



Association of
Institutional Investors (API)

Research report on PJSOC Bashneft

as of 09/30/2016



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

Brief capital structure overview

As follows from the breakdown of capital (voting shares), the combined interest of private minority shareholders is low (11.5% including individuals). Following the Company's privatization (which took place after the reporting date of this research), Rosneft Oil Company owns the majority block of voting shares. Quasi-treasury shares account for 2.32% of the share capital. Given the size of the Board of Directors / BoD (10 members), this capital structure theoretically enables minority shareholders to elect 1 independent director (INED) by their votes without involving the principal shareholders (the indicative passing score is approximately 8.5%, i.e. votes of more than 70% of the minority shareholders are required).

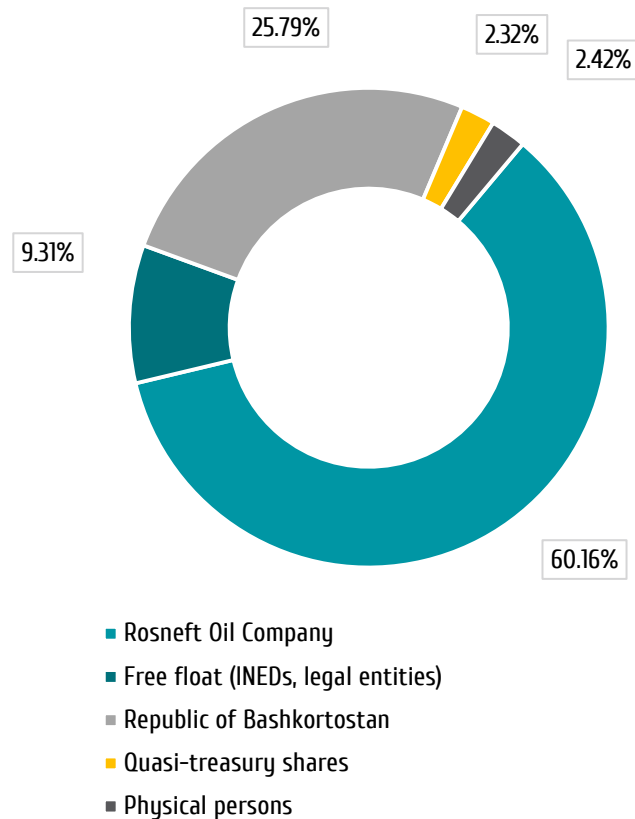
As regards ordinary shares, the Company has received a mandatory offer for the acquisition of shares by Rosneft at a price of RUB 3,706.41 per share, effective if the shareholder applies for the sale until January 31, 2017. Upon completion of this process, the structure of voting shareholders will most likely prevent any opportunities for minority shareholders to exert real influence on corporate governance within the scope of their rights.

At the same time, the Company's authorized capital consists of type A preferred shares (16.77%) and ordinary shares (83.23%). The annual dividend per preferred share is 10% of the nominal share value; the parity of dividend payments is guaranteed by the Articles of Association in case dividends on ordinary shares exceed dividends on preferred shares.

Corporate governance self-assessment

According to self-assessment, the Company complied with 61, partially complied with 13, failed to comply with 4 out of 79 principles and recommendations of the Corporate Governance (CG) Code in 2015; one recommendation is not applicable to the Company (stock bonuses to BoD members).

Breakdown of voting shares



Summary of CG practice

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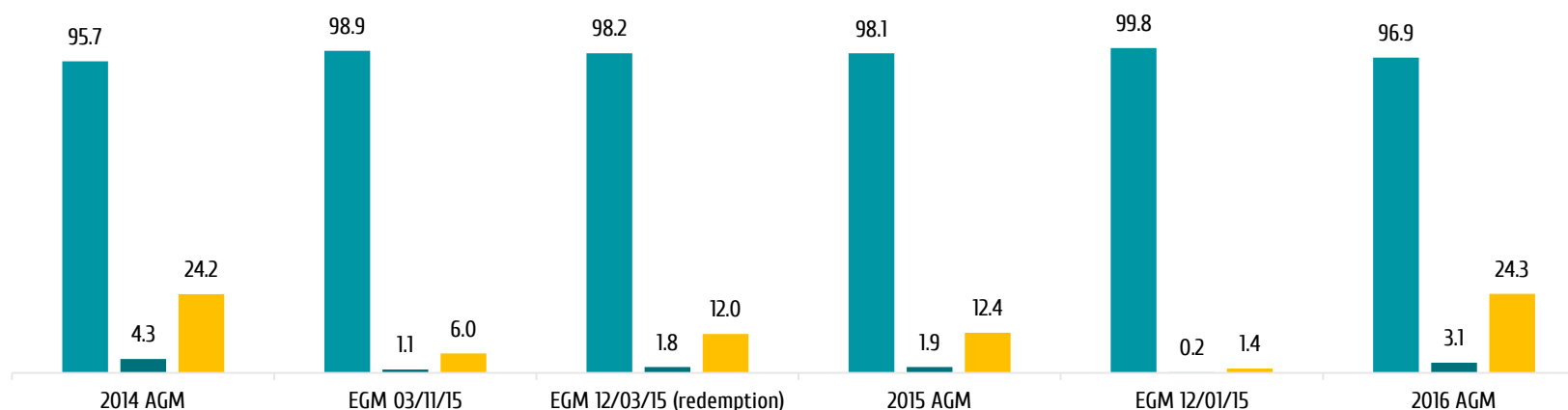
- 3 out of 10 BoD members are independent directors (all of them being non-residents as of 09/30/2016); their contribution to the Board's activity was highly appreciated by the BoD and the management;
 - The Audit Committee and the Nomination & Remuneration Committee wholly consist of INEDs and predominantly hold physical meetings (as of September 30, 2016);
 - The Company has a full-fledged internal audit (IA) division consisting of 3 thematic departments;
 - In addition to standard internal audit-related issues, the BoD has the power to approve the budget of the internal audit division;
 - to a large extent, the Company follows the CG Code recommendations as regards passing resolutions on key issues by a qualified majority or by a majority vote of the elected BoD members;
 - the Company follows the CG Code recommendations to consider key issues at physical BoD meetings (although the BoD Chair may decide to consider them in absentia by way of exception);
 - the BoD is authorized by the Articles of Association to determine the procedure for the Company's engagement with entities and organizations in which the Company has equity interests and to make decisions on such companies according to this procedure. Resolutions on such matters shall be passed by a majority of the elected BoD members;
 - the "hotline" details (phone numbers, email, postal address) for reporting violations, faults and cases of corruption to the compliance control department are easily available on the website, privacy is guaranteed; on behalf of the parent company, cash rewards are promised for providing information that enables the Company to repair damage, including damage caused to reputation;
 - many by-laws are disclosed, including internal audit and internal control-related documents; information on persons proposing agenda items for general shareholders meetings (GSMs) and candidates to the BoD and the Internal Audit Commission (IAC), as well as brief rationales for transactions and the profit distribution are included in GSM-related materials.
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- there were no INEDs among BoD members at the EGM on December 16, 2016 – the Company faces the prospect of having its shares excluded from the quotation list;
 - the reports on BoD resolutions provided in the disclosure system have been omitting information on specific voting results (except that the quorum is available and resolutions are passed) since Rosneft gained control over the Company, which is a negative practice;
 - the Company's shareholders have no right to call for a BoD meeting;
 - the practice of awarding short-term bonuses to BoD members for the growth of capitalization is not consistent with the CG Code recommendations (conditionally negative, given different international practices);
 - the reports on BOD resolutions do not disclose the individual voting by BoD members on the issues discussed at meetings and the terms and conditions of related party transactions;
 - (conditionally negative) the top management remuneration system description is one of the best among the companies covered by the research, highlighting, among others, the availability of a long-term remuneration program and providing details of the top 5 highest-paid BoD members' remuneration. However, no specific provisions of the motivation system are disclosed.



General shareholders meeting: activity of shareholders, related party transactions

The activity of minority shareholders at GSMs is steadily low. At least 70% of all minority shareholders' votes need to be consolidated to elect at least one INED, which is hardly possible in practice. At the AGMs in 2015-2016, only the Russian Federation nominated candidates to the BoD and the Internal Audit Commission.

In the period from the start of 2015 to September 2016, 8 related party transactions for a total amount of RUB 269 million and \$1.05 million were considered at two AGMs and three EGMs.



- Proportion of Russia, Rep. of Bashkortostan and quasi-treasury shares in the quorum
- Proportion of private shareholders in the quorum
- Private shareholders' participation ratio, %



Information on the shareholders, according to Bloomberg data and information disclosure by the shareholders

Shareholder name	Voting stake, %	Comment on voting
Russian Federation	60.16	No voting policy, Rosimushchestvo votes as instructed by the Government of Russia.
Republic of Bashkortostan	25.79	Voting policy is not available (not disclosed)
NORGES BANK	2.11	At the 2016 AGM, the shareholder voted for all the independent directors. At the EGM on 12/16/2016, it voted against all the candidates to the BoD (following the majority stake acquisition by Rosneft). The shareholder discloses the voting policy and the way it actually voted in the last 4 years. The bank has so far not nominated BoD/Supervisory Board candidates in Russia, unlike other countries. The shareholder receives recommendations from proxy advisory firms.
VANGUARD GROUP	0.44	The shareholder discloses Vanguard's proxy voting guidelines in relation to GSMS, as well as the way it voted in the last corporate season. For funds focused on investments in Russia, the shareholder disclosed voting for all the independent directors at the 2016 AGM. The shareholder does not nominate BoD/SB candidates, but supports, according to the generally disclosed approaches to voting, the idea of nominating at least 20% of INEDs by a group of shareholders holding at least 3% of the company's shares in the preceding 3 years. The shareholder receives recommendations from proxy advisory firms.
GRANTHAM MAYO VAN OTTERLOO & CO	0.21	GMO's Proxy Voting Policy discloses voting in accordance with ISS recommendations. No disclosure of the voting results. In 2016, the ISS recommendation to the shareholders was to vote for independent directors.
PROSPERITY CAPITAL MANAGEMENT UK	0.16	PCM usually takes an active approach to participating in GSMS, including the nomination of independent directors. No disclosure of the voting results.
SEB	0.12	The shareholder has disclosed the basic document of the asset management division (Ownership policy for SEB Investment Management AB), The voting results are not disclosed.
SWEDBANK AB	0.11	The shareholder has disclosed the basic document of the asset management division (Swedbank Robur Fonder AB ownership policy); concise disclosure of the 2015 results through the PRI portal (Swedbank Robur Fonder AB is generally a rare voter at Russian companies' meetings).
PICTET FUNDS	0.10	The shareholder discloses its Proxy Voting Policy for funds, participates in GSMS on behalf of clients, receives recommendations from ISS. According to the 2016 disclosure, the shareholder did not participate in the 2016 GSM, but took part in the EGM in December 2016 voting in the affirmative ("FOR") on all issues, except for the BoD election where it voted against all candidates.



General shareholders meeting: disclosure of information

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- the GSM-related materials, including their translation into English, are disclosed 30 days prior to the GSM date, according to the standards of corporate by-laws;
- the GSM materials specify the persons proposing agenda items and candidates to the BoD and the Internal Audit Commission (IAC);
- the materials include draft amendments to the Company's by-laws, with comparative tables and rationales for changes attached to them, which should be regarded as the best practice;
- rationales are also available for the approval of interested party transactions and the profit distribution (*conditionally positive, because the rationales are generally based on formal grounds*);
- the materials contain information on candidates for auditors, the selection procedure employed by the Company (*without specifying the bidders and their bids*), and the cost of the winning bidder's services;
- the Company discloses the list of parties in interest to related-party transactions and a rationale for recognizing related-party interest;
- the period for proposing candidates to the BoD and the IAC, as well as agenda items is increased to 60 days.

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- the GSM-related materials do not include details on the participants in the open competitive auditor selection procedure and their respective bids (the terms proposed by them).



Board of Directors: international and domestic practice

BoD activity aspect	Royal Dutch Shell	BP	Exxon Mobil	PJSOC Bashneft
INEDs/total number of BoD members	9/11	13/15	11/13	3/10
Participation in meetings of BoD and committees in 2015: number of meetings (attendance ratio)	BoD: 12 meetings (3 BoD members missed 1 meeting), Audit Committee: 6 meetings (1 non-attendance), Nomination Committee: 7 meetings (100% attendance), Remuneration Committee: 5 meetings (1 BoD member missed 2 meetings)	BoD: 13 meetings (2 via teleconference), 1 BoD member missed 2 meetings, 3 BoD members missed 1 meeting each. Audit Committee: 11 meetings (3 members missed 1 meeting each)	BoD held 11 meetings, Audit Committee 11 meetings, Compensation Committee 7 meetings, Board Affairs Committee 7 meetings. Average attendance ratio: 92%, attendance ratio at BoD and all committees is at least 75% (no individual disclosure).	BoD: 21 meetings (incl. 7 physical meetings) – (2 BoD members missed all meetings (2) held during their tenure). Average attendance ratio: 95%. AC: 100% (1 expression in writing at 9 meetings), Nomination and Remuneration Committee: 100%
Remuneration of BoD members / actual payments for 2015	(2016) €850K to BoD Chair, €130K to BoD member, €55K to senior INED, €55 (25)K to AC Chair / member, €35K (17.25K) to Remuneration Committee Chair/member, €25K (12K) to Nomination Committee Chair. Actual (2015): €147-315K (616K to BoD Chair)	£785K to BoD Chair, £120K to Senior INED, £90K to BoD member, £30/20K to Committee Chair/member. Actual: £141-178K for corporate year	\$110K to BoD member, \$10K to Committee Chair + 2,500 shares annually (+ 8,000 shares upon taking office) and dividends on them (not applicable if resigned before age of 72). Actual: \$110-120K+ \$231K in shares	Base remuneration: RUB 5 million (RUB 6.5 million to INED). Additional payments: RUB 0.125 million for committee membership (RUB 0.25 million to INED), RUB 0.25 million for committee chairmanship (RUB 0.5 million to INED). Uplift factor: 25-55% of base remuneration for capitalization growth (as compared with 5 peers). Actual: RUB 4.49 - 18 million. Deductions for non-attendance: 25% for missing 20%, 100% for missing 40%.



Board of Directors: practical activity aspects (as of 09/30/2016)

Chairman of the Board of Directors

Alexey Teksler

non-executive director (until the EGM on 12/16.20126), no shareholding in the Company;

Chairman of the Nomination and Remuneration Committee

Maurice Dijols (INED),

no shareholding in the Company;

Chairman of the Audit Committee

Anthony Considine (INED),

no shareholding in the Company.

A BoD member* referred to the BoD as "one of the best Boards of Directors in terms of activity and contribution of independent directors." All the INEDs are extremely effective at work and entirely focused (together with experts) on BoD affairs during their stay in Moscow.

Besides, the management team highly appreciated the performance of the Government's representatives on the BoD (after the ownership of these shares was transferred to the Russian Federation).

Decisions are worked out at committees, physical BoD meetings are held at least once in a quarter, meetings of committees once every 1-2 months. The BoD takes full account of recommendations provided by the committees, relies on independent directors in relation to audit and remuneration issues and does not actually consider materials for BoD meetings until receiving the committees' recommendations on these issues.

Cases of non-unanimous voting are extremely rare; where BoD members disagree on specific aspects, issues are most often left for further consideration with the aim of achieving a consensus, including the approval by independent BoD members.

*The API met with a member of the previous Board of Directors.



Board of Directors: practical activity aspects

For the period under review (2015 and 9 months of 2016), the BoD held 37 meetings, including 11 physical meetings (30%). 220 issues were considered. The number of transactions is relatively small compared to other PJSCs (12 transactions addressed in 8 agenda items).

The BoD also considered the following significant issues:

- performance results, reports (9 issues);
- key performance indicators (5 issues);
- long-term corporate development program (2 issues);
- internal audit and internal audit service's activity (6 issues);
- risk management and risk reports (2 issues);
- budget and business plan (5 issues).

The Company implements a noteworthy practice of business dinners (normally on the eve of BoD meetings) in which independent directors, non-executive directors, key senior managers and the Corporate Secretary participate. INEDs also have an opportunity to discuss shareholders' opinion on the Company's activities with non-executive directors representing the principal shareholder. 7 such meetings took place in 2015, which ensured more effective discussions at the succeeding BoD meetings. In 2015, the BoD Chairman had a number of meetings with INEDs (without other BoD members or the management in attendance) addressing matters which, in INEDs' view, required special attention. We regard this as the best practice among the companies covered by the research.

Strategy, business plan and KPIs

Minor tweaks were made to the KPI system following the change of ownership in late 2014 (as follows from the disclosure system, TSR and ROIC were added to the list of KPIs), the practice of revising targets shortly before the reporting date is generally not followed, the only case of approving 2015 KPIs in June 2015(!) occurred because of the change of ownership and the shareholders meetings this change entailed.

KPIs can be adjusted under the influence of changes in macroeconomic indicators as recent years' volatility, to a large extent, lays the groundwork for their changes. Such adjustments are considered and substantiated by the Nomination & Remuneration Committee. In general, the Company always has several scenarios as regards KPIs.

Benchmarks are used as a mandatory requirement when setting targets and evaluating progress. To ensure comparability of values, the Company primarily focuses on major Russian players in the segments/components of the industry (upstream & downstream).

When handling systemic issues, (KPI list, types of incentives, development strategy etc.), the Company extensively uses an international benchmark, as proved by related disclosure materials.

The 2015 business plan was approved at the end of March 2016 due to a change of ownership and a BoD reshuffle. At the same time, we were unable to detect the issue "Key parameters of the 2016 business plan of PJSC Bashneft" in the disclosure of information on BoD resolutions. In late December, the Board only considered the issue "Key performance indicators (KPIs) of senior executives of PJSC Bashneft for 2016."



Audit Committee (AC)

All members of the Committee, including the Chairman, are INEDs, which is in line with the best practices.

The powers and rights of the Committee members generally meet the best CG practice and the CG Code recommendations.

In 2015, the AC held 10 meetings, including 7 physical meetings, and considered 46 issues. The agendas mainly covered the standard range of issues relevant for the Committee, including consideration of the candidate for external auditor, dismissal and approval of the head of the internal audit division, review of financial statements, approval of by-laws within the competence of the Committee, etc.

In addition to these standard issues, the AC considered the risk management report and the risk management development plan for 2015, a plan of corrective measures in the internal control system, development of the compliance function at the Company, safeguarding of shareholders' investments and the Company's assets.

Unfortunately, it was clear at the time of the research that the BoD was in for a major change, which prevented us from arranging a meeting with the AC Chairman due to the lack of time.

Nomination and Remuneration Committee (NRC)

All members of the Committee, including the Chairman, are independent directors, the powers of its members meet the best CG practices and the Code of Corporate Governance recommendations.

In 2015, the committee held 11 meetings, including 6 physical meetings, considered 52 issues.

The NRC, inter alia, considered the Company's documents defining the terms of remuneration, bonuses to the Company's senior managers (including long-term and short-term incentive programs) based on the achievement of KPIs, approval of KPIs, conducted a comparative review of the remuneration of different groups of employees at petroleum companies.

The NRC was involved in the process of agreeing upon the proposal of BoD candidates for the corporate year 2016 to the principal shareholder (Rosimushchestvo), which we regard as a good practice.

Information on the consideration by the NRC of the BoD performance appraisal is not disclosed.

The Committee is authorized to consider all the terms of the employment contracts with the President, Management Board members and even the sole executive bodies (CEOs) of controlled companies, as well as the motivation system.



Essential CG aspects

External auditor

The Company chose CJSC Deloitte & Touche CIS for the audit of consolidated financial statements of the Company, its subsidiaries and structural divisions (the Group) according to IFRS standards as of, and for the years ending on, December 31, 2015, 2016 and 2017; reviews of condensed interim consolidated IFRS financial statements of the Group as of, and for the 3-month periods ending on, March 31, 2015, 2016 and 2017, as of, and for the 6-month periods ending on, June 30, 2015, 2016 and 2017, as of, and for the 9-month periods ending on, September 30, 2015, 2016 and 2017; review of the financial information included in the Company's annual report; review of the financial information contained in the prospectus for bonds registered for the issue on exchanges in the Russian Federation. The amount of remuneration is not supposed to exceed RUB 47.2 million.

Besides, the Company chose RSM RUS LLC as the auditor of Bashneft Group's financial statements prepared according to RAS (Russian GAAP) standards as of, and for the years ending on, December 31, 2015, 2016 and 2017. The amount of remuneration is not supposed to exceed RUB 8.084 million.

Internal audit, internal control, risk management

The IA division consists of 3 departments, an evidence of the Company's attention to the IA function. The BoD has the following powers in relation to the IA system:

- approval of the appointment, dismissal and the amount of remuneration and other payments to the head of the internal audit division (Senior Auditor);

- approval of the Company's Internal Audit Regulation, the activity plan and budget of the internal audit division.

The organization procedure for the internal control system and the proposals for structuring an internal control division were approved by the Audit Committee in the 1st quarter of 2016.

The Company has a hotline service for countering corporate fraud, corruption, theft of corporate property, unfair competition, conflicts of interests, as well as a hotline for customers. The hotline phone number, email and postal addresses are easily available on the Company's website.

The internal control division regularly monitors the Company's activities (analysis of performance results, follow-up checks on selected business operations, regularly appraisals and updates of by-laws and executive documents).

The Company has established a dedicated compliance control division. No involvement of BoD members and Management Board members in any conflicts of interest was detected in 2015.

Dividend policy

The Company has approved a dividend policy which recommends earmarking at least 25% of its IFRS net profit for dividends and notes the Company's commitment to increasing dividends every year while ensuring financial stability, meeting covenants in relation to liabilities and keeping leverage moderate (the net debt to EBITDA ratio does not exceed 2). The 4-year dividend history shows that the Company complies with the dividend policy recommendations.



2015 dividend payout ratios at Bashneft vs. (conditional) peers

	<i>Royal Dutch Shell</i>	<i>BP plc*</i>	<i>Exxon Mobil</i>	<i>PJSOC Bashneft</i>
Payout ratio*	63%	176%	75%	56% of RAS profit (51% of IFRS profit)

*information on 2014 dividends is provided for companies posting losses in 2015

Information disclosure

- The Company's mandatory disclosure system provides the results of voting at BoD meetings but no individual voting data, so that the results of voting by BoD members on separate significant agenda items cannot be properly analyzed;
- material terms of related party transactions (parties, price/limits, validity period) are not disclosed for all such transactions considered by the BoD. Many transactions are not covered at all;
- in addition to the generally accepted practice of disclosing the discipline of BoD members' participation in meetings of the BoD and its committees, the Company discloses the number of contributions (speeches, reports etc.) made at meetings, which is a superior practice, a good way of demonstrating the activity of directors.



Disclosure of the management remuneration system at international peers

Approximate proportions of CEO remuneration components at Bashneft vs. peers in 2015

	Royal Dutch Shell	BP	Exxon Mobil	PJSOC Bashneft (5 coll. exec. body members)
Fixed annual remuneration	28%	14%	13%	75%
Annual bonuses	34%	11%	10%	25%
Long-term remuneration	38%	75%	77%	0%*

	Royal Dutch Shell	BP	Exxon Mobil	PJSOC Bashneft (5 coll. exec. body members)
Disclosure: all payments, incl. in the form of stock, estimate of future payments	CEO+CFO. Actual (CEO): €1,430K in salaries, €3,500K in bonuses (including 50% deferred for 3 years). €163K in long-term remuneration, unadjusted for deferred annual bonus payments	CEO+CFO. Actual (CEO): \$1,854K in salaries, \$1,391K in bonuses, \$2,603K in deferred stock bonuses (2/3 of the annual bonus) + shares Long-term remuneration in the form of shares for KPI achievement: \$7,116K	CEO + CFO + 3 top managers Actual (CEO): \$3,047K in salaries, \$2,386K in bonuses \$18,288K in the long-term remuneration in the form of shares	Collective executive body (CEB) and separately to 5 highest-paid CEB members Actual 2015 (5 CEB members): RUB 237 million in salaries, RUB 41.5 million in annual bonuses, RUB 36 million in other bonuses in the course of the year (no long-term premiums were paid in 2015)
KPIs influencing the short-term (annual) variable remuneration component (incl. fixed relative weights of KPIs, if any)	Operating cash flow, project delivery in time and budget, production, sales, capacity utilization, security, energy and water efficiency	Reduction in the number of primary environmental pollution cases, accident rate, number of industrial accidents (10% each); operating cash flow, replacement cost profit (20% each); net investment 15%, corporate and functional expenses 10%, priority projects 5%	Safety and operational performance, ROCE, TSR vs. peers, FCF, payments to shareholders, strategic results, implementation of projects. Additionally, 50% of the bonus is deferred until target EPS achievement	TSR, ROIC, EBITDA NetDebt/EBITDA Reduction in operating expenses, operating availability, labor productivity, oil production, increment of reserves, yield of light products, integral KPI of innovation activities



	Royal Dutch Shell	BP	Exxon Mobil	PJSOC Bashneft (5 coll. exec. body members)
KPIs influencing the long-term variable remuneration (target KPIs set for 3-year periods)	TSR (30%); EPS growth in relation to cost of supplies (30%); increase in operating cash flow balance (20%); ROACE (20%) for peers divided into 5 groups with 20% increments	TSR vs. peers 1/3, operating cash flow 1/3, stock replenishment rate, safety and industrial risks, implementation of priority projects 1/3 in total	See annual remuneration component	TSR vs. peers, EBITDA per tonne of oil produced (vs. peers). Reserve replacement ratio, evaluation of the business plan execution, sustainable development (qualitative evaluation)
Long-term bonuses	Base salary x 3.4 (CEO) x KPI achievement ratio (0-2) x TSR underachievement ratio (1/2)	Part of annual remuneration (3-year period) is converted into shares and long-term remuneration in shares for KPI achievement (3-year accumulation period)	Payment of long-dated shares: 50% in 5 years, 50% in 10 years or in case of resignation	The Company approved a long-term incentive program* for 2015-2019. Payments have been effected since 2016. No program details are disclosed

* The incentive program is approved by the Regulation on the 2015-2019 long-term incentive program. Participation of top managers in the program is subject to BoD decisions to include certain positions in lists of program plan participants. Plan 1 is intended for 2015-2017, plan 2 for 2016-2018, plan 3 for 2017-2019. Payments under plan 1 are made annually, while plans 2 and 3 provide for payments upon completion of the program plan.

The Company has a long-term incentive system with relevant KPIs providing for the distribution of treasury preferred shares. In case of ownership change employees are entitled to these shares without conditions suspensive, but to the extent of their actual tenure.

Disclosure of information, including long-term remuneration details, is not sufficient compared with peers, despite the Company's progressive attitude towards the management remuneration system.

Disclosure of information on shareholdings of the Company's Management Board (5 largest shareholdings)

Management Board member	Rounded-off value of share package as of 09/30/2016
Alexander Korsik	RUB 16 million
Kirill Andreychenko	RUB 6 million
Mikhail Stavsky	RUB 7 million
Denis Stankevich	RUB 6 million
Vladislav Pozdyshev	RUB 4 million



Corporate social responsibility

In 2015, the Company's charity activities were as follows:

Republic of Bashkortostan: approximately RUB 1.5 billion in the following segments:

- support of infrastructure projects:
 - educational projects (including construction, reconstruction and repairs): RUB 426.6 million;
 - road building (rehabilitation of roads/bridges): RUB 196 million.;
 - water supply improvements, environmental protection: RUB 179.4 million;
 - healthcare (construction, reconstruction and repairs of healthcare institutions): RUB 159.1 million;
 - culture: RUB 70.7 million;
- development of physical training and sports: RUB 325.6 million;
- assistance to the poor and disadvantaged, other social projects: RUB 75.8 million;
- supply of high-quality drinking water to districts of the Republic: more than 164 million.

Nenets Autonomous Okrug: RUB 40 million;

Orenburg region: RUB 20 million.

<i>Spending on charity at Bashneft vs. conditional peers</i>	<i>Royal Dutch Shell</i>	<i>BP plc*</i>	<i>Exxon Mobil</i>	<i>PJSOC Bashneft</i>
Direct expenses for social investment and charity in relation to IFRS profit	0.82%	1.77%	1.66%	2.58%

*information on 2014 spending is provided for companies posting losses in 2015

