

Risk management

RISK MANAGEMENT SYSTEM

Gazprom Neft's Risk Management Policy sets out the objectives and principles of risk management to enhance stability of the Company's operations in the short and long term.

Our risk management strategy seeks to improve managerial decision-making by analysing the related risks, and to maximise the effectiveness of the management initiatives when these decisions are brought to life.

The Company's risk management system is based on the integration of the risk analysis and management tools into key corporate processes. Responsibility for risk management and reporting is determined in accordance with the Company's line and functional organisational structure, with individual managers assigned to oversee specific risk areas. Each function and key business process has a risk coordinator among the management staff. They are responsible for promoting and supporting the application of corporate risk management principles. The timing and objectives for risk analysis depend on the particular circumstances and requirements of each business process, with respect to which risk management is implemented.

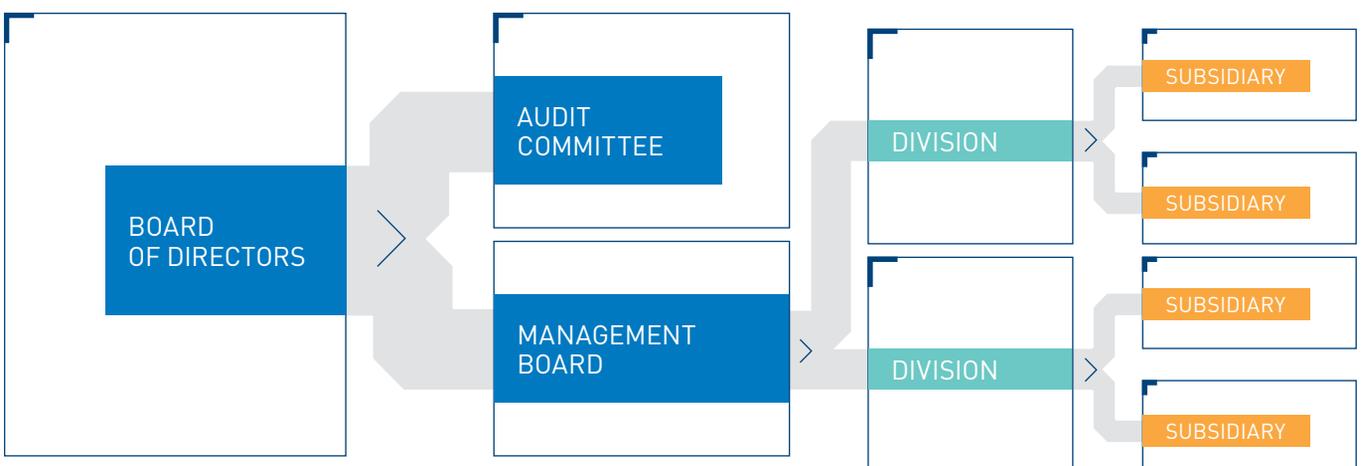
This approach allows the Company to designate areas of responsibility for risk management and monitor risks at all management levels. It also helps develop targeted response to significant risks for each subsidiary and Gazprom Neft as a whole.

Risk management deliverables:

- > develop risk management culture in the Company to achieve common understanding of the key principles and approaches to risk management by the management and employees;
- > design and implement comprehensive approach to identify and assess company-wide and specific area risks;
- > promote information sharing about risks between the Company's units and develop joint actions to manage them;
- > Provide regular risk updates for the the Company's management.

Financial impact levels of the risk and distribution of responsibilities within IRMF

METHODOLOGY ROLL-OUT



KEY RISKS

Key decisions and assessment of performance results are made at the Board of Directors meetings. Divisions are responsible for the immediate management of this type of risks

DIVISION RISKS

Risk monitoring and management at Division level

SUBSIDIARY RISKS

Risk monitoring and management at Subsidiary level

RISK DATA CONSOLIDATION

To deliver on these goals, the Company has developed and adopts a single approach to risk management, which, together with the uniform risk analysis and management tools, form an integrated risk management framework (IRMF).

The IRMF includes the following guidelines, regulations, and procedures:

- > Risk management policy;
- > Integrated Risk Management Framework standard;
- > Risk Management Guidelines;
- > additional guidelines and procedures on certain types of risks and specific risk analysis tools.

Risk management is an integral part of Gazprom Neft's corporate environment and includes:

- > introduction of a risk-oriented approach to all aspects of the Company's operations and management;
- > a comprehensive analysis of the identified risks;
- > a system to monitor and control risks and risk management activities;
- > awareness by all employees of the basic principles and approaches to risk management in the Company;
- > proper regulatory and methodological support;
- > distribution of powers and responsibility for risk management among the Company's units.

IRMF process at the Gazprom Neft Group



EVOLUTION OF INTEGRATED RISK MANAGEMENT FRAMEWORK

The Company's continuously evolving Integrated Risk Management Framework includes general guidelines on quantitative risk assessment and detailed procedures for assessing the most significant risks.

As of late 2018, the IRMF covered the Company's major assets with all new projects or acquisitions automatically included in the framework.

In 2019, the Company will continue developing regulations and procedures to analyse various significant risks and integrating risk analysis into the decision-making process. In addition, new educational programmes will be rolled out to train managers and employees in risk management tools and methods.

DISCRIPTION OF KEY RISKS

Description

Risk mitigants

Operational risks

1.1. Risks associated with geological exploration

The Company's key strategic objective is to increase its hydrocarbon resource base both in quantitative and qualitative terms to ensure a sufficient production level, which to a large extent depends on successful geological exploration. The main risks associated with geological exploration have to do with failure to confirm the anticipated hydrocarbon reserves and the objective decline in resource base quality. A major priority for the Company is geological exploration in a variety of geographic regions, including areas with adverse climatic conditions and environmental restrictions which often involves the risk of extra costs. The assessment is based on a number of variables and assumptions, including the following:

- > comparison of the region's historical production rates with the productivity of similar regions;
- > geological data interpretation;
- > government regulations and legal framework.

Gazprom Neft has significant experience in geological exploration using cutting-edge geological and geophysical methods of hydrocarbons exploration and employing advanced drilling and field development technology, including in harsh weather conditions to reduce the likelihood of such risks. The Company has engaged DeGolyer and MacNaughton for an independent audit of its reserves based on the estimates by Gazprom Neft subsidiaries. Gazprom Neft closely cooperates with the federal and regional authorities on sustainable use of natural resources.

1.2. Licence risks

As a company engaged in the exploration and mining of mineral resources, Gazprom Neft operates based on government subsoil licences. These licences specify the purpose of the work (type of subsoil use), geographic boundaries of the area, timeframe and terms and conditions of resource use. Under the Russian law, using subsoil resources without a licence is subject to civil and in some cases criminal liability.

In case of early withdrawal of the subsoil licence, the Company may face reputational risks and material losses related to the costs incurred to acquire the licence and develop the subsoil area, as well as lower capitalisation due to reduced resource base.

The Company has deployed an automated Subsoil Use Monitoring System, a key risk management tool featuring a risk matrix to track compliance with the main (material) terms and conditions of subsoil use. The System makes it possible to assess the current risk status based on the matrix indicators and plan for an acceptable risk level in the future.

The status of the current and potential licence risks as well as implementation of the regular risk mitigation activities are reviewed on a quarterly basis at the meetings of the permanent regional commissions for subsidiary licensing.

Subsidiary CEOs are responsible for maintaining subsoil licences.

Description

Risk mitigants

1.3. Project risks

The Company works continuously to initiate and implement investment projects aimed at achieving its strategic goals, including increased hydrocarbon production and improved product quality. While implementing these projects the Company faces various risks that can potentially result in missed deadlines and higher costs. The project risks are mainly related to inadequate planning, failure to comply with the project terms and safety requirements by contractors, as well as new circumstances, including higher cost of materials and supplies, infrastructure assessment errors, and new equipment suppliers.

To address these risks, the Company makes every effort to ensure thorough planning and coordination of its investment projects. In 2014, we rolled out a risk management framework to handle potential risks associated with the preparation and implementation of major projects. This framework is based on the stage-gate approach to project management that is widely used globally and provides for risk assessment at each stage of the project. Contractor requirements are determined based on risk assessment and the regulatory environment of the country, where the project is run. In addition, the Company has deployed a project monitoring system.

1.4. HR risks

Highly qualified personnel is key to effective operation of the Company's business. A lack of qualified employees, especially engineering and technology experts, can result in risks associated with personnel shortages. The Company's success largely depends on the efforts and expertise of key employees, including qualified engineering staff, and on its ability to attract and retain such personnel. Competition for the best talent in Russia and world-wide may intensify due to the shortage of qualified specialists in the labour market. Failure to attract qualified employees and/or retain the existing talent pool could have an adverse effect on the Company's reputation as an employer. Demand for qualified personnel and the associated costs are expected to grow further given the significant need for such employees in other industries.

The Company offers a safe work environment, opportunity to take part in major projects and exciting challenges, competitive salaries, and professional training programmes to its personnel. We work continuously to improve our recruitment procedures, limit staff turnover, and provide self-development opportunities for our employees.

Description

Risk mitigants

1.5. HSE risks

Risks associated with environmental, health and safety (including fire safety) legislation that may entail a temporary shutdown of facilities and licence revocation, along with the risks of accidents (fatalities and workplace injuries, fires/explosions/accidents, accidents with environmental consequences of nationwide scale).

In the field of industrial safety, the Company strives to achieve the strategic Goal – Zero: no injury or illness, no harm to property and environment.

The main focus areas reflected in the corporate HSE Policy Statement include:

- > safe production based on risk analysis, mitigation and management;
- > reduction of workplace injury and occupational disease rates, accident hazards and environmental impact;
- > consistent implementation of best global HSE practices.

The risk-based approach and the principle of integrating HSE risks into all key business processes of the Company underlie the occupational risk management ideology.

As part of the implementation of a risk-based approach, the Company focuses on the following parameters.

Fundamental barrier

setting obstacles for priority risks across the Company's assets and ensuring their reliability

Competency barrier

ensuring that only competent employees have access to work

Digital barrier management

eliminating human impact where applicable

The company is fully aware of its responsibility to preserve the environment. We keep monitoring our activities for compliance with relevant environmental requirements and run environmental protection programmes.

Our policy seeks to ensure compliance with Russia's environmental regulations by investing in environmental protection, including technologies to minimise environmental footprint. The outcome of these efforts is a considerably lower probability of environmental risks.

Description

Risk mitigants

1.6. IT, automation, and telecommunications risks

The Company is increasingly faced with the growing dependence of its main business processes on the quality of IT, automation, and telecommunications (ITAT).

Along with positive effects, the growing reliance on ITAT entails elements of uncertainty and related risks (ITAT risk).

As a high-tech company Gazprom Neft, places special emphasis on managing ITAT related risks.

ITAT risks have to do with with ITAT management, operation of IT systems (primarily in the areas of production and quantitative analysis), ITAT development projects, and the risk arising from the ban on purchasing and using foreign software and ITAT equipment due to sanctions and other restrictions.

We recognise the existence of ITAT risks and seek to manage them on a consistent basis.

In managing ITAT risks, the Company seeks to increase business efficiency by anticipating the impact of ITAT risk factors and to boost the effectiveness of its ITAT risk management activities.

We constantly monitor and carefully analyse the existing and potential ITAT threats.

The IT, Automation and Telecommunications Department at Gazprom Neft is responsible for developing regulations and procedures for ITAT risk management activities and implements a number of measures to mitigate the impact of these risks, including:

- > identifying events and developments that may adversely affect the Company's objectives;
- > analysing, assessing, and setting priorities for addressing ITAT risks;
- > designing optimal response strategy for ITAT risk management;
- > providing ongoing monitoring of ITAT risks and oversees implementation of ITAT risk management activities.

Market risks

2.1. Risks associated with potential changes in prices for feedstock and services

In the course of business, Gazprom Neft uses the infrastructure of natural monopolies and other dominant market players in oil and petroleum products transportation and electricity supply. We also purchase feedstock and services from a wide range of companies. Gazprom Neft has no control over the infrastructure of these natural monopolies and other dominant market players, their tariffs, as well as prices charged by feedstock and service suppliers.

To reduce the impact of such risks, the Company implements a number of activities, including:

- > long-term commodity flow planning and timely reservation of throughput for oil and petroleum products and the rolling stock required;
- > optimal redistribution of commodity flows by transport mode;
- > use of alternative and own power generation sources;
- > long-term contracts with fixed volumes and prices for the term of the contract;
- > use of transparent cost review formulas in long-term service contracts directly linked to market fluctuations.

These measures help reduce to an acceptable level the risks associated with procuring products and services from monopoly suppliers, and ensure the Company's seamless operation.

Description

Risk mitigants

2.2. Risks associated with potential price changes for oil and petroleum products, gas, and gas processing products

Gazprom Neft's financial results are directly linked to prices for oil and petroleum products. The Company does not have a full control over its product prices as they are subject to supply and demand fluctuations in the global and domestic oil markets and steps taken by regulators.

The Group has implemented a business planning system in line with the scenario approach based on which the Company's key performance indicators are linked to global oil prices. It helps cut costs, including by reducing or rolling forward investment programmes and using other mechanisms.

These measures reduce the risk to an acceptable level.

2.3. Industry competition risks

Russia's leading oil and gas companies compete in all main areas of business activity, including:

- > government auctions for subsoil use licences for hydrocarbon production;
- > acquisition of companies holding hydrocarbon production licences or owning hydrocarbon assets;
- > engagement of independent service companies;
- > procurement of high-tech equipment;
- > recruitment of the most experienced and highly qualified professionals;
- > access to transportation infrastructure;
- > acquisition of existing and construction of new assets to increase sales to end consumers.

Industry competition also includes suppliers of energy sources other than oil and gas such as coal, nuclear power, and renewable energy.

By implementing its strategic project portfolio aimed at boosting performance in key business areas, Gazprom Neft is consistently strengthening its positions in Russia's oil and gas industry and mitigating the risks related to industry competition.

2.4. Risks associated with potential changes in economic environment

The Russian economy remains sensitive to global price fluctuations for crude oil, natural gas, and other commodities. The negative trend in global prices for oil and petroleum products, as well as the slowdown of the world and Russian economies could adversely affect the Company's business by reducing its revenue and sales and increasing the cost of financial and other resources.

We take every effort to mitigate the impact of this risk on the Company's performance by maintaining proper balance between domestic sales and exports, oil production and refining, as well as a continued focus on expanding markets for premium distribution channels and increasing sales in foreign markets.

Our subsidiaries support the national economy as major tax payers and by contributing to large-scale infrastructure and social projects.

We are constantly upgrading our production facilities and improving performance efficiency by implementing major investment projects and renewing and modernising our fixed assets.

Description

Risk mitigants

Financial risks

3.1. Counterparty credit risk

Credit risk is the risk of the Group incurring financial losses due to failure of buyers or counterparties to fulfil their contractual obligations. This risk is primarily related to the Group's receivables from buyers and the investment securities.

Trade and other receivables include a large number of counterparties operating across different industries and geographical areas. To manage the credit risk, Gazprom Neft implements a number of activities, including: assessment of counterparty credit capacity, setting individual credit limits and payment terms depending on the counterparty's financial position, advance payment monitoring, measures to control receivables focused on specific business areas, and other initiatives.

3.2. Borrowing risk

Sanctions against Gazprom Neft imposed by the US, EU and other countries have substantially limited the range of available financing instruments for the Company.

The company effectively manages the risk associated with borrowings. Despite the sanctions from the US, EU and other countries imposed against Gazprom Neft in 2014, the Company has successfully completed its borrowing programme in 2018. Also, loan agreements with long-term availability, including revolving credit facilities. It will improve flexibility of the Company's financial policy and effectiveness of liquidity management. On top of that, the Company keeps looking for alternative funding sources.

3.3. FX risk

The foreign exchange risk primarily arises from the availability of borrowed funds denominated in currencies other than the functional currencies of the respective Group companies, which mainly include their local currencies. For example, rouble is the functional currency of the companies operating in Russia. The aforementioned borrowed funds are largely denominated in US dollar and euro.

The Group's FX risk is substantially mitigated by its FX-denominated assets and liabilities as the current mix of revenues and liabilities acts as a hedging mechanism with opposite cash flows offsetting each other. The Group applies a hedging policy to manage volatility in profit and loss with its FX-denominated cash flows.

3.4. Interest risk

The Group's borrowings were partly raised at a floating interest rate (linked to LIBOR, EURIBOR or the Bank of Russia's key rate), and partly at a fixed interest rate.

In an environment of lower borrowing rates, fixed interest rates may become more expensive than floating interest rates, and vice versa. The Group maintains a balanced portfolio structure, which minimises the risk of negative consequences arising from adverse changes in interest rates. In addition, the Group Treasury from time to time reviews current interest rates in the capital market, based on which hedging instruments are used, if necessary.

Description

Risk mitigants

Risks associated with government regulation and policy

4.1. Risks of increased EU and US sanctions

Sanctions against the Russian energy sector have been imposed by the US (with amendments to sanctions regime introduced in 2017 and 2018), EU, and a number of other countries since 2014. Tougher sanctions may adversely affect the overall situation in the industry, have impact on the Company's specific prospective projects and the ability of its counterparties to meet their obligations.

The sanctions have had a negligible impact on the business and financial condition of Gazprom Neft. As a response, the Company runs a targeted import substitution programme for services and equipment. The Company has no reason to believe that the new sanctions will target it specifically, but they can have an affect certain prospective projects. Following the assessment of the impact of sanctions, the Company's management thinks that sanctions do not affect its consolidated financial statements.

4.2. Political risks

Today, the political situation in Russia is stable, which is characterised by the stability of the federal and regional governments. Gazprom Neft is registered as a taxpayer in St Petersburg, the second largest city in Russia and the administrative centre of the North-Western Federal District, with a significant potential of natural resources, mature industry and extensive transport network. Subsidiaries of Gazprom Neft operate in the Central, North-Western, Ural, Volga, Siberian and Far Eastern federal districts.

In general, the Company assesses the political situation in the country as stable and believes that there are no risks of negative developments at the moment.

4.3. Risks associated with foreign assets

Gazprom Neft is implementing a number of foreign projects set to expand the geography of its operations. Entry into the markets of new regions is associated both with the opportunity of gaining additional competitive advantages and with the risks of underestimating the economic and political environment in the countries where the Company's assets are located, which could later result in failure to deliver on the performance targets.

Currently, Gazprom Neft assesses the level of risks associated with foreign assets as acceptable, but cannot rule out negative developments, since the described risks are beyond the Company's control.

4.4. Corruption risks

As the Company actively enters into new international markets, the risks of the US and UK anti-corruption laws being applicable to it aggravate.

Gazprom Neft implements the Corruption Risk Management Strategy on a permanent basis. The Company has approved the Anti-Fraud and Anti-Corruption Policy. In addition, recommendations were made to all subsidiaries of the Gazprom Neft Group for approving local policies. Knowing the key principles of and compliance with the requirements of this policy are mandatory for all Gazprom Neft employees. To control corruption risks when cooperating with external counterparties, Gazprom Neft CEO has developed and approved standard anti-corruption clauses to be included in agreements with third parties (both Russian and foreign ones). The Company also has an anti-fraud and anti-corruption hotline. When hotline operators receive messages, it triggers a mandatory internal investigation.

Description

Risk mitigants

4.5. Risks associated with changes in judicial practice concerning matters of the Company's operations

In Russia's law enforcement system, the legal positions of the highest judicial bodies such as the Constitutional Court and the Supreme Court are of utmost importance and can affect the environment, in which the Company operates.

We continuously monitor the decisions taken by the high courts and analyse the current trends in the law enforcement practice of arbitration courts in federal districts. This helps defend our rights and legitimate interests in court and resolve legal issues arising from our business. In this context, we believe that the risks associated with changes in the judicial practice are negligible.

It should be noted, however, that court rulings with respect to oil and gas companies have often been inconsistent, and it would be difficult to predict what direction they will take in the future. Potentially, the Supreme Court might take decisions that would adversely affect the Company's current and future legal proceedings.

4.6. Risks associated with changes in Russia's tax laws

The Group's major companies are among Russia's largest taxpayers, paying federal, regional and local taxes, including the mineral extraction tax (MET), excise tax, value added tax (VAT), corporate income tax, compulsory social security contributions, corporate property tax, and land tax.

Russia's tax system is constantly evolving and improving. A potential rise in taxes paid by the Company could increase costs and reduce the funds available to finance current activities, capital expenditures and obligations, including those relating to bonds issued.

Virtually any company in Russia could potentially suffer losses resulting from claims by tax authorities with respect to the past or current activities. However, such risks are considered moderate by the Company.

Gazprom Neft believes that the impact of the obligations arising from such potential events on the Company will not be more significant than the impact of similar obligations on other Russian oil companies with government ownership.

To reduce the risks associated with changes in Russia's tax laws, Gazprom Neft thoroughly examines draft laws and approved taxation-related regulations.

The most significant recent changes in Russia's tax laws affecting the Company include:

- > changes in MET rates, export duties and excise taxes resulting from the so-called tax manoeuvre;
- > changes in the tax laws affecting taxation of profits of controlled foreign companies and income of foreign organisations (effective since 2015) in line with the deoffshorisation effort;
- > introduction of a formula-based calculation of MET for gas and gas condensate from 1 July 2014;
- > Introduction of a tax on additional income from the extraction of hydrocarbons, effective from 1 January 2019.
- > increase in the VAT rate from 18% to 20%, effective from 1 January 2019;
- > introduction of a negative excise tax on crude oil, accounting for the damping coefficient, which reflects the difference between domestic motor fuel prices and export netbacks from 1 January 2019.

The Company assesses and forecasts the level of potential adverse effect of changes in Russia's tax laws, taking every effort to mitigate the risks arising from these changes.

In 2018, Gazprom Neft expanded the list of companies included in the new tax control mechanism, known as tax monitoring. In 2019, three of the Group's subsidiaries – major tax payers – will join it:

- > Gazpromneft-Noyabrskneftegaz;
- > Gazpromneft-Yamal;
- > Gazprom Neft Shelf.

This tax control mechanism allows the Company to obtain a reasoned opinion of the tax authority helping to mitigate the risk of additional tax charges. It is particularly helpful for the above companies, as they are covered by the new tax regimes in the oil industry, including the additional income tax, and the tax regime for new offshore fields).

Description

Risk mitigants

4.7. Risks associated with changes in customs duties and regulations

Gazprom Neft is a company engaged in foreign trade, hence it is exposed to risks associated with changes in the nation's legislation in the field of foreign trade regulation, as well as the customs legislation of the Eurasian Economic Union, which regulates the establishment of procedures for moving commodities and goods across the customs border of the Eurasian Economic Union, the establishment and application of customs regimes, the establishment, introduction and charging of customs duties.

As a risk, the Russian Government may change customs duty rates (both for imports and exports) on certain commodities and goods in respect of which the Company makes foreign trade transactions, and change in law enforcement practice in the area of customs regulation. The key negative consequences, if these risks materialise, are growing costs and lower efficiency of exports.

The Company meets the requirements of the customs legislation of Russia and the Eurasian Economic Union, draws up all the documentation necessary for both exports and imports in a timely manner, and has sufficient financial and human resources to comply with the customs-related rules and regulations and to respond to changes in customs legislation and law enforcement practice in a timely fashion.

Description

Risk mitigants

Strategic risks

5.1. Risk of failure to deliver on strategic goals

Since 2014, the market of oil and petroleum products has been undergoing significant changes along with the geopolitical environment. We believe that the likelihood of volatility in the market in the short term persists.

In the long run, the state of the global energy sector will depend on a wide range of factors that are hard to predict, including economic growth rates, international cooperation, innovation rate, and decarbonisation efforts. These factors determine the following key characteristics of the environment in which the Company, and the oil and gas industry as a whole, operate: oil price and consumption volumes, tax regime, access to technology, and international development opportunities.

Major changes in the external environment may affect the Company's ability to deliver on its strategic goals.

The Company conducts regular monitoring of market trends accounting for the threats and opportunities created by the unstable external environment while managing its project portfolio.

It successfully allocates resources between major strategic projects and those ensuring a quick return on investment and supporting the ongoing sustainability of the Company.

To deliver on the goals outlined in the Strategy, Gazprom Neft plans to overhaul its management framework, to effect digital, cultural, and organisational transformation of the Company. The reform will make the Company's management framework more flexible and will facilitate the decision-making process.

One of the key objectives set forth by the Strategy is the development of a partnership ecosystem helping the Company to enhance key competencies by engaging partners in joint development of scientific, human, and intellectual potential at all levels of interaction with the business, government, and society.

By focusing on flexible decision-making, technology development, operating efficiency, and safety the Company is able to produce high performance results and deliver steady growth of its financial and economic indicators.

We view our existing and soon-to-be launched assets as the key contributors to the Company's production growth in 2020 to 2030. The remaining upstream portfolio is expected to come from new exploration areas we tap into and putting on stream unconventional and hard-to-recover reserves, including in the Bazhenov, Domanic and Paleozoic formations, and Achimov deposits. The liquid hydrocarbon reserves in the Nadym-Pur-Taz region and offshore projects will also be a major driver.

We are also planning to take advantage of potential new market niches by creating innovative products, to continue growing in the mature petroleum product markets, and remain a leader in Russia in terms of distribution network efficiency.

Partner risks

6.1. Risks of partner engagement

In an unstable macroeconomic environment, engaging partners in joint projects is becoming an increasingly important and difficult task. As they drastically cut their investment budgets, potential business partners scale back their activities and put off any potential joint projects.

The sanctions against the Russian energy sector that have been imposed since 2014 by the United States (with amendments to sanctions regime introduced in 2017 and 2018), the European Union, and a number of other countries create additional hurdles for any potential partnership.

The Company keeps working to engage new partners, including companies in Russia and the Asia-Pacific countries that have not imposed sanctions on offshore, Arctic, deepwater and shale projects. To this end, we hold regular meetings and talks with potential partners, including with the involvement of Russian government agencies such as the Ministry of Energy, the Ministry of Foreign Affairs, and the Ministry of Economic Development of Russia.