2012-2013 and 2014, we expressed doubt as to the reasonableness of costs incurred totaling about UAH 29.5 billion according to the primary documents related to 2012, 2013 and the first quarter of 2014.

We also have doubts about the completeness of the recorded revenues from the sale of liquefied petroleum gas in 2012-2013, which amounted to UAH 4.6 billion, according to the primary documents. Information on each of these cases was properly reported to the relevant law enforcement authorities. In the opinion of the current management, the counterparties in these transactions could be companies and individuals associated with the former group management and the former government.

We also question the validity of the storage costs for technological oil approved by the former management of Ukrtransnafta in 2014, totaling UAH 164 million.

Until the completion of the respective investigations and enforcement of court decisions, all of the above mentioned transactions have been recorded based on the primary documents and accompanied by our comments in the corresponding notes to the consolidated financial statements. The auditor's report also makes relevant comments on these issues.

Furthermore, we strongly believe that another important way to improve operational effectiveness is the implementation of a transparent procurement system.

In particular, Naftogaz now solicits bids for goods and services not only in specialized publications but also through the mass media. In 2015, Naftogaz and UGV joined ProZorro, the newly developed system of e-procurement for public sector companies.

The transparency and availability of information about Naftogaz procurement allows us to reach a wide range of potential contractors and thus to ensure we get the optimal terms. A small example is the tender for cleaning services in Naftogaz headquarters. A subsidiary of Naftogaz, which had performed this function for many years, offered its services for UAH 11 million, which was almost five times higher than the best bid from external contractors that met the qualification criteria. Consequently, the independent company won the contract, and currently performs the same job at a much lower price.

As a result of correcting the business model and the improving the operational efficiency of Naftogaz, we expect to see a substantial reduction in the deficit of the group in 2015. Successful implementation of the reform of the gas market in Ukraine will enable Naftogaz to become profitable and deficit-free by 2017.

We will continue to work on improving the transparency of Naftogaz and its subsidiaries by publishing annual audited consolidated financial statements and by starting to publish interim (quarterly) consolidated financial statements starting from 2016.

*In two years, Naftogaz and its subsidiaries will be transformed from a 'black hole' of the state budget to a transparent and profitable group of companies that can compete successfully on the market and ensure stable tax revenue stream for the state budget*

SERGIY KONOVETS  
*Deputy Chairman of the executive board,  
Naftogaz of Ukraine*

## MANAGEMENT COMMENTS ON THE AUDITOR'S OPINION



At the time of the change in management in spring 2014, audited consolidated financial statements of Naftogaz had last been prepared in 2011. The process of preparing the group's financial statements for 2012 and 2013 had not begun. No auditor had been appointed to carry out a financial audit for this period.

Thus, preparation of the consolidated financial statements for 2012 and 2013 and respective audit began only in the second quarter of 2014. Failure to carry out necessary audit procedures at the end of the reporting period was the main reason for the auditor's disclaimer of opinion on Naftogaz financial statements for 2012 and financial results for 2013. As to the financial position as at 31 December 2013, the auditors expressed a qualified opinion with six qualifications.

The auditor expressed a qualified opinion on Naftogaz financial position and financial performance for 2014. Major part of the modifications in the auditors' report for 2014 were carried forward from the respective modifications for 2013 results as comparatives, and should not impact the auditors' report for the year 2015.

### OPINIONS OF THE INDEPENDENT AUDITOR ON THE CONSOLIDATED FINANCIAL STATEMENTS OF NAFTOGAZ

	2012	2013	2014
<b>STATEMENT OF FINANCIAL POSITION</b>	Disclaimer of opinion	6 qualifications, qualified opinion	1 qualification, qualified opinion
<b>STATEMENT OF PROFIT OR LOSS</b>	Disclaimer of opinion	Disclaimer of opinion	6 qualifications, related to 2013 financial report, qualified opinion



### AUDITOR'S QUALIFICATIONS AND RELATED COMMENTS

Auditor's qualification (the qualification number in the auditors report indicated in brackets)	Effect on :		Management comments
	Statement of financial position as of 31 December 2014	Statement of profit or loss 2014*	
<b>Technical accounting issues:</b>			
Absence of revaluation of property, plant and equipment at the beginning of the reporting period, and related impact of revaluation reserve in 2013 and 2014 (1)	no	yes (12% of net loss)	As at 31 December 2014, an independent revaluation of property, plant and equipment was carried out by Ernst & Young. Hydrocarbon reserves were evaluated by Ryder Scott.
Absence of independent revaluation of hydrocarbon reserves at the beginning of the reporting period, and related impact of revaluation on depletion in 2014 (2)	no	Yes (3% of net loss)	
Use of different accounting policies by the group and the group's associates and joint ventures (5)	yes (2% of assets)	yes (3% of net loss)	The company has started the process to unify accounting policies for the purpose of preparing consolidated financial statements. It should be noted that the ability to influence the accounting policies of companies not controlled by Naftogaz is limited.
<b>Loss of access to the financial information of Chornomornaftogaz:</b>			
Loss of access to the financial information and primary documents of Chornomornaftogaz (3)	no	yes (16% of net loss)	Management continues to take all possible legal and diplomatic measures to obtain a reimbursement of losses and renew control over the group's assets in Crimea
<b>Late appointment of auditor for 2013 audit:</b>			
Unconfirmed inventory quantities as of the beginning of the reporting period (4)	no	yes (1% of net loss)	Inventory stock-take as at 31 December 2014 was carried out with the participation of the auditors
<b>Presentation and accuracy of the consolidated financial statements and impact of possible alleged fraud by the previous management:</b>			
Nature of certain expenses may not be reflected in their legal form. Exposure to this issue amounts to UAH 2.3 billion for the 1st quarter of 2014 and UAH 8.8 billion for the year 2013 (6)	no	yes (3% of gross loss)	State prosecutor officials initiated criminal proceedings in respect of the possible alleged fraud by the previous management that may have resulted in certain costs
Lack of sufficient evidence regarding completeness of revenue on sales of petroleum in the amount of UAH 2.8 billion for the year 2013 (7)	no	no	

\*The impact on the result of operations was calculated with reference to the total line in the consolidated statement of profit or loss where the qualified amount was included

## OPERATING AND FINANCIAL HIGHLIGHTS

	2013	2014	+/-	%
<b>Key operating highlights of the group*</b>				
Proven hydrocarbon reserves (SPE-PRMS), million boe	N/A	1 618.56		
Gross natural gas production (excluding production sharing agreements), mcm	14 021	14 034	13	0%
Gross production of crude oil and gas condensate, thousand t	738	637	(100)	-14%
<i>In Ukraine</i>	645	535	(110)	-17%
<i>In Egypt</i>	93	102	10	11%
Volume of natural gas sold, mcm	32 123	29 232	(2 891)	-9%
Transportation of natural gas under the contract with Gazprom, mcm	86 126	62 197	(23 929)	-28%
Domestic transportation of natural gas in Ukraine, mcm	44 097	38 122	(5 975)	-14%
Transmission of crude oil, mcm	17.6	16.9	(1)	-4%
Sales of petroleum products, thousand t	687	403	(284)	-41%
Sales of LPG, thousand t	206	177	(29)	-14%
Sales of natural gas via petrol stations, mcm	130	97	(33)	-26%
<b>Key financial highlights of the group, in UAH million unless otherwise stated</b>				
Revenue	75 374	78 444	3 070	4%
Gross loss	(752)	(8 507)	(7 755)	1031%
EBITDA	(1 426)	(63 792)	(62 366)	4373%
Loss before tax, including	(15 492)	(77 603)	(62 111)	401%
Loss before tax from the regulated businesses**	(26 765)	(88 893)	(62 128)	232%
<i>Production of natural gas</i>	(1 163)	(4 696)	(3 533)	304%
<i>Storage of natural gas</i>	(661)	(2 986)	(2 325)	352%
<i>Wholesale distribution and trading of natural gas</i>	(24 941)	(81 211)	(56 270)	226%
Loss before tax from the non-regulated businesses	11 165	10 575	(590)	-5%
<i>Transmission of natural gas</i>	9 435	7 448	(1 987)	-21%
<i>Refinery of crude oil and gas condensate</i>	1 437	1 995	558	39%
<i>Transmission of crude oil</i>	435	1 115	680	156%
<i>Other</i>	(142)	17	159	-112%
Unallocated income and expenses	108	715	607	562%
Loss from discontinued operations	(874)	(13 786)	(12 912)	1477%
Net loss	(17 957)	(88 433)	(70 476)	392%
<b>Statement of financial position of the group, in UAH million unless otherwise stated</b>				
Total assets, including	237 918	514 979	277 061	116%
- property, plant and equipment	181 428	454 991	273 563	151%
Equity	106 975	356 958	249 983	234%
Borrowings, including	130 883	158 001	27 118	21%
- long term	14 388	26 188	11 800	82%
- short term	45 170	34 820	(10 350)	-23%
Working capital	(11 108)	12 320	23 428	-211%
Capital expenditure	4 234	3 672	(562)	-13%

	2013	2014	+/-	%	
<b>Statement of cash flows of the group, in UAH million unless otherwise stated</b>					
Net cash used in/generated from operating activities	(1)	7 155	(59 738)	(66 893)	-935%
Net cash used in investing activities	(2)	(3 231)	(3 959)	(728)	23%
Cash outflow from financing activities (repayment of borrowings, interest paid and mandatory budget contribution of profit share)	(3)	(29 122)	(43 873)	(14 751)	51%
Net change in cash balance	(4)	(109)	(1 002)	(893)	819%
Net cash flow before deficit financing and other sources (deficit)	(5 = 1 + 2 + 3 + 4)	(25 307)	(108 572)	(83 265)	329%
Sources to cover the deficit		25 307	108 572	83 265	329%
- proceeds from borrowings		19 483	11 962	(7 521)	-39%
- proceeds from sale of state treasury bonds contributed to share capital		5 824	96 610	90 786	1559%

\* operating indicators do not include information on SJS Chornomornaftogaz, as the group has lost control over the assets after the occupation of Crimea by the Russian Federation

\*\* regulated businesses are activities where sales prices and tariffs are regulated by the state

Entity	Operating profit / (loss), % to revenues	Net Profit / (loss), % to revenues	ROE	ROA	Liquidity ratio	Total in-debtedness / Total assets	Cash-flow from operations / Capital expenditure
<b>Naftogaz</b>							
2013	-9.0%	-23.8%	-15.7%	-7.1%	44.4%	25.0%	195.7%
2014*	-39.9%	-112.7%	-24.8%	-17.2%	70.7%	11.8%	-2053.6%
<b>Peers (2014)</b>							
Total	4.3%	2.0%	4.5%	1.8%	145.3%	24.6%	97.3%
BP	5.1%	1.1%	3.1%	1.3%	137.2%	18.6%	145.3%
Petrochina	6.7%	5.2%	9.4%	4.9%	67.5%	22.4%	122.2%
Conoco	13.5%	13.1%	13.2%	5.9%	130.6%	19.4%	98.0%
CNOOC	16.0%	12.9%	12.3%	7.1%	109.5%	25.4%	210.1%
Gazprom	23.7%	-2.4%	2.1%	1.5%	170.0%	17.7%	103.8%
GAS NATURAL	12.9%	5.9%	10.6%	3.1%	128.5%	40.8%	207.5%
NOVATEK	35.7%	10.4%	9.9%	5.8%	155.9%	35.1%	189.1%
Kazmunaigaz	17.2%	5.6%	3.5%	3.1%	191.6%	0.5%	215.6%
ENI	7.2%	1.2%	2.3%	0.9%	150.0%	17.7%	141.2%
PGNiG	13.9%	8.2%	9.6%	5.8%	176.3%	11.9%	179.0%
OMV	2.9%	1.0%	3.1%	1.1%	93.6%	21.6%	95.6%
MOL	0.8%	0.1%	0.3%	0.1%	92.3%	20.7%	81.6%
<b>Average</b>	<b>13.7%</b>	<b>7.4%</b>	<b>7.9%</b>	<b>4.2%</b>	<b>134.5%</b>	<b>20.5%</b>	<b>138.2%</b>
<b>Median</b>	<b>12.9%</b>	<b>5.7%</b>	<b>9.6%</b>	<b>3.1%</b>	<b>137.2%</b>	<b>20.7%</b>	<b>127.4%</b>

\* ROE and ROA are calculated with reference to the total equity and total assets as at 31 December 2014

## REVIEW OF THE FINANCIAL PERFORMANCE

### REVENUE AND GROSS LOSS

Despite the decline in sales volumes, the group's revenue increased by 4% in 2014 compared to the previous year and amounted to UAH 78.4 billion. The structure of the revenue was as follows:

- Revenue from regulated businesses (wholesale supply and trading of natural gas, production of natural gas and storage of natural gas) increased by 23% and amounted to UAH 46 billion, due to the increase in tariffs and selling prices for natural gas and gas storage services
- Revenue from non-regulated businesses (production of crude oil and natural gas condensate, transmission of natural gas, transmission of crude oil, refinery of crude oil and concentrate, and other segments) decreased by 15% and amounted to UAH 32.4 billion. The decrease of the revenue from non-regulated activities is mainly explained by a decline in gas transmission volumes

The share of the revenue from regulated businesses increased by 9% in 2014 compared to 2013, and comprised 59% of the group's total revenue.

The gross loss of the group in 2014 amounted to UAH 0.8 billion (2013: UAH 0.8 billion). The gross loss was formed

by regulated businesses, accounting for 59% of the total revenue in 2014, because of the distortion between selling prices for gas and gas storage tariffs and their economically justified levels.

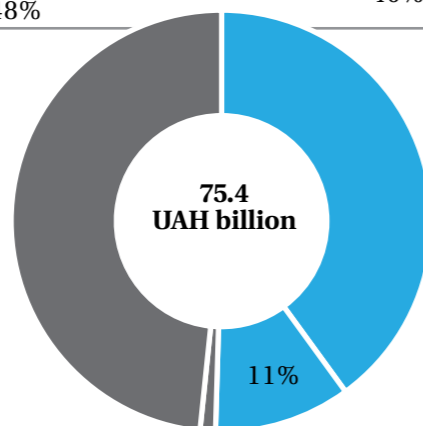
The gross profit margin of non-regulated businesses improved by 5% in 2014

compared to 2013, and reached 42%. This change was mainly driven by the increase in gross profit margin of crude oil transmission segment (explained by the devaluation of hryvnia) and the segment of production of petroleum products and LPG (explained by the 2.7 times increase in LPG prices).

REVENUE BY SEGMENT, 2013, %

Wholesale supply and trading of natural gas 48%

Transmission of natural gas 40%



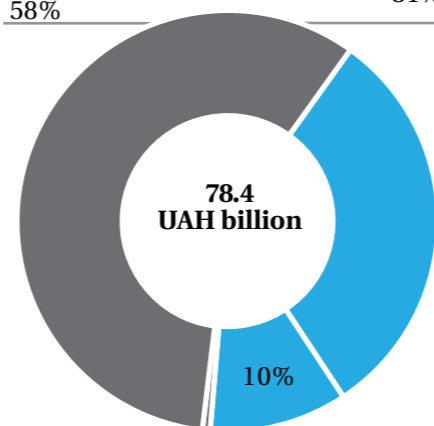
Regulated businesses 49%

Non-regulated businesses 51%

REVENUE BY SEGMENT, 2014, %

Wholesale supply and trading of natural gas 58%

Transmission of natural gas 31%



Regulated businesses 59%

Non-regulated businesses 41%



	Regulated segments				Non-regulated segments					Total
	Natural gas production	Natural gas storage	Wholesale supply and trading of natural gas	Total	Production of crude oil and condensate	Natural gas transmission	Crude oil transmission	Crude oil and condensate refining	Other	
<b>2013</b>										
Revenue, UAH million	446	443	36 447	<b>37 336</b>	207	30 131	1 411	5 778	511	<b>38 038</b>
Gross profit/(loss), UAH million	(97)	(612)	(13 946)	<b>(14 655)</b>	207	11 696	548	1 574	(122)	<b>13 903</b>
Gross margin (gross profit (loss)/revenue),%	-22%	-138%	-38%	<b>-39%</b>	100%	39%	39%	27%	-24%	<b>37%</b>
<b>2014</b>										
Revenue, UAH million	130	338	45 493	<b>45 961</b>	320	24 171	1 957	5 197	838	<b>32 483</b>
Gross profit/(loss), UAH million	(241)	222	(22 100)	<b>(22 119)</b>	320	9 482	1 110	2 182	520	<b>13 614</b>
Gross margin (gross profit (loss)/revenue),%	-185%	66%	-49%	<b>-48%</b>	100%	39%	57%	42%	62%	<b>42%</b>

## FINANCIAL RESULTS BY SEGMENTS

### REGULATED BUSINESS SEGMENTS

#### Gas upstream

The volume of natural gas produced by the group in 2014 amounted to 14 bcm, which is in line with the corresponding figure for 2013.

Gas production reflected in this segment is performed by one subsidiary of the group – Ukrgasdobuvannya (UGV), it excludes gas production under product sharing agreements of UGV and gas production of Ukrnafta.

As a result of the occupation of Crimea by the Russian Federation, Naftogaz lost control over assets of Chornomornaftogaz in Crimea 1Q 2014. Consequently, the financial results of Chornomornaftogaz have been excluded from these consolidated financial statements for 2013 and 2014. At the same time, Naftogaz purchased natural gas from Chornomornaftogaz for further sale to households of 1.6 bcm and 0.3 bcm in 2013 and 2014 respectively. Revenue and cost of such sales are included in the 'wholesale supply and trading of natural gas' segment.

The volume natural gas sold on by the group in 2014 amounted to 13.6 bcm (gross natural gas production volumes less gas used for technological needs, gas used as raw material for LPG

production, gas used for own needs (production premises heating, etc.), and sales of low condition gas).

According to the Law 'On the natural gas market functioning' (in effect till 1 October 2015), UGV is required to sell its marketable gas (all natural gas produced less gas used for technological and other own needs), to households via Naftogaz. Naftogaz purchase price of natural gas produced by UGV has been set by the National Energy and Utilities Regulatory Committee (NEURC). This price remained at the level of UAH 349.2/tcm excluding

VAT during 2013-2014. This is almost 10 times lower than the market price at which natural gas was sold to industrial customers. Revenues from natural gas sales to Naftogaz amounted to UAH 4.7 billion in 2014, and stayed at the same level as in 2013.

Losses in the production of natural gas in 2014 increased almost fourfold compared to 2013, and reached UAH 4.7 billion. This negative increase was driven mainly by impairment of property, plant and equipment totaling UAH 2.4 billion as a result of revaluation

### PRODUCTION OF NATURAL GAS

Key segment highlights, (in UAH million, unless otherwise stated)	2013	2014	+/-	%
Gross natural gas production (excluding product sharing agreements and Chornomornaftogaz), mcm	14 021	14 034	13	0%
including:				
technological needs	422	445	24	6%
as raw material for LPG production	92	92	(0)	0%
own needs	84	88	4	5%
for selling to households	13 423	13 409	(14)	0%
Segment assets	30 053	42 367	12 314	41%
Revenue, including	5 133	4 815	(318)	-6%
sales to Naftogaz	4 687	4 685	(2)	0%
sales to other entities	110	130	20	18%
services*	336	(336)	-100%	
Gross profit/(loss)	(97)	(241)	(144)	148%
% of revenue	-2%	-5%	-3%	165%
Segment result (loss before tax)	(1 163)	(4 696)	(3 533)	304%
% of revenue	-23%	-98%	-75%	330%
ROA (segment result/assets), %	-4%	-11%	-7%	186%
Capital expenditure	2 053	2 598	545	27%

\* such revenues moved to the "other" segment in 2014

### WHOLESALE SUPPLY AND TRADING OF NATURAL GAS

Key segment highlights, in UAH million unless otherwise stated	2013	2014	+/-	%
Volume of natural gas sold, mcm	32 123	29 232	(2 891)	-9%
Segment assets	29 869	28 347	(1 522)	-5%
Revenue, including:	46 275	53 257	6 982	15%
sales to third parties	36 447	45 493	9 046	25%
Gross profit/(loss)	(13 727)	(18 426)	(4 699)	34%
% of revenue	-30%	-35%	-5%	17%
Segment result (loss before tax)	(24 941)	(81 211)	(56 270)	226%
% of revenue	-54%	-152%	-99%	183%
ROA (segment result/assets), %	-84%	-286%	-203%	243%
Capital expenditure	30	262	232	773%

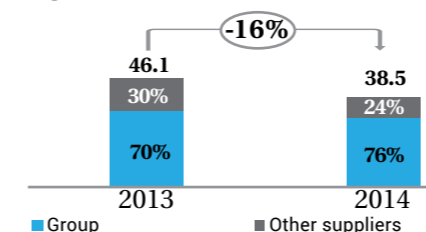
(no impairment was recognized in 2013), by an increase in foreign exchange losses of UAH 0.8 billion, and by a fall in revenues of UAH 0.3 billion.

#### Wholesale gas supply and trading

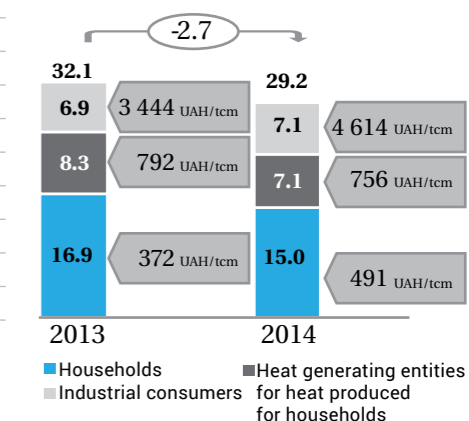
Natural gas consumption in Ukraine (excluding gas consumed for technological needs) in 2014 decreased by 16% compared to 2013 as a result of the economic crisis and industrial production decline, occupation of Crimea and the military conflict in the east of Ukraine. At the same time, volume of natural gas sold by the group decreased by only 9% compared to 2013, and amounted to 29.2 bcm. As a result, the group's share of the natural gas market increased by 6% in 2014 due to an increased share of industrial customers.

Revenue from sales of natural gas to third parties increased by 25% in 2014 compared to the previous year and amounted to UAH 45.5 billion (2013: UAH 36.4 billion). Despite a decline in the volume of sales, revenues in monetary terms increased due to a 56%

### NATURAL GAS SALES TO UKRAINIAN CONSUMERS, BCM



### VOLUME AND SELLING PRICE FOR NATURAL GAS SOLD TO CONSUMERS IN UKRAINE, BCM; UAH/TCM



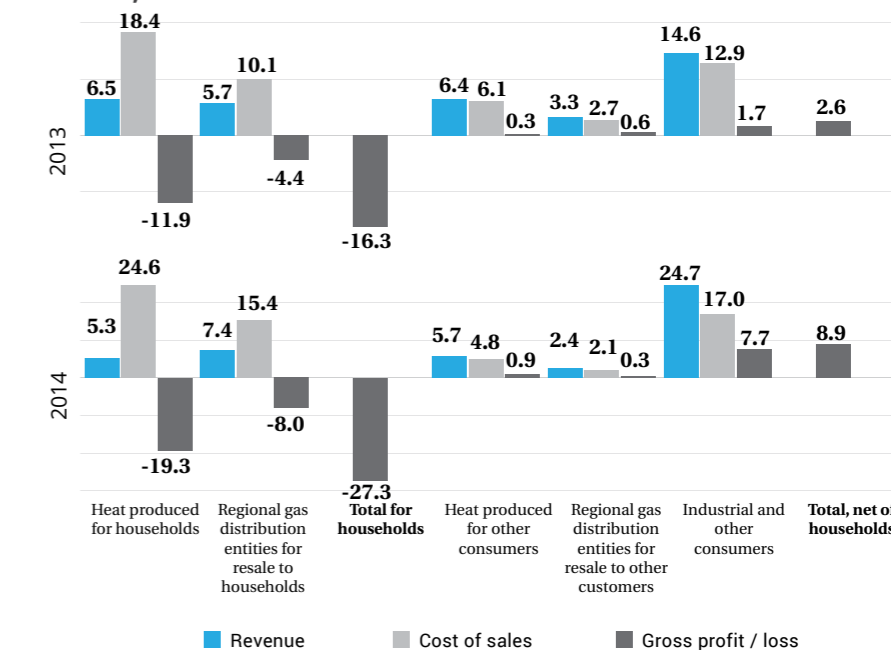
UAH 4.7 billion and amounted to UAH 18.4 billion in 2014. The main reason for the increased gross loss is the regulated selling price of imported natural gas to households set by the NEURC, which is significantly lower than the purchase price at which this gas was imported.

Households consume nearly 20 bcm of natural gas annually for cooking and heating, including consumption via

increase in natural gas selling price for households effective from 1 May 2014, and a 1.9 times increase in natural gas selling price for industrial customers executed in several steps during the year. The revenue decreased by UAH 3 billion because of the lower volumes of sold gas and increased by UAH 12 billion due to sale price adjustment.

However, the sale price increase was not able to fully offset the increase in the natural gas import price in UAH equivalent due to the devaluation of the national currency. As a result, the gross loss from natural gas sales increased by

### PROFIT/LOSS FROM NATURAL GAS SALES BY CONSUMER GROUPS IN 2013, UAH BILLION

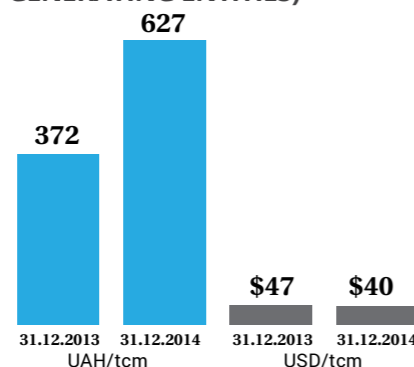


heat generating entities. This demand is partially covered by domestic supply amounting to nearly 60% (UGV and Chornomornaftogaz up until Q2 2014). Imported natural gas supplies covered 37% of the household demand in 2014 (for cooking and heating, including consumption via heat generating entities), direct sales to households included 1.6 bcm of imported gas.

As a result, additional gains from the sale price increase for households effective from 1 May 2014 (from UAH 372/tcm to UAH 627/tcm) were eliminated by the hryvnia devaluation. In fact, the weighted average gas price for households in dollar equivalent decreased by 15% during 2014 (from USD 47/tcm to USD 40/tcm).

Therefore, despite the sale price increase, the gross losses from natural gas sales for households grew to UAH 27.3 billion in 2014 (2013: UAH 16.3 billion).

### AVERAGE RETAIL GAS PRICES FOR HOUSEHOLDS (EXCLUDING SALES VIA HEAT GENERATING ENTITIES)



Gas sales to other groups of consumers (heat generating entities for heat produced for other customers, regional gas distribution entities for resale to other customers, direct contracts with industrial and other consumers) posted a positive margin. Based on regulations in effect till 1 October 2015, the NEURC sets maximum selling price for such

customers. Prices are reviewed monthly and adjusted for changes in import gas prices and UAH devaluation, ensuring positive gross margins of 11% and 27% for 2013 and 2014, respectively.

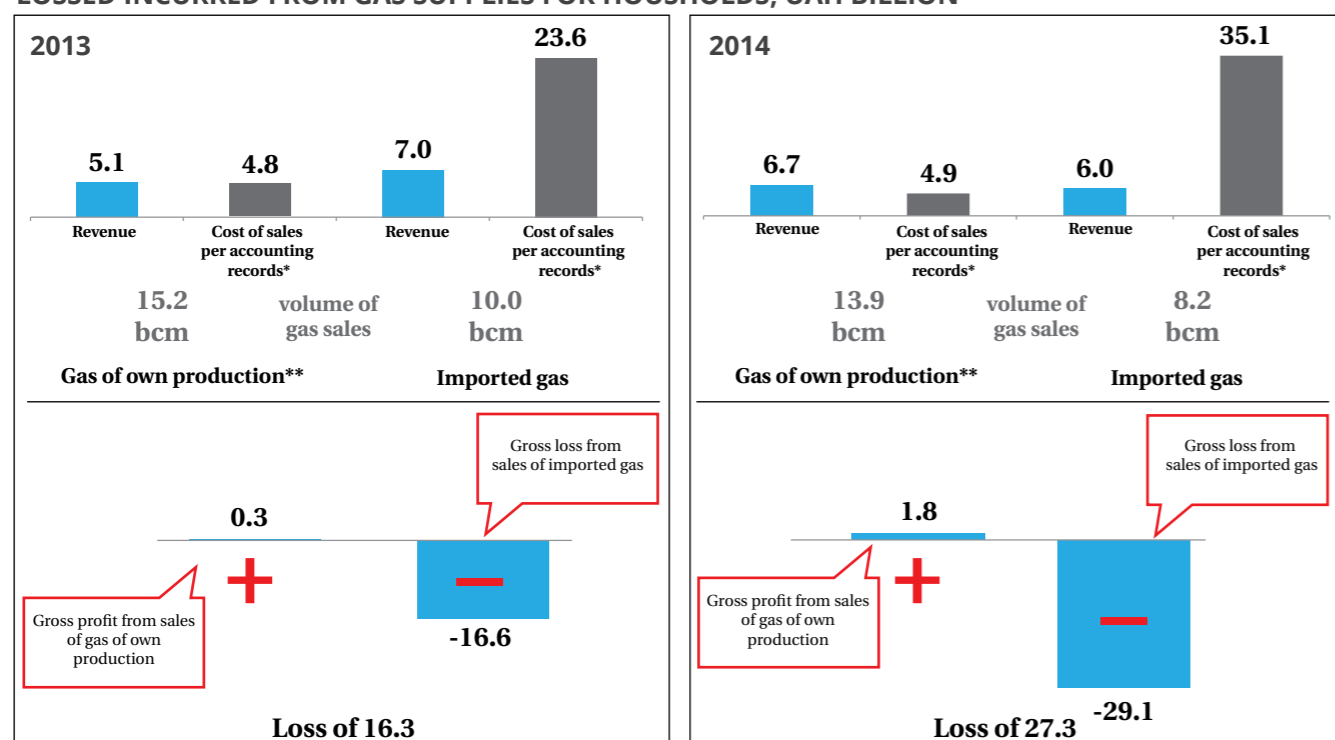
The gross profit from gas sales to non-household consumers in 2014 amounted to UAH 8.9 billion (2013: UAH 2.6 billion). However, this gross profit was not sufficient to cover the loss from gas sales to households. As a result, the segment posted a gross loss.

### Underground gas storage business

In 2014, the price of underground gas storage services increased by 2.6 times on average. As a result of this increase, revenues increased by 65% reaching UAH 1.4 billion. A major part of the underground storage services are consumed within the group (in 2014: 76%, in 2013: 49% of segment revenue).

Despite this revenue increase, the segment faced a UAH 3 billion loss in 2014, which is 4.5 times higher than

### LOSS INCURRED FROM GAS SUPPLIES FOR HOUSEHOLDS, UAH BILLION



\*cost of sales per accounting records includes inventory net realisable value adjustment according to IAS 2. This cost cannot be fully compared to the economic cost of sales, as it is not adjusted for the cost of capital, revaluation of property, plant and equipment and depreciation, depletion and amortisation.  
\*\*gas produced by Ukrgasvydobuvannya and Chornomornaftogaz

### STORAGE OF NATURAL GAS

Key segment highlights, UAH million unless otherwise stated	2013	2014	+/-	%
Tariffs for underground storage services, net of VAT*, UAH/tcm	16.50	42.83	26.33	160%
Revenue, including	868	1 430	562	65%
Sales to other segments	443	338	(105)	-24%
Segment result	(661)	(2 986)	(2 325)	352%
Segment assets	70 304	146 195	75 891	108%
ROA (segment result/assets), %	-1%	-2%	-1%	

\*tariff used to calculate the total price of services for natural gas pumping services, is calculated as the price of pumping services + 1/2 of tariff for gas underground storage services

the segment loss posted in 2013. The main reasons for the negative result were the UAH devaluation leading to increases in the cost of imported gas used for technological purposes, and the recognition of impairment loss for property, plant and equipment of UAH 2.3 million as a result of revaluation (no such losses were recognized in 2013). At the same time, the revaluation of property, plant and equipment was partially reflected as an increase in revaluation reserves in equity.

Negative segment results indicate that the current level of storage tariffs is below their economically justified levels. Naftogaz group plans to switch to the RAB methodology of calculating gas storage prices during 2016, in order to ensure a fair return on assets and improve the results of this segment.

### NON-REGULATED BUSINESS SEGMENTS

#### Gas transmission

The volume of natural gas transmission under the contract with Gazprom declined by 28% in 2014 compared to 2013 as a result of the policy of Russia to minimize the use of the Ukrainian gas transmission system to deliver gas to the EU. The share of the international transit from Russia to the EU and Turkey via the Nord Stream and Blue Stream pipelines which bypass Ukraine increased from 23% to 35% in 2014, according to Gazprom official data. Decreased gas demand in the European countries as a result of the warm winter (both at the

The volume of domestic gas transmission in Ukraine was 14% lower in 2014 compared to the previous year as a result of the economic crisis, the occupation of Crimea, and the military conflict in the eastern regions of Ukraine.

The decline in the revenue was caused by the following factors:

- Decrease in volumes of transmission (both international gas transmission under the contract with Gazprom and domestic transmission) contributed UAH 7.9 billion to the revenue decline
- Decrease of the transit fee under the contract with Gazprom by 10% in USD

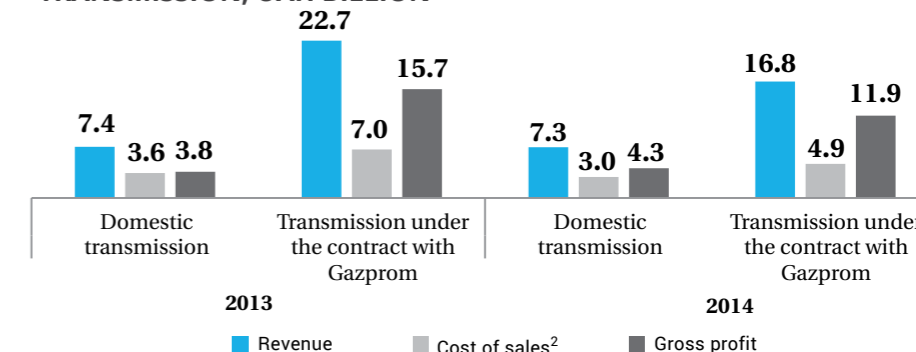
beginning and at the end of 2014) was an additional factor that contributed to the decline in international gas transit via Ukraine.

### NATURAL GAS TRANSMISSION

Key segment highlights, UAH million unless otherwise stated	2013	2014	+/-	%
Transmission of gas under the contract with Gazprom, mcm	86 126	62 197	(23 929)	-28%
Domestic transmission of natural gas, mcm	44 097	38 122	(5 975)	-14%
Segment assets	61 917	239 746	177 829	287%
Revenue, including:	30 131	24 228	(5 903)	-20%
international transmission	22 732	16 831	(5 901)	-26%
domestic transmission	7 399	7 340	(59)	-1%
Gross profit/(loss) <sup>1</sup>	11 696	9 482	(2 214)	-19%
% of revenue	39%	39%	0%	1%
Segment result (profit before taxes)	9 435	7 448	(1 987)	-21%
% of revenue	31%	31%	-1%	-2%
ROA (segment result/assets), %	15%	3%	-12%	-80%
Capital expenditure	1 195	295	(900)	-75%

<sup>1</sup>Including instate costs of the group

### KEY INDICATORS OF DOMESTIC AND INTERNATIONAL TRANSMISSION, UAH BILLION



<sup>2</sup> Not including internal costs of the group

equivalent in 2014 compared to 2013 resulted in a UAH 1.6 billion decrease in revenues

On the other hand, the following factors have partially offset the negative trend in the segment's revenue:

- Increase in tariffs for domestic gas transmission, set by the NERC, by almost 1.5 times effective from 1 June 2014. This resulted in a UAH 0.8 billion revenue increase
- UAH devaluation had an insignificant positive impact on the revenue, resulting in UAH 2.2 billion increase in the revenue from international gas transmission, as up to October 2014 the revenue was posted against advances made by Gazprom in 2010-2013 at a lower exchange rate

As a result of the revenue decline, the overall gas transmission segment result in 2014 decreased by 21% or by UAH 2 billion compared to 2013.

The significant decline in the ROA (return on assets, or ratio of the segment results to the segment assets) after the revaluation of property, plant and equipment in 2014 indicates that the transmission fee under the contract with Gazprom is lower than economically justified levels.

In October 2014, Naftogaz management initiated arbitration proceedings at the Arbitration Institute of the Stockholm Chamber of Commerce (SCC) regarding the gas transmission contract between Naftogaz and Gazprom in order to bring the transit fee to an economically justified level.

In addition, the NEURC plans to shift to RAB-methodology in determining transmission fees starting from 4Q 2015, in order to ensure fair return on assets, which will have a positive effect on the segment results.

#### Refining of crude oil and gas condensate, LPG production

The revenue of the segment amounted to UAH 5.2 billion, demonstrating a 10% decrease in 2014 compared to 2013. This decrease in segment revenue was mainly driven by a decline in sales of

### REFINERY OF CRUDE OIL AND CONDENSATE

Key segment highlights, UAH million unless otherwise stated	2013	2014	+/-	%
Sales of petroleum products, thousand t	687	403	(284)	-41%
Including:				
<i>petroleum products of own production</i>	474	364	(110)	-23%
<i>other sales</i>	214	39	(174)	-82%
Sales of LPG, thousand t	206	177	(29)	-14%
Sales of natural gas via petrol stations, mcm	130	97	(33)	-26%
Revenue, including:	5 778	5 197	(581)	-10%
<i>Sales of petroleum products of own production and LPG</i>	3 472	4 190	718	21%
<i>Sales of natural gas via filling stations</i>	688	659	(29)	-4%
<i>Other sales of petroleum products</i>	1 618	348	(1 270)	-78%
Segment results	1 437	1 995	558	39%
<i>Segment result margin (segment result/revenue), %</i>	25%	38%	14%	
Segment assets	2 387	5 007	2 620	110%
<i>ROA (segment result/assets), %</i>	60%	40%	-20%	

petroleum products produced from purchased raw materials by Naftogaz and Ukrtransnafta by UAH 1.3 billion. These activities are not core to Naftogaz and Ukrtransnafta, and they earned low margins, while freezing significant levels of working capital in inventory stock. Consequently, the management of the group has decided to cease this line of activity.

As a result, the revenue of this segment is formed largely by the sale of petroleum products and LPG produced from own raw materials by UGV and sale of compressed natural gas via filling stations of Ukravtogaz.

UGV revenue from this activity increased by UAH 0.8 billion in 2014 compared to 2013, despite a decrease in volumes of petroleum products and LPG sold by 110 thousand t and 29 thousand t, respectively.

The revenue growth is explained by the increase in LPG prices: 75% of the total LPG volume in 2013 was sold to households at low regulated prices, while 77% of the total LPG volume in 2014 was sold via commercial auctions at market prices. Reduction of sold volumes resulted in a 20% decline in

revenues, while the increased prices resulted in almost 40% revenue growth in 2014 compared to 2013.

Ukravtogaz revenue declined by UAH 0.03 billion in 2014 compared to 2013 because of a reduction of sales volumes caused by the military conflict in eastern regions of Ukraine.

The segment result improved by 39% in 2014 to UAH 2 billion. The segment profit margin reached 38%, showing a 14% increase from 2013 results. These results demonstrate that the terminating operations with petroleum products produced from purchased raw materials by Naftogaz and Ukrtransnafta was economically sound.

#### Crude oil transmission

Over the recent years volumes of crude oil transmission have continuously declined. This is explained by both a decrease in volumes of oil transmission to domestic refineries, and a decrease in oil transit volumes. The total volume of crude oil transmission decreased by 4% in 2014 compared to 2013 (including a 4% decline in crude oil transit and a 10% decline in the crude oil transmission to domestic refineries).

### OF CRUDE OIL TRANSMISSION

Key segment highlights, UAH million (unless otherwise stated)	2013	2014	+/-	%
Transportation of crude oil, million t	17.6	16.9	-1	-4%
Including:				
<i>international transmission</i>	15.6	15.0	-1	-4%
<i>transmission in Ukraine</i>	2.0	1.8	0	-10%
Revenue	1 411	1 957	546	39%
Segment result	435	1 115	680	156%
Segment assets	12 283	19 959	7 676	62%
<i>ROA (segment result/assets), %</i>	4%	6%	2%	

Out of 6 refineries in Ukraine, only the Kremenchuk Refinery is operating today. This refinery uses locally produced crude oil and light oil from the Caspian region delivered by railway transport. The main reason for other Ukrainian refineries to stop their activities was the competition from Belarusian, Russian and Baltic refineries, which take advantage of duty-free imports of oil products, close location to natural resources in the Russian Federation, the absence of Russian export duty and high level of technological development, allowing them to produce higher output of light oil products from Russian Urals crude oil.

The segment revenue rose to UAH 2.0 billion in 2014, showing a 39% increase compared to 2013 despite the decline in transmitted volumes. The main reason for this growth was the UAH devaluation, as oil transit charges are set in euros. Revenues increased by 43% as a result of UAH/EUR exchange rate changes, while the decrease in volume led to a 4% reduction in revenues.

ROA for the crude oil transmission segment indicates the low level of return on the assets employed. The oil transmission fee to Ukrainian refineries is approved by the NEURC and was set at the level of 2007. To improve the operating efficiency of Ukraine's domestic crude oil transmission network and infrastructure, the

domestic crude oil transmission fee has been increased by 6 times on average, effective from 1 July 2015.

#### Production of crude oil and gas condensate

The revenue of this segment is formed by sales made by the division in Egypt. All crude oil and gas condensate produced in Ukraine is refined and sold within the segment of refining crude oil and gas condensate.

The company entered into a concession agreement for oil exploration and development with the Arab Republic of Egypt (ARE) and the Egyptian General Petroleum Corporation (EGPC) covering the area of the Alam El Shawish East in the Western Desert (concession agreement) on 13 December 2006.

### PRODUCTION OF CRUDE OIL AND CONDENSATE

Key segment highlights, UAH million unless otherwise stated	2013	2014	+/-	%
Gross oil and condensate production in Egypt*, thousand t	92.6	102.4	10	11%
Including:				
<i>cost recovery portion</i>	59.4	65.9	7	11%
<i>profit sharing portion</i>	33.2	36.5	3	10%
Average oil price, USD/t	780	708	(72)	-9%
Revenue**	207	320	113	55%
Segment results**	207	291	84	41%
Segment assets**	-	3 424	3 424	
<i>ROA (segment result / assets), %</i>	-	8%		

\* Naftogaz share in gross output, excluding EGPC share

\*\*results earned in Egypt

The development period under the concession agreement is limited to a maximum of 25 years from the date of commercial oil discovery or from the date of the first natural gas deliveries, which started in 2011.

The concession agreement includes the following conditions:

- The company shall recover on a quarterly basis all exploration and development costs to the extent and out of 25% of all petroleum produced and saved from production areas and not used in petroleum operations
- The remaining 75% of the petroleum produced is shared by the company and EGPC depending on the volume of production. The company's share varies from 15% to 19%
- EGPC shall become the owner of all the company's assets acquired and owned within the concession agreement

Revenue increased by UAH 0.1 billion in 2014 compared to 2013, and reached UAH 0.3 billion. This increase in revenue is caused by an increase in crude oil production volumes (+UAH 0.02 billion) and the change in the UAH/USD exchange rate (+UAH 0.1 billion). Meanwhile, the revenue decreased by UAH 0.03 billion because of a decline in crude oil prices in 2014.

## NET LOSS FACTORS

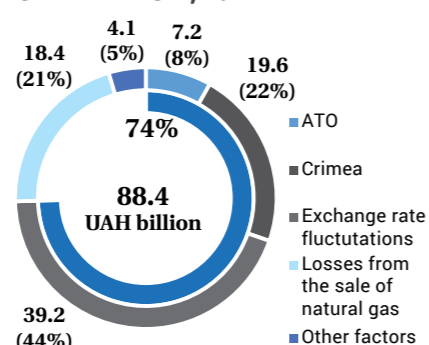
The group reported significant losses in 2014 compared to the previous year. The net loss for 2014 amounted to UAH 88.4 billion, which is almost five times higher than the net loss for the previous year (UAH 18 billion). In the total net result, 74% of net losses were caused by external factors beyond the group's management control: these included UAH devaluation and the loss of control over assets in Crimea and in the area of the Anti-Terrorist Operation (ATO) in the eastern Ukraine.

The main factors that contributed to the net loss in 2014 are as follows:

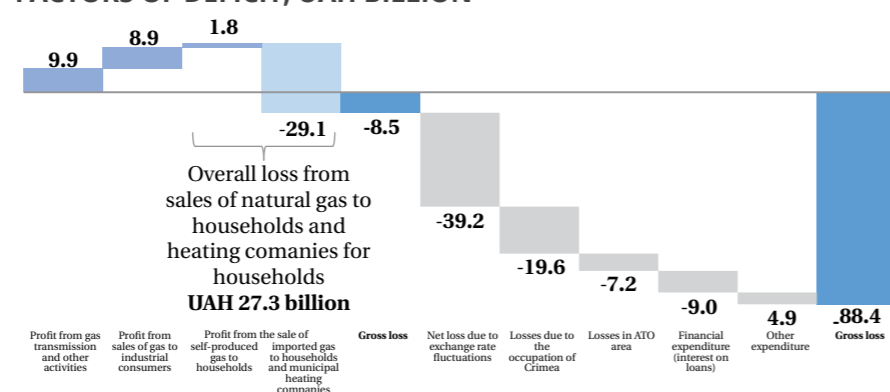
1. Net foreign exchange loss: UAH 39.2 billion, or 44% of total net losses. The group's indebtedness in foreign currency at the beginning of 2014 amounted to approximately USD 7 billion. During 2014 the UAH/USD exchange rate changed from UAH 7.99 per USD 1 at the beginning of the year to UAH 15.77 per USD 1 in December 2014, resulting in significant foreign exchange losses related to revaluation and settlement of the indebtedness denominated in foreign currencies
2. Loss on natural gas sales of UAH 18.4 billion, or 21% of total net losses
3. Losses incurred due to the loss of assets in Crimea – UAH 19.6 billion,

or 22% of total net losses. The group has faced UAH 13.8 billion losses in 2014 related to the temporary loss of control over the activities of its subsidiary Chornomornaftogaz, and

### LOSSES OF THE GROUP IN 2014, UAH BILLION, %



### FACTORS OF DEFICIT, UAH BILLION



additional UAH 5.8 billion losses from the loss of other assets located in that region. Additionally, the group has lost about 1.4 bcm of natural gas of domestic production that Naftogaz had to replace with natural gas imports

4. Losses incurred in the ATO area – UAH 7.2 billion, or 8% of total net losses. These losses were incurred because of unauthorized consumption of gas and further payment of VAT on such consumption, overdue receivables for gas consumed by those customers who stay on the territories beyond the control of the Ukrainian authorities, and losses of natural gas stored in the occupied regions

## REVIEW OF THE FINANCIAL POSITION

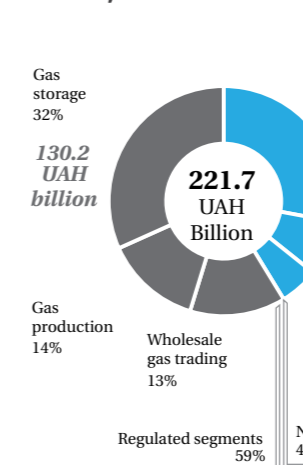
### ASSETS

As at 31 December 2014, the total assets of the group amounted to UAH 515 billion (including UAH 495.5 billion of segment assets). This amount is UAH 277.1 billion or two times higher than total assets as at 31 December 2013. The increase in the total assets is explained by an increase in non-current assets from UAH 194.8 billion up to UAH 471.7 billion (+143%) following a revaluation of property, plant and equipment. Compared to the previous revaluation performed in 2009, the key factors of this asset value increase were as follows:

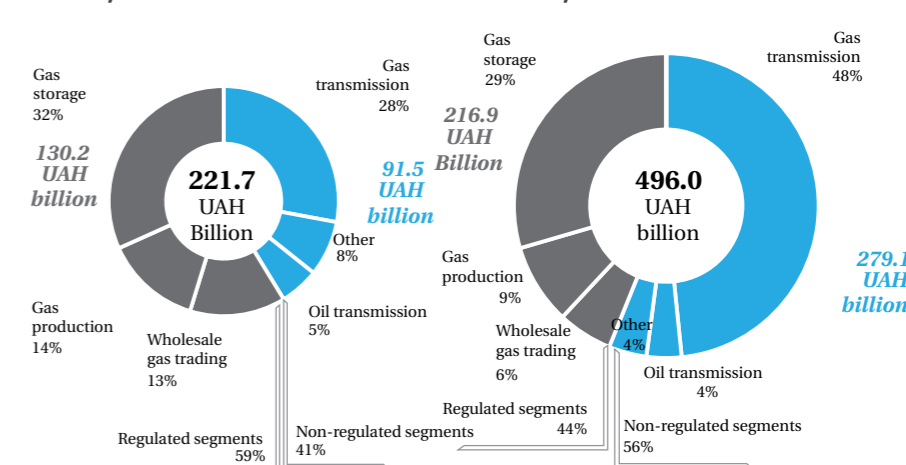
- Increase in prices of steel products, including pipes and steel structures
- Increase in fuel prices
- Increase in salary of construction and installation staff
- Increase in prices for both domestic and imported equipment
- Changes in the macroeconomic situation and oil and gas market forecasts

The share of assets of regulated businesses decreased from 59% as at 31 December 2013 to 44% as at 31 December 2014. The main factor contributing to the increase of share of non-regulated businesses in total assets was the revaluation of property, plant and equipment of the gas transmission segment.

### ASSETS BY SEGMENT 2013\*, %

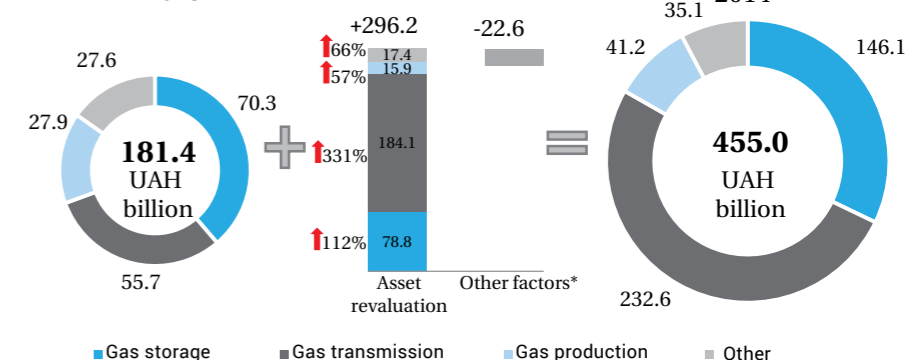


### ASSETS BY SEGMENT 2014\*, %



\*Not including unallocated assets and investments of UAH 16.2 billion in 2013, UAH 19.0 billion in 2014

### EFFECT OF REVALUATION ON THE VALUE OF PROPERTY, PLANT AND EQUIPMENT, UAH BILLION



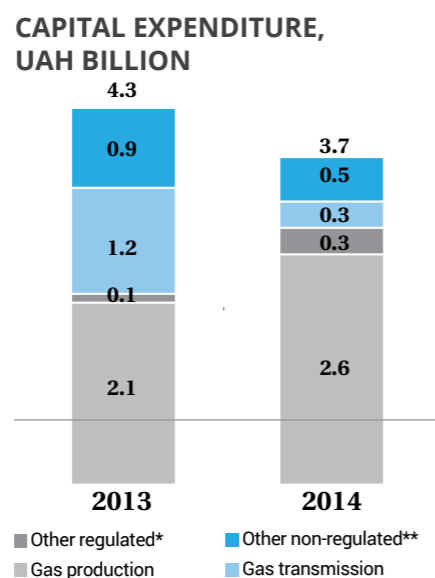
\*Receipt and transfer of fixed assets, disposal, calculation of depreciation, reclassification etc.

The total amount of the current assets did not change significantly during 2014. At the same time, their structure has changed: the amount of inventories and trade receivables decreased, while the amount of prepayments increased.

### CAPITAL EXPENDITURE

Naftogaz group's capital expenditure decreased by 14% in 2014 compared to 2013 and amounted to UAH 3.7 billion. In 2014, cash outflow related to capital expenditure amounted to UAH 2.9 billion, a decline of UAH 0.7 billion compared to 2013.

The priority for capital expenditures of the group is the natural gas production segment. In 2014, the capital expenditure in this segment amounted to UAH 2.6 billion. The main direction of capital expenditures within this sector was exploration and development drilling.



\*Other regulated segments: gas production and storage  
 \*\*Other nonregulated segments: production of crude oil and condensate, crude oil transmission and refining of crude oil and condensate, etc.

In 2014, the group had the lowest rate of capital expenditures in gas production and transmission among the group's domestic and international peers in oil and gas industry.

The underfinancing of capital expenditure was mainly caused by the misbalance between the selling price for gas produced by the group and market prices for gas. Another contributing factor and the necessity to finance the accumulation of large volumes of gas in underground gas storage facilities to ensure secure supply of gas to domestic consumers during the heating season.

### BORROWINGS

Naftogaz group's loans amounted to UAH 61 billion as at 31 December 2014 (31 December 2013: UAH 59.6 billion). This amount decreased by 48% from USD 7.5 billion to USD 3.9 billion in USD terms.

In 2014, Naftogaz:

- Repaid loans amounting to UAH 23.9 billion, including USD 1.6 billion or UAH 20.6 billion in Eurobonds
- Refinanced loans from Ukrainian banks amounting to UAH 12 billion
- Restructured loans that resulted in positive changes in the loan capital structure: long-term loans increased from UAH 14.4 billion to UAH 26.2 billion, while short-term liabilities decreased from UAH 45.2 billion to UAH 34.8 billion

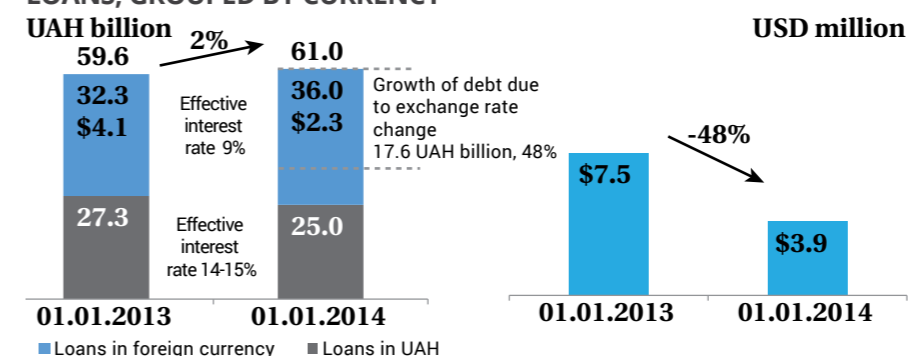
However, due to the devaluation of hryvnia, the amount of loans denominated in foreign currencies increased to UAH 25.3 billion.

Consequently, despite the fact that loans in USD terms decreased by 48% in 2014 compared to 2013, loans in UAH equivalent increased by 2%.

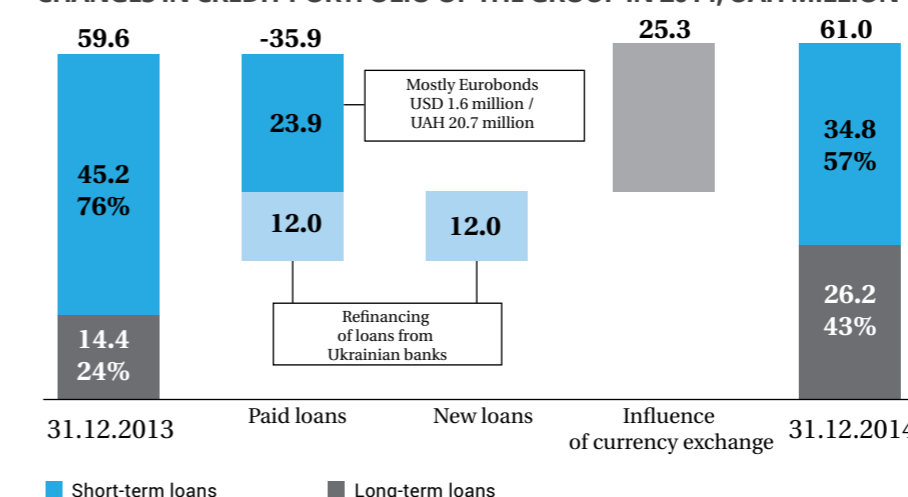
### WORKING CAPITAL

Naftogaz group's working capital structure depends on the conditions of natural gas sales and purchases and the conditions for providing natural gas transportation services under the existing contract with Gazprom. In 2013, Gazprom was the main supplier of imported natural gas to the company. Payments for the imported gas were made

### LOANS, GROUPED BY CURRENCY



### CHANGES IN CREDIT PORTFOLIO OF THE GROUP IN 2014, UAH MILLION



upon delivery according to the terms of the current agreement.

In 2013, due to a lack of available funds, the previous Naftogaz management negotiated a payment deferral with Gazprom for gas supplies for 4Q 2013 that resulted in an increase in accounts payable to USD 2.8 billion as at 31 December 2013. The group partially covered its deficit by advances received from Gazprom for transportation services. Advances received as at the beginning of 2014 amounted to USD 1.8 billion.

As a result of the outstanding accounts payable to Gazprom for gas supplies and the advances received for gas transportation services, the group had a negative working capital of UAH 11.2 billion as at 31 December 2013.

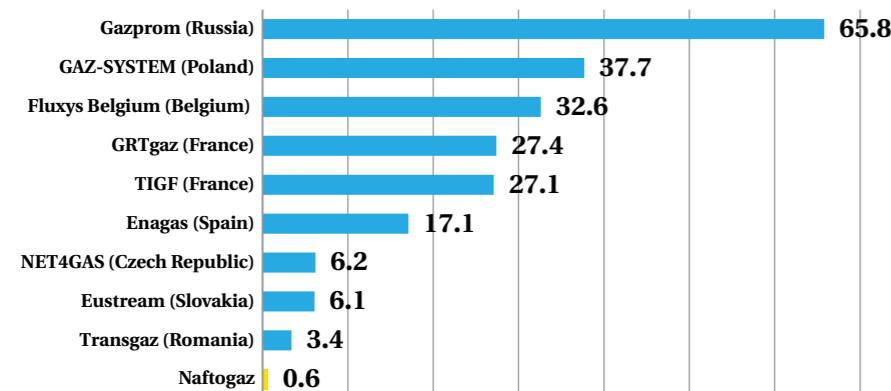
In 2014, because of the dispute between Naftogaz and Gazprom, the management

actively sought to diversify sources of supply of gas and to review the conditions of the current gas supply contract with Gazprom. This led to the signing of an amendment to the gas supply contract for the period of deliveries during the 2014-2015 heating season (in the framework of the so-called trilateral 'winter package' between Ukraine, Russia and the EU). As a result, the group prepays gas deliveries from both European suppliers and Gazprom.

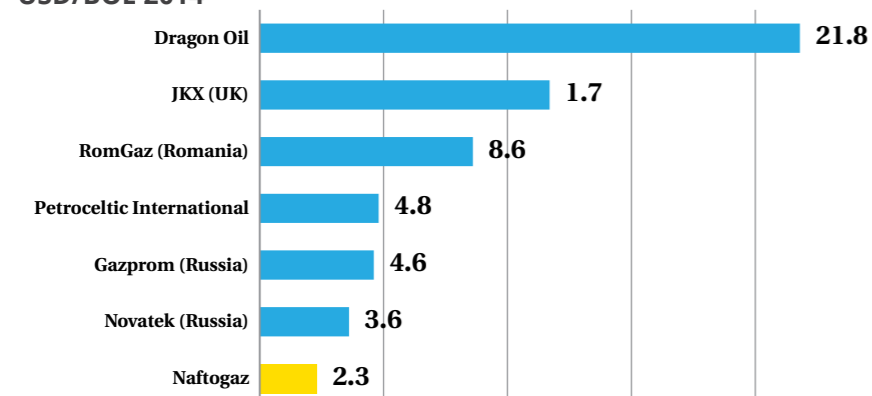
These changes to the operating conditions led to the following changes in the working capital:

- Inventories decreased by UAH 7 billion as at 31 December 2014, and amounted to UAH 10 billion. The main component of inventories (80%) is gas - the so-called 'active gas' (held in underground storage facilities and available for sale to consumers), as well as gas in the gas transmission system (nearly 1 bcm). The main factors behind the decrease in the inventory balance were a decrease in the volume of natural gas by 2.3 bcm, as well as a decrease in the weighted average cost of gas in the UGS and the gas transportation system. In addition, the

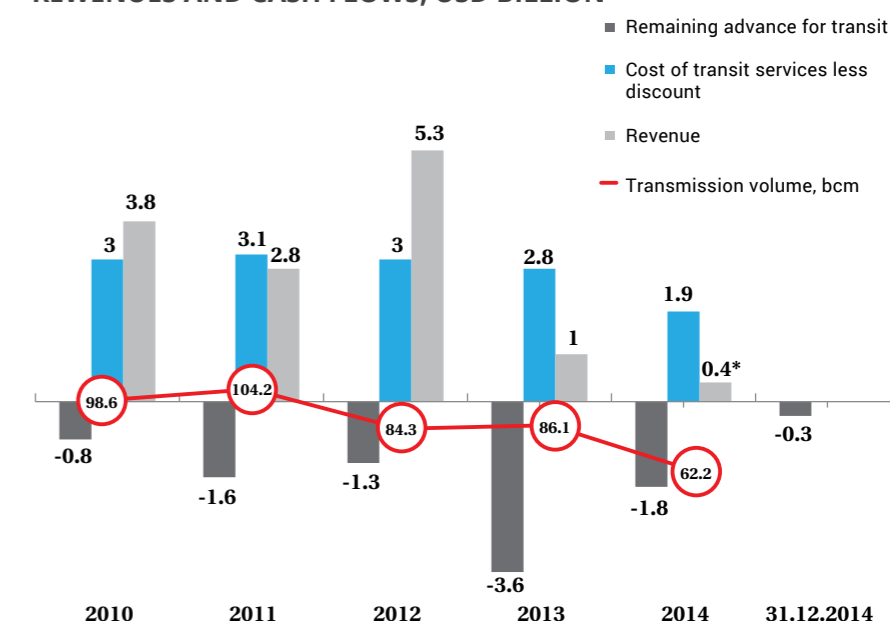
### CAPITAL INVESTMENTS TO NETWORK LENGTH, USD MILLION/KILOMETER, 2014



### CAPITAL INVESTMENTS TO PRODUCTION, USD/BOE 2014

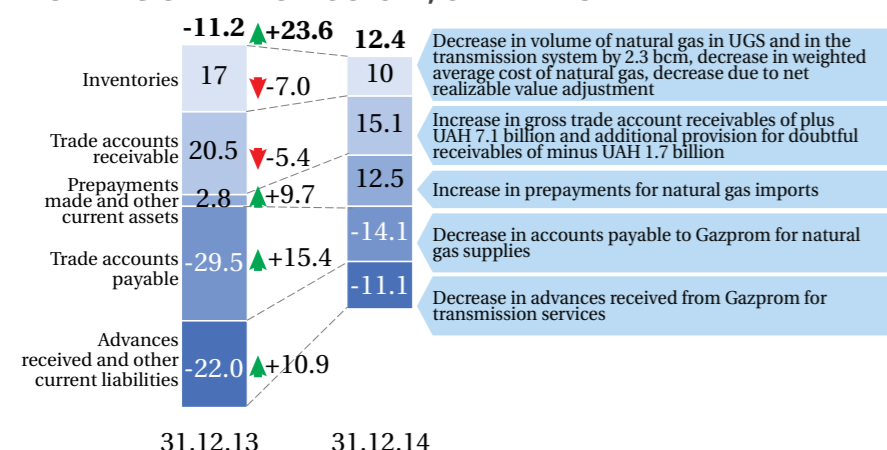


### GAS TRANSMISSION UNDER THE CONTRACT WITH GAZPROM REVENUES AND CASH FLOWS, USD BILLION



\*Including the cost of services for December, for which revenue was obtained in January 2015

### WORKING CAPITAL STRUCTURE, UAH BILLION



group performed net realizable value and impairment adjustments.

- Trade accounts receivable decreased by UAH 5.4 billion in 2014, and amounted to UAH 15.1 billion as of 31 December 2014. At the same time, the nominal value of trade accounts receivable (i.e. before the provision for doubtful debts) increased by UAH 1.7 billion and amounted to UAH 34.1 billion as of 31 December, 2014. This increase resulted from an increase in sale prices that affected the receivables from customers paying their bills one month in arrears (households, municipal heat generating entities, government bodies). At the same time, the average settlement level increased to 94% in 2014, compared to 82% in 2013. Additionally, the provision for impairment increased by UAH 7.1 billion, or from UAH 11.9 billion as at 31 December 2013 to UAH 19.0 billion as at 31 December 2014, leading to an overall reduction in the net book value of trade accounts receivable
- Prepayments made increased in 2014, mainly due to an increase in prepayments to suppliers of gas from the EU countries that amounted to UAH 12.5 billion as at 31 December 2014 (31 December 2013: UAH 2.8 billion).
- Trade accounts payable amounted to UAH 14.1 billion as at 31 December 2014, which is UAH 15.4 billion less than as at 31 December 2013. This change was due to the settlement of outstanding trade payables to Gazprom for gas supplied

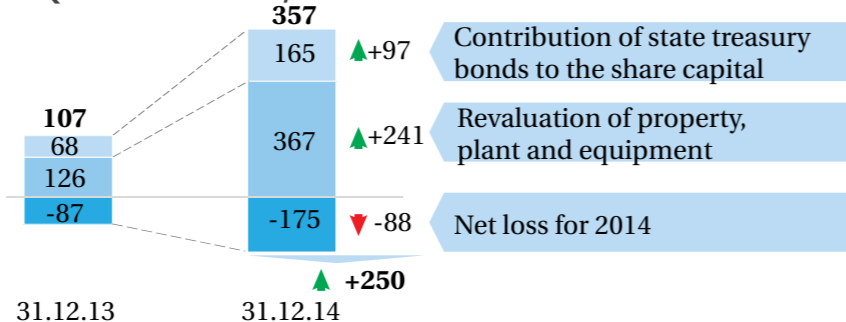
in 2013 amounting to USD 2.3 billion or UAH 24.2 billion.

- During 2014, natural gas transmission services provided to Gazprom were performed against advance payments received in 2010-2013, to the amount of USD 1.5 billion or UAH 12 billion.
- The group has invested UAH 23.6 billion into its working capital in 2014 as a result of the changes in the operating model. Those funds were mainly directed to prepayments for natural gas imports and the settlement of payables to Gazprom incurred in prior periods (both for gas supplies and advances for gas transmission services). As a result, the working capital turned positive and amounted to UAH 12.4 billion as at 31 December 2014.

### REVIEW OF CHANGES IN EQUITY

The group's total equity amounted to UAH 357 billion as at 31 December 2014

### EQUITY STRUCTURE, UAH BILLION



which is UAH 249.9 billion or 2.3 times higher than the total equity as at 31 December 2013. This increase was caused by the following factors:

- Contribution of state treasury bonds to the share capital of Naftogaz in the amount of UAH 96.6 billion
- Revaluation of fixed assets resulting in an increase in revaluation reserves of UAH 240.5 billion

On the other hand, the group incurred a net loss in 2014 that resulted in an increase of the accumulated deficit by UAH 88.6 billion.

The company receives financial support from the state in the form of state treasury bonds in exchange for new share issues. The purpose of these funds is to cover the cash deficit of Naftogaz although in fact they can also be viewed as a form of compensation for the losses incurred by Naftogaz from supplying gas for households at prices administratively capped by the state below the market level. However, this interpretation is currently not legally supported by the current legislation. In addition, there is no reconciliation act or a similar document between the company and the government of Ukraine where such compensation would be confirmed.

Had Naftogaz received the compensation of the price differences in cash and not in the form of state treasury bonds, this money would be recognized as income. This would also result in a reduction of the accumulated losses and in an increase of the group's taxable profit, increasing the amount of income tax payments to the state budget.

## REVIEW OF CASH FLOWS

### CASH DEFICIT FACTORS

In 2014, the group's cash deficit amounted to UAH 108.6 billion and was caused by the following factors:

- Net cash used in the operating activities amounted to UAH 59.7 billion. The negative cash flow from the operating activities was the result of:
  - Loss-making activities of the group: net losses before taxes amounted to UAH 77.6 billion as adjusted for certain non-cash items, depreciation, losses on the disposal of fixed assets and adjusted for financial costs amounting to UAH 35.0 billion
  - Investment in working capital amounting to UAH 23.6 billion: prepayments made for natural gas imports, settlement of accounts payable and advances from Gazprom
  - Payment of corporate income tax amounting to UAH 1.4 billion
  - Interest received amounting to UAH 0.3 billion
- Net cash used in investing activities amounted to UAH 4 billion. This amount includes investment cash flows of UAH 2.9 billion on capital expenditure and UAH 1.2 billion on the bank deposits of Ukrtransnafta
- Cash outflows in financing activities amounted to UAH 43.9 billion, including repayment of loans totaling UAH 35.9 billion, interest payments of

UAH 7.9 billion and mandatory budget contribution of profit share paid amounting to UAH 0.2 billion

- As at 31 December 2014, cash balance decreased by UAH 1 billion compared to 31 December 2013.

The cash deficit was covered by:

- Contribution of state treasury bonds to the company's share capital in the amount of UAH 96.6 billion
- Proceeds from loans amounting to UAH 12 billion

### EFFECT OF MANAGEMENT ACTIONS ON THE REDUCTION OF THE CASH DEFICIT

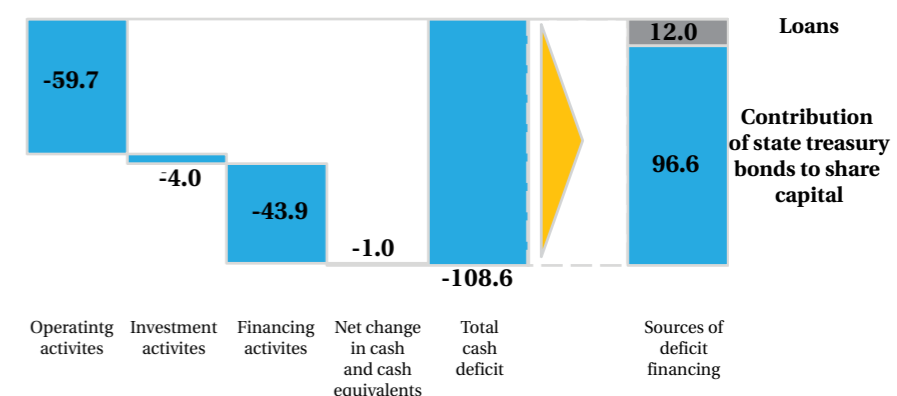
The factors contributing to the cash flow deficit of the group in 2014 include:

- Short-sighted financial management in the previous years leading to:

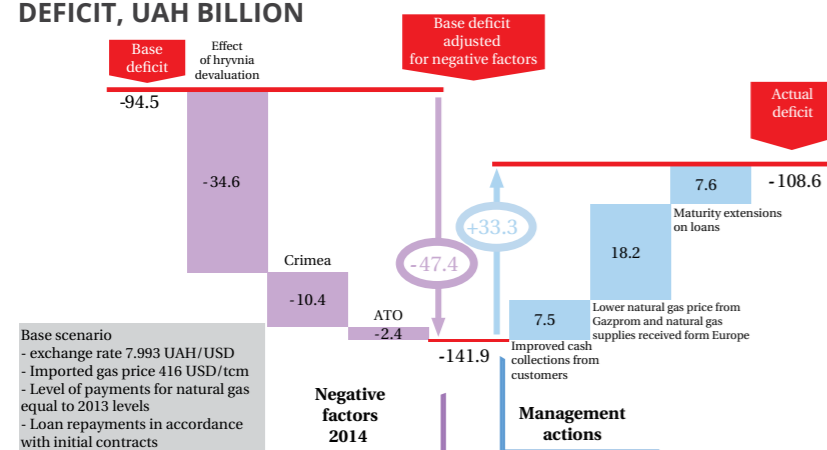
- Accumulation of payables to Gazprom at the beginning of 2014 (USD 2.8 billion for natural gas and USD 1.8 billion as advances received for gas transmission services)
- Accumulation of loans maturing in 2014 for a total amount of UAH 36.1 billion
- A contract with Gazprom on natural gas supply on economically unjustified terms
- Accumulation of significant volumes of overdue accounts receivable for gas sold to consumers
- Decline in natural gas inventories in the underground storage facilities

The basic scenario of cash flow deficit (assuming the exchange rate of UAH 7.993

### FACTORS CONTRIBUTING TO NAFTOGAZ DEFICIT AND SOURCES OF DEFICIT FINANCING, 2014, UAH BILLION



### IMPACT OF MANAGEMENT ACTIONS ON GROUP'S CASH DEFICIT, UAH BILLION



per USD, the purchase of gas under the initial contract conditions with Gazprom starting from 2Q 2014 at an average price of USD 415/tcm and payment upon delivery) was forecasted at the level of UAH 94.5 billion at the beginning of 2014.

- Negative factors which appeared in 2014, including:
  - UAH devaluation that led to a UAH 34.6 billion increase in the cash flow deficit, largely due to the increased outflows for gas imports in UAH equivalent totaling UAH 41.5 billion, and cash outflows on interest and loan repayments totaling UAH 9 billion. On the other hand, revenues from gas sales to industrial customers increased by UAH 15.9 billion. Prices for this group of customers were reviewed on a monthly basis and included adjustment for foreign currency risk.
  - Loss of the gas source in Crimea, resulting in a UAH 10.4 billion increase of cash outflows. The group lost 0.7 bcm of gas stored in the Crimean underground storage facility operated by Chornomornaftogaz, and 1.4 bcm of gas produced by Chornomornaftogaz which was intended for households in other regions of Ukraine (the difference between 2.1 bcm of

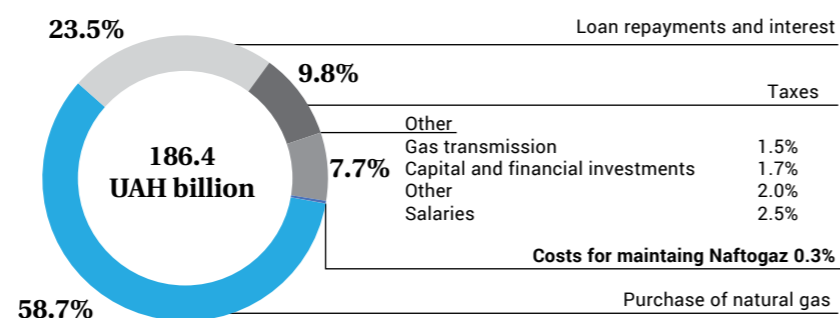
marketable gas produced by Chornomornaftogaz and 0.7 bcm consumed by households in Crimea). As a result, the group had to import 1.4 bcm gas more at a higher price to cover the needs of households in Ukraine

- Unauthorized consumption of gas in the ATO area, leading to a UAH 2.4 billion increase in cash outflow. The group lost 0.4 bcm of natural gas worth UAH 2 billion and UAH 0.4 billion in unpaid VAT for this illegally consumed natural gas.

When adjusted to take into account these negative factors, the cash deficit for 2014 should have reached to UAH 141.9 billion.

New management of the company has taken a number of steps to reduce the group's cash deficit:

### STRUCTURE OF THE GROUP'S SPENDING



- Reducing the price of natural gas supplied by Gazprom and significantly increasing natural gas supplies from Europe, which resulted in a reduction of cost of gas imports by UAH 18.2 billion
- Improving the collection of payments for gas supplied to consumers (trade receivables increased by UAH 1.7 billion in 2014, compared to an increase of UAH 9.1 billion in 2013)
- Extending maturity of loans amounting of UAH 7.6 billion

As a result of these measures, the group's cash deficit declined by UAH 33.3 billion to UAH 108.6 billion

### CASH SPENDING STRUCTURE

General and administrative costs of Naftogaz as a holding company amounted to approximately 0.3% of the total cash outflows of the group in 2014.

Spending for natural gas supplies accounted for 58.7% of total outflows, and the repayment of loans raised in previous years accounted for nearly 23.5% of the total outflows. In addition, 9.8% of cash outflows were taxes paid to the state budget. The remaining portion of the group outflows consisted of payroll of subsidiaries, payment for gas distribution services and for booking of transmission capacities, capital and financial expenditure, production expenses and other expenses.

## RISK MANAGEMENT

### RISK MANAGEMENT SYSTEM

The group implements risk management system at all levels of its operations. Although Naftogaz currently has no separate risk management division, the risk management work is integrated into other processes of the company within the existing organizational structure.

In the beginning of 2014, the group had significant issues with the effectiveness of internal controls. The new management made the creation of an internal risk control system one of its key priorities, as part of establishing an effective system of corporate governance in Naftogaz. Currently internal control functions are mainly performed by the internal audit department reporting directly to the CEO.

Risk management process is structured to ensure continuous monitoring and control, the timely detection and consistent management of risks associated with the activities of the group in order to maintain an unobstructed channel of information and communication on existing, identified or potential risks. The various elements of risk management include job descriptions, regulations, rules of corporate culture, as well as operating methods and procedures.

#### Components of the system include:

- Detection and assessment of risks
- Development of alternative ways to manage identified risks
- Risk management according to the chosen methodology
- Monitoring and control
- Information and communication

The main risks that could cause materially adverse effects on the group's operating

performance, cash flows and financial position, are described below.

### KEY RISK FACTORS

#### RISKS ASSOCIATED WITH RELIANCE ON A SINGLE SUPPLIER FOR NATURAL GAS IMPORTS

Under the legislation in effect until 1 October 2015, Naftogaz is the guaranteed gas supplier for industrial customers with an annual gas consumption of more than three mcm and enterprises engaged in the production of heating energy. These groups of customers are supplied with natural gas which the company is obliged to import. In addition, for industrial and technological needs, Ukrtransgaz also uses imported natural gas. Since 2009, Naftogaz purchased almost all of its imported gas from Gazprom under long-term contracts at prices that did not correspond to market prices. Dependence on one supplier for such long-term contracts could adversely affect not only the ability of Naftogaz to provide Ukrainian customers with natural gas, but also the continuity and reliability of the gas transmission system, increasing political risks and worsening the financial condition of the company.

#### Risk management

- Naftogaz is actively taking steps to diversify the sources of imported natural gas. The share of imports from the EU increased from 8% in 2013, to 26% in 2014. As of 31 July 2015, Ukraine has a capacity to receive 61.1 mcm/day in gas deliveries from within the EU, including 4.3 mcm from Poland, 16.8 mcm from Hungary, and 40 mcm from Slovakia. On 29 May 2015, a direct interconnection agreement was signed between Ukrtransgaz and FGSZ, the Hungarian gas transmission system operator. Ukraine plans to

sign similar agreements with TSOs of other neighboring EU countries. Such agreements will increase the level of cooperation between Ukraine's TSO and the TSOs of Poland, Slovakia, Hungary and Romania on the exchange of information about free transmission capacity and booking on a non-discriminatory basis, provide flexibility and speed up operations, and, to some degree, reduce the power of the current monopoly holder of capacity at the interconnectors. Finally, these agreements enable the use the interconnectors for both physical and virtual reverse flow operations, thus contributing to the diversification of sources of imported gas

- In June 2014, Naftogaz initiated arbitration proceedings in the Arbitration Institute of the Stockholm Chamber of Commerce (SCC) regarding its gas supply contract with Gazprom and submitted a statement of claim in January 2015. The group claims that the import price for gas delivered in the period 2010-2014 was overstated. Naftogaz expects that as a result of this arbitration, it will import gas from Gazprom at fair market-based prices
- The group aims to maximize the volume of domestic gas production, and has made this segment of activity the top priority for capital investments
- The group is promoting and encouraging special projects to improve energy efficiency to reduce the need for imported gas. A number of projects concerning the development of alternative energy sources are also being considered
- Naftogaz has actively supported the adoption of the new gas market law

which comes into effect on 1 October 2015. In particular, the changes it introduces will significantly liberalize the company's position in supplying gas to industrial consumers

### RISKS RELATED TO THE RELIANCE ON A SINGLE CUSTOMER FOR INTERNATIONAL TRANSMISSION SERVICES

The most profitable sector for the group is the gas transmission. The group provides international transmission services to Gazprom in accordance with the contract concluded in 2009 for 10 years. The contract determines the transmission fee based on a specific volume of gas to be transmitted annually. The actual volume of transmitted gas in the 2010-2014 was well below the base amount specified in the contract. The transmission fees have never been revised, contrary to the European principles of gas transmission pricing, leading to losses for the group. However, no other consumers of the international transmission services of via Ukraine's gas transmission system are currently available. Gazprom declares a policy of bypassing Ukraine for natural gas transmission (in 2015, the transport volumes are expected to fall by 20% compared to 2014 and by 42% compared to 2013), which could negatively affect the group's operations.

#### Risk management

- In October 2014, Naftogaz initiated arbitration proceedings in the Arbitration Institute of the Stockholm Chamber of Commerce (SCC) regarding its gas transit contract with Gazprom and submitted a statement of claim in April 2015. Among other demands, Naftogaz requests to set the transmission fee at an economically justified level. The process should also lead to a decision on the validity of claims regarding the basic volume of gas transportation guaranteed by Gazprom
- The company contributes to creating a single gas infrastructure and trading area between Ukraine, Poland, Slovakia, Hungary and Romania, as well as creating a single East European gas hub that will allow for a diversification of customers for gas transmission and storage services.

- Ukraine introduces a new tariff methodology that is in line with European principles and is based on the 'entry/exit' tariff-setting system and RAB-principles (which implies a certain level on income on the TSO's regulatory asset base). It is expected that the market regulator will switch to this methodology for calculating gas transmission tariffs before the end of 2015.

### STATE REGULATION OF THE OIL AND GAS INDUSTRY

State regulation of the oil and gas industry in Ukraine is carried out by the Cabinet of Ministers of Ukraine and the NEURC, covering both technical and financial aspects:

- Technical measures concerning efficiency in the use of gas resources, ensuring safe operations of the gas transmission system, correct and safe delivery, distribution and consumption of gas
- Financial measures mainly concerned with setting prices and tariffs and maintaining relevant financial measures for the market division between its participants

The group acts as a guaranteed supplier of natural gas to certain groups of customers in Ukraine, but its ability to adjust prices to end consumers in accordance with the fluctuations in the price of imported gas is limited, as these prices are regulated by the NEURC at every stage from gas production to the supply to end consumers.

In 1998, upon the creation of the company, the government contributed certain shares of joint-stock companies to the share capital of the company. These joint-stock companies included JSC Main Pipelines Druzhba and JSC Prydniprovskiy Main Pipelines that were reorganized in 2001 into JSC Ukrtransnafta, JSC Ukrspetstransgaz, Chornomornaftogaz National JSC, JSC Ukrnafta, as well as fifty-four regional gas distribution entities. The government may transfer ownership or control over all or part of the company's equity interest in those joint-stock companies and/or other state-owned oil and gas transmission and storage facilities to other companies or government agencies, and those actions could have a

material adverse effect on the company's operations.

In 1998, the company entered into an agreement on the use of state-owned property not subject to privatization with the State Property Fund of Ukraine, and received the right to operate oil and gas transmission systems. This agreement was signed for one year, and its term is prolonged automatically each year unless terminated by notice from either party, and is binding on the legal successor of each party. Historically, the agreement has been prolonged automatically, as neither party initiated its termination. As state property not subject to privatization forms a substantial part of the group's business, the future operations and financial performance of the group depends on the prolongation of this agreement.

The state controls oil and gas exploration and production activities in Ukraine via issuing relevant licenses. According to the current legislation, separate licenses are issued for exploration, development and production activities for each oil and gas field. Separate licenses are issued for oil and gas transmission, supply and storage. Licenses are provided for periods of from two to twenty years, and could be prolonged for the same period.

#### Risk management

- In April 2015, Ukraine adopted the Law 'On the Natural Gas Market' aimed at the implementation of the EU Directive 2009/73/EC and Regulation 715/2009 in Ukraine. Naftogaz has actively supported this process. The law becomes effective on 1 October 2015. As a result, the activities of the NEURC and other state authorities regulating the natural gas market are to be conducted in accordance with standard European practice, which should enable establishment of an efficient, open and liquid natural gas market in Ukraine
- Naftogaz group takes all due steps to extend the validity of special permits for subsoil use through appropriate applications to the central government and local authorities

- Under the terms of the 3rd Energy Package, which Ukraine now implements, operators of gas transmission and distribution systems will be unbundled from the vertically integrated enterprises engaged in the production and supply of natural gas, as well as gas storage operators. Thus the state property will be used by independent operators of gas transmission and distribution systems. Therefore, the company believes that the group will be able to continue its activities with regard to state property over the near term

### TAXATION RELATED RISKS

Ukraine's tax environment is characterized by complexity in tax administration, arbitrary interpretations by tax authorities of tax laws and regulations that, inter alia, can increase fiscal pressure on taxpayers. Inconsistent application, interpretation, and enforcement of tax laws can lead to litigation which, as a consequence, may result in the imposition of additional taxes, penalties, and interest, and these amounts could be material.

#### Risk management

- The group complies with the requirements of Ukrainian tax law, continuously monitors the changes and additions made to the relevant laws and regulations, evaluates and estimates the degree of possible impact of such changes on its activities
- The group focuses on cooperation with state agencies to ensure compliance with currency control regulations and tax law

### CURRENCY RISKS

Naftogaz operates in Ukraine and its exposure to foreign currency risk is determined mainly by the fact that its gas purchases are mainly foreign currency denominated and its sales are denominated in hryvnia. The group also raises foreign currency loans. The group does not hedge its foreign currency positions.

#### Risk Management

- The price on imported natural gas for almost all groups of customers (except households and heat generating

entities producing heat for households) is reviewed by the regulator on a monthly basis, adjusting prices for changes in the purchase price of imported natural gas and currency fluctuations.

- Market prices are expected to be applied for all groups of customers upon the implementation of the Law of Ukraine 'On the Natural Gas Market'. The law deregulates the prices for industrial and other commercial consumers starting from 1 October 2015. By April 2017 it gradually deregulates the prices for households and heat generating companies that produce heat for households

### LIQUIDITY RISKS

The activities of Naftogaz are seasonal. Sales of natural gas and transmission services during the heating season constitute about 70% of the total annual volume. As a result, revenues for goods and services increase considerably during the heating season. On the other hand, during the summer when the group receives less operating cash flow from sales, there is a need for additional funding to finance the injection of natural gas into the underground storage facilities. In addition, the poor payment discipline by consumers of natural gas and switching to prepayment for imported natural gas in 2014 led to a decrease in cash flow from operating activities of the company.

#### Risk Management

- The group finances its working capital needs through raising loans and receiving government support (government bonds transferred to the share capital).
- During 2015, Ukraine's parliament adopted a series of amendments to existing legislation to enhance the liquidity of the group including, but not limited to the following:
  - The company has the right not to enter into contracts for the supply of natural gas with costumers that have filed for bankruptcy or who cannot by gas on the prepaid basis

- The company is obligated to stop natural gas supplies in cases of overdue payments for natural gas
- The moratorium on the forced property sale for entities where the state holds at least 25% of shares in order to repay debts for natural gas consumed in previous years has been cancelled
- The company should have the opportunity to sell its receivables through auctions

These legislative changes are expected to reduce the accounts in arrears from customers and prevent their accumulation in the future

- Naftogaz group takes measures for a gradual transition to payment for imported gas upon delivery, and for raising credit resources from foreign financial markets to finance the injection of natural gas into the underground gas storages at interest rates which are lower than in the Ukrainian market

### RISKS ASSOCIATED WITH ASSET SECURITY AND SAFETY

Naftogaz activities are associated with operating risks of a technological, technical and climatic nature. Additionally, actions of personnel and third parties could lead to negative consequences, including results of human errors, theft, terrorist acts, sabotage, etc.

#### Risk Management

- Implementing modern methods of diagnosis, reconstruction and modernization at Ukraine's gas transmission system
- Auditing existing systems of infrastructure protection, including the use of drones and the capabilities for remote sensing of the State Space Agency of Ukraine
- Constant interaction with the Ministry of Internal Affairs of Ukraine and its structural divisions, and in some areas, with the Ministry of Energy and Coal Industry of Ukraine, and the state security agency to ensure greater safety and security

## FORECAST 2015

### OPERATING ENVIRONMENT

#### Planned gas sources and uses

According to the forecasted balance of gas sources and planned consumption in Ukraine for 2015, approved by the Cabinet of Ministers on April 15 2015 by Decision #410, which takes into account actual data for the first four months of 2015, gas consumption in Ukraine is expected to fall by 13% compared to 2014. As a result, Naftogaz sales are expected to decrease by 12% compared to the previous year. The projected reduction in gas consumption is explained by the general decline in the economy, the armed conflict in eastern Ukraine, as well as a decrease in gas consumption by households (for cooking and heating) because of the higher prices.

The volume of domestically produced gas will reach 12.6 bcm in 2015, which will consist exclusively of gas produced by Ukrgasvydobuvannya.

The volume of gas in underground storage facilities in Ukraine at the beginning of 2015 amounted to 11.5 bcm including 8.5 bcm of gas owned by Naftogaz.

The approved gas balance indicates that by the end of 2015, the volume of gas accumulated in underground gas storages should amount to 17 bcm. In order to ensure such volumes in storage, Naftogaz would have to buy 23 bcm of gas. However, the sources of financing the corresponding volumes of imported gas were not

determined. The state budget for 2015, and the Cabinet of Ministers decision of June 24 2015, have provided Naftogaz a possibility to obtain state guarantees on loans totaling USD 1 billion for the formation of strategic gas reserves in UGS.

Given the cash-flow constraints, Naftogaz expects to reduce the amount of gas imports in 2015 to nearly 17.3 bcm. Accordingly, the volume of gas stored in the underground gas storages as at 31 December 2015 is estimated at approximately 12.2 bcm (of which 10.6 bcm is expected to belong to Naftogaz).

#### Major changes in legislation and their expected impact on the group

In February 2015, an agreement was reached between Ukraine and the International Monetary Fund regarding the Extended Finance Facility (EFF) which resulted in the signing of a Memorandum on Economic and Financial Policies stating the following obligations of the Ukrainian government:

- Gradually bring natural gas prices for all customers and heating tariffs for the households to full parity with the price of imported gas by 2017
- Adopt the law on the natural gas market and reform the gas sector
- Adopt appropriate laws and regulations that will lead to an improvement on the collection of receivables for Naftogaz

- Implement other measures necessary to restore the financial viability of Naftogaz

In April 2015, Ukraine adopted a new Law 'On the Natural Gas Market' which is fully compliant with the provisions of the 3<sup>rd</sup> Energy Package and with the IMF Memorandum. The law provides for:

- Ensuring non-discriminatory access to Ukraine's gas transmission infrastructure
- Integration with the European gas market
- Restructuring of Naftogaz in accordance to the requirements of the 3<sup>rd</sup> Energy Package with respect to the separation of natural gas transmission pipelines from other activities, including the production and supply of natural gas.
- Approval of tariff-setting principles for services of natural monopolies (transportation and storage of natural gas) in line with European standards

The implementation of certain provisions of the new law requires adoption of the appropriate secondary legislation and regulations.

In May 2015, the Law 'On Amendments to Certain Laws of Ukraine to Stabilize the Financial State of the National Joint Stock Company Naftogaz of Ukraine' was adopted, in accordance with the conditions of the IMF Memorandum. This law envisages the termination of the moratorium on the enforcement of proceedings and court

### FORECAST HIGHLIGHTS ON GROUP ACTIVITY FOR THE YEAR 2015

	2013	2014	2015
<b>Key 2015 operating highlights, forecast*</b>			
Gross gas production (excluding production sharing agreements), mcm	14 021	14 034	13 212
Gross production of crude oil and gas condensate, thousand t	738	637	662
<i>In Ukraine</i>	645	535	501
<i>In Egypt</i>	93	102	161
Volume of natural gas sold, mcm	32 123	29 232	25 675
Gas transmission under the contract with Gazprom, mcm	86 126	62 197	50 000
Domestic gas transmission, mcm	44 097	38 122	34 428
Transmission of crude oil, mcm	17.6	16.9	16.9
Petroleum products supply, thousand t	687	403	346
LPG supply, thousand t	206	177	168
Gas supply via filling stations, mcm	130	97	68
Expected weighted average cost of gas imports, USD/tcm	\$396.46	\$293.81	\$295.42
<b>Key financial highlights of the group, in UAH million unless otherwise stated**</b>			
Revenue	75 374	78 444	131 542
Gross profit/(loss)	(752)	(8 507)	9 434
Profit/(loss) before tax, including:	(15 492)	(77 603)	(32 480)
<i>Loss before tax from regulated businesses</i>	(26 765)	(88 893)	(51 385)
<i>Profit before tax from non-regulated businesses</i>	11 165	10 575	19 592
<i>Unallocated income and expenses</i>	108	715	(687)
Net profit/(loss)	(17 957)	(88 433)	(34 351)
<b>Cash flows of Naftogaz group, in UAH million unless otherwise stated**</b>			
Net cash from operating activities	(1)	7 155	(59 738)
Net cash from investing activities***	(2)	(3 231)	(3 959)
Cash outflow from financing activities (repayment of loans, payment interest and mandatory budget contribution of profit share)	(3)	(29 122)	(43 873)
Net change in cash balance (4)	(109)	(1 002)	1 533
Net cash flow before budget financing and other sources (Deficit)	(5 = 1 + 2 + 3 + 4)	(25 307)	(108 572)
Sources to cover the deficit	25 307	108 572	53 624
<i>- Proceeds from loans</i>	19 483	11 962	23 924
<i>- Proceeds from sale of state treasury bonds contributed to share capital</i>	5 824	96 610	29 700

\* Operating indicators do not include information on SJS Chornomornaftogaz as the group lost control over these assets after the occupation of Crimea by the Russian Federation

\*\* The forecast for 2015 is based on the following documents and assumptions: the draft financial plan draft of Naftogaz for 2015 agreed by the governmental committee for economic development and European integration (paragraph 36 of the protocol #17 dated 05/06/2015); the financial plan of Ukrtransgaz for 2015 approved by the Cabinet of Ministers Decision #851 dated 19/08/2015; the draft financial plan of Ukrgasvydobuvannya for 2015; the approved financial plans (or draft plans) of other subsidiaries of the group; estimated UAH/USD exchange rate of 21.7.

\*\*\*Expenditure on capital investment for 2015 corresponds to the planned figures, however untimely approval of financial plans of the group companies may lead to a significant reduction in actual expenditure on capital investment because of the Cabinet of Ministers Decree no. 899 (which prohibits carrying out capital expenditure prior to the approval of a financial plan).

decisions regarding energy sector companies and unconditional cessation of gas supplies to municipal heating enterprises if they violate the conditions of the concluded agreements, as well as the ability to sell receivables at auction starting from 1 September 2015. The implementation of certain provisions of this law requires the adoption of appropriate secondary legislation and regulations.

#### Assumptions regarding gas prices and tariffs for gas transmission and storage

According to the draft financial plan of Naftogaz prepared in 2Q 2015, the average purchase price of imported gas (including transmission costs) is forecasted at USD 295/tcm in 2015 (2014: USD 294/tcm).

In the draft financial plan of Naftogaz, the following assumptions were used on retail gas prices for households (both direct use and for centralized heat production), net of the VAT and other taxes, transmission and distribution charges:

- as of 1 April 2015, for households, the first 200 cubic meters per month during the heating season: UAH 2 166.83/tcm
- as of 1 April 2015, for households, in excess of 200 cubic meters per month during the heating season and all gas in other months of the year: UAH 5 041.83/tcm
- as of 1 May 2015, for heat generating entities for heat production for households: UAH 1 802.99/tcm

The selling price for marketable gas produced by Ukrigasvydobuvannya is changed from UAH 349.20/tcm to UAH 1 590/tcm net of VAT as of 1 April 2015.

It is assumed in the draft financial plan that prices for gas supplied to industrial consumers are adjusted on a monthly basis, according to the purchase price of imported natural gas and exchange rates (in fact the prices for this category are liberalized starting from 1 October 2015).

It is further expected that in 2015 compared to 2014:

- the average tariff for gas transmission will increase by 108%
- the average tariff for gas storage will increase by 31%

#### Assumptions regarding currency devaluation and losses in the ATO area

At the beginning of 2015, the group's debts in foreign currency amounted to nearly USD 3 billion, and the exchange rate was UAH 15.77 per USD. At the same time, the average exchange rate in 2015 is forecasted at UAH 21.7 per USD, which will lead to an increase the group's payables in hryvnia terms and will result in foreign exchange losses amounting to approximately UAH 20 billion.

Unauthorized consumption of gas in the ATO area during January and February 2015 amounted to nearly 0.4 bcm which caused losses amounting to UAH 2.6 billion, including the cost of illegally withdrawn gas (UAH 2.2 billion) and VAT which is paid to the budget along with the sale of natural gas (UAH 0.4 billion).

#### EXPECTED RESULTS

Based on these assumptions, the group expects the following results.

##### Net loss of the group

The net loss of the group for 2015 is forecasted at UAH 34.4 billion.

The primary factor contributing to the net loss is the losses from the sale of gas to households (for direct consumption and centralized heat production), which is expected to amount to UAH 32.2 billion.

It is expected that the group will make a profit on gas sales to industrial consumers, public sector enterprises and other customers. Including the expected income from other activities, the group expects to receive a gross profit of UAH 9.4 billion.

The gross profit will not be sufficient to compensate for other expected losses, including:

- Foreign exchange losses of approximately UAH 20 billion

- Loss of assets in the ATO area of UAH 2.6 billion.
- Financial expenses amounting to UAH 12.5 billion, or UAH 3.5 billion more compared to 2014, because of the devaluation of hryvnia and the forecasted increase in loans

#### Cash deficit of the group

Naftogaz expects that in 2015 the group's cash deficit (net cash flows before deficit financing) will amount to approximately UAH 53.6 billion.

It is expected that the cash deficit will be financed by:

- State treasury bonds to be contributed to the share capital of Naftogaz amounting to UAH 29.7 billion (already received)
- Loans amounting to approximately UAH 23.9 billion, mostly secured by state guarantees foreseen in the state budget for 2015 in the amount of USD 1 billion.

Compared to 2014, the cash deficit from operating and investing activities in 2015 is expected to decrease by almost 50%.

In 2014, the settlement of obligations incurred in the previous years accounted for almost 60% of the deficit. These obligations included payment for imported gas, providing gas transmission services against the advances received from Gazprom, and the redemption of Eurobonds together with the associated interest.

In 2015, the deficit is expected to be caused primarily by the group's loss-making regulated activities (estimated net loss of UAH 34.4 billion), as well as the working capital financing needs.

In particular, the group needs to finance the expected growth in trade accounts receivable associated with the retail price increase, as well as to fund the accumulation of gas in the underground gas storages. It is expected that the volume of stored gas owned by the group will increase by 2.1 bcm as at 31 December 2015 compared to the level as at the previous year end.

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## The Public Company "The National Joint Stock Company "Naftogaz of Ukraine"

### Consolidated Annual Financial Statement Ending 31 December 2014

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## INDEPENDENT AUDITOR'S REPORT

To the shareholder of Public Joint Stock Company "National Joint Stock Company "Naftogaz of Ukraine":

We have audited the accompanying consolidated financial statements of Public Joint Stock Company "National Joint Stock Company "Naftogaz of Ukraine" (the "Company") and its subsidiaries (collectively, the "Group"), which comprise the consolidated statement of financial position as at 31 December 2014, and the consolidated statement of profit or loss, the consolidated statement of comprehensive income, the consolidated statement of changes in equity and the consolidated statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

### MANAGEMENT'S RESPONSIBILITY FOR THE CONSOLIDATED FINANCIAL STATEMENTS

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

### AUDITOR'S RESPONSIBILITY

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

## BASIS FOR QUALIFIED OPINION

- 1) As discussed in Note 25 to the consolidated financial statements, the Group has adopted the revaluation model for measurement of property, plant and equipment, which requires revaluations to be carried out with sufficient regularity so that the carrying amount of property, plant and equipment as at the reporting date does not differ materially from its fair value. The Group has revalued its property, plant and equipment as at 31 December 2014 and the revaluation demonstrated that the fair value of property, plant and equipment was materially different from its carrying amount before revaluation. Given the significant economic developments since previous revaluation as at 31 December 2009, including changes in natural gas transportation tariffs and costs, selling prices of the Group's own produced natural gas and construction costs, we believe the difference between the fair value and carrying amount of property, plant and equipment was also material as at 31 December 2013. Since no revaluation of property, plant and equipment was performed as at that date, we were unable to obtain sufficient and appropriate audit evidence about the impact of this matter on the Group's property, plant and equipment with the carrying amount of UAH 89 526 million and related impact on revaluation reserve as at 31 December 2013 and the depreciation, depletion and amortisation expense for the years ended 31 December 2014 and 2013. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.
- 2) As discussed in Note 25 to the consolidated financial statements, the Group's oil and gas assets are depleted using a unit-of-production method in proportion to proved developed hydrocarbon reserves. Management engaged an independent expert to conduct a valuation of the Group's hydrocarbon reserves as at 31 December 2014. Thus, such valuation was inconsistent with the valuation as at 31 December 2013 as the 2014 valuation involved an independent expert, while the 2013 valuation was based on internal management estimates only. Due to inconsistency of the valuations, we were unable to obtain sufficient and appropriate audit evidence about the impact of this matter on the Group's oil and gas assets stated at UAH 20 416 million as at 31 December 2013, and the related impact on the depreciation, depletion and amortisation expense for the years ended 31 December 2014 and 2013. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.
- 3) As discussed in Note 20 to the consolidated financial statements, in March 2014 the Group lost control over one of its subsidiaries, JSC Chornomornaftogaz, the majority of whose assets are located on the territory of the Autonomous Republic of Crimea. As we were not provided with access to the financial information of this subsidiary as at 31 December 2013, we were not able to obtain sufficient and appropriate audit evidence about carrying value of the total assets and liabilities (net of intercompany balances) of this subsidiary as at that date in the amounts of UAH 15 711 million and UAH 1 925 million, respectively, and its total revenues and expenses for the year ended 31 December 2013 in the amounts of UAH 525 million and UAH 1 399 million, respectively. Additionally, we were not able to observe other assets of the Group located on the territory of the Autonomous Republic of Crimea stated at UAH 2 898 million as at 31 December 2013. The Group deconsolidated the assets and liabilities of JSC Chornomornaftogaz and fully impaired the other assets located in Crimea during the year ended 31 December 2014. Since the carrying amounts of such assets and liabilities as at 31 December 2013 affect the determination of the loss from discontinued operations and operating expenses for the year ended 31 December 2014, we were unable to determine whether adjustments to the results of operations were necessary.
- 4) Because we were appointed auditors of the Group in 2014, we were not able to observe the counting of the physical inventories as at 31 December 2013 or satisfy ourselves concerning inventory quantities as at 31 December 2013 (except for the natural gas in stock) by alternative means. Since these inventories stated at UAH 607 million affect the determination of the results of operations for the years ended 31 December 2014 and 2013, we were unable to determine whether adjustments to the results of operations for respective years were necessary.
- 5) As discussed in Note 6 to the consolidated financial statements, the Group has investments in associates and joint ventures, which are accounted for using the equity method of accounting. We were unable to obtain sufficient and appropriate audit evidence regarding recoverability of trade and other receivables of one of the associates as at 31 December 2014 with the Group's share amounting

to UAH 515 million and substance of certain expenses incurred by one of the associates during the years ended 31 December 2014 and 2013 with the Group share of such expenses amounting to UAH 179 million and UAH 925 million, respectively. Also, some of the associates and joint ventures did not adopt the revaluation model for measurement of their property, plant and equipment, which constitutes a departure from IAS 28 "Investments in Associates and Joint Ventures" requiring use of uniform accounting policies with Group. The effect of this departure on the carrying value of the Group's investments in its associates and joint ventures as at 31 December 2014 and 2013, and related impact on the Group's share of their after-tax results for the years then ended is not reasonably determinable.

6) As discussed in Notes 16, 17 and 25, during the first quarter of the year ended 31 December 2014 and during the year ended 31 December 2013, the Group has incurred expenditures for:

- Purchases of services and inventories amounting to UAH 334 million and UAH 1 082 million, respectively, included into cost of sales and research; development and exploration costs amounting to UAH 160 million and UAH 455 million, respectively, included into other operating expenses, for which the primary documents were sequestered and are under investigation by the office of State Prosecutor of Ukraine;
- Purchases of property, plant and equipment of UAH 660 million and UAH 4 335 million, respectively; and
- Purchases of services and inventories included into cost of sales and other operating expenses of UAH 1 102 million UAH 2 927 million, respectively.

As stated in the Notes indicated above the substance of these expenditures may not reflect their legal form according to the primary documents. We were unable to obtain sufficient and appropriate audit evidence to satisfy ourselves as to the amounts and nature of the above expenditures and their classification in the consolidated financial statements for the years ended 31 December 2014 and 2013. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

7) We were unable to obtain sufficient and appropriate audit evidence regarding completeness of revenue recorded in the accompanying consolidated financial statements of the Group on sales of petroleum products to certain customers in the amount of UAH 2 853 million for the year ended 31 December 2013. As a result of this matter, we were unable to determine whether any adjustments to this amount were necessary. Our audit opinion on the consolidated financial statements for the year ended 31 December 2013 was modified accordingly. Our opinion on the current period's consolidated financial statements is also modified because of the possible effect of this matter on the comparability of the current period's figures and the corresponding figures.

## QUALIFIED OPINION

In our opinion, except for the possible effects of the matters described in the Basis for Qualified Opinion paragraphs, the consolidated financial statements present fairly, in all material respects, the financial position of the Group as at 31 December 2014, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

## EMPHASIS OF MATTER

The accompanying consolidated financial statements have been prepared assuming that the Group will continue as a going concern. As discussed in Note 2 and Note 21 to the consolidated financial statements, the excess of the Group's current liabilities over its current assets as at 31 December 2014 and 2013 amounted to UAH 17 908 million and UAH 53 893 million, respectively, and for the years then ended the Group incurred net losses in the amounts of UAH 88 433 million and UAH 17 957 million, respectively, and there is uncertainty as to the outcome of significant ongoing litigations for the Group. These conditions raise substantial doubt about the Group's ability to continue as a going concern without continuing support from the Government of Ukraine. Management's plans concerning these matters are discussed in Note 2 to the consolidated financial statements. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty. Our opinion is not qualified in respect of this matter.

We also draw your attention to Note 21 to the consolidated financial statements, which describes uncertainty with regard to claim in the Arbitration Institute of the Stockholm Chamber of Commerce issued by the Company to JC "Gazprom" and counterclaim from JC "Gazprom" to the Company. Our opinion is not qualified in respect of this matter.

We further draw your attention to Note 2 to the consolidated financial statements, which describes that the impact of the continuing economic crisis and political turmoil in Ukraine and their final resolution are unpredictable and may adversely affect the Ukrainian economy and the operations of the Group. Our opinion is not qualified in respect of this matter.

31 July 2015

PJSC Deloitte and Touche

# PUBLIC JOINT STOCK COMPANY "NATIONAL JOINT STOCK COMPANY "NAFTOGAZ OF UKRAINE" CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 2014

In millions of Ukrainian hryvnias	Note	31 December 2014	31 December 2013
<b>ASSETS</b>			
Non-current assets			
Property, plant and equipment	5	454 991	181 428
Investments in associates and joint ventures	6	11 169	9 942
Prepaid corporate income tax		1 195	709
Other non-current assets	7	4 346	2 737
<b>Total non-current assets</b>		<b>471 701</b>	<b>194 816</b>
<b>Current assets</b>			
Inventories	8	9 983	17 024
Trade accounts receivable	9	15 097	20 539
Prepayments made and other current assets	10	12 501	2 823
Prepaid corporate income tax		942	378
Cash and bank balances	11	4 361	2 138
Restricted cash		394	200
<b>Total current assets</b>		<b>43 278</b>	<b>43 102</b>
<b>TOTAL ASSETS</b>		<b>514 979</b>	<b>237 918</b>
<b>EQUITY</b>			
Share capital	12	59 997	53 997
Revaluation reserve		366 204	125 663
Unregistered contributed capital	12	104 610	14 000
Cumulative exchange difference		1 405	-
Accumulated deficit		(175 258)	(86 685)
Equity attributable to owners of the Parent		356 958	106 975
Non-controlling interest in equity		20	60
<b>TOTAL EQUITY</b>		<b>356 978</b>	<b>107 035</b>

In millions of Ukrainian hryvnias	Note	31 December 2014	31 December 2013
<b>Non-current liabilities</b>			
Borrowings	13	26 188	14 388
Provisions	14	1 852	1 601
Deferred tax liabilities	19	68 726	17 521
Other long-term liabilities		49	378
<b>Total non-current liabilities</b>		<b>96 815</b>	<b>33 888</b>
<b>Current liabilities</b>			
Borrowings	13	34 820	45 170
Provisions	14	778	304
Trade accounts payable		14 137	29 478
Advances received and other current liabilities	15	11 124	22 016
Corporate income tax payable		327	27
<b>Total current liabilities</b>		<b>61 186</b>	<b>96 995</b>
<b>TOTAL LIABILITIES</b>		<b>158 001</b>	<b>130 883</b>
<b>TOTAL LIABILITIES AND EQUITY</b>		<b>514 979</b>	<b>237 918</b>

These consolidated financial statements were authorised for issue on behalf of the Board of the Company on 31 July 2015.

Andriy Kobolyev  
Chairman of the Board

Sergiy Konovets  
Deputy Chairman of the Board

**PUBLIC JOINT STOCK COMPANY  
“NATIONAL JOINT STOCK COMPANY  
“NAFTOGAZ OF UKRAINE”**

**CONSOLIDATED STATEMENT OF PROFIT OR LOSS  
FOR THE YEAR ENDED 31 DECEMBER 2014**

<i>In millions of Ukrainian hryvnias</i>	<i>Note</i>	<i>2014</i>	<i>2013</i>
<b>Continuing operations:</b>			
Revenue	3	78 444	75 374
Compensation of price difference from the State Budget	2	-	-
Cost of sales	16	(86 951)	(76 126)
<b>Gross loss</b>		(8 507)	(752)
Other operating income		808	749
Other operating expense	17	(23 621)	(6 778)
<b>Operating loss</b>		(31 320)	(6 781)
Finance costs	18	(9 003)	(8 868)
Finance income		417	206
Share of after-tax results of associates and joint-ventures	6	1 488	536
Net foreign exchange loss		(39 185)	(585)
<b>Loss before income tax*</b>		(77 603)	(15 492)
Income tax benefit/(expense)	19	2 956	(1 591)
<b>Net loss from continuing operations</b>		(74 647)	(17 083)
<b>Discontinued operations</b>			
Loss for the year from discontinued operations	20	(13 786)	(874)
<b>Net loss for the year</b>		(88 433)	(17 957)
<b>Net loss is attributable to:</b>			
Equity holders of the Company		(88 373)	(17 948)
Non-controlling interest		(60)	(9)
<b>Net loss for the year</b>		(88 433)	(17 957)

\* (Loss)/profit before tax from regulated and non-regulated businesses was as follows:

<i>In millions of Ukrainian hryvnias</i>	<i>Note</i>	<i>2014</i>	<i>2013</i>
from regulated businesses		(88 893)	(26 765)
from non-regulated businesses		11 290	11 273
<b>Total loss before tax</b>		<b>(77 603)</b>	<b>(15 492)</b>

Regulated businesses are activities where sales prices and tariffs and purchase prices are regulated by the State (as described in Note 2), and include (loss)/profit before tax of the reporting segments “Production of natural gas”, “Storage of natural gas”, and “Wholesale distribution and trading of natural gas” as described in Note 3.

**PUBLIC JOINT STOCK COMPANY  
“NATIONAL JOINT STOCK COMPANY  
“NAFTOGAZ OF UKRAINE”**

**CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME**

<i>In millions of Ukrainian hryvnias</i>	<i>Note</i>	<i>2014</i>	<i>2013</i>
<b>Net loss for the year</b>		(88 433)	(17 957)
<b>Other comprehensive income</b>			
<b>Items that will not be reclassified subsequently to profit or loss, net of income tax:</b>			
Gain/(loss) on revaluation of property, plant and equipment (net of income tax of UAH 55 254 million (2013: UAH 987 million))	19	240 975	(5 199)
Share of other comprehensive income of associates (net of income tax of UAH 38 million (2013: UAH 4 million))	19	(171)	19
Remeasurement of defined benefit obligation (net of income tax of UAH 64 million (2013: UAH 5 million))	19	(294)	33
Remeasurement of decommissioning liability (net of income tax of UAH 1 million)	19	7	-

<i>In millions of Ukrainian hryvnias</i>	<i>Note</i>	<i>2014</i>	<i>2013</i>
<b>Items that may be reclassified subsequently to profit or loss, net of income tax:</b>			
Cumulative exchange difference		1 405	-
Reclassification adjustments relating to disposal of available-for-sale investments in the year (net of income tax of UAH 8 million)		-	(44)
Other comprehensive income/(loss) for the year		241 922	(5 191)
<b>Total comprehensive income/(loss) for the year</b>		<b>153 489</b>	<b>(23 148)</b>
<b>Total comprehensive income/(loss) is attributable to:</b>			
Equity holders of the Company		153 529	(23 139)
Non-controlling interest		(40)	(9)
<b>Total comprehensive income/(loss) for the year</b>		<b>153 489</b>	<b>(23 148)</b>

**PUBLIC JOINT STOCK COMPANY  
“NATIONAL JOINT STOCK COMPANY  
“NAFTOGAZ OF UKRAINE”**

**CONSOLIDATED STATEMENT OF CHANGES IN  
EQUITY FOR THE YEAR ENDED 31 DECEMBER 2014**

<i>In millions of Ukrainian hryvnias</i>	<i>Share capital</i>	<i>Revaluation reserve</i>	<i>Unregistered contributed capital</i>	<i>Cumulative exchange difference</i>	<i>Accumulated deficit</i>	<i>Total</i>	<i>Non-controlling interest</i>	<i>Total equity</i>
<b>Balance at 31 December 2012</b>	53 997	131 238	6 000	-	(69 076)	122 159	69	122 228
Loss for the year	-	-	-	-	(17 948)	(17 948)	(9)	(17 957)
Other comprehensive income/(loss) for the year	-	(5 219)	-	-	28	(5 191)	-	(5 191)
<b>Total comprehensive income/(loss) for the year</b>	<b>-</b>	<b>(5 219)</b>	<b>-</b>	<b>-</b>	<b>(17 920)</b>	<b>(23 139)</b>	<b>(9)</b>	<b>(23 148)</b>
Transfer of revaluation reserve	-	(356)	-	-	356	-	-	-
Transfer of investments to the State Property Fund	-	-	-	-	(2)	(2)	-	(2)
State treasury bonds received (Note 12)	-	-	8 000	-	-	8 000	-	8 000
Profit share payable to the State Budget (Note 12)	-	-	-	-	(43)	(43)	-	(43)
<b>Balance at 31 December 2013</b>	53 997	125 663	14 000	-	(86 685)	106 975	60	107 035
Loss for the year	-	-	-	-	(88 373)	(88 373)	(60)	(88 433)
Other comprehensive income/(loss) for the year	-	240 791	-	1 405	(294)	241 902	20	241 922
<b>Total comprehensive income/(loss) for the year</b>	<b>-</b>	<b>240 791</b>	<b>-</b>	<b>1 405</b>	<b>(88 667)</b>	<b>153 529</b>	<b>(40)</b>	<b>153 489</b>
Transfer of revaluation reserve	-	(250)	-	-	250	-	-	-
State treasury bonds received (Note 12)	-	-	96 610	-	-	96 610	-	96 610
Registration of shares (Note 12)	6 000	-	(6 000)	-	-	-	-	-
Profit share payable to the State Budget (Note 12)	-	-	-	-	(156)	(156)	-	(156)
<b>Balance at 31 December 2014</b>	59 997	366 204	104 610	1 405	(175 258)	356 958	20	356 978

**PUBLIC JOINT STOCK COMPANY  
“NATIONAL JOINT STOCK COMPANY  
“NAFTOGAZ OF UKRAINE”**

**CONSOLIDATED STATEMENT OF CASH FLOWS  
FOR THE YEAR ENDED 31 DECEMBER 2014**

<i>In millions of Ukrainian hryvnias</i>	<i>Note</i>	<i>2014</i>	<i>2013</i>	<i>In millions of Ukrainian hryvnias</i>	<i>Note</i>	<i>2014</i>	<i>2013</i>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>				<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
<b>Loss before income tax</b>		(77 603)	(16 089)	Purchase of property, plant and equipment and intangible assets		(2 909)	(3 657)
Adjustments for:				Proceeds from sale of property, plant and equipment		125	588
Depreciation of property, plant and equipment and amortisation of intangible assets	5	5 225	5 959	Withdrawal of restricted cash		-	(200)
Loss on disposal of property, plant and equipment	17	7	105	Placement of bank deposits	11	(1 221)	-
Impairment of property, plant and equipment	17	5 625	852	Cash attributable to discontinued operations	20	(6)	-
Write down of inventories	8	12 485	422	Dividends received		52	38
Net movement in provision for trade accounts receivable and prepayments made, other current assets, financial investments and VAT receivable				<b>Net cash used in investing activities</b>		<b>(3 959)</b>	<b>(3 231)</b>
Change in provisions	14	430	358	<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Write off of accounts payable and other current liabilities		(110)	(139)	Proceeds from borrowings		11 962	19 483
Share of after-tax results of associates and joint-ventures	6	(1 488)	(536)	Repayment of borrowings		(35 844)	(22 367)
Unrealised foreign exchange loss		25 901	-	Interest paid		(7 873)	(6 710)
Finance costs, net		8 586	8 704	Mandatory budget contribution of profit share paid		(156)	(45)
<b>Operating cash flows before working capital changes</b>		<b>(11 103)</b>	<b>1 971</b>	Net proceeds from sale of State treasury bonds contributed to share capital		96 610	5 824
(Increase)/decrease in other non-current assets		(249)	677	Net cash generated from/(used in) financing activities		64 699	(3 815)
(Increase)/decrease in inventories		(5 857)	10 015	<b>Net increase in cash and cash equivalents</b>		<b>1 002</b>	<b>109</b>
Increase in trade accounts receivable		(2 136)	(9 809)	CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE YEAR		2 138	2 029
(Increase)/decrease in prepayments made and other current assets		(12 684)	2 086	<b>CASH AND CASH EQUIVALENTS AT THE END OF THE YEAR</b>	<b>11</b>	<b>3 140</b>	<b>2 138</b>
Increase/(decrease) in other long-term liabilities		10	(3)	<b>Significant Non-Cash Transactions</b>			
Decrease in provisions	14	(126)	(214)	Contribution of the State treasury bonds to the share capital	12	96 610	8 000
(Decrease)/increase in trade accounts payable		(15 765)	17 448				
Decrease in advances received and other current liabilities		(10 694)	(12 730)				
<b>Cash (used in)/generated from operations</b>		<b>(58 604)</b>	<b>9 441</b>				
Income taxes paid		(1 432)	(2 295)				
Interest received		298	9				
<b>Net cash (used in)/generated by operating activities</b>		<b>(59 738)</b>	<b>7 155</b>				

# PUBLIC JOINT STOCK COMPANY “NATIONAL JOINT STOCK COMPANY “NAFTOGAZ OF UKRAINE”

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2014

### 1. THE ORGANISATION AND ITS OPERATIONS

Public Joint Stock Company “National Joint Stock Company “Naftogaz of Ukraine” (“Naftogaz of Ukraine”, the “Parent” or the “Company”) was founded in 1998 in accordance with the Resolution of the Cabinet of Ministers of Ukraine №747 dated 25 May 1998.

Naftogaz of Ukraine and its subsidiaries (hereinafter collectively referred to as the “Group”) are beneficially owned by the State of Ukraine. The Government of Ukraine, as represented by the Cabinet of Ministers of Ukraine, controls the Company through participation in the shareholders’ meetings and the Supervisory Board meetings, as well as through the appointment of the Chairman of the Board and the Board members.

Naftogaz of Ukraine is a vertically integrated oil and gas company engaged in full cycle of operations in gas and oil field exploration and development, exploratory drilling and production, gas and oil transportation and storage, supply of natural gas and liquefied petroleum gas (“LPG”) to customers.

The Company holds stakes in various entities that form the national system of production, refinery, distribution, transportation, and storage of natural gas, condensate, and oil.

The Company is registered at 6 B. Khmelnytskoho Street, Kyiv, Ukraine.

The Group conducts its business and holds its production facilities mainly in Ukraine. The principal subsidiaries are presented as follows:

Name/Segment	% Interest held as at		Country of registration
	31 December		
	2014	2013	
<b>Production of gas, oil and refinery products</b>			
Ukrasvydobyvannia, PJSC	100.00	100.00	Ukraine
Chornomornaftogaz, State-owned JSC* (“Chornomornaftogaz”)	100.00	100.00	Ukraine
Zakordonnaftogaz, Subsidiary Enterprise	100.00	100.00	Ukraine
<b>Oil and gas transportation</b>			
Ukrtransgaz, PJSC	100.00	100.00	Ukraine

Name/Segment	% Interest held as at		Country of registration
	31 December		
	2014	2013	
Ukrtransnafta, PJSC	100.00	100.00	Ukraine
Ukrspetstransgaz, PJSC	100.00	100.00	Ukraine
<b>Wholesale and retail distribution of oil, gas and refinery products</b>			
Gaz Ukrainy, Subsidiary Enterprise	100.00	100.00	Ukraine
Naftogaz Overseas S.A.	100.00	100.00	Switzerland
Kirovogradgaz, Open JSC	51.00	51.00	Ukraine
Ukravtogaz, Subsidiary Enterprise	100.00	100.00	Ukraine
<b>Other</b>			
Vuglesynteziyaz Ukrainy, Subsidiary Enterprise	100.00	100.00	Ukraine
Ukrnaftogazkomplekt, Subsidiary Enterprise	100.00	100.00	Ukraine

\* As discussed in Note 20, during 2014 the Company has lost control over the assets of its subsidiary Chornomornaftogaz located in Crimea due to occupation of Autonomous Republic of Crimea by the troops of the Russian Federation.

### 2. OPERATING ENVIRONMENT

Emerging markets such as Ukraine are subject to different risks than more developed markets, including economic, political and social, legal and legislative risks. Laws and regulations affecting businesses in Ukraine continue to change rapidly, tax and regulatory frameworks are subject to varying interpretations. The future economic direction of Ukraine is heavily influenced by the fiscal and monetary policies adopted by the government, together with developments in the legal, regulatory, and political environment.

In 2014, the Ukrainian hryvnia has devalued against major foreign currencies. The National Bank of Ukraine introduced a range of stabilisation measures aimed at limiting outflow of customer deposits from the banking system, improving liquidity of banks and supporting of the exchange rate of the Ukrainian hryvnia against major foreign currencies.

In 2014, the economy of Ukraine displayed characteristics of being in recession. Since the end of 2013, Ukraine has been in a political and economic turmoil. As a result of a number of protests, the President was dismissed and newly formed Parliament majority coalition was formed. In February 2014 the new Prime Minister and new Government were appointed. Following the changes in the Government, the Company’s management had been changed in March-June 2014, and new Board was formed.

The Group is a guaranteed supplier of natural gas in Ukraine to certain groups of customers, and its ability to adjust prices to the end customers, together with increased prices for the imported gas, is limited, since such prices are regulated at each stage from exploration to end customers by the National Energy and Utilities Regulatory Commission (“NEURC”, before 27 August 2014 – National Committee for Energy Regulation, NCRE). The domestic natural gas supply in Ukraine satisfies at about half of the total demand. Consequently, significant level of gas import is required to meet needs of domestic consumption. During 2014 there were significant fluctuations in natural gas purchase prices in Ukrainian hryvnia equivalent due to destabilisation of the Ukrainian hryvnia against major foreign currencies.

The Government of Ukraine controls the Group’s operations through its ownership rights in the Company. Such an impact may result in social and economic initiatives that may lead to an adverse effect on the Group’s operations. Management is unable to predict a potential impact of such initiatives on the Group’s consolidated financial position and its performance.

#### State regulation of the natural gas market in Ukraine

State regulation of the natural gas market in Ukraine is performed by the Cabinet of Ministers of Ukraine and by the NEURC. State regulation covers both technical and financial aspect of the market functioning. Technical measures relate to effective use of natural gas resources, ensuring secure technical exploitation of the gas transportation system, maintaining correct and safe supply, distribution and consumption of the natural gas. Financial measures mainly relate to the tariff and price setting and to the keeping the correct financial means allocation between the market participants.

The Cabinet of Ministers of Ukraine must approve annual forecast of natural gas supply and its distribution.

NEURC performs regulation of tariffs and prices set at the each stage from production to sales of natural gas, by setting appropriate prices and tariffs and approving procedures of calculating those prices and tariffs. Accordingly, NEURC approves the maximum sales price of natural gas for entities financed from the State and local budgets, the maximum sales price of natural gas for industrial customers and other entities (including heat generating entities, producing heat for households), retail sales prices of natural gas for households, tariffs for transportation services via transmission and distribution pipelines within Ukraine, tariffs for distribution and supply of natural gas under the regulated tariffs, tariffs for storage and pumping services.

NEURC approves procedures of setting sales prices for natural gas for natural gas production entities, sales prices for natural gas for households, and setting transportation, distribution and storage tariffs for natural gas. Additionally, NEURC is responsible for protection of the customer rights in the area of tariff setting, security of supplies and quality of services.

The following tariffs and prices were set:

	30 June 2015	31 December 2014
Retail prices of natural gas for households depend on the volume of consumption and availability of gas meters (UAH per cubic meter), including VAT, duties in the form of additional levy to the existing tariffs, tariffs for transportation and distribution of natural gas under the regulated tariffs. Starting from 1 April 2015, differentiation depending on the volume of consumption and availability of gas meters is no longer applied. Two types of prices are used: regular and preferential, the latter applied in the period from 1 October to 30 April (heating season) for customers using gas in a single package of 200 cubic meters per month.	Effective from 1 April 2015: UAH 7.19 per cubic meter; UAH 3.6 per cubic meter within 200 cubic meters per month for customers using gas in a single package during the period from 1 October to 30 April (heating season)	From UAH 1.18 to UAH 4.01 per cubic meter, effective from May 2014
Maximum purchase price of natural gas for industrial customers, net of VAT, duties in the form of additional levy to the existing tariffs, tariffs for transportation and distribution of natural gas under the regulated tariffs. The following maximum purchase prices of natural gas for industrial customers and entities financed from the state and local budgets, net of VAT, duties in the form of additional levy to the existing tariffs, and tariffs for gas transportation, distribution, and supply services at the regulated tariffs.	UAH 6 600 per thousand cubic meters starting from 1 June 2015 (from 1 April 2015 to 1 June 2015 – UAH 7 200)	UAH 4 020 per thousand cubic meters
Total tariff for storage (storage and pumping services), net of VAT, UAH per thousand cubic meters per one season of storage.	112	112
Total tariff for transportation services via transmission and distribution pipelines within Ukraine, net of VAT, UAH per thousand cubic meters.	656.20 from 1 April 2015	287.00
Maximum natural gas prices for entities generating heat for household needs, including VAT and duties in the form of additional levy, UAH per cubic meter.	UAH 2.99 per cubic meter from 1 April 2015	UAH 1.31 per cubic meter

According to the Law of Ukraine “On the natural gas market functioning”, the total volume of natural gas produced in Ukraine, net of natural gas used for technological purposes and other needs as stipulated by this law, by the entities owned 50% and more by the State, should be sold to the households via the Company at regulated prices. If the demand of the households exceeds the production volumes, it is satisfied from the other sources of supply, including imports. Natural gas volumes

consumed by households are reported via the gas meters. If no meters are available the sales volume is reported at the average normal consumption rates set by the respective regulations.

All customers, except for heat generating companies, settle their debts on natural gas consumed via special purpose bank accounts. The list of banks creating such accounts is approved by the Cabinet of Ministers of Ukraine. According to current procedure, guaranteed natural gas suppliers and distributors of natural gas for all groups of customers should open special purpose bank accounts to receive payments for natural gas consumed. Amounts accumulated on the special purpose bank accounts are allocated to current accounts of the transmission pipelines operator, distribution pipelines operators and guaranteed suppliers according to ratios calculated by the guaranteed suppliers and approved by NEURC. Balances on the special purpose accounts could not be arrested or blocked.

Heat generating companies also open special purpose banks accounts for the settlement of debts for heat supplied. Cash received by heat generating entities on their special purpose bank accounts then allocated, among others, to current bank accounts of the guaranteed suppliers of natural gas according to ratios approved by NEURC monthly. The special purpose bank accounts of heat generating companies also could not be blocked or arrested.

#### Compensation of price difference between sales tariffs and price of imported gas and other types of financial support by the State

As described above, the Company imports significant amount of natural gas to meet the domestic demand. The price of imported gas is significantly higher than the sales tariff set by NEURC and invoiced by the Company to certain groups of domestic customers, namely households and heat generating companies. The negative difference is compensated by the State to the Company, as prescribed by the Resolution of the Cabinet of Ministers of Ukraine No.605 dated 29 April 2006 ("compensation of price difference"). Historically, such compensation of price difference covered 70-75% of the price of imported gas. The timing and legal form of such compensation is not set in the Ukrainian legislation. The actual amount of price difference to be compensated in respective period is approved by the State as an expense in the Law on the State Budget for respective period.

The Company calculates the full amount of price difference accumulated during each year and submits it to the Government. However, during the reporting periods and up to the date of these consolidated financial statements there were no documents stating the amount of compensation of price difference due to the Company. The Company recognises income from the compensation actually received on a cash basis.

The following information summarises the information on the price difference estimated by the Company for compensation, and financial support provided by the Government to the Company in 2013-2014 (unaudited):

In millions of Ukrainian hryvnias	2014	2013
Estimated price difference for the period	12 802	6 264
Financial support from the State:		
Compensation of price difference received in cash during the period	-	-
State treasury bonds received from the Government in exchange for the new share issue during the period	96 610	8 000
<b>Total financial support received from the State</b>	<b>96 610</b>	<b>8 000</b>

Estimated price difference is calculated as a difference in fair import prices and NEURC sales tariffs of gas sold to regional gas distribution entities and heat generating companies for selling to households. As described in Note 21, the Company has requested the Arbitral Tribunal to render an award in relation to the level of the natural gas import prices for 2010-2014. The price actually paid to JSC "Gazprom" ("Gazprom"), is higher than the fair price as claimed by the Company. Had the Company calculated the price difference at amounts actually paid to Gazprom, the estimated price difference for 2014 and 2013 would be UAH 19 091 million and UAH 20 753 million, respectively.

Together with the compensation of price difference, the Company receives financial support from the State in the form of the State treasury bonds received in exchange of new share issue of the Company (Note 12). The funds received are aimed to cover the current liquidity gap of the Company. It could be claimed that the amount of State treasury bonds received by the Company in exchange of the new share issue partially covers compensation of the price difference, however, there is no legal support or documents confirming this statement, and there is no reconciliation act or similar document signed between the Company and the Government of Ukraine, stating the outstanding amount of compensation of the price difference. As a result, the Group's capital structure is not balanced, representing significant amount of share capital and accumulated losses.

#### Political instability and military actions in Eastern regions of Ukraine

In early 2014 Ukraine has suffered from the armed aggression of the Russian Federation resulting in occupation of the Autonomous republic of Crimea ("Crimea") and occupation of the parts of Luhansk and Donetsk regions by terrorist formations armed, controlled, directed and financed by the Russian Federation as well as in the result of an overt intervention of regular military forces of the Russian Federation. Part of the Group's assets is located in these regions. As a result of these actions, the Group has reflected impairment of assets (property, plant and equipment, receivables and inventories) located at occupied territories of Luhansk and Donetsk regions amounting to UAH 7 203 million as at 31 December 2014 (Note 17).

Additionally, as a result of occupation of Crimea by the Russian Federation, the Group has lost control over its assets located at this area. To reflect the temporary inability to control its business activities in Crimea, the Group has presented respective part of net assets of its subsidiary Chornomornaftogaz as discontinued operations (Note 20). Management assumes that as control over Crimea or the net assets of the Group located in Crimea is renewed in the future, these net assets will be restored in the consolidated financial statements in respective period. Additionally, the Group reflected impairment of assets (property, plant and equipment, receivables and inventories) located in Crimea amounting to UAH 5 809 million at 31 December 2014 (Note 17). Management continues to pursue available legal and diplomatic routes aiming to recover damages and restore control over the Group's assets in the affected regions.

#### Going Concern

The excess of current liabilities over current assets as at 31 December 2014 amounted to UAH 17 908 million (31 December 2013: UAH 53 893 million); for the year ended 31 December 2014 negative cash flow from operating activities amounted to UAH 59 738 million; for the year then ended the Group incurred net losses in the amount of UAH 88 433 million (2013: loss of UAH 17 957 million).

Management of the Group believes that it is appropriate to prepare these consolidated financial statements on a going concern basis as the Group and the Government of Ukraine has undertaken several initiatives aimed to improve the financial performance and liquidity of the Group, including, but not limited by the following:

- Since the beginning of 2014, the Government of Ukraine has undertaken a number of measures aiming to gradually bring the retail gas and heating prices to cost recovery levels based on international gas prices. The Government announced its plans to change energy subsidy system by increasing the direct subsidies to final consumers (mainly households and heat producing entities) and reducing the extent of the price regulation. Successful implementation of these plans would significantly reduce the Group's financial deficit in 2015-2016 and completely eliminate it by 2017. As mentioned above in this Note, retail prices for natural gas for households, maximum purchase price of natural gas for industrial customers and tariffs for storage were increased several times in 2014 and 2015. Additionally, following recent changes to the legislation in July 2015, the Parliament of Ukraine adopted changes to the current legislation that prohibits setting heat tariffs below the economically justified level. This measure should enhance liquidity and profitability of the heat generating entities, improving their ability to settle debts due to the Group.
- The Government of Ukraine and the Group have been undertaking steps to diversify the sources of gas supplies

primarily from European companies through gas transportation networks of Slovakia, Poland and Hungary. In addition, the Group can reasonably expect that market prices for gas will go down following a substantial reduction of oil prices that occurred in the end of 2014 and onwards.

- During 2014 and 2015 the Government of Ukraine has provided to the Company State treasury bonds amounting to UAH 96.6 billion and UAH 29.7 billion (received up to the date of these consolidated financial statements were authorised for issue), respectively, in exchange for the new share issue. The Company registered share capital increase of UAH 6.0 billion in 2014, and received a temporary share registration certificates for UAH 104.6 billion. The bonds received in 2014 and 2015 were sold for cash, except for treasury bonds amounting to UAH 1.5 billion, received in 2015.
- During 2015 the Parliament enacted a series of amendments to existing laws to improve the Group's liquidity position, including but not limited to: the right of the Company not to conclude contracts for the sale of natural gas with customers declared bankrupt and those which cannot provide any security for future natural gas sales; the obligation of the Company to stop natural gas sales in case of non-timely payments for natural gas sold etc. These amendments became effective on 6 June 2015. A set of secondary legislation shall be put in place to make them operational.
- The Parliament also cancelled the moratorium on the forced property sale in respect of entities with the State shareholding of 25 and more per cent which had not settled their debts to the Company and its subsidiary, Gaz of Ukraine, for gas sold in past periods. This change allows the forced sale of property of such companies in order to settle their gas debts to the Company and its subsidiary, Gaz of Ukraine. The procedure for the forced property sale in such cases shall be approved by the Cabinet of Ministers of Ukraine. The Company and its subsidiary, Gaz of Ukraine, are entitled to claim debt settlements from such customers in the court following cancellation of the respective moratorium from 1 September 2015.

Management believes that the combination of the above mentioned and other measures from the Government of Ukraine will enable the Group to continue as a going concern. These consolidated financial statements do not include any adjustments relating to recoverability and classification of the recorded assets amounts, or to the amounts and classification of liabilities that may be necessary if the Group is unable to continue as a going concern.

#### 3. SEGMENT INFORMATION

The Board is the Group's chief operating decision maker. Management has determined the operating segments used for disclosure by the Group based on reports reviewed by the Board and the Ministry of Energy and Coal Industry of Ukraine for assessing their financial performance.

Management assesses the performance of the operating segments based on the amount of net profit/(loss) before income tax from continuing operations. Reportable segments are defined by management in accordance with the type of activity as follows:

- **Production of natural gas.** Natural gas production is mainly performed in Poltava, Kharkiv, Sumy, Dnipropetrovsk, Lviv and Zakarpattya regions. Exploration works are mainly performed in Carpathian and Dniprov'sko-Donetsk regions. The Group controls about 70% of all natural gas produced in Ukraine.
- **Production of crude oil and gas condensate.** Oil exploration was performed in Crimea. After occupation of Crimea by the Russian Federation in early 2014, the Company has lost its control over the assets located there and respective cash flows (Note 20). Production of gas condensate is performed in the area of natural gas exploration.
- **Transportation of natural gas.** This segment is presented by the gas transmission and distribution pipelines operated by the Group. Ukrainian gas transportation system is one of the largest in the world in terms of its transportation capacities. The total length of gas transmission pipelines in Ukraine is 38.5 thousand km. Over 40% of natural gas supplied from the Russian Federation to European countries was transported through Ukrainian transmission gas pipelines in 2014 (2013: over 50%).

- **Storage of natural gas.** Ukrainian gas transportation system includes 11 underground gas storage facilities located in mainland Ukraine. The total capacity of the underground gas storage system located in Ukraine is 31 billion cubic meters of gas.
- **Transportation of crude oil.** This segment is presented by the transmission oil pipelines operated by the Group. The total length of oil transmission pipelines in Ukraine is 4.7 thousand km. Segment also includes oil storage, presented by 11 oil reservoirs with total capacity of 1.1 million tonnes of oil.
- **Refinery of crude oil and gas condensate.** This segment is presented by 5 oil and gas refineries. The refinery products mainly include gasoline and diesel fuel, and LPG.
- **Wholesale distribution and trading of natural gas.** As described in the Note 2 above, the natural gas producers in Ukraine, owned 50% and more by the State, should sell total volume of natural gas produced, net of natural gas used for technological purposes and other needs as stipulated by the law, to the households via the Company.
- **Other.** Revenues of this segment include revenues from sales of material and services by supporting Group entities, mainly supporting services.

The accounting policies of the reportable segments are the same as the Group's accounting policies described in Note 25.

Segment information for the reportable business segments of the Group for the year ended 31 December 2014 is as follows:

In millions of Ukrainian hryvnias	Production of natural gas	Production of crude oil and gas condensate	Transportation of natural gas	Storage of natural gas	Transportation of crude oil	Refinery of crude oil and gas condensate	Wholesale distribution and trading of natural gas	Other	Elimination	Total
Sales – external	130	320	24 171	338	1 957	5 197	45 493	838	-	78 444
Sales to other segments	4 685	-	57	1 092	-	27	7 764	-	(13 625)	-
Compensation of price difference	-	-	-	-	-	-	-	-	-	-
<b>Total revenue and Compensation of price difference</b>	<b>4 815</b>	<b>320</b>	<b>24 228</b>	<b>1 430</b>	<b>1 957</b>	<b>5 224</b>	<b>53 257</b>	<b>838</b>	<b>(13 625)</b>	<b>78 444</b>
<b>Segment result</b>	(4 696)	291	7 448	(2 986)	1 115	1 995	(81 211)	(274)	-	(78 318)
Unallocated income/(expense), net										715
Loss before income tax										(77 603)

Management considers segments “Production of natural gas”, “Storage of natural gas”, and “Wholesale distribution and trading of natural gas” as regulated businesses as sales prices and tariffs and purchase prices in those types of business are regulated by the State (as described in Note 2). All other segments are considered as non-regulated businesses as they are fully or their major parts are independent of special price and tariff regulations by the State.

**Material non-cash items included in segment results:**

Depreciation, depletion and amortisation	(2 210)	-	(2 344)	(257)	(139)	(111)	(12)	(152)	-	(5 225)
Net movement in provision for trade and other receivables and prepayments made and other current assets	(135)	-	29	-	(18)	-	(9 715)	-	-	(9 839)
Impairment of property, plant and equipment and intangible assets	(2 394)	-	(52)	(2 725)	(134)	(78)	(141)	(101)	-	(5 625)
Net foreign exchange (loss)/gain	(783)	-	(548)	-	468	-	(38 322)	-	-	(39 185)
Capital expenditure	2 598	-	295	28	120	106	262	263	-	3 672
Segment assets	42 367	2 317	239 746	146 195	19 959	5 007	28 347	10 968	-	496 013
Investments in associates and joint ventures										11 169
Unallocated assets										7 797
<b>Total assets</b>										<b>514 979</b>
Sales – external	446	207	30 131	443	1 411	5 778	36 447	511	-	75 374
Sales to other segments	4 687	-	-	425	-	-	9 828	-	(14 940)	-
Compensation of price difference	-	-	-	-	-	-	-	-	-	-
Total revenue and Compensation of price difference	5 133	207	30 131	868	1 411	5 778	46 275	511	(14 940)	75 374
Segment result	(1 163)	207	9 435	(661)	435	1 437	(24 941)	(349)	-	(15 600)
Finance costs, not included in segment result										-
Unallocated income/(expense), net										108
<b>Loss before income tax</b>										<b>(15 492)</b>

In millions of Ukrainian hryvnias	Production of natural gas	Production of crude oil and gas condensate	Transportation of natural gas	Storage of natural gas	Transportation of crude oil	Refinery of crude oil and gas condensate	Wholesale distribution and trading of natural gas	Other	Elimination	Total
<b>Material non-cash items included in segment results:</b>										
Depreciation, depletion and amortisation	(2 309)	-	(2 393)	(312)	(162)	(157)	-	(348)	-	(5 681)
Net movement in provision for trade and other receivables and prepayments made and other current assets	(5)	-	(238)	-	(25)	-	(1 888)	-	-	(2 156)
Impairment of property, plant and equipment and intangible assets	-	-	(837)	-	-	-	-	(15)	-	(852)
Capital expenditure	2 053	429	1 195	75	58	250	30	144	-	4 234
Segment assets	30 053	9 402	61 917	70 304	12 283	2 387	29 869	5 513	-	221 728
Investments in associates and joint ventures										9 942
Unallocated assets										6 248
<b>Total assets</b>										<b>237 918</b>

External customers concentration, exceeding 10% of total revenues

During the years ended 31 December 2014 and 2013 the only external customer with concentration of revenue exceeding 10% of total revenues was Gazprom. Amount of revenue from Gazprom related to transportation of natural gas in 2014 amounted to UAH 16 831 million (2013: UAH 22 732 million).

Revenues, gross profit and receivables of the segment 'Transportation of natural gas' by main types of transportation services are as follows:

31 December 2014

In millions of Ukrainian hryvnias	Revenue	Gross profit	Trade accounts receivable, carrying amount
Domestic transportation	7 340	4 310	449
International transit	16 831	11 891	1 729
<b>Total</b>	<b>24 171</b>	<b>16 201</b>	<b>2 178</b>

31 December 2013

In millions of Ukrainian hryvnias	Revenue	Gross profit	Trade accounts receivable, carrying amount
Domestic transportation	7 399	3 798	2 282
International transit	22 732	15 722	-
<b>Total</b>	<b>30 131</b>	<b>19 520</b>	<b>2 282</b>

Revenues, gross (loss)/profit and receivables of the segment 'Wholesale distribution and trading of natural gas' by main groups of customers are as follows:

31 December 2014

In millions of Ukrainian hryvnias	Revenue	Gross (loss)/profit	Trade accounts receivable, gross amount	Trade accounts receivable, provision for impairment	Trade accounts receivable, carrying amount
Heat generating entities for heat produced for households	5 341	(19 329)	5 249	(2 327)	2 922
Heat generating entities for heat produced for other customers	5 653	856	7 208	(3 068)	3 940
Regional gas distribution entities – for reselling to households	7 390	(7 968)	1 897	(429)	1 468
Regional gas distribution entities – for reselling to other customers	2 380	324	1 608	(28)	1 580
Industrial and other customers	24 729	7 691	8 328	(6 088)	2 240
<b>Total</b>	<b>45 493</b>	<b>(18 426)</b>	<b>24 290</b>	<b>(12 140)</b>	<b>12 150</b>

31 December 2013

In millions of Ukrainian hryvnias	Revenue	Gross (loss)/profit	Trade accounts receivable, gross amount	Trade accounts receivable, provision for impairment	Trade accounts receivable, carrying amount
Heat generating entities for heat produced for households	6 487	(11 875)	9 085	(1 367)	7 718
Heat generating entities for heat produced for other customers	6 401	338	5 689	(856)	4 833
Regional gas distribution entities – for reselling to households	5 668	(4 460)	2 138	(322)	1 816
Regional gas distribution entities – for reselling to other customers	3 333	623	174	(26)	148
Industrial and other customers	14 558	1 647	10 762	(7 218)	3 544
<b>Total</b>	<b>36 447</b>	<b>(13 727)</b>	<b>27 848</b>	<b>(9 789)</b>	<b>18 059</b>

Main sales prices and tariffs for the Group's sales of natural gas are set out in Note 2.

Geographical information

In millions of Ukrainian hryvnias	2014	2013
Ukraine	61 292	52 434
The Russian Federation	16 831	22 732
Egypt	320	207
Europe	1	1
<b>Total revenue and Compensation of price difference</b>	<b>78 444</b>	<b>75 374</b>

Allocation of sales in the table above is made based on the country of residence of the Group's customers.

#### 4. BALANCES AND TRANSACTIONS WITH RELATED PARTIES

Parties are generally considered to be related if one party has the ability to control the other party, is under common control, or can exercise significant influence or joint control over the other party in making financial and operational decisions. In considering each possible related party relationship, attention is directed to the substance of the relationship, not merely the legal form.

As discussed in the Note 1, The Group is ultimately controlled by the Government of Ukraine, and therefore, all state-controlled entities are considered as related parties under common control.

Transactions with related parties are performed on terms that would not necessarily be available to unrelated parties.

Significant transactions and balances with related parties as at and for the years ended 31 December 2014 and 2013 are presented in the table below.

#### Revenue, trade accounts receivable, prepayments made and other current assets

In millions of Ukrainian hryvnias	2014		2013	
	State-controlled entities and entities under significant influence of the State	Associates	State-controlled entities and entities under significant influence of the State	Associates
Revenue	6 982	11 628	6 439	10 480
Share of after-tax results of associates and joint-ventures	-	1 488	-	536
Trade accounts receivable	5 052	3 723	7 640	764
Provision for impairment of trade accounts receivable	(3 051)	(73)	(1 351)	(57)
Other non-current assets	488	27	468	28
Prepayments made and other current assets	466	628	205	423
Provision for impairment of prepayments made and other current assets	(258)	(180)	(129)	(171)
Cash and bank balances	2 075	-	1 033	-

Purchases, trade and other payables and borrowings

In millions of Ukrainian hryvnias	2014		2013	
	State-controlled entities and entities under significant influence of the State	Associates	State-controlled entities and entities under significant influence of the State	Associates
Cost of purchased oil, natural gas and petroleum products	-	-	-	1 024
Cost of purchased oil, natural gas and petroleum products	-	-	-	1 024

In millions of Ukrainian hryvnias	2014		2013	
	State-controlled entities and entities under significant influence of the State	Associates	State-controlled entities and entities under significant influence of the State	Associates
Other purchases	683	1 341	150	1 147
Other operating expense	31	239	12	4
Net movement in provision for trade accounts receivable, prepayments made and other current assets and direct write-offs	(1 819)	(25)	227	146
Finance costs	3 265	-	-	-
Trade accounts payable	461	4 239	389	3 997

In millions of Ukrainian hryvnias	2014		2013	
	State-controlled entities and entities under significant influence of the State	Associates	State-controlled entities and entities under significant influence of the State	Associates
Borrowings	30 304	-	27 261	-
Advances received and other current liabilities	875	61	751	966

**Key management remuneration.** Key management personnel during 2014 consisted on average of 8 Board members (2013: 14 Board members). Compensation to the key management personnel included into other operating expense consists of salary and additional current bonuses and comprises UAH 6 million for the year ended 31 December 2014 (2013: UAH 11 million). As at 31 December 2014 key management personnel consisted of 5 Board members.

## 5. PROPERTY, PLANT AND EQUIPMENT

Movements in the carrying amount of property, plant and equipment were as follows:

In millions of Ukrainian hryvnias	Pipelines and related equipment	Oil and gas producing properties	Machinery and equipment	Buildings	Technological oil and gas	Drilling and exploration equipment	Other fixed assets	Construction in progress	Total
<b>At 31 December 2012</b>									
Cost or valuation	56 026	24 885	13 938	14 526	83 077	732	3 510	16 263	212 957
Accumulated depreciation and impairment	(6 324)	(4 904)	(3 210)	(3 054)	-	(304)	(1 788)	(2 127)	(21 711)
<b>Net book value at 31 December 2012</b>	49 702	19 981	10 728	11 472	83 077	428	1 722	14 136	191 246
Additions	919	1 476	1 077	449	-	26	269	119	4 335
Revaluation	-	-	-	-	(6 186)	-	-	-	(6 186)
Disposals	(7)	-	(20)	(23)	(348)	-	(148)	(147)	(693)
Depreciation charge	(2 265)	(1 810)	(1 174)	(763)	-	(79)	(379)	-	(6 470)
Impairment	(54)	-	(45)	(10)	-	-	-	(695)	(804)
<b>Net book value at 31 December 2013</b>	48 295	19 647	10 566	11 125	76 543	375	1 464	13 413	181 428
Cost or valuation	56 936	26 361	14 931	14 928	76 543	758	3 486	16 235	210 178
Accumulated depreciation and impairment	(8 641)	(6 714)	(4 365)	(3 803)	-	(383)	(2 022)	(2 822)	(28 750)

In millions of Ukrainian hryvnias	Pipelines and related equipment	Oil and gas producing properties	Machinery and equipment	Buildings	Technological oil and gas	Drilling and exploration equipment	Other fixed assets	Construction in progress	Total
Additions and transfers	354	1 712	526	(177)	-	18	101	687	3 221
Revaluation	124 679	12 232	61 536	36 260	56 852	169	4 501	-	296 229
Disposals	-	-	(1)	(100)	(23)	-	(8)	-	(132)
Depreciation charge	(1 990)	(1 608)	(970)	(760)	-	(28)	(285)	-	(5 641)
Reclassification to discontinued operations (Note 20)	(4 275)	(968)	(2 295)	-	(800)	(216)	(25)	(5 910)	(14 489)
Impairment	(1 637)	(347)	(660)	(201)	(404)	(1)	(65)	(2 310)	(5 625)
<b>Net book value at 31 December 2014</b>	165 426	30 668	68 702	46 147	132 168	317	5 683	5 880	454 991
Cost or valuation	165 447	30 668	68 827	46 172	132 168	317	5 900	8 669	458 168
Accumulated depreciation and impairment	(21)	-	(125)	(25)	-	-	(217)	(2 789)	(3 177)

The Group engaged independent appraisers to determine the fair value of its property, plant and equipment as at 31 December 2014. Fair value was determined with reference to depreciated replacement cost or market-based evidence, in accordance with International Valuation Standards.

Taking into account the nature of the Group's property, plant and equipment, fair value was determined using depreciated replacement cost for specialised assets, and using market-based evidence for non-specialised assets. Consequently, the fair value of main producing properties and equipment was primarily determined using depreciated replacement cost. This method considers the cost to reproduce or replace the property, plant and equipment, adjusted for physical, functional or economic depreciation, and obsolescence. The depreciated replacement cost was estimated based on internal sources and analysis of available market information for similar property, plant and equipment (published information, catalogues, statistical data etc.), and industry experts and suppliers.

Included in oil and gas producing properties carrying value of gas producing licenses as at 31 December 2014 of UAH 343 million (31 December 2013: UAH 325 million).

In 2014, the depreciation expense of UAH 5 126 million (2013: UAH 5 847 million) was included in cost of sales, UAH 99 million (2013: UAH 70 million) in other operating expense, and UAH 428 million (2013: UAH 553 million) were capitalised in the cost of property, plant and equipment.

As at 31 December 2014 and 2013 the Group has pledged its property, plant and equipment with carrying amount of UAH 15 240 million and UAH 7 794 million, respectively, to secure its borrowings (Note 13).

Had the Group's property plant and equipment been measured on a historical cost basis, their carrying amount would have been as shown in the table below:

In millions of Ukrainian hryvnias	31 December 2014	31 December 2013
Oil and gas producing properties	8 480	9 553
Pipelines and related equipment	6 520	13 119
Machinery and equipment	5 934	8 417
Buildings	5 446	5 835
Technological oil and gas	1 131	1 017
Drilling and exploration equipment	153	360
Other fixed assets	882	989
<b>Total</b>	<b>28 546</b>	<b>39 290</b>

## 6. INVESTMENTS IN ASSOCIATES AND JOINT VENTURES

The Group's investments in associates and joint ventures were as follows:

In millions of Ukrainian hryvnias	31 December 2014	31 December 2013
Investments in associates	9 739	9 165
Investments in joint ventures	1 430	777
<b>Total</b>	<b>11 169</b>	<b>9 942</b>

### Investments in associates

Details of each of the Group's associates at the end of the reporting period are as follows:

Name of associate	Principal activity	Place of incorporation and principal place of business	Proportion of ownership interest	
			31 December 2014	31 December 2013
"Ukrnafta" PJSC	Oil and gas production	Ukraine	50.00%+ 1 share	50.00%+ 1 share
"Ukratnafta" PJSC	Oil refinery	Ukraine	43.05%	43.05%

All of the above associates are accounted for using the equity method in these consolidated financial statements.

Summarised financial information in respect of each of the Group's associates is set out below. The summarised financial information below represents amounts shown in the associate's financial statements prepared in accordance with IFRS.

#### "Ukrnafta" PJSC

In millions of Ukrainian hryvnias	31 December 2014	31 December 2013
Current assets	14 983	9 118
Non-current assets	18 227	19 123
	<b>33 210</b>	<b>28 241</b>
Current liabilities	15 922	8 703
Non-current liabilities	2 468	1 795
	<b>18 390</b>	<b>10 498</b>

In millions of Ukrainian hryvnias	31 December 2014	31 December 2013
Revenue	27 892	21 101
Profit for the year	1 265	190
Other comprehensive (loss)/income for the year	(389)	31
Total comprehensive income for the year	876	221

Reconciliation of the above summarised financial information to the carrying amount of the interest in "Ukrnafta" PJSC recognised in the consolidated financial statements:

In millions of Ukrainian hryvnias	31 December 2014	31 December 2013
Net assets of the associate	14 820	17 743
Dividends declared by associate but not yet paid	3 799	-
Proportion of the Group's ownership interest in "Ukrnafta" PJSC	50.00%	
+1 share		
+1 share		
<b>Carrying amount of the Group's interest in "Ukrnafta" PJSC</b>	<b>9 310</b>	<b>8 872</b>

#### "Ukratnafta" PJSC

In millions of Ukrainian hryvnias	31 December 2014	31 December 2013
Current assets	7 411	4 302
Non-current assets	2 048	1 946
	<b>9 459</b>	<b>6 248</b>

In millions of Ukrainian hryvnias	31 December 2014	31 December 2013
Current liabilities	8 256	5 397
Non-current liabilities	206	170
	<b>8 462</b>	<b>5 567</b>

In millions of Ukrainian hryvnias	31 December 2014	31 December 2013
Revenue	20 647	18 398
Profit for the year	350	251
Other comprehensive (loss)/income for the year	(33)	19
<b>Total comprehensive income for the year</b>	<b>317</b>	<b>270</b>

Reconciliation of the above summarised financial information to the carrying amount of the interest in "Ukratnafta" PJSC recognised in the consolidated financial statements:

In millions of Ukrainian hryvnias	31 December 2014	31 December 2013
Net assets of the associate	997	681
Proportion of the Group's ownership interest in "Ukratnafta" PJSC	43.05%	43.05%
<b>Carrying amount of the Group's interest in "Ukratnafta" PJSC</b>	<b>429</b>	<b>293</b>

#### Investments in joint ventures

Details of the Group's material joint venture at the end of the reporting period are as follows:

Name of associate	Principal activity	Place of incorporation and principal place of business	Proportion of ownership interest	
			31 December 2014	31 December 2013
Misen Enterprices AB (LLC Carpatygas)	Oil and gas production	Ukraine	49.99%	49.99%

Summarised financial information in respect of the Group's material joint venture is set out below. The summarised financial information below represents amounts shown in the joint venture's financial statements prepared in accordance with IFRS not adjusted by the Group for equity accounting purposes.

#### Misen Enterprices AB (LLC Carpatygas)

In millions of Ukrainian hryvnias	31 December 2014	31 December 2013
Current assets	935	1 141
Non-current assets	2 906	1 819
	<b>3 841</b>	<b>2 960</b>
Current liabilities	1 025	1 199
Non-current liabilities	86	227
	<b>1 111</b>	<b>1 426</b>

The above amounts of assets and liabilities include the following:

Cash and cash equivalents	297	-
Current financial liabilities (excluding trade accounts payable and provisions)	(483)	(418)
Non-current financial liabilities (excluding trade accounts payable and provisions)	(52)	(221)

In millions of Ukrainian hryvnias	2014	2013
Revenue	3 942	1 676
Profit for the year	1 228	643
Other comprehensive income for the year	-	-
Total comprehensive income for the year	1 228	643
Dividends received from the joint venture during the year	-	-

The above profit for the year include the following:

Depreciation and amortisation	(96)	(18)
Finance income	9	-
Finance costs	(429)	(11)
Income tax expense	(285)	(108)

Reconciliation of the above summarised financial information to the carrying amount of the interest in the joint venture recognised in the consolidated financial statements:

In millions of Ukrainian hryvnias	2014	2013
Net assets of the joint venture	2 730	1 534
Proportion of the Group's ownership interest in the joint venture	49.99%	49.99%
Contribution to capital	9	-
Other adjustments	25	(25)
<b>Carrying amount of the Group's interest in the joint venture</b>	<b>1 390</b>	<b>742</b>

## 7. OTHER NON-CURRENT ASSETS

In millions of Ukrainian hryvnias	31 December 2014	31 December 2013
Accounts receivable on product sharing agreement	2 176	903
Restructured accounts receivable of gas consumers	1 122	1 130
Intangible assets	371	376
Other	677	328
<b>Total</b>	<b>4 346</b>	<b>2 737</b>

**Accounts receivable on product sharing agreement.** The Company entered into a concession agreement for oil exploration and development with the Arab Republic of Egypt and Egyptian General Petroleum Corporation ("EGPC") on 13 December 2006. Under the terms of the concession agreement the Company have the right to recover all exploration and development costs incurred in connection with the concession agreement (Note 25). The amount presented in the table above represents such costs claimed by the Group for recovery, and which are expected to be refunded after one year since the reporting date.

**Restructured accounts receivable of gas consumers.** In May 2011, the Law of Ukraine "On certain matters on indebtedness for natural gas and electricity consumed" #3319-VI was approved. According to this Law, accounts receivable due from entities supplying natural gas under the regulated tariff that were originated in 2010, were restructured for the period from 1 to 20 years and are stated at amortised cost using effective interest rate which at the restructuring dates varied from 14% to 15% per annum.

During the year ended 31 December 2014 the Group recognised additional provision in respect of restructured accounts receivable of gas customers in the amount of UAH 95 million (2013: additional provision of UAH 21 million).

**Other non-current assets.** As at 31 December 2014 and 2013, included in other non-current assets are research and development expenditures amounting to UAH 525 million and UAH 200 million, respectively, that were incurred within the concession agreement for oil exploration and development with the EGPC on 13 December 2006, but not yet claimed for recovery (Note 25).

## 8. INVENTORIES

The Group's inventories were as follows:

In millions of Ukrainian hryvnias	31 December 2014	31 December 2013
Natural gas	7 885	14 146
Spare parts	844	1 388
Crude oil and petroleum products	363	459
Raw materials	327	704
Other	564	327
<b>Total</b>	<b>9 983</b>	<b>17 024</b>

Management estimates the necessity of write-down of inventories to their net realisable value taking into consideration the ageing of inventories and indications of economical, technical and physical obsolescence. In 2014 total write-down adjustment amounted to UAH 3 893 million, included in other operating expense and UAH 8 592 million included in cost of sales (2013: UAH 422 million included in other operating expense).

As at 31 December 2014 and 2013 inventories with carrying value of UAH 5 308 million and UAH 11 803 million, respectively, were pledged as a collateral for borrowings (Note 13).

## 9. TRADE ACCOUNTS RECEIVABLE

In millions of Ukrainian hryvnias	31 December 2014	31 December 2013
Trade accounts receivable	34 095	32 424
Less: provision for impairment	(18 998)	(11 885)
<b>Total</b>	<b>15 097</b>	<b>20 539</b>

Out of total carrying value of trade accounts receivable as at

31 December 2014 there are UAH 12 150 million of accounts receivable for natural gas (31 December 2013: UAH 18 059 million) (Note 3).

Movements in provision for impairment of trade accounts receivable were as follows:

In millions of Ukrainian hryvnias	2014	2013
<b>Balance at 1 January</b>	<b>11 885</b>	<b>11 222</b>
Provision for impairment recognised during the year	8 027	2 047
Reversal of provision	(611)	(808)
Amounts written off during the year as uncollectible	(227)	(576)
Transfer to discontinued operations (Note 20)	(76)	-
<b>Balance at 31 December</b>	<b>18 998</b>	<b>11 885</b>

Analysis of credit quality of trade accounts receivable is as follows:

In millions of Ukrainian hryvnias	31 December 2014	31 December 2013
Neither past due nor impaired	9 921	4 814
Past due but not impaired:		
Less than 30 days overdue	2 258	4 263
31 to 90 days overdue	913	5 486
91 to 180 days overdue	325	669
181 to 365 days overdue	1 606	3 288
Over 365 days overdue	74	2 019
Past due and individually impaired (gross):		
Less than 30 days overdue	1 263	68
31 to 90 days overdue	322	53
91 to 180 days overdue	177	113
181 to 365 days overdue	1 872	125
Over 365 days overdue	15 364	11 526
Less: provision for impairment	(18 998)	(11 885)
<b>Total</b>	<b>15 097</b>	<b>20 539</b>

## 10. PREPAYMENTS MADE AND OTHER CURRENT ASSETS

The Group's prepayments made and other current assets were as follows:

In millions of Ukrainian hryvnias	31 December 2014	31 December 2013
Prepayments to suppliers for natural gas	11 083	-
Promissory notes receivable	1 698	1 513
Prepayments to suppliers for materials, works and services	1 463	2 646
Receivables under assignment agreements in respect of natural gas sales	1 384	1 737
Taxes prepaid, other than income tax	473	798
VAT recoverable	35	300
Other	2 580	1 543
Less: Provision for impairment	(6 215)	(5 714)
<b>Total</b>	<b>12 501</b>	<b>2 823</b>

Movements in provision for impairment of prepayments made and other current assets were as follows:

In millions of Ukrainian hryvnias	2014	2013
<b>Balance at 1 January</b>	<b>5 714</b>	<b>5 248</b>
Provision for impairment recognised during the year	1 812	802
Reversal of provision	(86)	(103)
Amounts written off during the year as uncollectible	(1 225)	(233)
<b>Balance at 31 December</b>	<b>6 215</b>	<b>5 714</b>

## 11. CASH AND BANK BALANCES

In millions of Ukrainian hryvnias	31 December 2014	31 December 2013
Cash in banks	2 475	1 697
Term deposits	1 869	416
Other	17	25
<b>Total</b>	<b>4 361</b>	<b>2 138</b>

Included in term deposits are bank deposits amounting to UAH 1 221 million with original maturity of more than three months and less than one year, which are excluded from cash and cash equivalents for the purpose of cash flow statement.

## 12. SHARE CAPITAL

As at 31 December 2014 the registered, issued and fully paid share capital of the Company was UAH 59 997 million, comprising 55 840 905 ordinary shares with a par value of UAH 1 000 per share (31 December 2013: UAH 53 997 million, comprising 49 840 905 ordinary shares with a par value of UAH 1 000 per share).

As at 31 December 2014 and 2013 share capital of the Company has been adjusted for the effect of hyperinflation in accordance with IAS 29 "Financial Reporting in Hyperinflationary Economies" by UAH 4 156 million.

During 2014 the Company has completed a new share issue, started in 2013, of UAH 6 000 million to the Government of Ukraine in return of the State treasury bonds with maturities up to 2015 with nominal coupon rates in a range of 9.45%-9.95% per annum.

### Unregistered contributed capital

In 2014 and 2013, according to several Resolutions of the Cabinet of Ministers of Ukraine, the Government issued UAH 96 610 million and UAH 8 000 million, respectively, of the State treasury bonds in exchange to the new share issue of the Company. The State treasury bonds have maturities in 2018-2024 and bear 12.5%-14.3% coupon rates. As at 31 December 2014 the Company has sold these State treasury bonds for cash at price equal to face value or above.

As at 31 December 2014 new share issues were not registered and presented as unregistered contributed capital.

## Profit share payable to the state budget

In accordance with the Budget Code of Ukraine and the Law of Ukraine "On Management of State-owned Items", the Company, being a state-owned enterprise, has to transfer to the state budget 30% of its statutory net profits calculated under Ukrainian Accounting Standards. For the year ended 31 December 2014, the obligatory profit amount payable to the State Budget amounted to UAH 156 million (2013: UAH 43 million).

## Distribution of profits

Profits available for distribution to the owner in respect of any reporting period are determined by reference to the statutory financial statements prepared in accordance with Ukrainian Accounting Standards. Under Ukrainian legislation, dividends are limited to the net profits of the reporting year or any other distributable reserves not exceeding retained earnings as set out in the statutory financial statements.

## 13. BORROWINGS

The Group's borrowings were as follows:

In millions of Ukrainian hryvnias	31 December 2014	31 December 2013
Non-current		
Bank borrowings	26 188	14 388
Total non-current portion	26 188	14 388
Current		
Bank borrowings	34 274	31 734
Eurobonds	-	12 749
Interest accrued	546	717
Unamortised issuance costs	-	(30)
Total current portion	34 820	45 170
<b>Total</b>	<b>61 008</b>	<b>59 558</b>

The effective interest rates and currency denomination of borrowings were as follows:

In millions of Ukrainian hryvnias	31 December 2014		31 December 2013	
	Balance	% per annum	Balance	% per annum
UAH	25 014	15%	27 232	14%
US Dollars	35 919	9%	32 326	9%
EUR	75	12%	-	-
<b>Total</b>	<b>61 008</b>		<b>59 558</b>	

## Pledges

The Group's borrowings in the context of secured and non-secured balances were as follows:

	31 December 2014	31 December 2013
Secured	61 008	58 839
Non-secured	-	719
<b>Total</b>	<b>61 008</b>	<b>59 558</b>

The Group's bank borrowings were secured by the following pledged assets:

	31 December 2014	31 December 2013
Proceeds from future sales	108 603	81 145
Property, plant and equipment (Note 5)	15 240	7 794
Inventories (Note 8)	5 308	11 803
<b>Total</b>	<b>129 151</b>	<b>100 742</b>

Guarantees. As at 31 December 2014 the Group's borrowings were guaranteed by the State in the amount of UAH 11 611 million (31 December 2013: UAH 24 381 million).

Compliance with borrowing terms. As at 31 December 2014 the carrying amount of bank borrowings past due comprised UAH 939 million. Before the date of these consolidated financial statements the borrowings in amount of UAH 710 million were settled. As at 31 December 2013, the Group did not comply with certain covenants on borrowings from third party banks, with the carrying amount of UAH 15 073 million. Those borrowings were classified as short-term as at 31 December 2013.

## 14. PROVISIONS

Movements in provisions for the year were as follows:

In millions of Ukrainian hryvnias	Provisions for litigations	Employee benefit obligations	Decommissioning provision	Total
Balance at 31 December 2012	231	1 253	161	1 645
Charge for the year	304	54	-	358
Unwinding of discount (Note 18)	-	142	20	162
Used or paid during the year	(64)	(142)	(8)	(214)
Unused amount reversed	-	-	(8)	(8)
Remeasurements	-	(38)	-	(38)
<b>Balance at 31 December 2013</b>	<b>471</b>	<b>1 269</b>	<b>165</b>	<b>1 905</b>
Non-current	176	1 269	156	1 601
Current	295	-	9	304
Charge for the year	323	115	-	438
Unwinding of discount (Note 18)	-	148	21	169

In millions of Ukrainian hryvnias	Provisions for litigations	Employee benefit obligations	Decommissioning provision	Total
Used or paid during the year	(17)	(107)	(2)	(126)
Unused amount reversed	-	-	(8)	(8)
Transferred to discontinued operations	-	(58)	(48)	(106)
Remeasurements	-	358	-	358
<b>Balance at 31 December 2014</b>	<b>777</b>	<b>1 725</b>	<b>128</b>	<b>2 630</b>
Non-current	16	1 725	111	1 852
Current	761	-	17	778

#### Provisions for Litigations

The Group is involved into a number of litigations both as a plaintiff and as a defendant. Provision for litigations represents management assessment of the probable outflow of the Group's resources arising from a negative (adverse) outcome of the court and arbitration procedures.

#### Employee Benefit Obligations

The Group companies have certain obligations to its employees, prescribed by the collective agreements. Those benefits include lump sum benefits payable upon retirement and post-retirement benefit programs. Those employee benefits plans are not funded, and there are no plan assets.

Of the current service cost expensed in 2014, an amount of UAH 107 million (2013: UAH 48 million) was included to cost of sales and UAH 8 million (2013: UAH 6 million) was included to other operating expense.

The principal actuarial assumptions used were as follows:

	2014	2013
Nominal discount rate, %	14.1-14.5	12.8-13.0
Nominal salary increase rate, %	7.0-15.0	5.6-11.0
Staff turnover ratio, %	2.0-8.9	2.4-8.6

The sensitivity of the employee benefit obligations to changes in the principal assumptions is as follows:

	2014	2013
Nominal discount rate increase/decrease by 1%, %	(10.5) / 11.9	(7.1) / 8.2
Nominal salary increase/decrease by 1%, %	10.0 / (8.5)	6.2 / (5.5)
Staff turnover increase/decrease by 1%, %	(3.9) / 4.4	(6.9) / 7.9

The sensitivity analysis presented above may not be representative of the actual change in the employee benefit obligations as it is unlikely that the change in assumptions would

occur in isolation of one another as some of the assumptions may be correlated.

Furthermore, in presenting the above sensitivity analysis, the present value of the employee benefit obligations has been calculated using the projected unit credit method at the end of the reporting period, which is the same as that applied in calculating the obligation recognised in the consolidated statement of financial position.

There were no changes in the methods and assumptions used in preparing the sensitivity analysis from prior years.

#### Decommissioning Provision

In accordance with the legislation requirements, the Group is obliged to restore the lands that underwent changes in the relief structure, environmental state of soils and parent rocks, as well as hydrological regime due to drilling, geological survey, constructing and other works. The decommissioning provision represents present value of decommissioning costs relating to oil and gas properties.

The principal assumptions used in determining the decommissioning provision were as follows:

	31 December 2014	31 December 2013
Pre-tax discount rate, %	18.0	18.0
Long-term inflation rate, %	9.0	9.0

#### 15. ADVANCES RECEIVED AND OTHER CURRENT LIABILITIES

The Group's advances received and other current liabilities were as follows:

In millions of Ukrainian hryvnias	31 December 2014	31 December 2013
Advances for natural gas transportation	2 366	15 241
Advances for natural gas supplies	793	1 694
Other advances received	1 070	299
Total advances received	4 229	17 234
VAT payable	3 227	210
Liabilities for purchase of property, plant and equipment	1 061	1 182
Taxed payable other than income tax	744	1 240
Wages, salaries and related social charges payable	442	728
Accrual of employees' unused vacations	269	261
Other current liabilities	1 152	1 161
<b>Total</b>	<b>11 124</b>	<b>22 016</b>

Out of total carrying value of advances for natural gas transportation as at 31 December 2014 there were UAH 2 306 million of advances received from single customer for natural gas transportation services via main gas pipelines through the territory of Ukraine (31 December 2013: UAH 14 293 million).

#### 16. COST OF SALES

In millions of Ukrainian hryvnias	2014	2013
Cost of purchased natural gas	69 587	54 283
Depreciation, depletion and amortisation	5 126	5 568
Taxes, other than on income	4 354	4 433
Staff costs and related social charges	4 178	4 098
Oil and gas transportation costs	1 967	2 584
Repair and maintenance costs	667	794
Cost of purchased oil and petroleum products	359	2 993
Other	713	1 373
<b>Total</b>	<b>86 951</b>	<b>76 126</b>

Rent charge, included in taxes, other than on income, is calculated with reference to the volume of crude oil, gas condensate or natural gas produced, and volume of crude oil and natural gas transportation.

Included in cost of sales are expenses incurred on works performed by contractors and inventory used in the amounts of UAH 334 million for the first quarter of 2014 (year ended 31 December 2013: UAH 1 082 million). Current management of the Group does not have enough evidence to prove the nature of those expenditures, and recognises them as expense when incurred and as was evidenced by the primary documents. In respect of certain expenses criminal proceedings were initiated in 2014, and primary documents were withdrawn by the state prosecutor officials.

#### 17. OTHER OPERATING EXPENSE

In millions of Ukrainian hryvnias	2014	2013
Losses incurred on occupied territories (Note 2)	7 203	-
Losses incurred in Crimea (Note 2)	5 809	-
Impairment of property, plant and equipment	3 283	852
Net movement in provision for trade accounts receivable, prepayments made and other current assets and direct write-offs	2 382	2 009
Staff costs and related social charges	1 129	923
Write down on inventories to net realisable value	494	426
Impairment of cash	336	-
Change in provision for litigations (Note 14)	323	304
Fines and penalties	221	163
Impairment of VAT receivable	185	146
Research, development and exploration costs	184	543
Professional fees	130	94
Charity and social assets maintenance	91	160
Loss on disposal of property, plant and equipment	7	105
Other	1 844	1 053
<b>Total</b>	<b>23 621</b>	<b>6 778</b>

Included in losses incurred on occupied territories are impairment loss on property, plant and equipment of UAH 1 543 million, net movement in provision for trade accounts receivable,

prepayments made and other current assets of UAH 3 848 million, write down on inventories of UAH 1 473 million, and VAT written off of UAH 339 million.

Included in losses incurred in Crimea are net movement in provision for trade accounts receivable, prepayments made and other current assets of UAH 3 057 million, write down on inventories of UAH 1 925 million, impairment loss on property, plant and equipment of UAH 799 million, and VAT written off of UAH 28 million.

Both losses incurred on occupied territories in Crimea, Luhansk and Donetsk regions were recognised by the Group as a result of the armed aggression of the Russian Federation including the occupation of Crimea and military invasion and occupation of Luhansk and Donetsk regions in early 2014 (Note 2).

Included in research, development and exploration costs are expenditures on geological survey amounting to UAH 160 million for the first quarter of 2014 (year ended 31 December 2013: UAH 455 million). The Group paid respective amounts to the contractors to perform those works and recognised them as expense when incurred and as was evidenced by the primary documents. In respect of these expenses criminal proceedings were initiated in 2014 and primary documents were withdrawn by the state prosecutor officials.

Included in other operating expense are oil storage costs of UAH 164 million for 2014 related to the Company's subsidiary "Ukrtransnafta" PJSC. Management of the Group believes that these costs are overstated as a result of subsidiary's management override of controls. Subsequently, subsidiary's management was replaced in the first half 2015.

#### 18. FINANCE COSTS

In millions of Ukrainian hryvnias	2014	2013
Interest expense on bank borrowings	6 325	7 323
Interest expense on Eurobonds	1 256	1 211
Interest on payment deferral	1 106	-
Unwinding of discount on employee benefit obligations (Note 14)	148	142
Unwinding of issuance costs	30	40
Unwinding of discount of decommissioning provision (Note 14)	21	20
Other finance costs	117	132
<b>Total</b>	<b>9 003</b>	<b>8 868</b>

Interest expense on payment deferral represents interest on late payment to a natural gas supplier.

#### 19. INCOME TAX

The components of income tax expense for the years ended 31 December were as follows:

In millions of Ukrainian hryvnias	2014	2013
Current tax expense	665	1 867
Deferred tax benefit	(3 621)	(276)
Income tax (benefit)/expense	(2 956)	1 591

The Group is subject to taxation in Ukraine. In 2014 Ukrainian corporate income tax was levied on taxable income less allowable expenses at the rate of 18% (2013: 19%).

Reconciliation between the expected and the actual taxation charge is provided below.

In millions of Ukrainian hryvnias	2014	2013
<b>Loss before income tax from continuing operations</b>	<b>(77 603)</b>	<b>(15 492)</b>
<b>Income tax at statutory rate of 18% (2013: 19%)</b>	<b>(13 969)</b>	<b>(2 943)</b>
Adjustments to deferred tax attributable to tax rates different from tax rates effective as at 31 December 2014	(121)	(51)
Indexation of property, plant and equipment for tax purposes	(149)	-
Tax effect of items not deductible or assessable for taxation purposes:		
- Non-deductible expenses	8 426	815
- Non-taxable income	(206)	(86)
Tax effect of items taxed at a rate different from 19%	-	1 520
Additional income tax accrued based on a lost court decision	139	557
Change in unrecognised deferred tax asset	2 924	1 779
<b>Income tax (benefit)/expense</b>	<b>(2 956)</b>	<b>1 591</b>

Parent and its subsidiaries are separate tax payers and, therefore, the deferred tax assets and liabilities are presented on an individual basis. The deferred tax liabilities and assets reflected in the consolidated statement of financial position after appropriate set off are as follows:

In millions of Ukrainian hryvnias	31 December 2014	31 December 2013
Deferred tax asset	-	-
Deferred tax liability	(68 726)	(17 521)
Net deferred tax liability	(68 726)	(17 521)

Net deferred tax liability as at 31 December 2014 related to the following:

In millions of Ukrainian hryvnias	31 December 2013	Recognised in profit or loss	Recognised in other comprehensive income	Transferred to discontinued operations (Note 20)	31 December 2014
Property, plant and equipment	(18 314)	904	(55 254)	327	(72 337)
Trade accounts receivable	82	2 853	-	-	2 935
Investments in associates and joint ventures	(627)	116	38	-	(473)
Advances received and other current liabilities	1 049	(626)	-	-	423

In millions of Ukrainian hryvnias	31 December 2013	Recognised in profit or loss	Recognised in other comprehensive income	Transferred to discontinued operations (Note 20)	31 December 2014
Provisions	261	21	63	-	345
Inventories	74	225	-	-	299
Prepayments made and other current assets	6	67	-	-	73
Trade accounts payable	6	(1)	-	-	5
Other non-current assets	(58)	62	-	-	4
<b>Net deferred tax liability</b>	<b>(17 521)</b>	<b>3 621</b>	<b>(55 153)</b>	<b>327</b>	<b>(68 726)</b>

Net deferred tax liability as at 31 December 2013 related to the following:

In millions of Ukrainian hryvnias	31 December 2012	Recognised in profit or loss	Recognised in other comprehensive income	Transferred to discontinued operations (Note 20)	31 December 2013
Property, plant and equipment	(19 518)	217	987	-	(18 314)
Trade accounts receivable	83	(1)	-	-	82
Investments in associates and joint ventures	(593)	(38)	4	-	(627)
Advances received and other current liabilities	1 176	(127)	-	-	1 049
Provisions	265	1	(5)	-	261
Inventories	(100)	174	-	-	74
Prepayments made and other current assets	(9)	15	-	-	6
Trade accounts payable	3	3	-	-	6
Other non-current assets	(67)	9	-	-	(58)
<b>Net deferred tax liability</b>	<b>(18 760)</b>	<b>253</b>	<b>986</b>	<b>-</b>	<b>(17 521)</b>

As at 31 December 2014 and 2013 unrecognised deductible temporary differences and unused tax losses are as follows:

In millions of Ukrainian hryvnias	31 December 2014	31 December 2013
Tax losses carried forward	43 484	2 906
Inventories	14 157	9 367
Trade accounts receivable, prepayments made and other current assets	10 099	20 975
Provisions	469	248

In millions of Ukrainian hryvnias	31 December 2014	31 December 2013
Trade accounts payable	314	699
Property, plant and equipment	62	-
Available-for-sale investments	-	14 000
Advances received and other current liabilities	-	3 263
Other non-current assets	-	940
Borrowings	-	273
Other	330	-
	<b>68 915</b>	<b>52 671</b>

According to provisions of the Tax Code of Ukraine tax losses accumulated by the Group as at 31 December 2014 can be carried forward for unlimited periods of time.

## 20. DISCONTINUED OPERATIONS

Since November 2013, Ukraine has been subject to political unrest. On 27 February 2014, pro-Russian fractions under military support of the regular forces of the Russian Federation illegally took control over the Parliament of the Autonomous republic of Crimea, an autonomous region of Ukraine, which then voted to hold a pseudo-referendum on the status of Crimea in March 2014. Following this pseudo-referendum and having the region under military occupation of the Russian regular forces, Crimea was unlawfully annexed by the Russian Federation. On 17 March 2014, Crimean occupational authorities announced the nationalisation of the assets of Chornomornaftogaz, the Company's subsidiary, located in Crimea.

These events led to a loss of control of the Group over Chornomornaftogaz's assets in Crimea.

According to paragraph 9 of the Law of Ukraine "On protecting citizen rights and law enforcement on the temporarily occupied territory of Ukraine", any authority, its officials and activities on the temporarily occupied territory are considered as unlawful, if this authority and officials are created or elected in order not prescribed by the law of Ukraine. Any document issued by such authorities or officials are not legally binding and do not create any legal consequences.

The Group had no access to financial statements, primary documents or any other financial information of Chornomornaftogaz for period from 1 January 2014 to date of loss of control in 2014. Based on this fact management of the Group decided to account for loss of control based on Chornomornaftogaz's net assets as of 31 December 2013.

Management continues to pursue available legal and diplomatic routes aiming to recover damages and restore control over the Group's assets in Crimea.

Chornomornaftogaz's net assets as at the date of loss of control were as follows:

In millions of Ukrainian hryvnias	31 December 2013
Property, plant and equipment (Note 5)	14 489
Other non-current assets	64
Inventories	413
Trade accounts receivable	32
Prepayments made and other current assets	690
Prepaid corporate income tax	17
Cash and cash equivalents	6
Deferred tax liabilities (Note 19)	(327)
Provisions (Note 14)	(106)
Other long-term liabilities	(339)
Borrowings	(504)
Trade accounts payable	(572)
Advances and other current liabilities	(77)
<b>Net assets at the date of loss of control</b>	<b>13 786</b>

Chornomornaftogaz's financial results for the year from discontinued operations:

In millions of Ukrainian hryvnias	2014	2013
Revenue	-	525
Other gains	-	24
	-	549
Expenses	-	(1 146)
Loss before income tax	-	(597)
Attributable income tax expense	-	(277)
<b>Loss on disposal of operation</b>	<b>(13 786)</b>	<b>-</b>
<b>Loss for the year from discontinued operations (attributable to owners of the Parent)</b>	<b>(13 786)</b>	<b>(874)</b>

Cash flows from discontinued operations:

In millions of Ukrainian hryvnias	2014	2013
Cash flows from discontinued operations	-	-
Net cash inflows from operating activities	-	212
Net cash outflows from investing activities	-	(235)
Net cash outflows from financing activities	-	(33)
<b>Net cash inflows</b>	<b>-</b>	<b>(56)</b>

## 21. CONTINGENCIES, COMMITMENTS AND OPERATING RISKS

**Tax legislation.** Ukraine's tax environment is characterised by complexity in tax administering, arbitrary interpretation by tax authorities of tax laws and regulations that, inter alia, can increase fiscal pressure on tax payers. Inconsistent application, interpretation, and enforcement of tax laws can lead to litigation which, as a consequence, may result in the imposition of additional taxes, penalties, and interest, and these amounts could be material. Facing current economic and political issues, the Government has implemented certain reforms in the tax system of Ukraine by adopting the Law of Ukraine "On Amending the Tax Code of Ukraine and Certain Laws of Ukraine" which is effective from 1 January 2015, except for certain provisions which will take effect at a later date.

In the ordinary course of business the Group is engaged in transactions that may be interpreted differently by the Group and tax authorities. Where the risk of outflow of financial resources associated with this is deemed to be probable and the amount is measured with sufficient reliability, the Group provides for those liabilities. Where management of the Group estimates the risk of financial resources outflow as possible, the Group makes a disclosure of these contingent liabilities. As at 31 December 2014, management estimated possible tax exposures in total amount of UAH 6 175 million (2013: UAH 5 553 million) with respect to the following:

- Corporate income tax amounting to UAH 3 122 million (2013: UAH 2 421 million) and related penalties amounting to UAH 863 million (2013: UAH 745 million);
- Value added tax amounting to UAH 1 514 million (2013: UAH 1 656 million) and related penalties amounting to UAH 538 million (2013: UAH 429 million);
- Other taxes amounting to UAH 138 million (2013: UAH: 302 million).

Management believes that it is not likely that any significant settlement will arise from the above cases and, therefore, the Group's consolidated financial statements do not include any amount of provision in this respect.

The Group conducts transactions with its subsidiaries. It is possible with evolution of the interpretation of tax law in Ukraine and changes in the approach of tax authorities under the new Tax Code, that such transactions could be challenged in the future. The impact of any such challenge cannot be estimated, however, management believes that it should not be significant.

Starting from 1 September 2013 the Tax Code of Ukraine introduced new, based on the OECD transfer pricing guidelines, rules for determining and applying fair market prices, which significantly changed transfer pricing ("TP") regulations in Ukraine. The Group exports refinery products and transportation services, performs intercompany transactions and is involved in transactions with related parties, which may potentially be in the scope of the new Ukrainian TP regulations. Part of the Group's companies has submitted the controlled transaction report within the required deadline. Another part of the Group's companies has prepared all necessary documentation on controlled transactions as required by legislation and plans to submit the reports. Management believes that the Group is in compliance with TP requirements.

**Arbitral Tribunal requests.** In June 2014 the Company has requested the Arbitration Institute of the Stockholm Chamber of Commerce to render an award in respect of the price determination according to the Agreement on gas purchase between the Company and Gazprom. The Company claims that the import prices for natural gas supplied during 2010-2014 are overstated. The import prices for natural gas, as prescribed by

the Agreement on gas purchase, are calculated using the formula. The Company claims that the formula components were not calculated properly, the formula stipulated by the Agreement on gas purchase does not reflect current level of gas market prices and that the import prices should be revised downwards. As at 31 December 2014, management of the Group believes that it has settled all its liabilities for natural gas supplied during 2010-2014, and requests a compensation of excessively paid amounts of USD 12 billion.

In June 2015 Gazprom submitted its Statement of Defense and Counterclaim to the arbitration, updating and qualifying its claim for payments of USD 26.7 billion (USD 18.5 billion as claimed before) for natural gas which Gazprom did not deliver but the Company allegedly was obliged to pay for pursuant to the current contract (so-called take-or-pay provision in the Agreement on gas purchase). Management cannot predict the final outcomes of those claims, and does not recognise any obligation or related provisions in this respect.

In October 2014, the Company has also requested the Stockholm Arbitral Tribunal to render an award in respect of the natural gas transit charge through the territory of Ukraine according to the agreement on gas transit between the Company and Gazprom. The actual transit charge was calculated for the certain volume of the natural gas transit from the Russian Federation via Ukraine ("basic transit volume"). Expenditures of the Ukrainian natural gas transmission pipelines operator Ukrtransgaz are mainly fixed costs, and thus, decrease in volume of transit should cause higher transit charge per unit. However, taking that the actual transit volumes in 2010-2014 were significantly lower than the basic transit volume, the natural gas transit charge has never been revised. The Company requests a compensation for unpaid revenues from international transit above USD 11.7 billion.

**Legal proceedings.** From time to time and in the normal course of business, claims against the Group arise. Where the risk of outflow of financial resources associated with such claims is assumed as probable, a respective liability is recognised as a component of provision for litigations (Note 14). Where management estimates the risk of outflow of financial resources associated with such claims as possible, or amount of outflow cannot be measured reliably, no provision is recognised, and respective amount is disclosed in the consolidated financial statements. Management believes that it has provided for all material losses in these consolidated financial statements.

The Group and certain natural gas suppliers have disputes in respect of volumes and/or prices for natural gas supplied to the Group. Management assesses its contingent liabilities under such disputes at the level of UAH 4 681 million. Management cannot reliably estimate amount of potential losses on these obligations, if any.

The Group and certain suppliers have disputes in respect of payables not settled by the Group. Management assesses its

contingent liabilities under such disputes at the level of UAH 382 million. Management cannot reliably estimate amount of potential losses on these obligations, if any.

**Possible transfer of the Company's equity interest in the subsidiaries to the State.** In 1998, upon creation of the Company, the Government of Ukraine contributed certain shares of joint-stock companies to the share capital of the Company. These joint-stock companies included JSC Long-Distance Pipeline "Druzhba" and JSC "Prydniprovskiy" Long-Distance Pipeline that were reorganised in 2001 into JSC Ukrtransnafta, JSC Ukrspetstransgaz, Chornomornaftogaz National JSC, JSC Ukrnafta and fifty-four regional gas distribution entities.

The Government of Ukraine may transfer ownership or control over all or part of the Company's equity interest in those joint-stock companies and/or other state-owned oil and gas transportation and storage facilities to other companies or Government agencies, and those actions could have a material adverse effect to the Company's operations.

**State property not subject to privatisation.** In 1998, the Company entered into an agreement "On use of State owned property not subject to privatisation" ("Agreement") with the State Property Fund of Ukraine, and received oil and gas transportation system into the operational control. The Agreement was signed for one year, and its term is prolonged automatically for one year, unless terminated by notice from either party, and is binding on the legal successor of each party. Historically, the agreement has been prolonged automatically, as neither party initiated its termination. As the State property not subject to privatisation forms an essential part of the Group's business, the future operations and financial performance of the Group depends on the prolongation of the Agreement. The Company's management believes that the Group will continue to operate with this property in the foreseeable future.

Pursuant to the Agreement, the Company is required, inter alia, to handle oil and gas transmission and distribution pipelines owned by the State of Ukraine, keep the state property in adequate operational condition, and transfer 50% share of profits received from using those assets to the State. The amount of such transfer could be reduced by the amount of capital investments in those assets. The Agreement does not provide a mechanism of such calculations, and historically there were no payments from the Group to the State in respect of using such assets. The Group believes that had the mechanism for calculating the state share in profits from using the assets been determined by the State, the capital investments performed by the Group would be greater, and no payment in favour of the State would occur. Accordingly, no liability for such payment was recognised in these consolidated financial statements.

**Licenses.** The State controls the oil and gas exploration and production activities in Ukraine via issuing respective licenses. According to the current legislation, separate licenses are issued

for exploration, development and production activities for each oil and gas field. Separate licenses are issued for oil and gas transportation, supply and storage. Licenses are provided for the period from two to twenty years, and could be prolonged for the same period.

Certain licenses for exploration, development and production activities were transferred as a contribution to joint ventures. However, this is not allowed according to the current legislation and the State has the right to suspend such licenses. Currently no licenses of the Group were suspended due to this reason and there are no litigations in respect of the matter. The Group management believes that licenses will not be suspended due to the matter in the foreseeable future.

**Capital commitments.** Capital commitments for purchase of property, plant and equipment, and exploration and development of oil and gas fields comprise UAH 400 million as at 31 December 2014 (31 December 2013: UAH 742 million).

## 22. FINANCIAL RISK MANAGEMENT

The Group's activities expose it to a variety of financial risks: market risk (including currency risk and interest rate risk), concentration risk, credit risk and liquidity risk. The Group reviews and agrees risk management policies to minimise the potential adverse effects on the Group's financial performance for those risks.

Major categories of financial instruments:

In millions of Ukrainian hryvnias	Note	31 December 2014	31 December 2013
Trade accounts receivable	9	15 097	20 539
Other non-current assets	7	3 309	2 130
Prepayments made and other current assets	10	588	1 427
Cash and bank balances	11	4 361	2 138
Restricted cash		394	200
<b>Total financial assets</b>		<b>23 749</b>	<b>26 434</b>
Borrowings	13	(61 008)	(59 558)
Trade accounts payable		(10 384)	(25 725)
Advances received and other current liabilities	15	(1 772)	(2 171)
Other long-term liabilities		(49)	(378)
<b>Total financial liabilities</b>		<b>(73 213)</b>	<b>(87 832)</b>

**Market risk.** The Group takes on exposure to market risks. Market risks arise from open positions in (a) foreign currencies, (b) interest bearing assets and liabilities and (c) equity investments, all of which are exposed to general and specific market movements.

**Currency risk.** The Group operates within Ukraine and its exposure to foreign currency risk is determined mainly by

purchase of natural gas from foreign suppliers, which are denominated in USD. The Group also receives borrowings in foreign currencies. The Group does not hedge its foreign currency positions.

The Group's exposure to foreign currency risk is as follows, based on carrying amounts of respective currency assets and liabilities:

In millions of Ukrainian hryvnias	31 December 2014			31 December 2013		
	USD	EUR	Others	USD	EUR	Others
Restricted cash	394	-	-	200	-	-
Cash and bank balances	507	71	9	21	110	-
Bank deposits	94	1 124	-	-	-	-
Trade accounts receivable	2 356	-	-	-	-	-
Prepayments made and other current assets	495	4	-	-	-	-
Other non-current assets	2 176	81	-	-	-	-
Borrowings	(35 919)	(75)	-	(32 326)	-	-
Advances received and other current liabilities	(363)	-	(96)	-	-	-
Trade accounts payable	(7 107)	(120)	(2)	(22 067)	-	-
<b>Net (short) long currency position</b>	<b>(37 367)</b>	<b>1 085</b>	<b>(89)</b>	<b>(54 172)</b>	<b>110</b>	<b>-</b>

The following table presents sensitivities of profit or loss and equity to reasonably possible changes in exchange rates applied at the reporting date, with all other variables held constant.

The exposure was calculated only for monetary balances denominated in currencies other than the functional currency of the Group's entities.

In millions of Ukrainian hryvnias	At 31 December 2014		At 31 December 2013	
	Impact on profit or loss	Impact on equity	Impact on profit or loss	Impact on equity
USD strengthening by 10%	(3 737)	(3 737)	(5 417)	(5 417)
USD weakening by 10%	3 737	3 737	5 417	5 417
EUR strengthening by 10%	109	109	11	11
EUR weakening by 10%	(109)	(109)	(11)	(11)

**Interest rate risk.** The Group normally has no significant interest bearing assets, and its income and operating cash flows are substantially independent of changes in market interest rate. The Group's interest rate risk exposure arises from borrowings at variable interest rates. Borrowings at fixed rate expose the Group to fair value interest rate risk.

The Group mainly attracts borrowings at fixed rate.

The borrowing activities are reviewed on an annual budget. Long-term investing activities and associated funding are considered separately, and are subject on the Government of Ukraine approval.

The maturity dates and effective interest rates of financial instruments are further disclosed in this note.

**Concentration risk.** The Group is exposed to concentration risk on advances received and revenues from natural gas transportation, other current liabilities and trade accounts payable as 54% of all total advances received and 50% of trade accounts payable as at 31 December 2014 (31 December 2013: 83% and 93%, respectively) comprise advances received from and trade payables to a single supplier (Note 15). Concentration on revenues from natural gas transportation is disclosed in Note 3.

**Credit risk.** The Group takes on exposure to credit risk, which is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation. Exposure to credit risk arises as a result of the Group's sales of products on credit terms and other transactions with counterparties giving rise to financial assets. The Group's policy is that the customers that wish to pay on credit terms are subject to the solvency check. Significant outstanding balances are also reviewed on an ongoing basis. At the same time, the Group must follow the state regulations as a guaranteed supplier of natural gas to the population and state-owned entities irrespective whether they are delinquent or not.

The Group establishes a provision for impairment that represents its estimate of incurred losses in respect of trade accounts receivable. The main component of this provision is a specific loss component that relates to individually significant exposures.

The maximum exposure to credit risk as at 31 December 2014 is UAH 23 749 million (31 December 2013: UAH 26 434 million).

The Group does not hold any collateral as security.

**Liquidity risk.** Prudent liquidity management implies maintaining sufficient cash and the availability of funding to meet existing obligations as they fall due. The Group's objective is to maintain a balance between the continuity of funding and flexibility through the use of credit terms provided by suppliers and banks. Prepayments are commonly used to manage

both liquidity and credit risks. The Group analyses ageing of its assets and maturity of its liabilities and plans liquidity depending on their expected repayment. The Group has capital construction programs which are funded both through existing business cash flows and borrowed funds. Borrowed funds are also used to finance the Group's working capital needs.

The following table analyses the Group's financial liabilities into relevant maturity groupings based on the remaining period at the reporting date to the contractual maturity date. The amounts disclosed in the table are undiscounted cash flows of principal and interest payments. The maturity analysis of financial liabilities as at 31 December 2014 was as follows:

In millions of Ukrainian hryvnias	Up to 6 months	6-12 months	1-2 years	2-5 years	Over 5 years	Total
Borrowings	29 879	8 703	14 977	14 077	-	67 636
Other long-term liabilities	-	-	49	-	-	49
Trade accounts payable	10 384	-	-	-	-	10 384
Advances received and other current liabilities	1 772	-	-	-	-	1 772
<b>Total</b>	<b>42 035</b>	<b>8 703</b>	<b>15 026</b>	<b>14 077</b>	<b>-</b>	<b>79 841</b>

The maturity analysis of financial liabilities as at 31 December 2013 was as follows:

In millions of Ukrainian hryvnias	Up to 6 months	6-12 months	1-2 years	2-5 years	Over 5 years	Total
Borrowings	27 678	22 637	12 610	5 745	-	68 670
Other long-term liabilities	-	-	349	29	-	378
Trade accounts payable	25 725	-	-	-	-	25 725
Advances received and other current liabilities	1 820	351	-	-	-	2 171
<b>Total</b>	<b>55 223</b>	<b>22 988</b>	<b>12 959</b>	<b>5 774</b>	<b>-</b>	<b>96 944</b>

**Gearing ratio.** Consistent with others in the industry, the Group monitors capital on the basis of gearing ratio. This ratio is calculated as net debt divided by total capital under management. Net debt is calculated as total borrowing (current and non-current as shown in the consolidated statement of financial position) less cash and cash equivalents. Total capital under management equals equity as shown in the consolidated statement of financial position plus net debt.

The gearing ratio at the end of the reporting period was as following:

In millions of Ukrainian hryvnias	31 December 2014	31 December 2013
Total borrowings (Note 13)	61 008	59 558
Less: cash and cash equivalents (Note 11)	(3 140)	(2 138)
<b>Total Net Debt</b>	<b>57 868</b>	<b>57 420</b>
Total Equity	356 978	107 035
<b>Total Equity plus Total Net Debt</b>	<b>414 846</b>	<b>164 455</b>
<b>Gearing ratio</b>	<b>0.14</b>	<b>0.35</b>

## 23. FAIR VALUE

IFRS defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

The estimated fair values have been determined by the Group using available market information, where it exists, and appropriate valuation methodologies. However, judgement is necessarily required to interpret market data to determine the estimated fair value. Management has used all available market information in estimating the fair value. The estimates presented herein are not necessarily indicative of the amounts the Group could realise in a market exchange from the sale of its full holdings of a particular instrument or pay in the transfer of liabilities.

### Fair value of the Group's financial assets and financial liabilities measured at fair value on a recurring basis and fair value of property, plant and equipment

The Group's available-for-sale investments and property, plant and equipment are measured at fair value at the end of each reporting period. The following table provides information about how the fair values of these assets are determined (in particular, the valuation techniques and inputs used):

Assets	Fair value hierarchy	Valuation techniques and key inputs
Property, plant and equipment	3	The Group engages professional independent appraisers to determine the fair value of its property, plant and equipment by using a replacement cost method for the majority of groups. The fair value is determined as the cost of construction of these items at current prices less the economic obsolescence and physical tear and wear to date. The main parameter used in this valuation technique are current prices on construction. For items for which there are market analogs (mainly buildings), the sales comparison method is used, the prices of market-based sales of comparable properties in the immediate proximity are adjusted with reference to differences in main parameters (such as floor space of the property). The main parameter used in this valuation technique is the price per square meter of a property.
Property, plant and equipment	2	The fair value of technological oil and gas is determined by application of the market price of oil and gas at the end of the reporting date to the volume of technological oil and gas. The main parameters used in this valuation technique are market prices for oil and gas at the end of the reporting period. The market value of the technological gas equal to the market price of gas less costs of its pumping and transportation to the point of sale.

The following table summarises financial instruments and property, plant and equipment recognised at fair value after initial recognition using a fair value hierarchy:

31 December 2014

In millions of Ukrainian hryvnias	Level 2	Level 3	Total
Property, plant and equipment	132 168	316 943	449 111
<b>Total</b>	<b>132 168</b>	<b>316 943</b>	<b>449 111</b>

31 December 2013

In millions of Ukrainian hryvnias	Level 2	Level 3	Total
Property, plant and equipment	76 543	91 472	168 015
<b>Total</b>	<b>76 543</b>	<b>91 472</b>	<b>168 015</b>

Details of the Group's property, plant and equipment and information about the fair value hierarchy as at 31 December 2014 are as follows:

Description	Group of assets	Valuation technique	Unobservable inputs	Range of unobservable inputs	Interrelationship between key unobservable inputs and fair value measurement
Gas transmission system and gas storages	Pipelines and related equipment	Depreciated replacement cost method using the income approach for economic obsolescence determination	Date of implementation of incentive tariff regulation system	Regulatory Asset Base (RAB) start in 2016	The later the implementation of new tariff system, the lower the fair value
	Buildings		Rates of return on Regulatory Asset Base	Same rates of return for old and new capital	The higher the rate, the lower the fair value
	Machinery and equipment		Nominal WACC for USD-denominated cash flow	8%	The higher the WACC, the lower the fair value
	Other fixed assets				
Gas extraction assets	Pipelines and related equipment	Depreciated replacement cost method using the income approach for economic obsolescence determination	The remaining period of the deposit extraction, years (based on proven and probable reserves determined by independent expert)	0 – 35	The lower the period, the lower the fair value because of lower remaining useful life of infrastructure assets
	Oil and gas producing properties		Gas sale price	Market price based on a parity with the import gas price	The higher the gas sale price, the higher the fair value
	Buildings		Royalty tax rate long-term projection (as calculated on sale price)	29%	The higher the tax rate, the lower the fair value
	Machinery and equipment		Nominal WACC for UAH-denominated cash flow	20,55%	The higher the WACC, the lower the fair value
Oil transmission system and storages	Pipelines and related equipment	Depreciated replacement cost method using the income approach for economic obsolescence determination	Cumulative factor of physical and functional depreciations	0,79	The higher the factor, the lower the fair value
	Buildings		Nominal WACC for UAH-denominated cash flow	16,4%	The higher the WACC, the lower the fair value
	Machinery and equipment				
	Other fixed assets				

Other assets of Group's property, plant and equipment comprise other fixed assets of level 3 and amounted to UAH 3 489 million.

#### Fair value of financial assets and financial liabilities that are not measured at fair value on a recurring basis (but fair value disclosures are required)

The Group's management believes that, except for item included in the table below, the carrying amounts of financial assets and financial liabilities recognised in the consolidated financial statements approximate their fair values due to short-term nature:

In millions of Ukrainian hryvnias	31 December 2014		31 December 2013	
	Carrying amount	Fair value	Carrying amount	Fair value
Borrowings	61 008	59 185	59 558	59 495
<b>Total</b>	<b>61 008</b>	<b>59 185</b>	<b>59 558</b>	<b>59 495</b>

The following table provides information about how the fair value of borrowings is determined (in particular, the valuation techniques and inputs used):

Liabilities	Fair value hierarchy	Valuation techniques and key inputs
Borrowings	2	Discounted cash flows. Future cash flows are estimated based on the inputs that are observable, either directly or indirectly, and the estimates use one or more observable quoted prices for orderly transactions in the markets that are not considered active. Fair value of borrowings was determined applying range of interest rates for UAH denominated borrowings from 17.0% p.a. to 20.0% p.a. (31 December 2013: 12.5% p.a. to 14.5% p.a.) and for USD denominated borrowings from 9.5% p.a. to 12.0% p.a. (31 December 2013: 8.5% p.a. to 10.5% p.a.).

## 24. SUBSEQUENT EVENTS

**Share capital increase and State treasury bonds received.** In July 2015 the Company has registered a new share capital issue amounting to UAH 104 610 million out of unregistered share capital existed as at 31 December 2014, taking total nominal registered and fully paid share capital to UAH 160 451 million as at 31 July 2015 (or UAH 164 607 million together with adjustment for the effect of hyperinflation of UAH 4 156 million, Note 12).

In July 2015, according to the Resolution of the Cabinet of Ministers of Ukraine, the Company's share capital was increased by UAH 29 700 million. New share issue was made to the Government of Ukraine in return of the State treasury bonds maturing in 2020 and bearing nominal interest of 14.5% per annum. As at the date of these consolidated financial statements the Company has sold UAH 28 200 million of these State treasury bonds for cash.

**Changes to the Ukrainian legislation related to quorum of the General meetings of shareholders.** In March 2015, according to changes in the Law of Ukraine "On Joint-Stock Companies", quorum of the General meetings of shareholders was lowered from 60%+1 share down to 50%+1 share. Currently, management of the Group estimates the effect of these changes to the accounting for the Group's associates.

**Profit share payable to the State Budget.** The General shareholders' meetings held in June 2015, PJSC Ukrgasvydobyvannia and PJSC Ukrtransgaz, 100% subsidiaries of the Company, has approved profit distribution to the State Budget of Ukraine amounting to UAH 277 million payable within 6 months after the date of respective meeting.

**Economic instability in Ukraine.** During the first half 2015, the Ukrainian hryvnia continued to devalue against the US Dollar. According to the National Bank of Ukraine, the average exchange rate for the first half 2015 amounted to UAH 21.36 for USD 1.00.

In March 2015, International Monetary Fund ("IMF") approved a four-year extended arrangement under the Extended Fund Facility for Ukraine. The arrangement amounts to the equivalent of SDR (Special Drawing Rights) 12.3 billion (equivalent to USD 17.5 billion) and was approved under the Fund's exceptional

access policy. Also was announced Ukraine's decision to cancel the Stand-By Arrangement ("SBA") for Ukraine that was approved on in April 2014. In March 2015, IMF had provided Ukraine with SDR 3.5 billion tranche (equivalent to USD 4.9 billion).

Stabilisation of the economic and political situation depends, to a large extent, upon success of the Ukrainian government's efforts, yet further economic and political developments are currently difficult to predict.

**Effect of gas transportation unbundling obligations.** Pursuant to Ukraine's commitments under the Energy Community Treaty and the Ukraine – European Union ("EU") Association Agreement, by 1 June 2016 operators of gas transmission systems of Ukraine must be effectively unbundled from activities related to gas production and supply per one of the allowed unbundling models. Currently, a new gas market law initiated by the Government is undergoing adoption in the Cabinet of Ministers of Ukraine, which envisages two options for unbundling (ownership unbundling and the ISO model) in line with the EU laws in that respect. The owner of the state-owned gas transmission system (i.e. the state acting through its authorised bodies) is responsible for selecting the applicable unbundling model. Certain preliminary steps were taken by the Ukrainian state authorities in connection with the contemplated unbundling (Government's authorisation for establishing two Public Joint-Stock Companies, Magistralni Gazoprovody Ukrayiny and Pidzemni Gazoshovusha Ukrayiny; amendments to the current natural gas market law allowing for foreign investments into the operator of the Unified Gas Transmission System). As a result, the structure of the Group, its assets, liabilities and activities might undergo certain changes, the scope of which will be determined by the selected unbundling model.

**Loans repayment and prolongation.** In 2015 the Group has obtained new loan of UAH 554 million due in 2016, to restructure its liabilities to other banks, which were payable in 2015.

Also the Group has prolonged successfully to 2016-2020 loans in total amount of UAH 18 238 million, which were due in 2015.

Subsequent to 31 December 2014 and up to the date of these consolidated financial statements, the Group has repaid loans amounting to UAH 9 016 million.

## 25. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**Statement of compliance.** These consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS").

**Basis of preparation.** The consolidated financial statements have been prepared on the historical cost basis except for property, plant and equipment and certain financial instruments that are measured at revalued amounts or fair values at the end of each reporting period, as explained in the accounting policies below.

Historical cost is generally based on the fair value of the consideration given in exchange for goods and services.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, regardless of whether that price is directly observable or estimated using another valuation technique.

Included in assets (mainly property, plant and equipment) and expenses for the first quarter 2014 are expenditures and expenses related to purchase of services and inventories (except for expenses related to purchase of natural gas and crude oil, and staff costs and related social charges) amounting to UAH 660 million and UAH 938 million, respectively (year 2013: UAH 4 335 million and UAH 2 927 million, respectively). Classification and disclosure of these expenses and expenditures in the consolidated financial statements have been made on the basis of the relevant primary documents. However, given the information available to current management of the Group, there are certain grounds to believe that the nature of these expenditures could be different from their legal form according to primary documents.

These policies have been consistently applied to all periods presented, unless otherwise stated.

**Functional and presentation currency.** Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the Group operates ("the functional currency"). The consolidated financial statements are presented in Ukrainian hryvnias ("UAH"), which is the Company's functional and the Group's presentation currency. All amounts presented in the consolidated financial statements are presented in UAH, rounded to the nearest million, if not otherwise stated.

Transactions denominated in currencies other than the relevant functional currency are translated into the functional currency, using the exchange rate prevailing at the date of the transaction. Foreign exchange gains and losses, resulting from settlement of such transactions and from the translation of foreign currency denominated monetary assets and liabilities at year end, are recognised in the consolidated statement of profit or loss. Translation at year end does not apply to non-monetary items including equity investments. The effects of exchange rate changes on the fair value of equity securities are recorded as part of the fair value gain or loss.

As at 31 December, the exchange rates used for translating foreign currency balances were:

In Ukrainian hryvnias	2014	2013
USD 1.00	15.76	7.99
EUR 1.00	19.23	11.04
RUB 10.00	3.00	2.45

Exchange restrictions in Ukraine are limited to compulsory receipt of foreign receivables within 90 days of sales and to the compulsory conversion of 75% of proceeds in foreign currency to

Ukrainian hryvnia. Foreign currency can be easily converted at a rate close to the National Bank of Ukraine rate. At present, UAH is not freely convertible outside Ukraine.

**Basis for consolidation.** Subsidiaries are those companies over which the Group has control. The Group controls an entity when the Group is exposed to, or has rights to, variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. Subsidiaries are consolidated from the date on which control is transferred to the Group (acquisition date) and are deconsolidated from the date that control ceases.

Inter-company transactions, balances and unrealised gains or losses on transactions between the Group companies are eliminated. Accounting policies of subsidiaries have been changed where necessary to ensure consistency with the policies adopted by the Group.

The Company reassesses whether or not it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control listed above.

When the Group has more than a majority of the voting rights of an investee, it still considers whether the voting rights are sufficient to give it the practical ability to direct the relevant activities of the investee unilaterally and, thus, has the power over the investee.

The Group considers all relevant facts and circumstances in assessing whether or not the Group's voting rights in an investee are sufficient to give it power, including:

- The size of the Group's holding of voting rights relative to the size and dispersion of holdings of the other vote holders;
- Potential voting rights held by the Group, other vote holders or other parties;
- Rights arising from other contractual arrangements; and
- Any additional facts and circumstances that indicate that the Group has, or does not have, the current ability to direct the relevant activities at the time that decisions need to be made, including voting patterns at previous shareholders' meetings.

**Transactions with non-controlling interests.** The Group treats transactions with non-controlling interests as transactions with equity owners of the Group. For purchases from non-controlling interests, the difference between any consideration paid and the relevant share acquired of the carrying value of net assets of the subsidiary is recorded in equity. Gains or losses on disposals to non-controlling interests are also recorded in equity.

When the Group ceases to have control or significant influence, the retained interest in the entity is remeasured to its fair value, with the change in carrying amount recognised in profit or loss. The fair value is the initial carrying amount for the purposes of

subsequently accounting for the retained interest as an associate, joint venture or financial asset. In addition, any amounts previously recognised in other comprehensive income in respect of that entity are accounted for as if the Group had directly disposed of the related assets or liabilities. This may mean that amounts previously recognised in other comprehensive income are reclassified to profit or loss.

If the ownership interest in an associate is reduced but significant influence is retained, only a proportionate share of the amounts previously recognised in other comprehensive income are reclassified to profit or loss where appropriate.

**Investments in associates.** Associates are entities over which the Group has significant influence but not control. Investments in associates are accounted for using the equity method of accounting. The Group's investment in associate includes goodwill identified on acquisition, net of any accumulated impairment loss.

The Group's share of its associates' post-acquisition profits or losses is recognised in the statement of profit or loss, and its share of post-acquisition movements in other comprehensive income is recognised in other comprehensive income. The cumulative post-acquisition movements are adjusted against the carrying amount of the investment. When the Group's share of losses in an associate equals or exceeds its interest in the associate, including any other unsecured receivables, the Group does not recognise further losses, unless it has incurred obligations or made payments on behalf of the associate. Unrealised gains on transactions between the Group and its associates are eliminated.

Accounting policies of associates have been changed where necessary to ensure consistency with the policies adopted by the Group.

Dilution gains and losses arising on investments in associates are recognised in the consolidated statement of profit or loss.

**Interest in joint ventures.** A joint venture is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the joint arrangement. Joint control is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require unanimous consent of the parties sharing control.

The Group recognises its interest in the joint venture using the equity method applied as described above in the paragraph Investment in associates.

**Interest in joint operations.** A joint operation is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement. Joint control is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require unanimous consent of the parties sharing control.

When a group entity undertakes its activities under joint operations, the Group as a joint operator recognises in relation to its interest in a joint operation:

- Its assets, including its share of any assets held jointly;
- Its liabilities, including its share of any liabilities incurred jointly;
- Its revenue from the sale of its share of the output arising from the joint operation;
- Its share of the revenue from the sale of the output by the joint operation; and
- Its expenses, including its share of any expenses incurred jointly.

The Group accounts for the assets, liabilities, revenues and expenses relating to its interest in a joint operation in accordance with the IFRSs applicable to the particular assets, liabilities, revenues and expenses.

When a group entity transacts with a joint operation in which a group entity is a joint operator (such as a sale or contribution of assets), the Group is considered to be conducting the transaction with the other parties to the joint operation, and gains and losses resulting from the transactions are recognised in the Group's consolidated financial statements only to the extent of other parties' interests in the joint operation.

When a group entity transacts with a joint operation in which a group entity is a joint operator (such as a purchase of assets), the Group does not recognise its share of the gains and losses until it resells those assets to a third party.

**Concession agreement (product sharing agreement).** The Company entered into a concession agreement for oil exploration and development ("Concession Agreement") with the Arab Republic of Egypt and Egyptian General Petroleum Corporation ("EGPC") on 13 December 2006.

The Concession Agreement includes the following conditions:

- Subject to the auditing provisions under the Concession Agreement, the Company shall recover on a quarterly basis all exploration and development costs to the extent and out of 25% of all petroleum produced and saved from all production areas and not used in petroleum operations ("Cost Recovery"). Petroleum products under the Concession Agreement include crude oil or gas and LPG.
- Remaining 75% of the petroleum produced is shared by the Company and EGPC depending on the volume of production and the product type (crude oil or gas and LPG). The Company's share varies from 15% to 19%.
- EGPC shall become the owner of all the Company's assets acquired and owned within the Concession Agreement, which assets were charged to Cost Recovery by the Company

in connection with the operations carried out by the Company; land shall become the property of EGPC as soon as it is purchased; title to fixed and movable assets shall be transferred automatically and gradually from the Company to EGPC as they become subject to the Cost Recovery.

The development period under the Concession Agreement is limited to maximum 25 years from the date of commercial oil discovery or from the date of first gas deliveries, started in 2011.

Accounting for all exploration and evaluation and other costs and incomes related to the product sharing agreement is similar to the accounting for a normal production process, as described in this Note.

**Segment reporting.** Operating segments are reported in a manner consistent with the internal reporting provided to the Group's chief operating decision maker. Segments whose revenue, results or assets are ten percent or more of all the segments are reported separately. Segments falling below this threshold can be reported separately at management decision.

**Property, plant and equipment.** The Group uses the revaluation model to measure property, plant and equipment. Fair value was based on valuations made by external independent valuers. The frequency of revaluation depends on the movements in the fair values of the assets being revalued. The last independent valuation of the fair value of the Group's property, plant and equipment was performed as at 31 December 2014. Subsequent additions to property, plant and equipment are recorded at cost. Cost includes expenditure directly attributable to acquisition of the items. The cost of self-constructed assets includes the cost of materials, direct labour and an appropriate proportion of production overheads. Cost of acquired and self-constructed qualifying assets includes borrowing costs.

Any increase in the carrying amounts resulting from revaluations are credited to revaluation reserve in equity through other comprehensive income. Decreases that offset previously recognised increases of the same asset are charged against revaluation reserve in equity through other comprehensive income; all other decreases are charged to the consolidated statement of profit or loss. To the extent that an impairment loss on the same revalued asset was previously recognised in the consolidated statement of profit or loss, a reversal of that impairment loss is also recognised in the statement of profit or loss. Each year the difference between depreciation based on the revalued carrying amount of the asset charged to the statement of profit or loss and depreciation based on the asset's original cost is transferred from revaluation reserve to retained earnings.

Expenditure incurred to replace a component of an item of property, plant and equipment that is accounted for separately, is capitalised with the carrying amount of the replaced component being derecognised. Subsequent costs are included in the asset's carrying amount or recognised as a separate asset, as appropriate, only when it is probable that future economic

benefits associated with the item will flow to the Group and the cost of the item can be measured reliably. All other repairs and maintenance are charged to the statement of profit or loss during the financial period in which they are incurred. Property, plant and equipment are derecognised upon disposal or when no future economic benefits are expected to be received from the continued use of the asset. Gains and losses on disposal determined by comparing proceeds with carrying amount of property, plant and equipment are recognised in the consolidated statement of profit or loss. When revalued assets are sold, the amounts included in other reserves are transferred to retained earnings.

Property, plant and equipment includes technological oil and gas which is required to be held in the pipelines and storage facilities for the operating activities of the Group companies in transportation segment.

Construction in progress includes also prepayments for property, plant and equipment.

**Exploration expenses.** Exploration expenses comprise the costs associated with unproved reserves. These include geological and geophysical costs for the identification and investigation of areas with possible oil and gas reserves and administrative, legal and consulting costs in connection with exploration. They also include all impairments on exploration wells where no proved reserves could be demonstrated.

**Research and development expenses.** Research and development (R&D) expenses include all direct and indirect materials, personnel and external services costs incurred in connection with the focused search for new development techniques and significant improvements in products, services and processes and in connection with research activities. Expenditure related to research activities is shown as R&D expenses in the period in which it is incurred. Development costs are capitalised if the recognition criteria according to IAS 38 are fulfilled.

**Exploration and evaluation assets.** Oil and gas exploration and evaluation expenditures are accounted for using the successful efforts method of accounting. Costs are accumulated on a field-by-field basis. Costs directly associated with an exploration well, and exploration and property leasehold acquisition costs, are capitalised as long as the following conditions are satisfied:

- Sufficient oil and gas reserves have been discovered that would justify completion as a production well;
- Sufficient progress is being made in assessing the economic and technical feasibility to justify beginning field development in the near future.

If it is determined that commercial exploitation has not been achieved, these costs are charged to expense.

Expenditures related to the following activities are initially

measured at cost and capitalised within property, plant and equipment in the consolidated statement of financial position:

- Acquisition of rights to explore;
- Topographical, geological, geochemical and geophysical studies;
- Exploratory drilling;
- Trenching, sampling; and
- Activities in relation to evaluating technical feasibility and commercial viability of extracting a mineral resource.

Exploration and evaluation assets are carried forward during the exploration and evaluation stage and are not amortised but assessed for impairment in accordance with the indicators of impairment as set out in IFRS 6 Exploration for and Evaluation of Mineral Resources. In circumstances where a property is abandoned, the cumulative capitalised costs relating to the property are written off in the period. No amortisation is charged prior to the commencement of production.

In circumstances where a property is identified as containing economically recoverable resources then the accumulated exploration and evaluation costs associated with that property are transferred to oil and gas producing properties and are presented within the property, plant and equipment in the consolidated statement of financial position.

**Depreciation and depletion.** Depreciation is charged to the consolidated statement of profit or loss on a straight-line basis to allocate costs of individual assets to their residual value over their estimated useful lives. Depreciation commences on the date of acquisition or, in respect of self-constructed assets, from the time an asset is completed and ready for use.

Oil and gas assets, including oil and gas producing properties are depleted using a unit-of-production method. The cost of producing wells is amortised over proved developed reserves. Licence acquisition, common facilities and future decommissioning costs are amortised over total proved and probable reserves.

Other property, plant and equipment are depreciated on a straight line basis over its expected useful life. The typical useful lives of the Group's other property, plant and equipment are as follows:

	<i>Useful lives in years</i>
Pipelines and related equipment	9-60
Machinery and equipment	3-60
Buildings	3-60
Drilling and exploration equipment	3-30
Other fixed assets	3-30

Construction in progress and technological oil and gas are not depreciated.

**Intangible assets.** Intangible assets have definite useful lives and primarily include capitalised computer software. Acquired computer software are capitalised on the basis of the costs incurred to acquire and bring them to use. Intangible assets are carried at cost less accumulated amortisation and impairment losses, if any. If impaired, the carrying amount of intangible assets is written down to the higher of value in use and fair value less costs to sell.

**Leases.** Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Payments made under operating leases (net of any incentives received from the lessor) are charged to the consolidated statement of profit or loss on a straight-line basis over the period of the lease. Finance leases are capitalised at the lease commencement at the lower of the fair value of the leased property and the present value of the minimum lease payments.

**Decommissioning liabilities.** The Group's assessment of the decommissioning liabilities is based on the estimated future costs expected to be incurred in respect of the decommissioning and site restoration, adjusted for the effect of the projected inflation for the upcoming periods and discounted using interest rates applicable to the provision. Estimated costs of dismantling and removing an item of property, plant and equipment are added to the cost of an item of property, plant and equipment when the item is acquired, and corresponding obligation is recognised. Changes in the measurement of an existing decommissioning liability, that result from changes in the estimated timing or amount of the outflows, or from changes in the discount rate used for measurement, are recognised in the statement of profit or loss or, to the extent of any revaluation balance existence in respect of the related asset, other reserves. Provisions in respect of decommissioning activities are evaluated and re-estimated annually, and are included in the consolidated financial statements at each reporting date at their expected present value, using discount rates which reflect the economic environment in which the Group operates.

Interest expense related to the provision is included in finance costs in profit or loss.

**Impairment of non-financial assets.** Assets are reviewed for impairment whenever events and changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognised for the amount by which the assets carrying amount exceeds its recoverable amount. The recoverable amount is the higher of fair value less cost to sell and value in use. For purposes of assessing impairment, assets are grouped to the lowest levels for which there are separately identifiable cash flows (cash generating unit). Non-financial assets that have suffered impairment are reviewed for possible reversal of the impairment at each reporting date.

**Classification of financial assets.** The Group classifies its financial assets into the following measurement categories: (a) loans and receivables; (b) available-for-sale financial assets.

Loans and receivables include financial receivables created by the Group by providing money, goods or services directly to a debtor, other than those receivables which are created with the intention to be sold immediately or in the short term, or which are quoted in an active market. Loans and receivables comprise primarily loans, trade accounts receivable including purchased loans and promissory notes. All other financial assets are included in the available-for-sale category.

**Initial recognition of financial instruments.** Financial assets and financial liabilities are initially measured at fair value.

The Group's principal financial instruments comprise available-for-sale investments, borrowings, cash and cash equivalents and short-term deposits. The Group has various other financial instruments, such as trade receivables and trade payables, which arise directly from its operations.

All purchases and sales of financial instruments that require delivery within the time frame established by regulation or market convention ("regular way" purchases and sales) are recorded at trade date, which is the date that the Group commits to deliver a financial instrument. All other purchases and sales are recognised on the settlement date with the change in value between the commitment date and settlement date not recognised for assets carried at cost or amortised cost, and recognised in equity for assets classified as available-for-sale.

**Subsequent measurement of financial instruments.**

Subsequent to initial recognition, the Group's financial liabilities, loans and receivables are measured at amortised cost. Amortised cost is calculated using the effective interest method and, for financial assets, it is determined net of any impairment losses. Premiums and discounts, including initial transaction costs, are included in the carrying amount of the related instrument and amortised based on the effective interest rate of the instrument.

The face values of financial assets and liabilities with a maturity of less than one year, less any estimated credit adjustments, are assumed to be their fair values. The fair value of financial liabilities is estimated by discounting the future contractual cash flows at the current market interest rate available to the Group for similar financial instruments.

Gains and losses arising from a change in the fair value of available-for-sale assets are recognised directly in other comprehensive income. In assessing the fair value of financial instruments, the Group uses a variety of methods and makes assumptions based on market conditions existing at the reporting date.

When available-for-sale assets are sold or otherwise disposed of, the cumulative gain or loss recognised in other comprehensive income is included in the determination of net profit. When a decline in fair value of available-for-sale assets has been recognised in equity and there is objective evidence that the assets are impaired, the loss recognised in other comprehensive

income is removed and included in the determination of net profit, even though the assets have not been derecognised.

Interest income on available-for-sale debt securities is calculated using the effective interest method and recognised in the consolidated statement of profit or loss. Dividends on available-for-sale equity instruments are recognised in the consolidated statement of profit or loss when the Group's right to receive payment is established and the inflow of economic benefits is probable. Impairment losses are recognised in the consolidated statement of profit or loss when incurred as a result of one or more events that occurred after the initial recognition of available-for-sale investments. A significant or prolonged decline in the fair value of an instrument below its cost is an indicator that it is impaired. The cumulative impairment loss measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that asset previously recognised in the consolidated statement of profit or loss, is removed from equity and recognised in the consolidated statement of profit or loss.

Impairment losses on equity instruments are not reversed through the consolidated statement of profit or loss. If, in a subsequent period, the fair value of a debt instrument classified as available-for-sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised in the consolidated statement of profit or loss, the impairment loss is reversed through current period's consolidated statement of profit or loss.

A provision for impairment of loans and accounts receivable is established when there is objective evidence that the Group will not be able to collect all amounts due according to the original terms. Significant financial difficulties of the debtor, probability that the debtor will enter bankruptcy or financial reorganisation, and default or delinquency in payments are considered to be indicators that the trade receivable is impaired. The amount of the provision is the difference between the asset's carrying amount and the present value of estimated future cash flows. The carrying amount of the asset is reduced through the use of a provision account, and the amount of the loss is recognised in the consolidated statement of profit or loss. When receivable is uncollectible, it is written off against the provision account for receivables. Subsequent recoveries of amounts previously written off are credited in the consolidated statement of profit or loss.

**Derecognition of financial instruments.** The Group derecognises financial assets when (i) the assets are redeemed or the rights to cash flows from the assets have otherwise expired or (ii) the Group has transferred substantially all the risks and rewards of ownership of the assets or (iii) the Group has neither transferred nor retained substantially all risks and rewards of ownership but has not retained control. Control is retained if the counterparty does not have the practical ability to sell the asset in its entirety to an unrelated third party

without needing to impose additional restrictions on the sale. The Group derecognises financial liabilities when, and only when, the Group's obligations are discharged, cancelled or they expire. The difference between the carrying amount of the financial liability derecognised and the consideration paid and payable is recognised in profit or loss.

**Income taxes.** Income taxes have been provided for in the consolidated financial statements in accordance with Ukrainian legislation enacted or substantively enacted by the end of reporting date. The income tax charge comprises current tax and deferred tax and is recognised in the consolidated statement of profit or loss unless it relates to transactions that are recognised, in the same or a different period, in other comprehensive income.

Current tax is the amount expected to be paid to or recovered from the taxation authorities in respect of taxable profits or losses for the current and prior periods. Taxes other than on income are recorded within operating expenses.

Deferred income tax is provided using the balance sheet liability method for tax losses carried forwards and temporary differences arising between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes. In accordance with the initial recognition exemption, deferred taxes are not recorded for temporary differences on initial recognition of an asset or a liability in a transaction other than a business combination if the transaction, when initially recorded, affects neither accounting nor taxable profit. Deferred tax liabilities are not recorded for temporary differences on initial recognition of goodwill and subsequently for goodwill which is not deductible for tax purposes. Deferred tax balances are measured at tax rates enacted or substantively enacted at the reporting date which are expected to apply to the period when the temporary differences will reverse or the tax losses carried forwards will be utilised. Deferred tax assets and liabilities are netted only within the individual companies of the Group. Deferred tax assets for deductible temporary differences and tax losses carried forwards are recorded only to the extent that it is probable that future taxable profit will be available against which the deductions can be utilised.

**Inventories.** Inventories are recorded at the lower of cost and net realisable value. The cost of inventories includes expenditures incurred in acquiring the inventories, production or conversion costs and other costs incurred in bringing them to their existing location and condition. Cost of manufactured inventories includes an appropriate share of production overheads based on normal operating capacity. The cost of inventories is determined on the first in first out basis and weighted average cost. Net realisable value is the estimated selling price in the ordinary course of business, less the cost of completion and selling expenses.

**Trade accounts receivable.** Trade and other receivables are recognised initially at fair value and subsequently measured at

amortised cost using the effective interest method, less provision for impairment.

**Prepayments made and other current assets.** Prepayments are carried at cost less provision for impairment. A prepayment is classified as non-current when the goods or services relating to the prepayment are expected to be obtained after one year, or when the prepayment relates to an asset which will itself be classified as non-current upon initial recognition.

Other prepayments are charged to the consolidated statement of profit or loss when the goods or services relating to the prepayments are received. If there is an indication that the assets, goods or services relating to a prepayment will not be received, the carrying value of the prepayment is written down accordingly and a corresponding impairment loss is recognised in the consolidated statement of profit or loss.

**Promissory notes.** Some purchases may be settled by promissory notes or bills of exchange, which are negotiable debt instruments. Purchases settled by promissory notes are recognised based on management's estimate of the fair value to be given up in such settlements. The fair value is determined with reference to observable market information.

**Cash and cash equivalents.** Cash and cash equivalents include cash in hand, deposits held at call with banks, and other short-term highly liquid investments with original maturities of three months or less. Cash and cash equivalents are carried at amortised cost using the effective interest method. Restricted balances are excluded from cash and cash equivalents for the purposes of the consolidated cash flow statement. Balances restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date are included in other non-current assets.

**Share capital.** Ordinary shares are classified as equity. Incremental costs directly attributable to the issue of new shares are shown in equity as a deduction, net of tax, from the proceeds.

**Dividends and mandatory budget contribution of profit share.** Dividends and mandatory budget contribution of profit share are recognised as a liability and deducted from equity at the reporting date only if they are declared before or on the reporting date. Dividends are disclosed when they are proposed before the reporting date or proposed or declared after the reporting date but before the consolidated financial statements are authorised for issue.

**Value added tax ("VAT").** In Ukraine VAT is levied at two rates: 20% on sales and imports of goods within the country, works and services and 0% on the export of goods and provision of works or services to be used outside Ukraine. A taxpayer's VAT liability equals the total amount of VAT collected within a reporting period, and arises on the earlier of the date of shipping goods to a customer or the date of receiving payment from the customer. A VAT credit is the amount that a taxpayer is entitled to offset

against his VAT liability in a reporting period. Rights to VAT credit arise when a VAT invoice is received, which is issued on the earlier of the date of payment to the supplier or the date goods are received. VAT related to sales and purchases is recognised in the consolidated statement of financial position on a gross basis and disclosed separately as an asset and liability. Where provision has been made for impairment of receivables, the impairment loss is recorded for the gross amount of the debtor, including VAT.

**Borrowings.** Borrowings include bank borrowings and bonds.

**Borrowing costs.** Borrowing costs directly attributable to the acquisition, construction or production of qualifying assets, which are assets that necessarily take a substantial period of time to get ready for their intended use or sale, are added to the cost of those assets, until such time as the assets are substantially ready for their intended use or sale. All other borrowing costs are recognised in profit or loss in the period in which they are incurred.

Borrowings are recognised initially at fair value, net of transaction costs incurred. Borrowings are subsequently stated at amortised cost using the effective interest method. Bank overdrafts are included into borrowings line item in the consolidated statement of financial position.

**Trade accounts payable.** Trade accounts payable are recognised and initially measured under the policy for financial instruments mentioned above. Subsequently, instruments with a fixed maturity are re-measured at amortised cost using the effective interest method. Amortised cost is calculated by taking into account any transaction costs and any discount or premium on settlement.

**Advances received.** Advances received are carried at amounts originally received. Amounts of advances received are expected to be realised through the revenue received from usual activities of the Group.

**Provisions.** Provisions are recognised when the Group has a present obligation (legal or constructive) as a result of a past event and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation.

Where the Group expects some or all of a provision to be reimbursed, for example under an insurance contract, the reimbursement is recognised as a separate asset but only when the reimbursement is virtually certain.

The expense on any provision is presented in the consolidated statement of profit or loss net of any reimbursement. If the effect of time value of money is material, provisions are discounted using a current pre-tax rate that reflects, where appropriate, the risks specific to the liability. Where discounting is used, the increase in provision due to the passage of time is recognised as

a finance cost.

**Other liabilities.** Other financial liabilities are recognised initially at fair value, net of transaction costs incurred, and are subsequently stated at amortised cost using the effective interest method. Other non-financial liabilities are measured at cost.

**Contingent assets and liabilities.** A contingent assets are not recognised in the consolidated financial statements but disclosed when an inflow of economic benefits is probable.

Contingent liabilities are not recognised in the consolidated financial statements unless it is probable that an outflow of economic resources will be required to settle the obligation and it can be reasonably estimated. Contingent liabilities are disclosed unless the possibility of an outflow of resources embodying economic benefits is remote.

**Revenue recognition.** Revenues from sales of goods are recognised at the point of transfer of risks and rewards associated with ownership of goods. If the goods are transported to a specified location, revenue is recognised when the goods are passed to the customer at the destination point.

Revenue from sale and resale of natural gas are recognised at the point of transfer of risks and rewards associated with ownership of these goods. Revenues are measured at the fair value of the consideration received or receivable, and are shown net of value added tax and discounts.

**Recognition of expenses.** Expenses are recorded on an accrual basis. The cost of goods sold comprises the purchase price, transportation costs, commissions relating to supply agreements and other related expenses.

**Finance income and costs.** Finance income and costs comprise interest expense on borrowings, losses on early repayment of loans, interest income on funds invested, income or loss on origination of financial instruments, unwinding of interest of the pension obligation and provisions, and foreign exchange gains and losses.

Borrowing costs that relate to assets that take a substantial period of time to construct are capitalised as part of the cost of the asset. All other interest and other costs incurred in connection with borrowings are expensed using the effective interest method.

Interest income is recognised as it accrues, taking into account the effective yield on the asset.

**Sale and repurchase agreements and lending of securities.** Sale and repurchase agreements (“repo agreements”) which effectively provide a lender’s return to the counterparty are treated as secured financing transactions. Securities sold under such sale and repurchase agreements are not derecognised. The securities are not reclassified in the consolidated statement of financial position unless the transferee has the right by contract or custom to sell or repledge the securities, in which case they

are reclassified as repurchase receivables. The corresponding liability is presented within amounts due to other banks or other borrowed funds.

**Employee benefits: Defined Contributions Plan.** The Group makes statutory unified social contributions to the Pension Fund of Ukraine in respect of its employees. The contributions are calculated as a percentage of current gross salary and are expensed when incurred. Discretionary pensions and other post-employment benefits are included in labour costs in the consolidated statement of profit or loss. The Company makes contributions to the State Pension Fund in Ukraine in respect of its employees in the amount of UAH 1 324 million and UAH 1 269 million for the years ended 31 December 2014 and 2013, respectively. The contributions are calculated as a percentage of current gross salary, and are expensed when incurred. Other post-employment benefits are included in labour costs in the statement of comprehensive income.

**Employee benefits: Defined Benefit Plan.** The Group provides lump sum benefits, payments on reaching certain age, and other benefits as prescribed by the collective agreement. The liability recognised in the consolidated statement of financial position in respect of the defined benefit pension plan is the present value of the defined benefit obligation at the reporting date. The defined benefit obligation is calculated annually using the projected unit credit method.

The present value of the defined benefit obligation is determined by discounting the estimated future cash outflows using interest rates of high-quality corporate bonds that are denominated in the currency in which the benefits will be paid, and that have terms to maturity approximating the terms of the related pension liability.

Actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions are charged or credited to other comprehensive income in the period in which they arise. Past service costs are recognised immediately in the consolidated statement of profit or loss.

## 26. CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS

**In the application of the Group's accounting policies,** management is required to make judgements, estimates and assumptions about the carrying amounts of assets and liabilities that are not readily apparent from other sources. The estimates and associated assumptions are based on historical experience and other factors that are considered to be relevant. Actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period, or in the period of the revision and future periods if the revision affects both current and future periods.

**Critical judgements in applying accounting policies.** The following are the critical judgements, apart from those involving estimations, that the Group management has made in the process of applying the Group's accounting policies and that have the most significant effect on the amounts recognised in the consolidated financial statements.

**Investment in “Ukrnafta” PJSC.** The Group holds 50% + 1 share of voting rights in “Ukrnafta” PJSC. The rest is owned by limited number of investors. According to the Law of Ukraine “On Joint Stock Companies” General Meeting of Shareholders is a superior management body of the Public Joint Stock Company. The General Meeting of Shareholders, among other things, mandatory deals with election of the Supervisory Board members, approves decisions on significant legal actions. As at 31 December 2014, according to the Ukrainian law, the General Meeting of Shareholders is legitimate if it is attended by the shareholders owing in aggregate not less than 60%+1 of the company's voting shares. Due to the fact that the Group has no unilateral ability to conduct legitimate General Meeting of Shareholders, management believes that the Group does not have control over “Ukrnafta” PJSC. Accordingly, the investment in “Ukrnafta” PJSC is accounted for as investment in associate (Note 6). Subsequent to the balance sheet date, there were changes to the Ukrainian legislation that lowered the percentage of the voting rights from 60%+1 share to 50%+1 share to allow for the legitimate General Meeting of Shareholders (Note 24).

**Impairment of trade accounts receivable.** Management estimates the likelihood of the collection of trade accounts receivable based on an analysis of individual accounts. Factors taken into consideration include an ageing analysis of trade accounts receivable in comparison with the payment history, credit terms allowed to customers and available market information regarding the counterparty's ability to pay. Should actual collections be less than management's estimates, the Group would be required to record an additional impairment expense.

**Key sources of estimation uncertainty.** The following are the key assumptions concerning the future, and other key sources of estimation uncertainty at the end of the reporting period, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

**Employee benefit obligations.** Management assesses post-employment and other employee benefit obligations using the projected unit credit method based on actuarial assumptions which represent management's best estimates of the variables that will determine the ultimate cost of providing post-employment and other employee benefits. The present value of the pension obligations depends on a number of factors that are determined on an actuarial basis using a number of assumptions. The major assumptions used in determining the net cost (income) for pensions include the discount rate and expected salary increases. Any changes in these assumptions will impact the carrying amount of pension obligations. Since there are no long-term, high quality corporate or government bonds issued in

Ukrainian hryvnias, significant judgement is needed in assessing an appropriate discount rate. Key assumptions are presented in Note 14.

**Deferred tax asset recognition.** The deferred tax asset, recognised in the consolidated statement of financial position, represents income taxes recoverable through future deductions from taxable profits. Deferred tax assets are recorded to the extent that realisation of the related tax benefit is probable. In determining future taxable profits and the amount of tax benefits that are probable in the future, management makes judgements and applies estimation based on historic taxable profits and expectations of future taxable income that are believed to be reasonable under the circumstances.

**Tax legislation.** Ukrainian tax, currency and customs legislation continues to evolve. Conflicting regulations are subject to varying interpretations. Management believes its interpretations are appropriate and sustainable, but no guarantee can be provided against a challenge from the tax authorities (Note 21).

**Decommissioning costs.** The decommissioning provision represents the present value of the decommissioning costs relating to oil and gas properties, which are expected to be incurred in the future (Note 14). These provisions were recognised, based on Group's internal estimates.

Main estimates includes future market prices for the necessary decommissioning costs, and are based on market conditions and factors. Additional uncertainties relates to the timing of the decommissioning costs, which depends on depletion of the fields, future oil and gas prices and as a result – expected point of time, when there are no further economic benefit in the production.

Changes in these estimates can lead to the material changes in the provisions recognised in the consolidated statement of financial position.

**Depreciation and depletion of the oil and gas assets.** Oil and gas assets are depleted using a unit-of-production method. The cost of producing wells is amortised over proved developed reserves. Licence acquisition, common facilities and future decommissioning costs are amortised over total proved reserves. Changes in estimates regarding the volumes of production, proved developed reserves and total proved reserves either downward or upward, can result in the change of related assets utilisation accounting. A reduction in proved developed reserves, as result of future inspections and production will increase depreciation, depletion and amortisation expenses.

**Impairment of property, plant and equipment.** Management reviews the carrying amounts of assets to determine whether there are any indicators that those assets are impaired. Latest review was performed during the revaluation of property, plant and equipment performed as at 31 December 2014 (Note 5).

In making the assessment for general impairment, assets that do not generate independent cash flows are allocated to an

appropriate cash-generating unit. The assessment of whether there are any indicators of a potential impairment are based on various assumptions including market conditions, asset utilisation and the ability to utilise the asset for alternative purposes. If an indication of impairment exists, the Group estimates the recoverable value (greater of fair value less cost to sell and value in use) and compares it to the carrying value, and records impairment to the extent the carrying value is greater than the recoverable amount. The value in use is based on estimated future cash flows that are discounted to their present value. The estimated future cash flows require management to make a number of assumptions including customer demand, production capacities, future growth rates and the appropriate discount rate. Any change in these estimates may result in impairment in future periods.

The Group did not identified any indicators of impairment as at 31 December 2014.

**Useful lives of other property, plant and equipment.** Group's property, plant and equipment, except oil and gas assets are depreciated using straight-line method over their estimated useful lives, which are based on management's business plans and operational estimates.

The factors that could affect the estimation of the useful life of the asset and its residual value include the following:

- Changes in technology;
- Changes in maintenance technology;
- Changes in regulations and legislation; and
- Unforeseen operational issues.

Any of the above could affect the prospective depreciation of property, plant and equipment and their carrying and residual values. The Group reviews the estimated useful lives of property, plant and equipment at the end of each annual reporting period. The review is based on the current condition of the assets and the estimated period during which they will continue to bring economic benefit to the Group. Any change in estimated useful life or residual value is recorded on a prospective basis from the date of the change. Latest review of useful lives was performed during the revaluation of property, plant and equipment performed as at 31 December 2014 (Note 5).

## 27. ADOPTION OF NEW OR REVISED STANDARDS AND INTERPRETATIONS

Adoption of new and revised International Financial Reporting Standards

The following standards have been adopted by the Group for the first time for the financial year beginning on or after 1 January 2014:

- Amendments to IFRS 10, IFRS 12 and IAS 27 – “Consolidated Financial Statements, Joint Arrangements and Disclosure of Interests in Other Entities: Transition Guidance”;

- Amendment to IAS 27 “Separate Financial Statements” (revised 2011) – Investment entities;
- Amendments to IAS 32 “Financial instruments: Presentation” – Application guidance on the offsetting of financial assets and financial liabilities;
- Amendments to IAS 36 “Recoverable amounts disclosures for non-financial assets”;
- Amendments to IAS 39 “Novation of derivatives and continuation of hedge accounting”;
- IFRIC 21 “Levies”.

Adoption of these Standards and Interpretations did not have significant impact on the amounts reported in these consolidated financial statements.

Standards and Interpretations in issue, but not yet effective. At the date of authorisation of these consolidated financial statements, the following Standards and Interpretations, as well as amendments to Standards were in issue but not yet effective:

<i>Standards/Interpretations</i>	<i>Effective for annual accounting period beginning on or after</i>
Amendments to IAS 19 “Employee Benefits” – Defined Benefit Plans: Employee Contribution	1 July 2014
Amendments to IFRSs – “Annual Improvements to IFRSs 2010-2012 Cycle”	1 July 2014
Amendments to IFRSs – “Annual Improvements to IFRSs 2011-2013 Cycle”	1 July 2014
Amendments to IFRS 7 “Financial instruments: Disclosures” – Disclosures about the initial application of IFRS 9	1 January 2015
IFRS 14 “Regulatory Deferral Accounts”	1 January 2016
Amendment to IFRS 10, IFRS 12 and IAS 28: Investment Entities: Applying the consolidation exception	1 January 2016
Amendments to IAS 1: Disclosure Initiative	1 January 2016
Amendments to IAS 27: Equity Method in Separate Financial Statements	1 January 2016
Amendments to IAS 16 and IAS 41: Bearer plants	1 January 2016
Amendments to IAS 16 and IAS 38: Classification of Acceptable Methods of Depreciation and Amortisation	1 January 2016
Amendments to IFRS 10 and IAS 28: Sale or Contribution of Assets between an Investor and its Associate or Joint Venture	1 January 2016
Amendments to IFRS 11: Accounting for acquisitions of Interests in Joint Ventures	1 January 2016
Amendments to IFRSs – “Annual Improvements to IFRSs 2012-2014 Cycle”	1 July 2016
IFRS 15 “Revenue from contracts with customers”	1 January 2017
IFRS 9 “Financial Instruments”	1 January 2018

Management is currently evaluating the impact of the adoption of Amendments to IAS 19 “Employee Benefits”, IFRS 9 “Financial Instruments”, Amendments to IAS 1: Disclosure Initiative, Amendments to IFRS 10 and IAS 28: Sale or Contribution of Assets between an Investor and its Associate or Joint Venture, Amendments to IFRS 11, Amendments resulting from Annual Improvements Cycles and IFRS 15 “Revenue from contracts with customers”.

For other Standards and Interpretations management anticipates that their adoption in future periods will not have a material effect on the consolidated financial statements of the Group in future periods.

## TERMS AND ABBREVIATIONS

**BCM** — billion of cubic meters

**BP** — British Petroleum, a transnational oil and gas, petrochemical and coal corporation

**CDB** — China Development Bank

**CABINET OF MINISTERS** — The Cabinet of Ministers of Ukraine

**CHP PLANT** — combined heat and power plant

**CRIMEA** — The Autonomous Republic of Crimea, a region of Ukraine currently occupied by the Russian Federation

**DHC** — district heating company (same as “teplokommunenergo”)

**DSNS, SESU** — State Emergency Service of Ukraine

**EBRD** — European Bank for Reconstruction and Development

**EC** — the European Commission

**EFET** — European Federation of Energy Traders

**EGPC** — Egyptian General Petroleum Corporation

**EIB** — European Investment Bank

**EU** — the European Union

**EUSTREAM** — Slovak gas transmission system operator

**FGSZ** — Hungarian gas transmission system operator

**FRONTERA RESOURCES** — US oil and gas company

**GAS** — natural gas, unless stated otherwise

**GAZPROM** — Public Joint Stock Company Gazprom, a Russian energy company

**GAZ-SYSTEM S.A.** — Polish gas transmission system operator

**GDS** — gas distribution station

**GENERAL MEETING, GM** — General Meeting of Shareholders

**GMS** — gas measuring station

**GROUP** — a group of companies that consists of NJSC Naftogaz of Ukraine, PJSC Ukrigasvydobuvannya, PJSC Ukrtransgaz, JSC Ukrtransnafta, SC Gas of Ukraine, SE Uktavtogaz, PJSC Chornomornaftogaz, OJSC Kirovohradgaz, SE Zakordonnaftogaz, PJSC Ukrspetstransgaz, Naftogaz Overseas SA, SE Vuhlesyntezi Ukraine, SE Ukrnaftogazkomplekt, SE Naukanaftogaz, SE Naftogazobsluhovuvannya, SE LIKVO, SE Naftogazbezpeka, SE Budivelnik

**GSE** — Gas Storage Europe, the association of European operators of underground gas storage facilities

**GTS** — gas transportation system

**IEA** — International Energy Agency

**IFRS** — International Financial Reporting Standards

**IAS** — International Accounting Standards

**IMF** — International Monetary Fund, a special UNO agency

**INTERCONNECTOR** — a joint cross-border gas pipeline

**LNG-TERMINAL** — a liquefaction terminal, receiving and regasification of liquefied natural gas

**MCM** — million of cubic meters

**ENERGY MINISTRY** — the Ministry of Energy and the Coal Industry of Ukraine

**NAFTOGAZ (NJSC NAFTOGAZ OF UKRAINE)** — National Joint Stock Company Naftogaz of Ukraine

**NAFTOGAZ OVERSEAS S.A.** — Joint Stock Company Naftogaz Overseas S.A. (Switzerland)

**NEURC (PREVIOUSLY NERC)** — National Energy and Utilities Regulatory Commission

**NISS** — National Institute for Strategic Studies under the President of Ukraine

**OECD** — Organization for Economic Co-operation and Development

**OJSC KIROVOHRADGAZ, KIROVOHRADGAZ** — Open Joint Stock Company Kirovohradgaz, a regional gas distribution and supply company

**OBLGAZ** — a regional gas distribution and supply company

**PJSC UKRGASVYDOBUVANNYA** — Public Joint Stock Company Ukrigasvydobuvannya

**PJSC UKRSPETSTRANSGAZ, UKRSPETSTRANSGAZ** — Public Joint Stock Company Ukrspetstransgaz

**PJSC UKRTRANSNAFTA, UKRTRANSNAFTA** — Public Joint Stock Company Ukrtransnafta

**RUSSIA** — the Russian Federation

**RESOLUTION 510** — the Resolution of the Cabinet of Ministers of Ukraine Resolution #510 of 03 September 2014 “On Improvement of State Policy in the Field of Regulation of the Natural Gas Transportation Pipelines Through Ukraine”

**RESOLUTION 583** — the Resolution of the Cabinet of Ministers #583 of 03 March 2015 “On Establishment of Retail Prices for Natural Gas Used for the Needs of Households”

**STATE COMPANY GAS OF UKRAINE, GAS OF UKRAINE** — a subsidiary of the National Joint Stock Company Naftogaz of Ukraine

**STATE ENTERPRISE ZAKORDONNAFTOGAZ, ZAKORDONNAFTOGAZ** — a subsidiary of NJSC Naftogaz of Ukraine

**SPF** — State Property Fund of Ukraine

**SUBSIDIARIES** — subsidiary companies of the National Joint Stock Company Naftogaz of Ukraine

**T** — ton

**TCM** — thousand cubic meters

**TEPLOKOMUNNERGO** — enterprises, producing heat and energy, district heating companies

**TSO** — transmission system operator

**UGS** — underground gas storage

**UGV** — Public Joint Stock Company Ukrigasvydobuvannya

**URENGOY-POMARY-UZHGOROD GAS PIPELINE (UPU)** — the gas export route connecting the Urengoy gas field and northern gas fields of Western Siberia to Uzhgorod at the western border of Ukraine

**USD** — United States Dollar

**VTP** — virtual trading point

**WORLD BANK** — the organization that provides assistance for development

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