Association of
Institutional Investors (API)

Research report on PJSC TRANSNEFT

as of 09/30/2016

RESEARCH LABORATORY FOR BUSINESS COMMUNICATIONS, NATIONAL RESEARCH UNIVERSITY HIGHER SCHOOL OF ECONOMICS

Brief capital structure overview

The capital structure assumes that the Company's is under full control of the state: decisions are taken by the sole shareholder, requirements for the preparation and holding of shareholders' meetings are not applicable except for the AGM timing requirement.

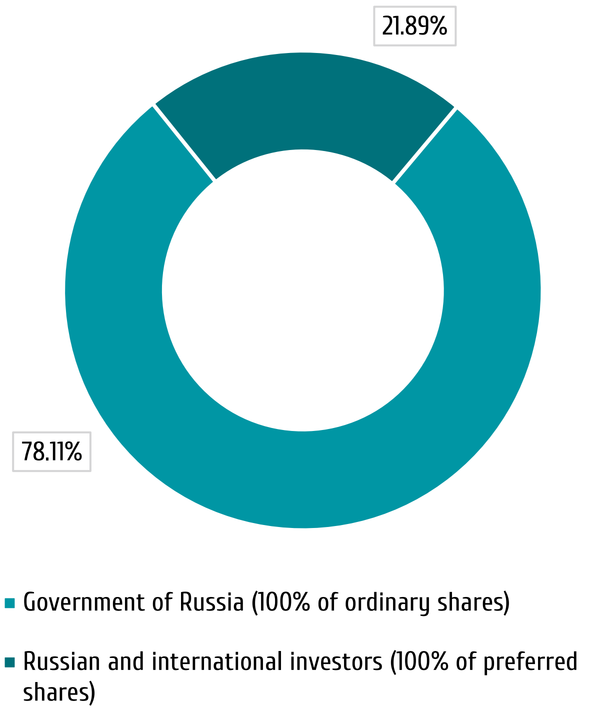
The Company has always paid dividends on preferred shares; accordingly, minority shareholders have never received voting rights.

The Company's management does not regard the holders of preferred shares as minority shareholders, which is a fundamental problem detrimental to the Company's investment appeal[1].

Corporate governance self-assessment

In 2015, according to self-assessment, the Company complied with a mere 32 (40%), partially complied with 33 (41.7%), failed to comply with 14 (17.7%) of the 79 principles and recommendations set forth in the Russian Corporate Governance Code (CG Code). This is one of the worst proportions among the PJSCs under review. A significant part of the requirements the Company fails to meet are related to the holding of GSMs, although there are also substantive issues.

Breakdown of voting shares



[1] The following quotation is taken from the President's speech (2015): "We have one shareholder, the state. No minority shareholders. There are preferred shareholders indeed, but they are called this conventionally, you know. They are no shareholders as a matter of fact."

Summary of CG practice

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- Proceeding from the disclosure of issues under consideration, the BoD exercises its powers to the full extent. The involvement of BoD members is not disclosed. According to one of the BoD members, the current BoD composition is sustainable and does not require additional expert appraisal;
- the BoD pays considerable attention to the long-term development program (LTDP): at least 7 of the 11 LTDP-related issues considered in the period under review were matters of substance;
- The Audit Committee (AC):

  - is historically directly involved in the open competitive selection of external auditors (the related information remains undisclosed, but a BoD member mentioned this practice in the survey);

  - has the right to engage independent consultants/experts and to request (even if through the management team) documents and information from the Company's divisions and subsidiaries;
- Essential terms of related party transactions considered by the BoD are disclosed, information on such transactions is included in the Company's annual reports (a good practice);
- according to the Company's Articles of Association, decision-making on most of the significant issues of the Company's activity recommended by the CG Code requires a majority vote of the elected BoD members;
- the Articles of Association vest the BoD with powers as regards large shareholdings, i.e. companies in which Transneft's interest exceeds 20%, including approval of the sole executive body, formulation of a position on the restructuring/liquidation, approval of transactions, divestiture of shares;
- the principal shareholder approved amendments to the Articles (after the reporting date of this study), providing for a fair approach to the payment of dividends on preferred shares which cannot be below the amount of dividends paid on ordinary shares. This should certainly be regarded as an improvement.

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- the dividend policy approved by the BoD for the first time in December 2016 (after the reporting date of this study), in our view, does not fully meet the interests of shareholders and the principal shareholder's requirements/recommendations, contains a number of internal contradictions;
- there are only two INEDs on the BoD (1 of them is recognized by the BoD as an independent director);
- the Articles of Association do not vest the BoD with the power to determine the remuneration payable to the head of the internal audit division and to approve the budget of this division;
- the CG Code recommendations concerning the issues to be only addressed at physical meetings are followed in relation to 4 out of 19 issues, with a remark about predominantly physical meetings;
- the independent internal audit (IA) system is at an early stage of development (after the reporting date, the BoD approved the general guidelines (the plan) and the head of the IA division;
- the following information is not disclosed:
  - BoD members' participation in meetings of the BoD and its committees;
  - remuneration payable to each of the BoD members;
  - top management remuneration system (the proportions between the of fixed and variable components, the long-term and short-term incentives), the correlation between the payments for the reporting period and the KPI achievement;
- the Company does not disclose the anti-corruption policy-related documents, the abuse prevention practices (in annual reports), including the "hot line" performance and the role of the AC;
- no rules or standards for preventing or handling a conflict of interest;
- the charity expenses are commensurate with dividends (in 2015, the ratio of charity expenses to dividends was 63%);
- the BoD remuneration system is not in line with the CG Code recommendations.

Board of Directors: practical activity aspects

Chairman of the Board of Directors
Alexander Novak
(representing the Russian Federation), Minister of Energy of the Russian Federation,
no equity stake in the Company;

Chairman of the Strategy, Investment and Innovation Committee
Mikhail Grishankov
(independent director*), Deputy Chairman for relations with the Government of Russia, JSC KTK-R, no equity stake in the Company

Chairman of the Audit Committee
Ilya Klebanov (INED)
Chairman of the Board of Directors, PAO Sovcomflot, no equity stake in the Company

Chairman of the Personnel and Remuneration Committee
Ilya Klebanov (INED)
Chairman of the Board of Directors, PAO Sovcomflot, no equity stake in the Company

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** The API met with the Chairman of the Strategy, Investment and Innovation Committee who qualified as an independent director until 2016 when he joined the Company's competitor JSC KTK-R (as disclosed by the Company). Subject to a decision of the Board of Directors, he was recognized as an independent director (after the reporting date). We were not able to meet with the other INEDs.*
We appreciate the BoD member's participation in the interview and believe that such annual meetings with the Company's investors and shareholders are extremely useful for assessing the BoD performance, among other things. It should be noted that Mr. Grishankov confirmed his readiness to hold such meetings annually.

Board of Directors: international and domestic practice

BoD activity aspect	*Enbridge Inc.*	*TransCanada Corporation*	*Sunoco Logistics Partners LP*	*PJSC Transneft*
INEDs/total number of members	10/11	11/12	4/8	Among the 8 BoD members, 3 INEDs were elected at 2016 AGM, currently 2/7*
Number of BoD meetings and committee meetings, attendance in 2015	BoD: 9 meetings, Audit Committee 4 meetings, HR & Compensation Committee 6 meetings 100% attendance in all cases	BoD 10 meetings, 1 BoD member missed 3 meetings, 3 BoD members missed 1 meeting each; Audit Committee: 5 meetings, 1 non-attendance; HR Committee: 3 meetings, 2 cases of non-attendance, Conflicts Committee: 5 meetings, 1 non-attendance, otherwise 100%.	BoD 5 meetings, Audit Committee 4 meetings, Compensation Committee 3 meetings, Conflicts Committee 4 meetings No attendance data are disclosed	BoD: 32 meetings (6 physical meetings), Audit Committee: 8 meetings (4 in presentia), Personnel and Remuneration Committee 5 meetings (1 in presentia) ; no attendance data are disclosed
Remuneration of BoD members / actual payments based on 2015 performance	$235K in base remuneration + bonus payment of $260K to BoD Chair, $10-25K to Chairs of committees. At least 50% in deferred stock. Actual: $230-340K to BoD members, $507K to BoD Chair	C$70K in base remuneration + C$110K in deferred phantom stock units. C$201K + C$291K to BoD Chair, C$5.5K additionally payable to committee members, C$12-20K to committee chairs + C$1.5K per BoD member per meeting. Median payments at peers taken account of for calculation purposes. Actual: C$227K-238K to BoD members, C$535K to Chair	Base remuneration of INEDs (others are not entitled to any) $50K + $15K/7.5K for chairmanship of AC/CC + $10K/5K to AC/CC members + $1.2K per AC/CC meeting + $100K in deferred units under a long-term motivation program. Actual: $128K-212K	Base remuneration: RUB 1 million + 0.025% of consolidated net profit, adjusted for KPI achievement (ROE, dividends, cost reduction, amount of R&D financing, share of procurement from SME) + additional payments (50% to BoD Chair, 20% to chairs of Committees, 10% for membership in each committee. Actual payments in 2015 based on 2014 performance: RUB 39.6 million to BoD members (8 directors, including public servants not entitled to remuneration, individual payments are not disclosed), which is equal to $608K proceeding from the exchange rate of 1 USD = RUB 65.12.

* In our view, after independent BoD member Chilingarov suspended his activity as a BoD member (even though he officially maintains the BoD member status as individual termination of BoD membership is contrary to the Russian legislation), the Company has only one independent director meeting the independence criteria of the Moscow Exchange Listing Rules and one director not fully complying with these criteria but recognized as an independent director by a resolution of the Board of Directors.

The fixed part of the remuneration payable to BoD members of Transneft is several times below the fixed remuneration paid by conditional peers. The variable remuneration is subject to operational KPIs and performance targets. For example, the dividend KPI achievement is assessed in terms of equivalence between the dividends recommended for payment to the shareholders and the target level approved by the BoD. In international practice, such approaches are not applicable. The Company does not disclose the KPI calculation method or the comparison between the target and actual KPIs. The procedure for adjusting the variable remuneration components is subject to approval by the Management Board, which is unacceptable in terms of good corporate governance.

Board of Directors: practical activity aspects

In the period under review (2015 and 9 months of 2016), the BoD held 48 meetings addressing 135 issues. The material facts disclosed by the Company do not contain information on the format of the meetings and the individual voting by BoD members. *According to the 2015 annual report, only 6 out of 32 meetings were held in the form of joint attendance, but, according to a BoD member, all important issues were addressed at physical meetings.*

Related party transactions accounted for 10% of the issues considered by the BoD. Their total amount reached RUB 973 million (the specific amounts of transactions are not always disclosed, but the material terms of most of such transactions are disclosed even if not included in the main body of the contracts).

In the said period, the BoD addressed the following essential groups of issues:

- long-term development program and related matters: 11 issues (the BoD pays considerable attention to this aspect; according to the BoD member, Transneft has the best long-term development program among state-owned corporations);
- key performance indicators: 6 issues (the BoD does not follow the practice of approving adjustments to KPIs one month before the reporting date / one quarter before the end of the reporting period, although the issue "On the KPIs of the business activities of PJSC Transneft" was addressed on December 23, 2015, according to the disclosure system, without indication of the period the issue refers to);
- budget for the financial year/adjustment: 3 issues;
- charity: 4 issues, one of them being "Optimization and cost efficiency improvement";
- risk management: 3 issues, one of them, "Currency and interest risk management policy", was considered in June 2016 based, among other things, on a discussion of losses from hedging;
- internal audit: 1 issue (approval of the Internal Audit Regulations in November 2015).

System-relevant issues of senior management and staff remuneration were considered as two agenda items at a meeting in January 2016, the changes, if any, to the system of remuneration are not disclosed.

The Company has no long-term motivation system and, according to a BoD member, the related issue was not raised at BoD meetings.

The corporate documents allow BoD members to express a dissenting opinion on the issues considered, and if expressed, such an opinion should be included in and attached to the minutes; the BoD members did not exercise this right in the period under review (2015 and 9 months of 2016). There is no practice of BoD members voting "against" or "abstained": the only negative vote was cast in the period under review on the Company's participation in nonprofit partnership Russian International Affairs Council; who precisely voted in the negative was not disclosed. Our recommendation is to adopt the practice of disclosing the voting by BoD members and their meeting attendance (whether indicating their presence or providing expressions in writing) which increases transparency of BoD members' activities.

The system of BoD members' remuneration contradicts the CG Code recommendations and the best practices, creates a potential conflict of interests by making payments to BoD members dependent on annual operating performance indicators, most of which are primarily under the management's control. However, the BoD, according to its member, is comfortable with the current state of affairs and has not called for changes. We recommend that the Company's policy be brought into line with the general practice.

According to a BoD member, the Company applies benchmarks when discussing both KPIs and the corporate strategy; moreover, the BoD and the Audit Committee actually commissioned a review of comparative parameters (the list of which is not precisely defined and not disclosed, no information disclosure in reporting documents either); the review was carried out by a Big Four audit firm. No benchmark was applied to the remuneration system, as far as we understand.

Audit Committee

The Audit Committee consists of 2 independent directors. The internal audit division is not accountable to the BoD; the approval of the appointment / dismissal and remuneration of the head of division, its budget and activity plan are not properly regulated. In 2015, the Audit Committee held 4 physical meetings and 4 meetings in absentia, mainly addressing external audit issues.

Personnel and Remuneration Committee

The Committee consists of 2 members, its Chairman is an independent director. In 2015, 5 meetings were held in absentia and only 1 in the form of joint attendance.

In October 2015, the Committee considered an objective assessment of the BoD members and formulated proposals to the shareholder for candidates to the Board of Directors (the consideration procedure is not disclosed).

Essential CG aspects

Dividend policy

The Company disclosed the dividend policy for the first time in December 2016. Transneft is the last among the state-owned companies covered by this research to approve such a document by the Board of Directors (after the reporting date of the research).

The dividend policy analysis shows that the approved document needs to be refined:

- the normalized consolidated IFRS profit indicator used by the Company is not adjusted for the share in profits of affiliated and jointly controlled companies, the income from financial investment revaluation, the positive balance of exchange rate differences and other non-recurring cash components of net profit. *Under this approach, it is fair that the Company also disregards the paper losses from revaluation, the negative balance of exchange rate differences and other non-recurring cash components reducing the profit for distribution;*
- the amount of dividends is limited to 25% of the proposed normalized profit (i.e. less than 25% of the IFRS net profit). In our opinion, subject to the benchmark and the Government of Russia's decision on 2015 dividends, the Board of Directors should opt for a more ambitious dividend payout ratio of at least 50% of the IFRS profit, with real values of respective adjustment factors used in the dividend policy;
- the proposed adjustment factors (for payment limitation purposes) almost similar to the dividend policy of Aeroflot – Russian Airlines are considerably over- or underestimated (depending on the factor) resulting in an understated ratio of dividends to net IFRS profit (payout ratio). *The BoD is recommended to consider adjusting the factors using the benchmark, among other things.*
- The Company's current dividend distribution policy is actually based on the leftover principle without taking into account the total ROIC ratio and the rate of return on investment projects (the policy does not contain a description of the approach to financing investment projects out of profits proceeding from the rate of return);
- the dividend policy does not provide for the payment of interim dividends.

In our view, the BoD has all powers and full capacity to make appropriate proposals / recommendations to the shareholders as regards amending the Articles of Association and to stay committed to eliminating the above-stated weaknesses in the dividend policy.

Dividend payout ratio at Transneft vs. conditional peers

million US dollars ($), million C$, million rubles	*Enbridge Inc. (USGAAP, adjusted)*	*TransCanada Corporation (USGAAP)*	*SUNOCO LOGISTICS PARTNERS L.P. (USGAAP)*	*Transneft (IFRS)*
Net profit	1,866	-1,140	395	143,378
Dividends for 2015	1,596	1,538	689	12,801
Dividend payout ratio (share of profit)	86%	not applicable	174%	**9%**

Risk management, internal audit

The Company's risk management activities as regards currency and interest risk management can be regarded as ineffective. In 2015, PJSC Transneft created provisions in the amount of RUB 19.8 billion against the loss of the Group's cash funds deposited with banking institutions which forfeited their general banking licenses (Vneshprombank and Bank Intercommerz). In 2014-2015, this policy resulted in substantial losses from currency hedging operations (more than RUB 80 billion) in relation to transactions effected in 2013-2014. As far as we understand, the Company probably did not envisage any limits on losses under strong volatility scenarios. According to the 2015 annual report, the related policy was not considered by the AC in 2015.

However, on June 29, 2016, the BoD approved the currency and interest risk management policy of PJSC Transneft: according to the BoD member, the changes were made factoring in the Company's losses, among other things.

As regards the internal audit system, the BoD approved an internal audit regulation which remains undisclosed. After the reporting date (09/30/2016), the BoD approved the general guidelines (the plan) and the head of the IA division. The interview of the BoD member also confirms that BoD has started following the generally accepted internal audit practice assuming, among others, related reports. How the IA division actually interacts with the Audit Committee will be clear after the first year of activity in the new format. The activity reporting procedure is not formalized.

External auditor

Just as in previous years, PJSC Transneft chose JSC KPMG as the auditor for 2016. The cost of services amounted to RUB 34.5 million for the audit in 2015 and Q1 2016, RUB 27.5 million (77.5% of the initial bid price) for the audit in 2016 and a review of the interim consolidated IFRS financial statements for Q1 2017. KPMG was engaged to audit the implementation of the long-term development program in 2014.

According to the BoD member, the auditor selection procedure is properly formalized and involves the Audit Committee on a mandatory basis. The annual report provides information on the consideration by the Committee of competition-specific issues. We support and welcome this practice.

Charity and social responsibility

In 2015, the charity projects cost the Company and the Group a total of RUB 8.1 billion (63% of the RAS net profit or the 2015 dividends, 5.6% of the IFRS net profit; *for reference, the peers' charity spending is as follows: C$7.54 million at TransCanada (0.4% of the 2014 net earnings), C$19 million at Enbridge (1% of the adjusted net profit).* In 2015, the Company and the Group's entities spent a total of RUB 97.4 million for the sponsorship of socially important events.

Seeing as the charity spending is commensurate with the dividends distributed by the Company (for example, the charity expenses in 2015 in relation to the 2015 dividends), it is advisable that the Company disclose approaches to setting limits on such expenses taking into account the financial and operating results.

Information disclosure

The mandatory disclosure by the Company generally meets the applicable requirements and, in certain aspects, even complies with the best practices (particularly concerning related party transactions, except for a few of them).

However, the Company does not disclose information on a number of CG-relevant issues:

1. individual voting by BoD members and their participation in meetings of the BoD and its committees;
2. the format of each meeting (only the total number of meetings in each format is specified in annual reports);
3. approaches to the distribution of charity expenses, including a system of applicable limits and exact amounts in absolute terms for each item;
4. system of remuneration of BoD directors and senior managers (the proportions between the monthly/quarterly, fixed and variable components), the correlation between the remuneration and the KPI achievement (including the actual and target payments).

The Company's Board of Directors certainly can and should consider approaches to disclosing this information as part of their responsibility for the CG system transparency.

Disclosure of information on the management remuneration system compared with international (conditional) peers of PJSC Transneft

Approximate proportions of CEO remuneration components (based on forecast, incl. shares) at Transneft vs. peers in 2015	*Enbridge Inc.*	*TransCanada Corporation*	*Sunoco Pipeline Partners LP*	*Transneft (estimated)*
Fixed annual remuneration	17%	15%	11%	45%
Annual bonuses	24%	18%	15%	55%
Long-term component	58%	66%	74%	0%

Transneft: the total amount of remuneration paid to the Management Board (10 members) based on the 2015 performance is RUB 779.5 million. No information is disclosed for 2014. The Company does not provide long-term incentives which account for more than 50% at foreign peers.

The following target KPIs are disclosed in Transneft's the 2015 annual report: accident rate, emissions, reduction in expenses/energy consumption, labor productivity; *implementation of plans*: financing of investment programs, capex reduction, delivery time for investment projects, pipe replacement plans, construction and renovation; financing of innovations/R&D, intellectual property (results of intellectual activity) for the 3-year period; commercialization of innovations; quality of the investment development program; debt/EBITDA ratio; ROIC; dividends; percentage of procurement from SMEs. *The correlation between these KPIs and the remuneration is not disclosed.*

Some of the above-stated KPIs (including dividends) are beyond the management's control. The peers prefer a fairer KPI of earnings per share (EPS). Priority is given to non-financial KPIs (the assumption is based on the number of disclosed KPIs absent disclosure of their relative weights)

	Enbridge Inc.	*TransCanada Corp.*	*Sunoco Pipeline LP*
Disclosure: all payments, incl. in the form of stock, estimate of future payments	CEO+CFO+3 top managers Actual: $7.15 million to CEO, including $1.24 million in salaries, $1.75 million in bonuses, $4.15 million in phantom stock and options. Other senior managers: $2.1-2.7 million.	CEO+CFO+3 top managers Actual: C$ 1.3 million to CEO, C$1.56 million in bonus, C$2.8 million in restricted stock units, C$2.8 million in options. Other managers: C$2-4.7 million.	CEO+CFO+4 top managers. Base salary is somewhat below market median value. Actual: $5.7 million to CEO, $1.2-1.4 million to others
KPIs influencing the short-term (annual) variable remuneration component, (incl. the fixed relative weight of the KPI)	60%: EPS adjusted for industry peers and TSX Composite index factoring in the growth of DPS, TSR and risk-adjusted TSR for 1,3,5 and 10 years; 20%: KPI of business units (security, adjusted earnings, FCF, expenses, relations with consumers and shareholders, implementation of individual plans and staff development); 20%: individual KPIs (undisclosed).	General corporate factor (application is not disclosed): EPS and income from operations 20%, industrial safety and economic security 10%, business value maximization 20%, implementation of projects 20%, portfolio of new projects 15% investment program implementation 15%	Comparison with target EBITDA value (75% for the Group, 25% for the business unit / division)
KPIs influencing the long-term variable remuneration	Deferred units (phantom units linked to stock price, calculation period 3 years): KPI adjusted EPS growth in relation to reference value (relative weight 50%), P/E versus peers (50%); KPI for options: achievement of 3 stock price targets in succession over a period of 6.5 years. No data on incentive options available.	Program of deferred units (phantom stock, calculation period 3 years). KPIs (rel. weight): 50% EPS, 25% TSR vs. S&P/TSX 60, 25% TSR vs. Peers + adjustment for ratio of accumulated 3-year dividends to accumulated 3-year EPS from operations (target percentage: 50%).	Undisclosed
Long-term bonuses	Options awarded for achieving targets (accumulation period 5 years + exercise period 3 years) and incentive options (accumulation period 4 years + exercise period 6 years)	Program of deferred units (payment period 3 years), with share options (accumulation period 3 years, 1/3 per year, exercise period 7 years)	Program of deferred restricted units (in replacement of shares) 60% in 3rd year + 40% in 5th year