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

*You should read the following management's discussion in conjunction with our unaudited consolidated interim condensed financial information as of and for the* six *months ended 3*0 June, *2005. The interim condensed financial information has been prepared in accordance with International Accounting Standard 34 "Interim financial reporting" ("IAS 34"). These financial statements should be read together with the consolidated financial statemen*ts for the year ended 31 Decembe*r*, *2004 prepared in accordance with International Financial Reporting Standards ("IFRS").*

## OVERVIEW

We are the world's largest natural gas company, and the world's largest publicly-traded hydrocarbons company, in terms of reserves, transportation and production volumes. Our revenues are primarily derived from sales of natural gas to western and central Europe, Russia and other former Soviet Union countries.

We divide our operations into the following four main business segments:

- Production: exploration, development and production operations relating to natural gas and other hydrocarbons.
- Refining: processing and refining of natural gas, gas condensate and other hydrocarbons, and sale of hydrocarbon products.
- Transportation: transportation of natural gas through the world's largest high-pressure trunk pipeline system (152,800 km). We own and operate a single centrally controlled system for natural gas production, processing, transportation, storage and deliveries. Beginning in the late 1990s, we began acquiring interests in gas distribution companies that own and operate medium- and low-pressure pipelines.
- Distribution: domestic and export sale of natural gas. We are the world's largest exporter of natural gas.

Other businesses primarily comprise banking, construction and media. These businesses are not separately reflected in our financial statements because they do not represent individually material segments.

## RESULTS OF OPERATIONS

| (RR million) | Six months ended June 30, 2005 | 2004 |
|---|---|---|
| Sales (net of excise tax, VAT and customs duties) | 611,233 | 471,474 |
| Operating expenses | (402,178) | (349,072) |
| **Operating profit** | **209,055** | **122,402** |
| Net finance (expense) income | (7,780) | 1,874 |
| Share of net income of associated undertakings | 8,943 | 3,122 |
| Gains on available-for-sale investments | 1,427 | 4,296 |
| **Profit before profit tax** | **211,645** | **131,694** |
| Current profit tax expense | (51,081) | (26,179) |
| Deferred profit tax expense | (6,565) | (12,610) |
| Total profit tax expense | (57,646) | (38,789) |
| **Profit for the period** | **153,999** | **92,905** |
| **attributable to:** | | |
| Equity holders of OAO Gazprom | 152,810 | 92,258 |
| Minority interest | 1,189 | 647 |

The following table sets out our volumes and realized prices for the six months ended June 30, 2005 and 2004.

| (RR million unless indicated otherwise) | **Six months ended June 30, 2005** | **2004** |
|---|---|---|
| **Sales of gas** | | |
| *Europe* | | |
| Gross sales [1] | 396,911 | 293,439 |
| Excise tax | (90) | (1,067) |
| Customs duties | (109,678) | (76,431) |
| Net sales | 287,143 | 215,941 |
| Volumes in billion cubic meters (bcm) | 81.4 | 78.8 |
| Average price, U.S.$ per mcm [2] (including excise tax and customs duties) [3] | 174.4 | 129.3 |
| Gross average price, RR per mcm [2] (including excise tax and customs duties) | 4,876.1 | 3,722.1 |
| *FSU* | | |
| Gross sales (net of value added tax (VAT)) | 54,257 | 40,015 |
| Excise tax | (87) | (470) |
| Customs duties | (8,373) | (9,856) |
| Net sales | 45,797 | 29,689 |
| Volumes in bcm | 36.4 | 29.4 |
| Average price, U.S.$ per mcm [2] (including excise tax and customs duties, net of VAT) [3] | 53.3 | 47.4 |
| Gross average price, RR per mcm [2] (including excise tax and customs duties, net of VAT) | 1,490.6 | 1,363.1 |
| *Russia* | | |
| Gross sales (net of VAT) | 164,181 | 134,890 |
| Excise tax | (1,165) | (1,418) |
| Net sales | 163,016 | 133,472 |
| Volumes in bcm | 162.1 | 163.0 |
| Gross average price, RR per mcm [2] (including excise tax, net of VAT) | 1,012.8 | 827.6 |
| *Total sales of gas* | | |
| Gross sales (net of VAT) | 615,349 | 468,344 |
| Excise tax | (1,342) | (2,955) |
| Customs duties | (118,051) | (86,287) |
| Net sales | 495,956 | 379,102 |
| Volumes in bcm | 279.9 | 271.2 |
| Sales of gas condensate and oil and gas products (net of excise tax, VAT and customs duties) | 74,108 | 54,968 |
| Gas transportation sales (net of VAT) | 12,181 | 15,297 |
| Other sales (net of VAT) | 28,988 | 22,107 |
| **Total sales (net of excise tax, VAT and customs duties)** | **611,233** | **471,474** |

Notes:

(1) VAT is not charged on sales to Europe.

(2) One mcm is the equivalent of a thousand cubic meters.

(3) Average prices and not a convenience translation.

Net sales revenue increased by RR139,759 million, or 30%, to RR611,233 million in the six months ended June 30, 2005 compared to the six months ended June 30, 2004. Net sales of gas accounted for 81% of total net sales in the six months ended June 30, 2005 (80% in the six months ended June 30, 2004) and were RR116,854 million, or 31%, higher than in the same period of 2004.

Net sales of natural gas to Europe increased by RR71,202 million, or 33%, to RR287,143 million in the six months ended June 30, 2005 compared to the six months ended June 30, 2004. This increase resulted primarily from a 35% increase in gross average realized U.S. dollar export gas prices, as well as with a 3% increase in sales volumes. The increase in net sales was also impacted by the depreciation of the RR against the U.S. dollar which was more than offset by appreciation of the RR against euro. The increase in sales volumes was primarily due to increased volumes sold to customers in Turkey and Belgium.

Net sales of natural gas to FSU countries increased by RR16,108 million, or 54%, to RR45,797 million in the six months ended June 30, 2005 compared to the six months ended June 30, 2004. This was due to a 24% increase in prices in RR terms (net of excise tax, customs duties and VAT) and a 24%, or 7.0 bcm, increase in volumes. The 24% increase in the average net RR price (net of excise tax, customs duties and VAT) of gas to RR1,258.2 per mcm was primarily due to the change in the VAT rate to zero (from 18%) on sales to the countries of CIS, to which we sell gas (except for Moldova) while the average realized gross U.S. dollar price charged to end customers remained almost flat. The increase in volumes of gas sold to FSU countries was primarily due to a 6.0 bcm increase in volumes of gas sales to Belarus due to contract disputes in the six months ended June 30, 2004. In 2005 we continued to restrict our shipments to Ukraine to those required to cover transportation services, so called “transit-gas”, which mitigates our collection risk. Shipments to Ukraine in the six months ended June 30, 2005 were 16.1 bcm compared to 16.8 bcm in the six months ended June 30, 2004.

Net sales of natural gas in the domestic market increased by RR29,544 million, or 22%, to RR163,016 million in the six months ended June 30, 2005 compared to the six months ended June 30, 2004. This was primarily due to the increase in domestic gas tariffs set by the FTS, which was slightly offset by a 1%, or 0.9 bcm, decrease in sales volumes.

Sales of gas condensate and oil and gas products increased by RR19,140 million, or 35%, to RR74,108 million in the six months ended June 30, 2005 compared to RR54,968 million in the six months ended June 30, 2004. The increase was primarily due to the increase in the domestic and export prices of oil and gas products. Sibur and its affiliated petrochemical companies accounted for 58% and 61% of the total sales of gas condensate and oil and gas products in the six months ended June 30, 2005 and 2004, respectively. Sales of gas condensate and oil and gas products (net of excise tax, VAT and customs duties) accounted for 12% of our total sales (net of excise tax, VAT and customs duties) in each of the six month ended June 30, 2005 and 2004.

Gas transportation sales decreased by RR3,116 million, or 20%, to RR12,181 million in the six months ended June 30, 2005 from RR15,297 million in six months ended June 30, 2004. This decrease primarily resulted from the termination of sales of gas transportation services to Eural Trans Gas from January 2005 and due to a RR1,994 million decrease in transportation sales to Trans Nafta, which supplied gas to Belarus during our contract disputes with Belarus in the first half of 2004. In the six months ended June 30, 2004 gas transportation sales to Eural Trans Gas amounted to RR5,291 million. These factors more than offset the amount of transportation services of RR3,606 million in the six months ended June 30, 2005, to RosUkrEnergo AG, an associated undertaking engaged from January 2005 in the sales of gas, produced in Russia and Central Asia to Ukraine and other countries in the six months ended June 30, 2005.

Other sales increased by RR6,881 million, or 31%, to RR28,988 million in the six months ended June 30, 2005 compared to RR22,107 million in six months ended June 30, 2004. Other sales represent activities including media, construction works, refinery services, and sales of other services and goods.

**Operating expenses**

Operating expenses increased by 15% in the six months ended June 30, 2005 to RR402,178 million from RR349,072 million in the six months ended June 30, 2004. Operating expenses as a percentage of sales decreased from 74% in the six months ended June 30, 2004 to 66% in the six months ended June 30, 2005. The table below presents a breakdown of operating expenses in each period:

| (RR million) | Six months ended June 30, 2005 | Six months ended June 30, 2004 |
|---|---|---|
| Staff costs | 70,126 | 60,066 |
| Depreciation | 61,403 | 56,527 |
| Gas transit costs | 53,206 | 53,936 |
| Taxes other than on income | 48,381 | 39,492 |
| Purchased gas | 32,903 | 29,894 |
| Materials | 29,994 | 25,439 |
| Repairs and maintenance | 24,656 | 14,332 |
| Electricity | 15,837 | 13,781 |
| Social expenses | 7,041 | 5,226 |
| Insurance | 6,942 | 4,374 |
| Cost of goods for resale, incl. refined products | 5,923 | 8,104 |
| Transportation services | 4,977 | 5,224 |
| Rental expenses | 4,467 | 2,175 |
| Provisions for liabilities and charges | 4,453 | 3,119 |
| Research and development | 3,651 | 2,827 |
| Equipment maintenance | 4,562 | 2,388 |
| (Release) charge for provisions for impairment of assets | (743) | 645 |
| Other | 24,399 | 21,523 |
| **Total operating expenses** | **402,178** | **349,072** |

*Staff costs*

Staff costs increased by 17% to RR70,126 million in the six months ended June 30, 2005 from RR60,066 million in the six months ended June 30, 2004. The increase primarily resulted from an increase in average base salaries, partially offset by a reduction of social contributions, resulting from the reduction in the rate of Unified Social Tax that took effect on January 1, 2005 and from a release of staff costs capitalized in the cost of gas in storage. The release of staff costs capitalized in the cost of gas in storage was due to the surplus of gas pumped out from gas storages over the gas pumped in during the six months ended June 30, 2005 compared to the six months ended June 30, 2004.

*Depreciation*

Depreciation increased by 9% to RR61,403 million in the six months ended June 30, 2005 from RR56,527 million in the six months ended June 30, 2004. The increase primarily resulted from our growing fixed assets base and a greater release of depreciation capitalized in the cost of gas in storage in the six months ended June 30, 2005 compared to the six months ended June 30, 2004.

*Gas transit costs*

Gas transit costs decreased by 1% to RR53,206 million in the six months ended June 30, 2004 from RR53,936 million in the six months ended June 30, 2004. Transit costs relate principally to fees charged by Ukraine, Poland and other eastern European countries and by some Central Asian countries. The decrease primarily resulted from a decrease in transit costs for transportation of gas through Kazakhstan and Uzbekistan, partially offset by an increase in tariffs for transportation through Poland. The decrease of expenses for the transportation through Kazakhstan and Uzbekistan resulted from a change in the arrangements by which Turkmenian gas is transported to Ukraine. Starting from January 1, 2005, Turkmenian gas is sold to Ukraine by RosUkrEnergo AG, our 50% owned associated company, which incurs transit costs on the territories of Kazakhstan and Uzbekistan. Prior to January 1, we incurred expenses for the transportation of Turkmenian gas, that Eural Trans Gas sold to Ukraine and included these costs in the amounts that we charged to Eural Trans Gas for transportation services.

*Taxes other than on income*

Taxes other than on income consist of:

| (RR million) | Six months ended June 30, 2005 | 2004 |
|---|---|---|
| Natural resources production tax | 38,654 | 31,313 |
| Property tax | 7,429 | 5,519 |
| Other taxes | 2,298 | 2,660 |
| **Taxes other than income tax** | **48,381** | **39,492** |

Natural resources production tax increased by 23% to RR38,654 million in the six months ended June 30, 2005 from RR31,313 million in the six months ended June 30, 2004 due to the change in tax legislation. From January 1, 2005, the natural resources production tax rate for natural gas increased from RR107 per mcm to RR135 per mcm. The increase in property tax can be explained by the increase of tax base for the revaluation of fixed assets for statutory reporting purposes, which we performed as of 1 January 2005 (except for the revaluation of trunk pipelines, which are exempted from the property tax base).

*Purchased gas*

Cost of purchased gas increased by 10% to RR32,903 million in the six months ended June 30, 2005 from RR29,894 million in the six months ended June 30, 2004. The increase was primarily related to purchases of gas from RosUkrEnergo for resale in European countries.

*Materials*

Cost of materials increased by 18% to RR29,994 million in the six months ended June 30, 2005 from RR25,439 million in the six months ended June 30, 2004. The increase was primarily related to increased volumes of purchases by the transportation and refining segments and higher prices of materials.

*Repairs and maintenance*

Cost of repairs and maintenance increased by 72% to RR24,656 million in the six months ended June 30, 2005 from RR14,332 million in the six months ended June 30, 2004. The increase was primarily due to the ageing of pipeline assets and an increase in the volume of repairs and maintenance services rendered by third-party providers primarily in the transportation segment.

*Other operating expenses*

Other expenses increased by 13% to RR24,399 million in the six months ended June 30, 2005 from RR21,523 million in the six months ended June 30, 2004. Other expenses include bank charges, financial aid and charity, security services, legal and consulting services and advertising.

*Other items of operating expenses*

Other items of operating expenses which individually comprise less than 4% of net sales changed for a number of factors, none of which is individually significant. For example, electricity expenses increased mainly due to the rise in tariffs in electricity consumed and insurance expenses increased due to the disposal of the stake in Sogaz.

**Net finance (expense) income**

| (RR million) | Six months ended June 30, 2005 | 2004 |
|---|---|---|
| Net exchange (loss) gain | (4,983) | 7,653 |
| Interest income | 9,456 | 6,180 |
| Interest expense | (13,242) | (12,465) |
| Gains on and extinguishment of restructured liabilities | 989 | 506 |
| **Net finance (expense) income** | **(7,780)** | **1,874** |

We recognized a net exchange loss of RR4,983 million in the six months ended June 30, 2005 compared to a net exchange gain of RR7,653 million in the six months ended June 30, 2004. The change reflects the impact of the 3.3% depreciation of the RR against the U.S. dollar (in which a major part of our borrowings are denominated) and an 8.7% appreciation of the RR against the euro in the six months ended June 30, 2005 compared to a 1.5% appreciation of the RR against the U.S. dollar and 4.2% appreciation of the RR against euro in the six months ended June 30, 2004.

**Share of net income of associated undertakings**

Share of net income of associates increased by RR5,821 million to RR8,943 million in the six months ended June 30, 2005 compared to RR3,122 million in the six months ended June 30, 2004. The increase was due to higher net profit recorded by EuRoPol GAZ S.A., our associated undertaking engaged in transportation and sales of gas, following the rise of transportation tariffs for its services, and RosUkrEnergo, which, became an associated undertaking, from January 1, 2005.

**Gains on available-for-sale investments**

Gains on available-for-sale investments decreased from RR4,296 million in the six months ended June 30, 2004 to RR1,427 million in the six months ended June 30, 2005 primarily due to additional impairment charges related to promissory notes held by companies in the Sibur group and decreases in realized gains on the disposal of promissory notes held by our subsidiaries.

**Profit tax**

Total profit tax expense increased by RR18,857 million, or 49%, to RR57,646 million in the six months ended June 30, 2005 compared to RR38,789 million in the six months ended June 30, 2004 primarily due to increased profit before tax.

Our overall effective profit tax rate in the six months ended June 30, 2005 compared to the six months ended June 30, 2004 has decreased slightly (from 29% to 27%, respectively) due to the reduced impact of non-deductible expenses.

Our effective current profit tax rate increased to 24% in the six months ended June 30, 2005 compared to 20% in the six months ended June 30, 2004 primarily as a result of our ability to benefit in the six months ended June 30, 2004 from the tax loss carry forward of OAO Gazprom which was fully utilized by June 30, 2004 and a partial reversal of taxable temporary differences in respect of property, plant and equipment which resulted in higher current profit tax expense in the six months ended June 30, 2005 compared to the six months ended June 30, 2004.

**Profit for the period**

As a result of the factors discussed above, our profit for the period increased by RR61,094 million, or 66%, from RR92,905 million in the six months ended June 30, 2004 to RR153,999 million in the six months ended June 30, 2005.

## LIQUIDITY AND CAPITAL RESOURCES

The following table summarizes our statements of cash flows for the six months ended June 30, 2005 and 2004:

| (RR million) | Six months ended June 30, 2005 | Six months ended June 30, 2004 |
|---|---|---|
| Net cash provided by operating activities | 163,357 | 91,573 |
| Net cash used for investing activities | (104,439) | (103,885) |
| Net cash provided by financing activities | 7,763 | 46,403 |

*Net cash provided by operating activities*

Net cash provided by operating activities amounted to RR163,357 million for the six months ended June 30, 2005 compared to RR91,573 million for the six months ended June 30, 2004. This was primarily due to higher sales and operating profit, which rose mainly due to the upward trend in gas prices, partially offset by an increase in profit tax paid.

*Net cash used for investing activities*

Net cash used for investing activities amounted to RR104,439 million for the six months ended June 30, 2005 compared to RR103,885 million for the six months ended June 30, 2004. This increase was primarily due to a significant increase in cash capital expenditures for a number of major construction projects.

*Net cash provided by financing activities*

Net cash provided by financing activities amounted to RR7,763 million for the six months ended June 30, 2005 compared to RR46,403 million for the six months ended June 30, 2004. This decrease was primarily due to net cash outflows of RR6,420 million related to operations with treasury shares for the six months ended June 30, 2005 compared to an inflow of RR11,520 million for the six months ended June 30, 2004 as well as a change in cash restricted on borrowings, which increased by RR2,309 million and decreased by RR17,163 million for six months ended June 30, 2005 and 2004, respectively. Significant portion of cash restricted on borrowings depends on the schedule of borrowings repayments and is a function of the next portion of service costs and principal repayments due. This cash restricted on borrowings fluctuates with borrowings service and repayment schedules.

### Capital expenditures

Total capital expenditures (excluding the effect of acquisitions of subsidiaries and reclassifications) increased by RR1,160 million, or 1%, from RR95,437 million in the six months ended June 30, 2004 to RR96,597 million in the six months ended June 30, 2005. Our cash capital expenditures increased by RR24,837 million, or 29%, from RR84,907 million in the six months ended 30 June 2004 to RR109,744 million in the six months ended 30 June 2005 primarily due to the increase in cash settlements for capital expenditures of prior periods.

Most of our capital expenditures during these periods were for production assets and transportation infrastructure. In the six months ended 30 June 2005 capital expenditure on production assets were RR34,715 million, or 36% of total capital expenditure in the six months ended 30 June 2005, decreasing from RR45,965 million, or 48% in the six months ended 30 June 2004. Capital expenditures in the production segment in the six months ended 30 June 2005 primarily include capital expenditures for the development of Pestsovaya area of Urengoyskoe field and Aneryakhinskoe and Kharvutinskaya areas of Yamburgskoye field. Capital expenditures on the transportation infrastructure comprised RR49,301 million, or 51% of total capital expenditure in the six months ended 30 June 2005, increasing from RR35,675 million, or 37% of total capital expenditure in the six months ended 30 June 2004. The increase of our capital expenditures in the transportation segment was primarily due to increased capital expenditure on the construction of major transportation projects, including the Yamal-Europe project and Pochinki-Izobilnoye pipeline.

Total capital expenditures by segment for the six months ended 30 June 2005 and 2004 and budgeted total capital expenditures by segment for the year ending December 31, 2005 are as follows (excluding expenditures for certain of our subsidiaries, namely ZAO Purgaz, OAO AK Sibur, ZAO Stimul, OAO Vostokgazprom, OAO Zapsibgazprom and OAO Sibneft):

| | Six months ended June 30, | | Budget for the year ending |
|---|---|---|---|
| (RR million) | **2005** | **2004** | **31 December 2005**[(1) (3)] |
| Transportation | 49,301 | 35,675 | 145,623 |
| Production | 34,715 | 45,965 | 62,768 |
| Refining | 3,687 | 3,557 | 11,600 |
| Distribution | 1,982 | 2,947 | 8,397 |
| Other [(2)] | 6,912 | 7,293 | 8,515 |
| **Total** | **96,597** | **95,437** | **236,903** |

Note:

(1) An adjusted capital expenditure budget for 2005 of RR236,903 million, including the following major projects: RR57,574 million for construction of a pipeline from the northern region of the Tyumen Oblast to Torzhok, RR16,305 million for construction of a pipeline from Torzhok to Belostok, RR6,312 million to extend the gas transportation system in the Urengoy region, RR18,905 million for construction of Pochinki-Izobilnoye pipeline, RR7,961 million to develop the Pestsovaya area of Urengoyskoe field, RR13,092 million to develop the Aneryakhenskaya and Kharvutinskaya areas of the Yamburgskoe field, and RR8,008 million for restoration of the Orenburg Helium Plant. The adjusted balance was approved by the Board of Directors on September 28, 2005.

(2) Primarily includes expenditures for service activities such as drilling, transportation services (other than gas transportation services) and repair.

(3) Includes VAT.

**Debt obligations**

Our net debt balance (defined as the sum of short-term borrowings, current portion of long-term borrowings, short-term promissory notes payable, long-term borrowings, long-term promissory notes payable and restructured tax liabilities, net of cash and cash equivalents and balances of cash and cash equivalents restricted as to withdrawal under the terms of certain borrowings and other contractual obligations) decreased by RR33,544 million, or 7%, from RR 499,855 million as of 31 December 2004 to RR466,311 million as of 30 June 2005. This was primarily due to increased balance of cash and cash equivalents, resulting primarily from an increase in cash inflows from operating activities.