

## 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 June 30, 2007. The interim condensed financial information has been prepared in accordance with International Accounting Standard 34 "Interim financial reporting" ("IAS 34"). This financial information should be read together with the consolidated financial statements for the year ended December 31, 2006 prepared in accordance with International Financial Reporting Standards ("IFRS").*

### OVERVIEW

We are one of the world's largest oil and gas companies in terms of reserves, production and market capitalization. Our revenues are primarily derived from sales of natural gas, crude oil and other hydrocarbon products to western and central Europe, Russia and other former Soviet Union countries.

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

- Production of gas – exploration and production of gas;
- Transport – transportation of gas;
- Distribution – domestic and export sales of gas;
- Production of crude oil and gas condensate – exploration of oil and gas condensate, sales of crude oil and gas condensate; and
- Refining – processing of oil, gas condensate and other hydrocarbons, and sales of refined products.

Other businesses primarily comprise banking, construction and media.

Our five main business segments are mutually dependent, with a significant portion of the revenues of one segment comprising a part of the costs of another segment. In particular, our Distribution segment purchases natural gas from our Production of gas segment and transportation services from our Transport segment. Our Refining segment purchases crude oil and gas condensate from the Production of crude oil and gas condensate segment. We establish internal transfer prices with reference to the specific funding requirements of the individual subsidiaries within each segment. Accordingly, the results of operations of these segments on a stand-alone basis do not necessarily represent each segment's underlying financial position and results of operations as if it were a stand-alone business. For this reason, we do not analyze any of our main segments separately in the discussion that follows.

### RESULTS OF OPERATIONS

(RR million)

	Six months ended June 30	
	2007	2006
Sales (net of excise tax, VAT and customs duties)	1,143,894	1,091,424
Operating expenses	<u>(792,215)</u>	<u>(686,425)</u>
<b>Operating profit</b>	<b>351,679</b>	<b>404,999</b>
Deconsolidation of NPF Gazfund	44,692	-
Finance income	63,229	61,845
Finance expenses	(51,128)	(39,354)
Share of net income of associated undertakings and jointly controlled entities	15,194	16,968
Gains on disposal of available-for-sale financial assets	<u>18,447</u>	<u>3,144</u>
<b>Profit before profit tax</b>	<b>442,113</b>	<b>447,602</b>
Current profit tax expense	(105,834)	(112,355)
Deferred profit tax expense	<u>(6,229)</u>	<u>(3,011)</u>
Total profit tax expense	(112,063)	(115,366)
<b>Profit for the period</b>	<b>330,050</b>	<b>332,236</b>
<b>Attributable to:</b>		
Equity holders of OAO Gazprom	313,180	321,491
Minority interest	<u>16,870</u>	<u>10,745</u>
	<b>330,050</b>	<b>332,236</b>

## Sales

The following table sets out our volumes and realized prices for the six months ended June 30, 2007 and 2006.

(RR million unless indicated otherwise)	Six months ended June 30	
	2007	2006
<b>Sales of gas</b>		
<i>Far Abroad</i>		
Gross sales <sup>(1)</sup>	533,738	589,353
Excise tax	(54)	(484)
Customs duties	(123,478)	(160,607)
Net sales	410,206	428,262
Volumes in billion cubic meters (bcm)	79.4	84.9
Gross average price, U.S.\$ per mcm <sup>(2)</sup> (including excise tax and customs duties) <sup>(3)</sup>	257.7	250.9
Gross average price, RR per mcm <sup>(2)</sup> (including excise tax and customs duties)	6,721.7	6,944.2
<i>FSU (Former Soviet Union)</i>		
Gross sales (net of value added tax (VAT))	145,401	118,242
Excise tax	-	-
Customs duties	(11,614)	(15,683)
Net sales	133,787	102,559
Volumes in bcm	50.4	51.1
Gross average price, U.S.\$ per mcm <sup>(2)</sup> (including excise tax and customs duties, net of VAT) <sup>(3)</sup>	110.6	83.5
Gross average price, RR per mcm <sup>(2)</sup> (including excise tax and customs duties, net of VAT)	2,884.6	2,312.4
<i>Russia</i>		
Gross sales (net of VAT)	214,300	191,909
Excise tax	-	(845)
Net sales	214,300	191,064
Volumes in bcm	165.1	170.8
Gross average price, RR per mcm <sup>(2)</sup> (including excise tax, net of VAT)	1,298.1	1,123.5
<i>Total sales of gas</i>		
Gross sales (net of VAT)	893,439	899,504
Excise tax	(54)	(1,329)
Customs duties	(135,092)	(176,290)
Net sales	758,293	721,885
Volumes in bcm	294.9	306.8
Net sales of refined products (net of excise tax, VAT and customs duties)	221,784	209,737
Net sales of crude oil and gas condensate (net of excise tax, VAT and customs duties)	74,994	95,470
Gas transportation sales (net of VAT)	21,059	16,976
Other revenues (net of VAT)	67,764	47,356
<b>Total sales (net of excise tax, VAT and customs duties)</b>	<b>1,143,894</b>	<b>1,091,424</b>

Notes:

<sup>(1)</sup> VAT is not charged on sales to Far Abroad countries.

<sup>(2)</sup> One mcm is equivalent to 35,316 cubic feet.

<sup>(3)</sup> Calculated on the basis of average rate.

Total sales (net of excise tax, VAT and customs duties) increased by RR52,470 million, or 5%, to RR1,143,894 million in the six months ended June 30, 2007 compared to the six months ended June 30, 2006.

Net sales of gas accounted for 66% of total net sales in the six months ended June 30, 2007 and 2006.

Net sales of gas increased from RR721,885 million in the six months ended June 30, 2006 to RR758,293 million in the six months ended June 30, 2007, or by 5%.

Net sales of gas to Far Abroad countries decreased in the six months, ended June 30, 2007 compared to the six months ended June 30, 2006 by RR18,056 million, or 4%. The decrease resulted primarily from a 6% decrease in sales volumes, which was partly compensated by 2% increase in net average prices in RR terms (net of excise tax, VAT and customs duties). The decrease in sales volumes was primarily due to a warmer winter in 2007 compared to 2006, and the related decline in volumes sold to customers in Germany, Italy, Slovakia, France, and Poland.

Net sales of gas to FSU countries increased in the six months ended June 30, 2007 compared to the six months ended June 30, 2006 by RR31,228 million, or 30%, to RR133,787 million. This increase was mainly due to a 32% increase in net average prices in RR terms (net of excise tax, customs duties and VAT), which was partly offset by

1%, decrease in sales volumes. The increase in prices in RR terms was primarily due to the increase in sales prices to customers in Belarus, Kazakhstan, Lithuania, and Moldova.

Net sales of gas in the domestic market increased by RR23,236 million, or 12%, to RR214,300 million in the six months ended June 30, 2007 compared to the six months ended June 30, 2006. This increase was mainly due to the increase in domestic gas tariffs set by the Federal Tariffs Service, which was partly offset by decrease in sales volumes by 3%, or 5.7 bcm.

Sales of refined products increased by RR12,047 million, or 6%, to RR221,784 million in the six months ended June 30, 2007 compared to RR209,737 million in the six months ended June 30, 2006. The increase mainly relates to the sales of OAO Sibur Holding and its consolidated subsidiaries, which accounted for 27% and 24% of the total sales of refined products for the six months ended June 30, 2007 and 2006, respectively. Sales of refined products (net of excise tax, VAT and customs duties) accounted for 19% of our total sales (net of excise tax, VAT and customs duties) in the six months ended June 30, 2007 and 2006.

Sales of crude oil and gas condensate (net of excise tax, VAT and customs duties) decreased by RR20,476 million, or 21%, to RR74,994 million in the six months ended June 30, 2007 compared to RR95,470 million in the six months ended June 30, 2006. Sales of crude oil included in net sales of crude oil and gas condensate, amounted to RR64,866 million and RR85,493 million in the six months ended June 30, 2007 and 2006, respectively. The decrease mainly related to Gazprom Neft activities and was caused by the fact, that more oil was used to produce refined products.

Gas transportation sales increased by RR4,083 million, or 24%, to RR21,059 million in the six months ended June 30, 2007 from RR16,976 million in the six months ended June 30, 2006. This increase was due to an increase in both transportation tariffs and volumes of gas transported.

Other revenues increased by RR20,408 million, or 43%, to RR67,764 million in the six months ended June 30, 2007 compared to RR47,356 million in the six months ended June 30, 2006. Other revenues represent activities including media, construction works and sales of other services and goods, including electricity.

### Operating expenses

Operating expenses increased by 15% in the six months ended June 30, 2007 to RR792,215 million from RR686,425 million in the six months ended June 30, 2006. Operating expenses as a percentage of sales increased from 63% in the six months ended June 30, 2006 to 69% in the six months ended June 30, 2007. The table below presents a breakdown of operating expenses in each period:

(RR million)	Six months ended June 30	
	2007	2006
Purchased oil and gas	188,436	131,127
Staff costs	108,399	91,205
Taxes other than on income	98,074	99,120
Depreciation	93,024	80,524
Transit of gas, oil and refined products	77,063	83,827
Materials	45,554	37,682
Repairs and maintenance	40,507	34,341
Electricity and heating expenses	22,748	20,499
Cost of goods for resale, including refined products	21,178	25,852
Social expenses	6,981	8,081
Insurance expenses	5,673	5,079
Research and development	5,640	4,775
Charge for impairment provisions	2,778	6,118
Other	76,160	58,195
<b>Total operating expenses</b>	<b>792,215</b>	<b>686,425</b>

#### *Purchased oil and gas*

Cost of purchased oil and gas increased by 44% to RR188,436 million in the six months ended June 30, 2007 from RR131,127 million in the six months ended June 30, 2006. The increase primarily relates to the increase in prices of gas purchased in Middle Asia, mainly for further reselling. One of the major consumers of this gas is RosUkrEnergO AG. The cost of purchased oil included in the cost of purchased oil and gas amounted to RR34,905 million and RR38,571 million in the six months ended June 30, 2007 and 2006, respectively.

### *Staff costs*

Staff costs increased by 19% to RR108,399 million in the six months ended June 30, 2007 from RR91,205 million in the six months ended June 30, 2006. The increase mainly resulted from the growth of average base salaries and an increase in expenses associated with pension obligations.

### *Taxes other than on income*

Taxes other than on income consist of:

(RR million)	Six months ended June 30	
	2007	2006
Natural resources production tax	76,992	78,035
Property tax	10,639	10,657
Other taxes	<u>10,443</u>	<u>10,428</u>
<b>Taxes other than on income</b>	<b>98,074</b>	<b>99,120</b>

### *Depreciation*

Depreciation increased by 16% to RR93,024 million in the six months ended June 30, 2007 from RR80,524 million in the six months ended June 30, 2006. The increase primarily relates to the growth in our fixed asset base.

### *Transit of gas, oil and refined products*

Transit of gas, oil and refined products decreased by 8% to RR77,063 million in the six months ended June 30, 2007 from RR83,827 million in the six months ended June 30, 2006. This decrease mainly relates to the decrease in volumes of gas transported through Ukraine and Eastern Europe countries and depreciation of U.S. dollar against the RR in the first half 2007 compared to the respective period of 2006.

### *Materials*

Cost of materials increased by 21% to RR45,554 million in the six months ended June 30, 2007 from RR37,682 million in the six months ended June 30, 2006. The increase was primarily related to higher prices of materials and increased volumes of purchases by the Transport and Refining segments.

### *Repairs and maintenance*

Cost of repairs and maintenance increased by 18% to RR40,507 million in the six months ended June 30, 2007 from RR34,341 million in the six months ended June 30, 2006. The increase was primarily due to an increase in volume of repairs and maintenance services rendered by third party providers mainly in Transport segment.

### *Electricity and heating expenses*

Electricity and heating expenses increased by 11% to RR22,748 million in the six months ended June 30, 2007 from RR20,499 million in the six months ended June 30, 2006, mainly due to an increase in electricity consumption in certain Group entities and higher electricity tariffs, which are set by the FTS.

### *Cost of goods for resale, including refined products*

Cost of goods for resale, including refined products decreased by 18% to RR21,178 million in the six months ended June 30, 2007 from RR25,852 million in the six months ended June 30, 2006. The decrease is mostly due to decrease in cost of purchased refined products in Gazprom Neft.

### *Other operating expenses*

Other operating expenses increased by 31% to RR76,160 million in the six months ended June 30, 2007 from RR58,195 million in the six months ended June 30, 2006. Other operating expenses include bank charges, security services, legal and consulting services and advertising.

## **Operating profit**

As a result of the factors discussed above, our operating profit decreased by RR53,320 million, or 13%, from RR404,999 million in the six months ended June 30, 2006 to RR351,679 million in the six months ended June 30, 2007. Our operating profit margin decreased from 37% in the six months ended June 30, 2006 to 31% in the six months ended June 30, 2007.

## Deconsolidation of NPF Gazfund

In 1994, Gazprom founded the Non-State pension fund NPF Gazfund. Historically, Gazprom consolidated NPF Gazfund primarily due to the fact that Gazprom management exhibited control over the financial and investment decisions of NPF Gazfund. Gazprom used NPF Gazfund as the Group's primary investment vehicle for purchasing strategic investments and NPF Gazfund did not have any other significant operations or investments.

During the first quarter of 2007, there were changes in legislation relating to pension funds, specifically Regulation No. 63 dated 1 February 2007, which introduced stringent requirements on pension fund's investment policies and on the composition of investment portfolios. After evaluating and assessing the specific provisions of the new legal requirements, executive management met in March 2007 and decided to discontinue the use of Gazfund as the Group's primary investment vehicle.

Based on the new legislation and management's decisions, NPF Gazfund was deconsolidated from the consolidated financial information of OAO Gazprom in first quarter 2007. As a result of this deconsolidation, the Gazfund investment assets are now accounted for as plan assets on the OAO Gazprom consolidated interim condensed balance sheet under IAS 19. The principal balance sheet line items affected are short term financial assets, other non-current assets, provisions for liabilities and charges, minority interest and equity including treasury shares. In addition, where NPF Gazfund continues to hold ownership interests in OAO Gazprom subsidiaries (for example, AB Gazprombank (ZAO), OAO Sibur-Holding), those interests are reflected as minority interest in the accompanying financial information.

This transaction resulted in the recognition of income in the amount of RR44,692 million and increase in retained earnings in the amount of RR111,015 million due to recognition of fair value of the pension assets on the balance sheet of the Group.

## Finance income and expenses

(RR million)	Six months ended June 30	
	2007	2006
Exchange gain	23,943	44,702
Exchange loss	(15,900)	(16,639)
Interest income	38,274	16,612
Interest expense	(35,228)	(22,715)
Gain on and extinguishment of restructured liabilities	<u>1,012</u>	<u>531</u>
<b>Net finance income</b>	<b>12,101</b>	<b>22,491</b>

Exchange gain decreased by 46% to RR23,943 million in the six months ended June 30, 2007, compared to RR44,702 million in the six months ended June 30, 2006. Exchange loss decreased by 4% to RR15,900 million in the six months ended June 30, 2007 from RR16,639 million in the six months ended June 30, 2006. The changes reflect the impact of the 2.0% appreciation of the RR against the U.S. dollar (in which a major part of our borrowings is denominated) and the 0.1% depreciation of the RR against the euro in the six months ended June 30, 2007 compared to the 5.9% appreciation of the RR against the U.S. dollar and the 0.6% appreciation of the RR against euro in the six months ended June 30, 2006.

Interest income increased by 130% to RR38,274 million in the six months ended June 30, 2007 from RR16,612 million in the six months ended June 30, 2006 mainly due to an increase in loans issued by AB Gazprombank (ZAO) and bank current accounts. Interest expense increased by 55% from RR22,715 million in the six months ended June 30, 2006 to RR35,228 million in the six months ended June 30, 2007 mainly due to increased borrowings.

## Share of net income of associated undertakings and jointly controlled entities

Share of net income of associated undertakings and jointly controlled entities decreased by RR1,774 million, or 10%, to RR15,194 million in the six months ended June 30, 2007 compared to RR16,968 million in the six months ended June 30, 2006. The decrease was primarily due to decrease in our share of net profit in OAO NGK Slavneft for the six months ended June 30, 2007 compared to six months ended June 30, 2006.

## Profit tax

Total profit tax expense decreased by RR3,303 million, or 3%, to RR112,063 million in the six months ended June 30, 2007 compared to RR115,366 million in the six months ended June 30, 2006. Our effective profit tax rate in the

six months ended June 30, 2007 compared to the six months ended June 30, 2006 decreased from 26% to 25% due to the one-time recognition of non-taxable income related to the NPF Gazfund deconsolidation discussed above.

**Profit for the period attributable to equity holders of OAO Gazprom**

As a result of the factors discussed above, our profit for the period attributable to equity holders of OAO Gazprom decreased by RR8,311 million, or 3%, from RR321,491 million in the six months ended June 30, 2006 to RR313,180 million in the six months ended June 30, 2007.

**Profit for the period attributable to minority interest**

Minority interest increased by 57% to RR16,870 million in the six months ended June 30, 2007 compared to RR10,745 million in the six months ended June 30, 2006.

**LIQUIDITY AND CAPITAL RESOURCES**

The following table summarizes our statements of cash flows for the six months ended June 30, 2007 and 2006:

(RR million)	Six months ended June 30	
	2007	2006
Net cash provided by operating activities	712,698	244,255
Net cash used for investing activities	(433,485)	(137,118)
Net cash provided by (used for) financing activities	229,220	(84,604)

*Net cash provided by operating activities*

Net cash provided by operating activities amounted to RR712,698 million in the six months ended June 30, 2007 compared to RR244,255 million in the six months ended June 30, 2006. This was primarily due to working capital changes in AB Gazprombank (ZAO) in the amount of RR488,145 million.

*Net cash used for investing activities*

Net cash used for investing activities amounted to RR433,485 million in the six months ended June 30, 2007 compared to RR137,118 million in the six months ended June 30, 2006. The increase was primarily due to the acquisition of an interest in Sakhalin Energy Investment Company Ltd. and higher capital expenditures on field development and gas transportation infrastructure.

*Net cash provided by (used for) financing activities*

Net cash provided by financing activities amounted to RR229,220 million in the six months ended June 30, 2007 compared to net cash used for financing activities in the amount of RR84,604 million in the six months ended June 30, 2006. This change was primarily due to early repayment of a portion of the loan from Dresdner Bank AG, that was received to finance the purchase of Gazprom Neft in the six months ended June 30, 2006, and proceeds from new borrowings received in the six months ended June 30, 2007.

## CAPITAL EXPENDITURES

Total capital expenditures (excluding the effect of acquisitions of subsidiaries, investments in associates and reclassifications) by segment for the six months ended June 30, 2007 and 2006 in nominal RR terms, amounted to the following:

(RR million)	Six months ended June 30	
	2007	2006
Transport	78,841	79,186
Production of gas	68,544	37,720
Production of crude oil and gas condensate	26,548	20,452
Refining	15,698	7,068
Distribution	13,201	7,371
Other <sup>(1)</sup>	<u>4,896</u>	<u>4,894</u>
<b>Total</b>	<b>207,728</b>	<b>156,691</b>

Note:

(1) Primarily includes expenditures for construction and acquisition of non-production assets.

Total capital expenditures (excluding the effect of acquisitions of subsidiaries, investments in associates and reclassifications) increased by RR51,037 million, or 33%, from RR156,691 million in the six months ended June 30, 2006 to RR207,728 million in the six months ended June 30, 2007. The increase of our capital expenditures in the Production of gas segment was primarily due to increased capital expenditure on the construction of new wells and associated gas preparation units at Bovanenkovskoye, Kharasaveiskoye, Kharvutinskoye and Yuzhno-Russkoye fields.

## 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 RR229,576 million, or 28%, from RR807,814 million as of 31 December 2006 to RR578,238 million as of 30 June 2007. This decrease can be explained by a significant increase of our cash and cash equivalents in bank accounts primarily due to temporary placement of funds in AB Gazprombank (ZAO) from third parties.