Management’s discussion and analysis of financial condition and results of operations

The following report represents management’s discussion and analysis of the financial condition and results of operations of OAO LUKOIL as of December 31, 2006 and each of the years ended December 31, 2004, 2005 and 2006 and significant trends that may affect its future performance. It should be read in conjunction with our US GAAP consolidated financial statements and notes and supplemental oil and gas disclosure.

References to “LUKOIL”, “the Company”, “the Group”, “we” or “us” are references to OAO LUKOIL and its subsidiaries and equity affiliates. All dollar amounts are in millions of US dollars, unless otherwise indicated. Tonnes of crude oil produced are translated into barrels using conversion rates characterizing the density of oil from each of our oilfields. Tonnes of crude oil purchased as well as other operational indicators expressed in barrels are translated into barrels using an average conversion rate of 7.33. Millions of cubic meters are translated into thousand barrels of oil equivalent (“BOE”) using a conversion rate of 5.89 and millions of cubic feet into thousand barrels of oil equivalent using a conversion rate of 0.167.

This report includes forward-looking statements – words such as “believes”, “anticipates”, “expects”, “estimates”, “intends”, “plans”, etc. - that reflect management’s current estimates and beliefs, but are not guarantees of future results. Please see “Forward-looking statement” on page 40 for a discussion of some of the factors that could cause actual results to differ materially.

Key financial and operational results

	2006	Change to 2005, %	2005	Change to 2004, %	2004
Sales (millions of US dollars)	67,684	21.4	55,774	64.8	33,845
Net Income (millions of US dollars)	7,484	16.2	6,443	51.7	4,248
EBITDA (millions of US dollars)	12,299	18.2	10,404	44.4	7,203
Earnings per share of common stock (US dollars)					
Basic earnings (US dollars)	9.06	14.5	7.91	52.1	5.20
Diluted earnings (US dollars)	9.04	16.0	7.79	51.9	5.13
Hydrocarbon production by the Group including our share in equity affiliates (thousands of BOE)	783,194	12.3	697,429	4.9	665,024
Crude oil production by the Group including our share in equity affiliates (thousands of tonnes)	95,235	5.6	90,158	4.6	86,200
Gas available for sale produced by the Group including our share in equity affiliates (millions of cubic meters)	13,612	141.6	5,635	14.4	4,924
Refined products produced by our subsidiaries (thousands of tonnes)	45,670	3.4	44,182	8.2	40,825
Hydrocarbon proved reserves including our share in equity affiliates (millions of BOE)	20,360	0.1	20,330	1.3	20,072

During 2006 our net income was $7,484 million, which is $1,041 million, or 16.2%, more than in 2005. The improvement of our performance resulted from favorable price conditions, increased refining margins, production and refining volumes. However, the growth of our net income was bounded by the growth of taxes linked to international crude oil price. This restraining factor, as well as other drivers impacting the results of our operations, are considered below in detail.

Segment information

Our operations are divided into three main business segments:

- **Exploration and Production** – which includes our exploration, development and production operations relating to crude oil and natural gas. These activities are primarily located within Russia, with additional activities in Azerbaijan, Kazakhstan, Uzbekistan, the Middle East, Colombia, and Northern and Western Africa

- **Refining, Marketing and Distribution** – which includes refining and transport operations, marketing and trading of crude oil, natural gas and refined products

- **Chemicals** – which includes processing and trading of petrochemical products

Other businesses include banking, finance and other activities. Each of our three main segments is dependent on the other, with a portion of the revenues of one segment being a part of the costs of the other. In particular, our Refining, Marketing and Distribution segment purchases crude oil from our Exploration and Production segment. As a result of certain factors considered in the "Domestic crude oil and refined products prices" section on page 8, benchmarking crude oil market prices in Russia cannot be determined with certainty. Therefore, the prices set for inter-segment purchases of crude oil reflect a combination of market factors, primarily international crude oil market prices, transportation costs, regional market conditions, the cost of refining crude oil and other factors. Accordingly, an analysis of either of these segments on a stand-alone basis could give a misleading impression of those segments' underlying financial position and results of operations. For this reason, we do not analyze either of our main segments separately in the discussion that follows. However we present the financial data for each in Note 23 "Segment information" to our consolidated financial statements.

Executive overview

Recent developments and outlook

In 2006, our Board of Directors approved the Company's development strategy where we set out targets for 2007-2016 years. According to this development strategy we plan to increase hydrocarbon production by up to 6.7% per year during this period, which would represent up to 4 million BOE of hydrocarbon production per day by 2016. Also we plan to increase our refining capacity up to 100 million tonnes per year by 2016.

The following has been achieved in 2006 and 2005:

- The Company aims to respond to changing market conditions on a timely basis. In 2006, our refined products exports and international sales increased by 14.2% in terms of volumes compared to 2005. As a result in 2006 we earned additional revenue from increased refining margins. The increase in refined product sales in 2006 led to a decrease of export and international sales of crude oil by 10.7%

- 11 new oil fields were brought on line in 2006 (2005: 8 oil fields and 1 gas field)

- 332 low production wells were shut in 2006 (2005: 425). Average production per well (well debits) increased to 11.20 tonnes a day in 2006, or by 1.2%, compared to 2005

Other achievements in 2006 are described in detail in other parts of this report.

Changes in the Group structure and acquisition of assets

In December 2006, the Company entered into an agreement with its related party ConocoPhillips to purchase 376 petrol stations in six countries in Europe. The agreement is expected to be finalized in the second quarter of 2007.

In December 2006, the Group sold its 100% stakes in LUKOIL Shelf Limited and LUKOIL Overseas Orient Limited, which owned and operated the Astra jack-up rig for approximately $40 million.

In June 2006, the Group acquired 41.81% of the share capital of OAO Udmurtnefteproduct for $25 million. OAO Udmurtnefteproduct is a Russian refined product distribution company, operating more than 100 petrol stations in the Udmurt Republic of the Russian Federation.

In June 2006, a Group company acquired 100% of the share capital of Khanty-Mansiysk Oil Corporation ("KMOC") from Marathon Oil Corporation for $847 million (including $249 million repayment of KMOC debt), which is subject to finalization of working capital and other adjustments in accordance with the purchase agreement. KMOC owns approximately 95% of the share capital of OAO Khantymansiyskneftegazgeologia and 100% of the share capital of OAO Paitykh Oil and OAO Nazymgeodobycha ("KMOC subsidiaries"). KMOC's subsidiaries operate oil and gas fields in the West Siberian region of the Russian Federation.

At the end of May 2006, the Group sold its remaining interest in OAO Bank Petrocommerce for $33 million.

In December 2005, the Company made a decision to sell ten tankers. A Group company finalized the sale of eight tankers in May 2006 for a price that approximated their carrying value of $190 million. As of December 31, 2005, the Group classified these tankers as assets held for sale in the consolidated balance sheet. The sale of the remaining two tankers is expected to be finalized in July 2007 for a price that approximates their carrying value of $75 million. As of December 31, 2006, the Group classified these tankers as assets held for sale in the consolidated balance sheet.

During the period from November to December 2005, a Group company acquired 51% of the share capital of OAO Primorieneftegaz for $261 million. OAO Primorieneftegaz is a Russian oil and gas exploration company operating in European Russia. Subsequently, in May 2006, a Group company acquired the remaining 49% of the share capital of OAO Primorieneftegaz for 4.165 million shares of common stock of the Company (at a market value of approximately $314 million), thereby increasing the Group's ownership stake in OAO Primorieneftegaz to 100%.

During the period from October 14 to December 5, 2005 a Group company acquired 100% of the share capital of Nelson Resources Limited ("Nelson") for $1,951 million. Nelson is an exploration and production company operating in western Kazakhstan. Nelson owns an effective 76% interest in the Karakuduk field, 50% interest in Alibekmola, Kozhasai, North Buzachi and Arman fields. In addition, Nelson holds an option to acquire a 25% interest in two exploration blocks in the Kazakhstan sector of the Caspian Sea – South Zhambai and South Zaburunye. In September 2006, a Group company acquired the remaining 40% of share capital of Chaparral Resources Inc. (owner of 60% interest in the Karakuduk field) for $89 million. This acquisition increased the Group's ownership stake in Chaparral Resources Inc. and effective interest in the Karakuduk field to 100%.

In November 2006, a Group company entered into an agreement with Mittal Investments S.A.R.L. to sell 50% of its interest in a Group's wholly owned subsidiary, Caspian Investment Resources Ltd. (Caspian, formerly Nelson), for $980 million. The transaction is expected to be finalized in the second quarter of 2007. In accordance with the agreement, Mittal Investments S.A.R.L. agreed to assume a liability in the amount of approximately $160 million, which represents 50% of Caspian outstanding debt to Group companies.

In November 2005, a Group company acquired the remaining 50% of the share capital of ZAO SeverTEK for $318 million from Neste Oil Corporation (including $98 million repayment of ZAO SeverTEK long-term debt). The acquisition increased the Group's ownership stake in ZAO SeverTEK to 100%. ZAO SeverTEK is an exploration and production company operating within the Komi Republic of the Russian Federation.

In July 2005, a Group company acquired 66.0% of the share capital of OOO Geoilbent for $180 million. OOO Geoilbent is an exploration and production company operating in the West Siberian region of the Russian Federation. All decisions over OOO Geoilbent's financing and operating activities required approval by at least a 66.7% majority of the voting rights. Since the minority shareholder of OOO Geoilbent held substantive participating rights, the Group accounted for its investment in OOO Geoilbent using the equity method of accounting. In January 2007, a Group company acquired the remaining 34% of share capital for $300 million, thereby increasing the Group's ownership stake in OOO Geoilbent to 100%.

In March 2005, we acquired 100% interests in Oy Teboil Ab and Suomen Petrooli Oy, which are incorporated in Finland, for $160 million. Oy Teboil Ab and Suomen Petrooli Oy are mainly engaged in the operation of 289 retail petrol stations and 132 retail diesel fuel outlets, wholesale of refined oil products as well as production and sale of lubricants.

Resource base

Maintaining a stable oil and gas resource base together with providing a high reserve replacement ratio are key elements of our long-term strategy. Following our strategy we increased proved hydrocarbon reserves including our share in equity affiliates from 20,330 in 2005 to 20,360 million BOE in 2006. The table below summarizes the net oil-equivalent proved reserves of consolidated subsidiaries and our share in equity affiliates:

(millions of BOE)	December 31, 2006	Changes in 2006			December 31, 2005
		Production*	Extensions, discoveries and acquisitions	Revision of previous estimates	
Western Siberia	11,234	(512)	393	98	11,255
Komi Republic	2,314	(90)	44	(165)	2,525
Ural region	2,215	(85)	24	5	2,271
Volga region	1,702	(28)	324	(26)	1,432
Northern Timan-Pechora	1,300	(13)	23	(47)	1,337
Other in Russia	245	(15)	11	(6)	255
Outside Russia	1,350	(54)	15	134	1,255
Proved oil and gas reserves	**20,360**	**(797)**	**834**	**(7)**	**20,330**
Probable oil and gas reserves	**12,340**				**12,300**
Possible oil and gas reserves	**6,022**				**6,043**

* Gas production shown before own consumption.

The revision of previous estimates in 2006 is represented by combination of two opposing factors, which partly offset each other.

One factor related to a change in the crude oil extraction tax legislation. Management's estimate of economic conditions underlying our reserves calculation as of December 31, 2005 was based on a 16.5% flat rate crude oil extraction tax, which we expected to be effective from January 1, 2007 according to legislation in effect when our management estimated the relevant economic conditions at that date. In 2006, the Russian government determined the methodology for calculating the crude oil extraction tax rate effective from January 1, 2007, which resulted in a higher extraction tax rate than management expected when estimating the relevant economic conditions (for details see page 10). These changes in underlying economic conditions resulted in a negative revision of crude oil reserves.

The second factor related to an increase of our proved gas reserves resulted from change in the approach for estimating gas reserves. Beginning from January 1, 2007, gas reserves include gas extracted and used for own consumption.

The acquisition of KMOC in 2006 added 226 million BOE to our proved crude oil reserves.

Operational highlights

Hydrocarbon production

	2006	Change to 2005, %	2005	Change to 2004, %	2004
Daily production of hydrocarbons, including Company's share in equity affiliates (thousand BOE per day)	2,145	12.2	1,911	5.2	1,817
- crude oil	1,926	5.8	1,820	4.7	1,738
- natural and petroleum gas*	219	141.6	91	14.8	79
Hydrocarbon extraction expenses (US dollar per BOE)	3.08	15.8	2.66	8.1	2.46

* Gas available for sale (excluding gas produced for our own consumption).

Crude oil production. In 2006 we increased our total daily crude oil production by 5.8% compared to 2005 (including the Company's share in equity affiliates) and produced 703.1 million barrels, or 95.2 million tonnes.

The following table represents our production in 2006 and 2005 by major regions.

(thousands of tonnes)	2006	Change to 2005 Total, %	Change in structure	Organic growth	2005
Western Siberia	58,414	1.9	1,233	(164)	57,345
Komi Republic	11,732	16.8	1,298	388	10,046
Ural region	10,854	6.1	–	620	10,234
Volga region	3,001	–	–	–	3,001
Northern Timan-Pechora	1,870	7.5	(35)	166	1,739
Other in Russia	2,059	13.4	(16)	260	1,815
Crude oil production in Russia	87,930	4.5	2,480	1,270	84,180
Crude oil produced internationally	3,607	79.2	1,416	178	2,013
Total crude oil produced by consolidated subsidiaries	**91,537**	**6.2**	**3,896**	**1,448**	**86,193**
Our share in crude oil production of equity affiliates:					
in Russia	1,631	(22.2)	(587)	121	2,097
outside Russia	2,067	10.7	–	199	1,868
Total crude oil production	**95,235**	**5.6**	**3,309**	**1,768**	**90,158**

The main oil producing region of the Company is Western Siberia. In the oil fields of Western Siberia the Company produced 63.8% of its crude oil in 2006 (66.5% in 2005). Significant growth of production in the Komi Republic (16.8% in 2006 compared to 2005) made it the second largest oil producing region for us. In order to maintain stable organic growth of oil production in traditional producing regions we constantly improve and optimize our oil production methods. As a result, our average production per well in the Russian Federation increased from 11.07 tonnes a day in 2005 to 11.20 tonnes a day in 2006. The organic decline of crude oil production in Western Siberia was compensated by an increase of production due to structural changes, namely acquisition of the remaining interest in ZAO SeverTEK and an increase in our share in ZAO Tursunt in late 2005, which are exploration and production companies operating within the Komi Republic and Western Siberia, respectively. Before 2006, the crude oil production of these companies was accounted for using equity method. Also, in June 2006 we acquired KMOC, which subsidiaries produced 901 thousand tonnes of crude oil in June-December. The structural growth in international production was attributable to the acquisition of Nelson in October-December of 2005.

In addition to our production, we purchase crude oil in Russia and on international markets. In Russia we primarily purchase crude oil from affiliated producing companies and other producers, including vertically integrated oil companies that lack refining capacity or are unable to export their crude oil. Then we may either refine or export purchased crude oil. Crude oil purchased on international markets is used for trading activities, for supplying our overseas refineries or for processing at third parties refineries. During 2006 we purchased 2,293 thousand tonnes in order to process at our and at third parties' refineries compared to 5,954 thousand tonnes during 2005. The decrease was primarily due to the temporary shutdown of the Odessa refinery for a wide-scale upgrade.

	2006		2005		2004	
	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)
Crude oil purchases in Russia	13,561	1,850	10,760	1,468	20,810	2,839
Crude oil purchases internationally	37,390	5,101	69,122	9,430	64,695	8,826
Total crude oil purchased	**50,951**	**6,951**	**79,882**	**10,898**	**85,505**	**11,665**

The volume of crude oil purchased in Russia in 2006 was 382 thousand tonnes more than in 2005 as a result of an increase in purchases from our equity affiliates. This trend reflects structural changes in the Group: crude oil purchases in 2006 include transactions with OOO Geoilbent, our equity affiliate acquired in July 2005. In January 2007, a Group company acquired the remaining 34% of OOO Geoilbent, thereby increasing the Group's ownership stake in OOO Geoilbent to 100%. The volume of crude oil purchased internationally during 2006 decreased by 4,329 thousand tonnes compared to 2005, which was the result of a decrease of crude oil refining at our overseas refineries and shift of our trading activity to refined products.

Gas production. In 2006 we produced 13,612 million cubic meters of gas available for sale (including our share in equity affiliates), an increase of 141.6% compared to 2005. This increase resulted from an increase in production from the Nakhodkinskoe gas field, which totaled 8,348 million cubic meters of natural gas in 2006. We started production on the Nakhodkinskoe gas field in April 2005. This is the first stage of development of the Bolshekhetskaya basin fields in the Yamalo-Nenetsky Autonomous District. The field's planned production capacity of 10 billion cubic meters per year is expected to be achieved in 2007. In order to ensure continuous supply of the natural gas from the Nakhodkinskoe gas field to market, in October 2003, we signed an agreement with OAO Gazprom. In accordance with the agreement OAO Gazprom undertakes to purchase the gas at the Yamburg Compressor Plant and to transport it through the Russian Unified Gas Supply System. In September 2006, we entered into an additional agreement with OAO Gazprom, under which OAO Gazprom undertakes to purchase 8 billion cubic meters of gas annually at a price of 1,059 rubles per 1,000 cubic meters.

Refining, marketing and trading

We operate four refineries located in European Russia and three refineries located overseas – in Bulgaria, Ukraine and Romania. In August 2005 we closed the Odessa refinery to commence a wide-scale upgrade. We plan to complete the first stage of the upgrade and to put the Odessa refinery back into operation in the fourth quarter of 2007 with an annual capacity of 2.8 million tonnes. The second stage is expected to be finished in 2008.

Production of refined products at our refineries in 2006 increased by 3.4% as compared to 2005. Russian refineries increased production by 6.1%. The production of overseas refineries decreased by 7.7% as a result of the temporary shutdown of the Odessa refinery.

In late 2004 we began changing the refined products mix at our refineries in order to produce higher quality and more profitable products. In particular, in 2006 we produced 6,542 thousand tonnes of Euro 4 and Euro 5 diesel fuel at our Russian refineries (in 2005 – 4,671 thousand tonnes), and 548 thousand tonnes of Euro 3 gasoline (in 2005 – nil).

Along with our own production of refined products we refined crude oil at third party refineries. In Russia we refined 3,289 thousand tonnes of crude oil at third party refineries during 2006, primarily to supply our network in the Ural region (in 2005 – 1,634 thousand tonnes). To supply our retail networks in Eastern Europe we refined 1,698 thousand tonnes of crude oil at third party refineries in Belorussia and Serbia in 2006 (in 2005 – 1,213 thousand tonnes).

Our marketing and trading activities mainly include wholesale and bunkering operations in Western Europe and South-East Asia and Central America and retail operations in the USA, Baltic states and some other regions. In 2006, we continued to expand these activities in Western Europe, South-East Asia, Northern and Central America. As a result of this expansion, the total volume of refined products purchased from third parties for wholesale and to supply retail networks increased to 35,928 thousand tonnes or $19,413 million in 2006 (32,225 thousand tonnes or $15,021 million in 2005).

In Russia we purchase refined products on occasion, primarily to manage supply chain bottlenecks.

The following table represents volumes of refinery throughput, refined products produced and purchased.

	2006	2005	2004
	(thousand barrels per day)		
Own refinery throughput	978	945	869
	(thousand of tonnes)		
Refined products produced at the Group refineries in Russia*	37,459	35,290	33,438
Refined products produced at the Group refineries outside Russia	8,211	8,892	7,387
Total refined products produced at the Group refineries	**45,670**	**44,182**	**40,825**
Refined products purchased in Russia	919	1,394	2,020
Refined products purchased internationally	36,034	32,238	20,507
Total refined products purchased	**36,953**	**33,632**	**22,527**

* Excluding production of mini refineries.

Exports of crude oil and refined products from Russia

During 2006, the Company exported from Russia 50.2% of its total domestic crude oil production (in 2005 – 54.4%). 3.0% of crude oil produced was exported bypassing Transneft (in 2005 – 8.7%). During 2006, we decreased the volume of crude oil exported from Russia by 1,684 thousand tonnes, or by 3.7%, compared to 2005 in order to obtain benefits from increased refined products prices in Russia and on international markets and due to a higher level of export tariffs on crude oil compared to on refined products.

The volumes of crude oil exported from Russia by our subsidiaries are summarized as follows:

	2006		2005		2004	
	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)
Exports of crude oil using Transneft export routes	304,034	41,478	282,418	38,529	285,204	38,909
Exports of crude oil bypassing Transneft	19,461	2,655	53,421	7,288	54,161	7,389
Total crude oil exports	**323,495**	**44,133**	**335,839**	**45,817**	**339,365**	**46,298**

The crude oil exported through our own export infrastructure was 2,149 thousand tonnes in 2006, compared to 3,755 thousand tonnes in 2005. The decrease in crude oil exported through our own terminals occurred because we stopped exporting crude oil through the Vysotsk terminal in the third quarter of 2005 due to increased capacity of the Baltic Pipeline System owned and operated by Transneft. As a result, the volume of crude oil exported via the Primorsk terminal in 2006 increased up to 13,662 thousand tonnes, or 3,949 thousand tonnes more than in 2005.

Currently we use the Vysotsk terminal to export refined products: in 2006 we exported 8,423 thousand tonnes of refined products through this terminal (in 2005 – 5,065 thousand tonnes). In September 2006, we completed the construction of the Vysotsk terminal and expanded its capacity up to 11.6 million tonnes per year and total reservoir volume up to 460 thousand cubic meters. In the future we expect to use the terminal to export both crude oil and refined products, depending on market conditions.

In 2006, we exported from Russia 20.5 million tonnes of refined products, an increase of 23.5% compared to 2005. We export from Russia primarily diesel fuel, fuel oil and gasoil. These products account for approximately 86% of our refined products export volumes.

Main macroeconomic factors affecting our results of operation

Change in the price of crude oil and refined products

The price at which we sell crude oil and refined products is the primary driver of our revenues. During 2006, the Brent crude oil price fluctuated between $55 and $79 per barrel. In January–August of 2006, crude oil prices have been changing cyclically, with an upward trend driven mainly by political instability in major oil producing regions (Middle East and West Africa) and growth of the world economy, driven mainly by China. Just after reaching historical price maximum of $78.69 per barrel, the oil market experienced a rapid price correction, caused by a combination of fundamental factors (mostly excessive supply) and weakening of speculative factors. OPEC concerns on falling prices led to its intention to cut crude output, which kept crude oil prices from declining further. However, warm weather in the Northern hemisphere led to a decline of the Brent price down to $59 per barrel in the end of 2006. Based on OPEC data, its actual daily production in 2006 was 29.6 million barrels per day, or 1.5% less than in 2005. According to the International Energy Agency (IEA), in 2006 the world demand for crude oil and, subsequently, refined products increased by 0.9% compared to 2005, averaging 84.4 million barrels per day. It should be noted that OPEC has an obvious intention to maintain the price above $50 per barrel (which is the weighted average price in the budgets of OPEC countries). This situation can be viewed as an indicator that crude oil prices may remain relatively high in the medium-term.

Substantially all of the crude oil that we export is Urals blend. The following table shows the average crude oil and refined product prices for 2006, 2005 and 2004.

	2006	Change to 2005, %	2005	Change to 2004, %	2004
	(in US dollars per barrel, except for figures in percent)				
Brent crude	65.16	20.0	54.31	41.9	38.27
Urals crude (CIF Mediterranean)*	61.37	21.1	50.67	46.9	34.50
Urals crude (CIF Rotterdam)*	61.23	22.2	50.12	46.9	34.13
	(in US dollars per metric tonne, except for figures in percent)				
Fuel oil 3.5% (FOB Rotterdam)	286.91	24.8	229.92	51.4	151.81
Diesel fuel (FOB Rotterdam)	577.92	14.4	505.01	44.5	349.37
High-octane gasoline (FOB Rotterdam)	619.29	15.9	534.11	33.4	400.33

Source: Platts.

* The Company sells crude oil on foreign markets on various delivery terms. Thus, our average realized sale price of oil on international markets differs from the average prices of Urals blend on Mediterranean and Northern Europe markets.

Domestic crude oil and refined products prices

Substantially all crude oil produced in Russia is produced by vertically integrated oil companies such as ours. As a result, most transactions are between affiliated entities within vertically integrated groups. Thus, there is no concept of a benchmark domestic market price for crude oil. The price of crude oil that is produced but not refined or exported by one of the vertically integrated oil companies is generally determined on a transaction-by-transaction basis against a background of world market prices, but with no direct reference or correlation. At any time there may exist significant price differences between regions for similar quality crude oil as a result of the competition and economic conditions in those regions.

Domestic prices for refined products are determined to some extent by world market prices, but they are also directly affected by local demand and competition.

The table below represents average domestic wholesale prices of refined products in 2006, 2005 and 2004.

	2006	Change from 2005, %	2005	Change from 2004, %	2004
	(in US dollars per metric tonne, except for figures in percent)				
Fuel oil	175.07	42.9	122.54	73.1	70.78
Diesel fuel	473.44	12.8	419.74	47.4	284.75
High-octane gasoline (Regular)	559.11	14.9	486.71	27.3	382.19
High-octane gasoline (Premium)	617.41	15.9	532.52	25.7	423.60

Source: Kortes (excluding VAT).

Changes in the US dollar-ruble exchange rate and inflation

A substantial part of our revenues is either denominated in US dollars or is correlated to some extent with US dollar crude oil prices, while most of our costs in the Russian Federation are settled in Russian rubles. Therefore, ruble inflation and movements of exchange rates can significantly affect the results of our operations. In particular, our operating margins are generally adversely affected by the real appreciation of the ruble against the US dollar because this will generally cause our costs to increase in US dollar terms relative to our revenues.

The following table gives data on inflation in Russia, the change in the ruble-dollar exchange rate, and the level of real ruble appreciation.

	2006	2005	2004
Ruble inflation (CPI), %	9.1	10.9	11.7
Change of the ruble-dollar exchange rate, %	8.5	(3.7)	5.8
Real appreciation of the ruble against the US dollar*, %	19.3	6.9	18.5
Average exchange rate for the period (ruble to US dollar)	27.19	28.29	28.82
Exchange rate at the end of the period (ruble to US dollar)	26.33	28.78	27.75

* Devaluation of purchasing power of the US dollar in the Russian Federation calculated on basis of the ruble-dollar exchange rates and the level of inflation in Russia.

Tax burden

Given the relative size of our activities in Russia, our tax profile is largely determined by the taxes payable in Russia (based on records maintained under Russian legislation – not US GAAP). For 2006, 2005 and 2004, the tax charge on the Russian part of our operations was more than 80% of our total tax charge.

In addition to income taxes, we are subject to a number of other taxes in Russia, many of which are based on revenue or volumetric measures. Other taxes to which we are subject include:

- mineral extraction tax
- excise and export tariffs
- property tax
- social taxes
- VAT
- other local and regional taxes

The effective rates of total taxes and tariffs (total taxes, including income taxes, taxes other than on income and excise and export tariffs, divided by income before taxes and tariffs) for 2006, 2005 and 2004, respectively, were 77%, 74% and 71%. In 2006, tax expenses in Russia were about 55% of the domestic sales revenue of Russian companies of the Group and export sales.

The measures that we use for tax planning and management strategies have been based on our understanding of tax legislation existing at the time of implementation of these measures. We are subject to tax authority audits on an ongoing basis, as is normal in the Russian environment, and, at times, the authorities have attempted to impose significant additional taxes on us. We believe that we have adequately met and provided for tax liabilities based on our interpretation of existing tax legislation. However, the relevant authorities may have differing interpretations and the effects could be significant. In 2005, the Group recognized an expense of $163 million in relation to the results of tax audits of the Group companies for periods prior to the 2004 financial year.

The following table represents average enacted rates for taxes specific to the oil industry in Russia for the respective periods.

		2006*	Change to 2005, %	2005*	Change to 2004, %	2004*
Export tariffs on crude oil	$/tonne	197.01	50.8	130.62	134.2	55.77
Export tariffs on refined products						
Light distillates (gasoline), middle distillates (jet fuel), diesel fuel and gasoils	$/tonne	143.40	55.4	92.26	143.2	37.93
Liquid fuels (fuel oil)	$/tonne	77.27	46.5	52.73	43.9	36.64
Excise on refined products						
High-octane gasoline	RUR/tonne	3,629.00	–	3,629.00	8.0	3,360.00
Low-octane gasoline	RUR/tonne	2,657.00	–	2,657.00	8.0	2,460.00
Diesel fuel	RUR/tonne	1,080.00	–	1,080.00	8.0	1,000.00
Motor oils	RUR/tonne	2,951.00	–	2,951.00	8.0	2,732.00
Mineral extraction tax						
Crude oil	RUR/tonne	2,265.69	20.8	1,876.26	78.2	1,052.76
Natural gas	RUR/1,000 m^3	147.00	8.9	135.00	26.2	107.00

* Average values.

Tax rates set in rubles and translated at the average exchange rates for the respective periods are as follows:

		2006*	Change to 2005, %	2005*	Change to 2004, %	2004*
Excise on refined products						
High-octane gasoline	USD/tonne	133.49	4.1	128.29	10.0	116.59
Low-octane gasoline	USD/tonne	97.74	4.1	93.93	10.0	85.36
Diesel fuel	USD/tonne	39.73	4.1	38.18	10.0	34.70
Motor oils	USD/tonne	108.55	4.1	104.33	10.0	94.80
Mineral extraction tax						
Crude oil	USD/tonne	83.34	25.7	66.32	81.5	36.53
Natural gas	USD/1,000 m^3	5.41	13.4	4.77	28.6	3.71

* Average values.

During 2006, the tax rates specific to the oil industry in Russia rose significantly compared to the previous year. These increases primarily resulted from the growth of the Urals crude oil price. The methods to determine the rates for such taxes are presented below. Excise taxes on refined products in Russia remained at the same level as in 2005.

Crude oil extraction tax rate. Effective from January 1, 2005, the base rate is 419 rubles per metric tonne extracted and is adjusted depending on the international market price of Urals blend and the ruble exchange rate. The tax rate is zero when the average Urals blend international market price for a tax period is less than or equal to $9.00 per barrel. Each $1.00 per barrel increase in the international Urals blend price over the threshold ($9.00 per barrel) results in an increase of the tax rate by $1.61 per tonne extracted (or $0.22 per barrel extracted using a conversion factor of 7.33). This method of determining the crude oil extraction tax was applied until December 31, 2006.

Effective from January 1, 2007, the crude oil extraction tax rate varies depending on the development and depletion of a particular oil field. The tax rate is zero for extra-heavy crude oil and for crude oil produced in certain regions of Eastern Siberia, depending on the period and volume of production. For crude oil produced in other regions the tax rate calculation described above should be multiplied by a coefficient characterizing the depletion of a particular oil field. The coefficient is equal to 1.0 for the oil fields with depletion below 80%. Each 1% increase of depletion of a particular oil field above 80% results in a decrease of the coefficient by 0.035. The minimum value of the coefficient is 0.3. The depletion level assessment is based on crude oil production and reserves information reported to the Russian government.

Natural gas extraction tax rate. Mineral extraction tax on natural gas production is calculated using a flat rate. From time to time Russian legislative authorities amend the tax rate. The current rate of 147 rubles per thousand of cubic meters of natural gas extracted has been effective since January 1, 2006.

Crude oil export duty rate is calculated on a three-layer progressive scale. The rate is zero when the average Urals blend international market price is less than or equal to approximately $15.00 per barrel ($109.50 per metric tonne). If the Urals blend price is in a layer between $15.00 and $20.00 per barrel ($146.00 per metric tonne), each $1.00 per barrel increase in the Urals blend price over the layer's lower bound results in an increase of the crude oil export duty rate by $0.35 per barrel exported. If the Urals blend price is in a layer between $20.00 and $25.00 per barrel ($182.50 per metric tonne), each $1.00 per barrel increase in the Urals blend price over the layer's lower bound results in an increase of the crude oil export duty rate by $0.45 per barrel exported. Each $1.00 dollar per barrel increase in the Urals blend price over $25.00 per barrel results in an increase of the crude oil export duty rate by $0.65 per barrel exported. Export duty rates are set by the Russian Government with regard to the average Urals blend price on international crude oil markets (Mediterranean and Rotterdam) during the latest monitoring period and are effective from the first date of the second calendar month following the monitoring period. Each monitoring period consists of two calendar months starting from November 1, 2001.

Thus, the calculation method for the crude oil export duty rate results in a two-month gap between movements in crude prices and amendment of export duty rate.

Export duty rates on refined products are set by the Russian government. The rate of export duty depends on internal demand for refined products and international crude oil market conditions.

Crude oil and refined products exported to CIS countries, other than Ukraine, are not subject to export duties. On January 1, 2007, customs regulations between Russia and Belorussia were changed. Crude oil exported from Russia to Belorussia is now subject to export duties. The latest amendments made by customs authorities set a coefficient of 0.293 to be applied from February 1, 2007 to the regular export duty rate set by the Russian Government for calculation of export duty on crude oil exports from Russia to Belorussia.

Transportation of crude oil and refined products in Russia

The main Russian crude oil production regions are remote from the main crude oil and refined products markets. Therefore, access of crude oil production companies to the markets is dependent on the extent of diversification of transport infrastructure and access to it. As a result, transportation cost is an important macroeconomic factor affecting our net income.

Transportation of crude oil produced in Russia to refineries and export destinations is performed primarily through the trunk oil pipeline system of state-owned OAO AK Transneft ("Transneft"). Access to the Transneft crude oil export pipeline network is allocated quarterly, based on recent volumes produced and delivered through the pipeline and proposed export destinations. There is a constraint on the ability of Russian companies to export their crude oil due to the limited capacity of Russian transportation infrastructure on the most profitable export routes. Moreover, the crude oil transported by Transneft is Urals blend – a mix of crude oils of various qualities, therefore Russian companies, which produce crude oil of a higher quality, can not obtain benefits from selling it using Transneft's pipeline. Alternative access to international markets bypassing Transneft export routes can be obtained through railroad transport, by tankers, and our own export infrastructure. Our own export infrastructure includes the Vysotsk terminal in the Leningrad region, the Varandey terminal in the Nenetsky Autonomous District and the Izhevskoye terminal in the Kaliningrad region.

Transportation of refined products in Russia is performed by railway transport and pipeline system of OAO AK Transnefteproduct. Russian railway infrastructure owned and operated by OAO Russian Railways. OAO Russian Railways and OAO AK Transnefteproduct are state-owned companies. Besides transportation of refined products OAO Russian Railways provides oil companies with crude oil transportation services. We transport the major part of our refined products by railway transport.

As the activities of the above mentioned companies fall under the scope of natural monopolies, the fundamentals of their tariff policies are defined by the state authorities to ensure the balance of interests of the state and all participants in the transportation process. Transportation tariffs of natural monopolies are set by the Federal Service for Tariffs of the Russian Federation ("FST"). The tariffs are dependent on transport destination, delivery volume, distance of transportation, and several other factors. Changes in the tariffs depend on inflation forecasts by the Ministry of Economic Development and Trade of the Russian Federation, the investment needs of owners of transport infrastructure, other macroeconomic factors, and compensation of economically reasonable expenses, incurred by entities of natural monopolies. Tariffs are to be revised by FST at least annually.

According to the Federal Statistics Service of the Russian Federation, during 2006 transportation tariffs increased as follows: transportation of crude oil by pipeline – 8.0%, transportation of refined products by pipeline – 4.1%, transportation by railway – 8.9%. These amounts differ from actual changes in tariffs for transportation of crude oil and refined products by the Group for the period considered due to the specifics in the routes and geography of our supplies from the Russian transportation averages.

Year ended December 31, 2006 compared to year ended December 31, 2005

Results of operations

The table below details certain income and expense items from our consolidated statements of income for the periods indicated.

	2006	2005	Change, %
	(millions of US dollars)		
Revenues			
Sales (including excise and export tariffs)	67,684	55,774	21.4
Equity share in income of affiliates	425	441	(3.6)
Total revenues	**68,109**	**56,215**	**21.2**
Costs and other deductions			
Operating expenses	(4,657)	(3,487)	33.6
Cost of purchased crude oil, petroleum and chemical products	(22,374)	(19,398)	15.3
Transportation expenses	(3,863)	(3,519)	9.8
Selling, general and administrative expenses	(2,885)	(2,578)	11.9
Depreciation, depletion and amortization	(1,851)	(1,315)	40.8
Taxes other than income taxes	(8,075)	(6,334)	27.5
Excise and export tariffs	(13,570)	(9,931)	36.6
Exploration expense	(209)	(317)	(34.1)
(Loss) gain on disposals and impairments of assets	(148)	52	–
Income from operating activities	**10,477**	**9,388**	**11.6**
Interest expense	(302)	(275)	9.8
Interest and dividend income	111	96	15.6
Currency translation gain (loss)	169	(134)	–
Other non-operating expense	(118)	(44)	168.2
Minority interest	(80)	(121)	(33.9)
Income before income taxes	**10,257**	**8,910**	**15.1**
Current income taxes	(2,906)	(2,301)	26.3
Deferred income taxes	133	(166)	–
Total income tax expense	**(2,773)**	**(2,467)**	**12.4**
Net income	**7,484**	**6,443**	**16.2**
Basic earnings per share of common stock (in US dollars)	9.06	7.91	14.5
Diluted earnings per share of common stock (in US dollars)	9.04	7.79	16.0

The analysis of the main financial indicators of the financial statements is provided below.

Sales revenues

Sales breakdown	2006		2005	
	(millions of US dollars)			
Crude oil				
Export and sales on international markets other than CIS	16,859	24.9%	15,589	28.0%
Export and sales to CIS	790	1.2%	778	1.4%
Domestic sales	376	0.6%	120	0.2%
	18,025	**26.7%**	**16,487**	**29.6%**
Refined products				
Export and sales on international markets				
Wholesale	30,302	44.7%	22,923	41.1%
Retail	7,157	10.6%	6,293	11.3%
Domestic sales				
Wholesale	5,431	8.0%	4,753	8.5%
Retail	2,720	4.0%	1,972	3.5%
	45,610	**67.3%**	**35,941**	**64.4%**
Petrochemicals				
Export and sales on international markets	1,260	1.9%	1,134	2.0%
Domestic sales	569	0.8%	469	0.9%
	1,829	**2.7%**	**1,603**	**2.9%**
Other	**2,220**	**3.3%**	**1,743**	**3.1%**
Total sales	**67,684**	**100.0%**	**55,774**	**100.0%**

Sales volumes	2006		2005	
Crude oil		(thousands of barrels)		
Export and sales on international markets other than CIS	278,972		312,712	
Export and sales to CIS	21,682		23,852	
Domestic sales	13,363		4,926	
Crude oil		(thousands of tonnes)		
Export and sales on international markets other than CIS	38,059	30.0%	42,662	34.7%
Export and sales to CIS	2,958	2.3%	3,254	2.6%
Domestic sales	1,823	1.4%	672	0.5%
	42,840	**33.7%**	**46,588**	**37.8%**
Refined products		(thousands of tonnes)		
Export and sales on international markets				
Wholesale	57,558	45.4%	49,549	40.2%
Retail	7,171	5.7%	7,117	5.8%
Domestic sales				
Wholesale	15,155	12.0%	16,421	13.3%
Retail	3,995	3.2%	3,549	2.9%
	83,879	**66.3%**	**76,636**	**62.2%**
Total sales volume of crude oil and refined products	**126,719**	**100.0%**	**123,224**	**100.0%**

Realized average sales prices

	2006		2005	
	($/barrel)	($/tonne)	($/barrel)	($/tonne)
Average realized price international				
Oil (excluding CIS)	60.43	442.96	49.85	365.41
Oil (CIS)	36.46	267.22	32.63	239.20
Refined products				
Wholesale		526.46		462.61
Retail		998.05		884.30
Average realized price within Russia				
Oil	28.16	206.43	24.44	179.15
Refined products				
Wholesale		358.38		289.41
Retail		680.79		555.80

During 2006 our revenues increased by $11,910 million, or by 21.4%, compared to 2005.

The total volume of crude oil and refined products sold amounted to 126.7 million tonnes, which is nearly at the same level as in 2005 (an increase of 2.8%). Our revenues from crude oil sales increased by $1,538 million, or by 9.3%. Our sales of refined products increased by $9,669 million, or by 26.9%.

Sales of crude oil and refined products on international markets, including the CIS, accounted for 83.4% of the total sales volume in 2006 (83.3% in 2005).

The increase in sales was principally due to the following:

- favorable price conditions (see “Change in the price of crude oil and refined products” on page 8)
- increase in total volume of crude oil production (see “Hydrocarbon production” on page 5)
- increase in trading activities (see page 6)
- increase in crude oil refining, resulting from an increase in refining margins

Sales of crude oil

In 2006 we reduced exports of crude oil from Russia by 1,684 thousand tonnes, or by 3.7%. However, revenue from crude oil sales on international markets increased by 7.8% compared to the previous year. The negative effect of reduced volumes of exports from Russia and our crude oil trading activities on international markets was offset by the growth of crude oil prices.

During 2006, we increased our sales of crude oil on the domestic market compared to 2005 by 1,151 thousand tonnes, or by 171.3%.

Sales of refined products

Sales of refined products made up 67.3% of our total revenues (66.3% in terms of volumes sold) compared to 64.4% (62.2% – in terms of volumes) in 2005. The portion of our domestic refined product sales in 2006 was 15.2% of the total tonnes sold (in 2005 – 16.2%), but represented 12.0% of our total revenues (in 2005 – 12.0%). The decrease in our domestic refined products sales as a percentage of total refined products sales was due to the expansion of our trading activities outside Russia.

The average realized wholesale price of refined products outside Russia increased by $63.85 per tonne, or by 13.8%, compared to 2005. Wholesale volumes of refined products sold outside Russia increased by 8,009 thousand tonnes, or by 16.2%, due to increased volumes of refined products trading and exports from Russia. As a result, our revenue from the wholesale of refined products outside Russia increased by $7,379 million, or by 32.2%.

In 2006, retail sales of refined products outside Russia were approximately at the same level as in 2005. Average retail prices increased up to $998.05 per tonne, or by 12.9% from 2005 to 2006. As a result, our revenue from retail sales increased by $864 million, or by 13.7% from 2005 to 2006. In 2006, revenue from retail sales was 19.1% (in 2005 – 21.5%) of total refined products sales outside Russia. Our international retail sales include supplies of refined products to third party retail networks within the bounds of long-term contracts with pricing similar to retail pricing.

The wholesale of refined products within Russia in 2006 decreased by 1,266 thousand tonnes, or by 7.7%, compared to 2005. The average domestic realized price on refined products increased by $68.97 per tonne, or by 23.8%. As a result, our revenue from the wholesale of refined products on the domestic market increased by $678 million, or by 14.3%. Volumes of refined products, which were not utilized in the domestic wholesale market were directed to a retail segment or exported from Russia.

Retail sales within Russia in 2006 increased by 446 thousand tonnes, or by 12.6%, compared to 2005. Average retail prices increased up to $680.79 per tonne, or by 22.5%. As a result, our revenue from retail sales increased by $748 million in 2006, or by 37.9%, compared to 2005. Revenue from retail sales was 33.4% of total refined products sales in Russia in 2006 (in 2005 – 29.3%).

Sales of petrochemical products

Revenue from sales of petrochemical products increased in 2006 by $226 million, or by 14.1%, compared to 2005, due to an increase in prices for petrochemical products.

Sales of other products

Other sales include revenues from sales of gas, gas refined products and other services provided and goods not related to our primary activities (such as electricity, heat, etc.) sold by our production and marketing companies. Other sales increased by $477 million, or by 27.4%, generally as a result of the growth in gas and gas refined products sales. Sales of natural gas amounted to $230 million in 2006. Our major purchaser of natural gas produced in Russian Federation is OAO Gazprom. In 2006 we sold 7.5 billion cubic meters to OAO Gazprom at an average realization price of $23.6 per 1,000 cubic meters. For details on the agreement with OAO Gazprom please refer to page 6.

Equity share in income of affiliates

Compared to 2005, our share in the income of affiliates decreased by $16 million, or by 3.6%. Our largest affiliate is ZAO Turgai-Petroleum, a 50% interest affiliate company developing the Kumkol oil field in Kazakhstan. The Group's share in the net income of ZAO Turgai-Petroleum in 2006 was $184 million, which represents a decrease of $14 million as compared to 2005. This decrease in the net income of ZAO Turgai-Petroleum, along with the effect of changes in our ownership of equity affiliates mitigated the overall growth in the profitability of our Russian oil and gas producing affiliates.

Operating expenses

Operating expenses include the following types of costs:

	2006	**2005**
	(millions of US dollars)	
Hydrocarbon extraction expenses	2,312	1,764
Refining expenses	730	644
Petrochemical expenses	247	214
Other operating expenses	1,782	1,275
	5,071	**3,897**
Change in operating expenses in crude oil and refined products inventory originated within the Group	(414)	(410)
Total operating expenses	**4,657**	**3,487**
Cost of purchased crude oil, petroleum and chemical products	**22,374**	**19,398**

Compared to 2005, operating expenses increased by $1,170 million, or by 33.6%, which is mainly explained by the growth of hydrocarbon extraction expenses and other operating expenses.

Real appreciation of the ruble against the US dollar is a significant factor affecting our operating expenses in Russia. For the year ended December 31, 2006 the real ruble appreciation was 19.3%.

Hydrocarbon extraction expenses. Our extraction expenses include expenditures related to repairs of extraction equipment, labor costs, expenses on artificial stimulation of reservoirs, fuel and electricity costs, property insurance of extraction equipment and other similar costs.

Expenses of the Company's oil and gas production enterprises related to the sale of services and goods (such as electricity, heat, etc.) that do not relate to core activities have been excluded from extraction expenses and are included in other operating costs.

In 2006 our extraction expenses rose by $548 million, or by 31.1%, compared to 2005. The increase resulted from growth of hydrocarbons production by our subsidiaries up to 753.8 million BOE, or by 13.3%, compared to 2005, the effect of the real ruble appreciation, increased expenses of artificial stimulation of reservoirs and expenses for power supply and materials. In 2006, extraction expenses included $95 million of expenses related to crude oil producing companies acquired in late 2005 and in 2006. Our average hydrocarbon extraction cost per barrel of oil equivalent increased from $2.66 to $3.08, or by 15.8%, compared to 2005.

Refining expenses at our refineries increased by $86 million, or by 13.4%, in 2006 compared to 2005.

Refining expenses of our domestic refineries increased by 14.3%, or by $65 million as a result of increased production volume and due to the effect of the real ruble appreciation.

Refining expenses of our international refineries in 2006 increased by 11.1%, or by $21 million, compared to 2005. The growth of refining expenses was primarily due to the growth of high-quality production output at our plant in Bulgaria, which was partly offset by the reduction of refining expenses at the Odessa refinery, due to its wide-scale upgrade.

Operating expenses of our petrochemical companies increased by $33 million, or by 15.4%, compared to 2005, mainly as a result of the increased cost of raw materials and power supply and maintenance activities performed at our Russian petrochemical plants in the second quarter of 2006.

Other operating expenses include operating expenses of our gas processing plants, the costs of other services provided and goods not related to our core activities (such as electricity, heat, etc.) sold by our production and marketing companies, and operating expenses of other non-core businesses of the Group. Other operating expenses also include transportation costs associated with the delivery of crude oil from the Group's exploration and production entities to the Group's refineries, and processing fees paid to third party refineries. Other operating expenses increased by $507 million, or by 39.8%, compared to 2005. This was due to increased volumes of our crude oil refined at third party refineries, increased purchases of gas and gas refined products from third parties and other services provided.

Change in operating expenses in crude oil and refined products inventory originated within the Group includes extraction and refining expenses related to crude oil and refined products produced by the Group during the reporting period, but not sold to third parties.

Before 2006, such amounts included changes in inventory balances related to mineral extraction taxes, export tariffs and transportation expenses. Commencing in the first quarter of 2006, such changes are reflected in the corresponding income statement lines. Since the Group's management assesses the effect of the change in this classification on the presentation of the income statement for the year 2005 as not material, no reclassifications were made to comparatives.

Cost of purchased crude oil, petroleum and chemical products increased by $2,976 million in 2006, or by 15.3%, compared to the previous year due to a significant increase in the volume of refined products trading and increase in market prices for crude oil and petroleum products. At the same time we saw a decrease in the cost of purchased crude oil of $1,166 million resulting from decreased volumes due to the temporary shutdown of the Odessa refinery.

Cost of purchased crude oil, petroleum and chemical products includes the result of hedging of international crude oil and refined products sales. In 2006 we recognized a $183 million gain on hedging compared to a loss of $171 million in 2005.

Transportation expenses

The increase in the total volume of sales together with the increase in transportation tariffs led to an increase in our transportation expenses in 2006 by $344 million, or by 9.8%, compared to 2005.

Average transportation tariffs weighted by volumes of the Group's crude oil and refined products export deliveries to different locations changed in 2006 compared to the previous year as follows: crude oil sea shipping tariffs decreased by 15.2%; crude oil pipeline tariffs increased by 21.5%; railway tariffs for refined products transportation increased by 26.6%.

Selling, general and administrative expenses

In 2006 our selling, general and administrative expenses increased by $307 million, or by 11.9%, compared to 2005. The above-mentioned expenses include general business expenses, payroll costs (excluding extraction entities' and refineries' production staff costs), insurance costs (except for property insurance related to oil and gas, and refinery equipment), costs of maintenance of social infrastructure, movement in bad debt provision and other expenses.

The increase in selling, general and administrative expenses was a result of the real ruble appreciation and the general expansion of our operations outside Russia. These expenses were also affected by an increase in costs related to our share-based compensation program for management in 2006 ($280 million compared to $263 million in 2005).

Selling, general and administrative expenses for 2006 also included $87 million of expenses related to the subsidiaries, that we acquired in late 2005 and in 2006.

Depreciation, depletion and amortization

Depreciation, depletion and amortization expenses include depletion of assets fundamental to production, depreciation of other productive and non-productive assets and certain intangible assets. Our depreciation, depletion and amortization expenses increased by $536 million, or by 40.8%, compared to 2005. The increase was a result of the Company's capital expenditures and the corresponding increase in depreciable assets. The increase included $198 million of depreciation, depletion and amortization expenses related to our acquisitions, in late 2005 and in 2006.

Exploration expenses

During 2006, the amount charged to exploration expense decreased by $108 million, or by 34.1%, compared to 2005. In 2006, dry hole costs amounted to $91 million, primarily related to international exploration projects in Egypt ($12 million) and exploration in Komi and Timan-Pechora in Russia ($53 million). Geological and geophysical costs, charged to exploration expense in 2006 were incurred primarily in Russia and Uzbekistan ($78 million and $12 million, respectively).

In 2005, dry hole costs amounted to $170 million. The Group completed drilling the first exploratory wells of the Yalama (D-222) and Tyub-Karagan exploration projects (located in Azerbaijan and Kazakhstan, respectively). Both exploratory wells were dry and the costs of $105 million were charged to expense.

(Loss) gain on disposals and impairments of assets

Loss on disposals and impairment of assets in 2006 amounted to $148 million compared to a $52 million gain in 2005.

The losses included the financial result from disposals of a number of non-core assets and individually insignificant impairments of non-performing business units. Losses in 2006 also included the impairment of unproved property in Azerbaijan of $68 million.

In 2005, we recognized a gain of $152 million on the sale of our 30% interest in OOO Narianmarneftegaz to ConocoPhillips, a gain of $4 million on the sale of our 38% interest in ZAO Globalstroy-Engineering and a gain of $25 million on the sale of our interest in ZAO Arktikneft.

Interest expense

Interest expense in 2006 increased by $27 million, or by 9.8%, compared to 2005. The growth of interest expense was primarily due to debt service related to the loan of $1,934 million, which the Group obtained to finance the acquisition of Nelson and a general increase of our indebtedness. Moreover, in the second quarter of 2006, the Group and ConocoPhillips reached an agreement to amend the contractual interest rates related to the financing of our joint venture OOO Narianmarneftegaz from 0.1% to 6.8-8.2% per annum, which also impacted interest expense.

Taxes other than income taxes

The increase in taxes other than income taxes resulted primarily from a $1,691 million increase in mineral extraction taxes, which are linked to international crude oil prices (see "Tax burden" on page 9). Other taxes for 2005 included a $150 million provision accrued in relation to the results of tax audits of the Group companies for periods prior to the 2004 financial year.

	2006		**2005**	
	In Russia	**International**	**In Russia**	**International**
	(millions of US dollars)			
Mineral extraction taxes	7,281	–	5,590	–
Social security taxes and contributions	309	47	284	40
Property tax	219	28	210	23
Other taxes	160	31	162	25
	7,969	**106**	**6,246**	**88**
Total		**8,075**		**6,334**

Excise and export tariffs

Our excise and export tariffs include taxes on sales of refined products and export tariffs on the export of crude oil and refined products. Excise and export tariffs increased by $3,639 million, or by 36.6%, compared to 2005. The increase in export tariff expenses resulted from a growth in export tariff rates (see "Tax burden" on page 9). Because of the two-month lag between the determination of the crude oil export tariff rate and the period of its application in the fourth quarter of 2006 we sold crude oil at lower prices while we paid export tariffs at higher rates. This resulted in approximately $0.4 billion of negative effect on income before income tax.

	2006		**2005**	
	In Russia	**International**	**In Russia**	**International**
	(millions of US dollars)			
Excise tax and sales taxes on refined products	610	2,835	654	2,679
Export tariffs	10,114	11	6,590	8
	10,724	**2,846**	**7,244**	**2,687**
Total		**13,570**		**9,931**

Income taxes

Our total income tax expense increased by $306 million, or by 12.4%, compared to 2005, due to an increase of income before income tax by $1,347 million, or by 15.1%.

Our effective income tax rate in 2006 was 27.0% (in 2005 it was 27.7%), which is higher than the maximum statutory rate for the Russian Federation (24%). This is attributable to the fact that some costs incurred during the period are not tax deductible or only deductible to a certain limit.

Reconciliation of net income to EBITDA (earnings before interest, income taxes, depreciation and amortization)

	2006	2005
	(millions of US dollars)	
Net income	**7,484**	**6,443**
Add back:		
Income tax expense	2,773	2,467
Depreciation and amortization	1,851	1,315
Interest expense	302	275
Interest and dividend income	(111)	(96)
EBITDA	**12,299**	**10,404**

EBITDA is a non-US GAAP financial measure. EBITDA is defined as net income before interest, taxes and depreciation and amortization. The Company believes that EBITDA provides useful information to investors because it is an indicator of the strength and performance of our business operations, including our ability to finance capital expenditures, acquisitions and other investments and our ability to incur and service debt. While depreciation and amortization are considered operating costs under US GAAP, these expenses primarily represent the non-cash current period allocation of costs associated with long-lived assets acquired or constructed in prior periods. Our EBITDA calculation is commonly used as a basis for some investors, analysts and credit rating agencies to evaluate and compare the periodic and future operating performance and value of companies within the oil and gas industry. EBITDA should not be considered in isolation as an alternative to net income, operating income or any other measure of performance under US GAAP. EBITDA does not include our need to replace our capital equipment over time.

Year ended December 31, 2005 compared to the year ended December 31, 2004

Results of operations

The table below details certain income and expense items from our consolidated statements of income for the periods indicated.

	2005	2004	Change, %
	(millions of US dollars)		
Revenues			
Sales (including excise and export tariffs)	55,774	33,845	64.8
Equity share in income of affiliates	441	213	107.0
Total revenues	**56,215**	**34,058**	**65.1**
Costs and other deductions			
Operating expenses	(3,487)	(2,880)	21.1
Cost of purchased crude oil, petroleum and chemical products	(19,398)	(10,124)	91.6
Transportation expenses	(3,519)	(2,784)	26.4
Selling, general and administrative expenses	(2,578)	(2,024)	27.4
Depreciation, depletion and amortization	(1,315)	(1,075)	22.3
Taxes other than income taxes	(6,334)	(3,505)	80.7
Excise and export tariffs	(9,931)	(5,248)	89.2
Exploration expenses	(317)	(171)	85.4
Gain (loss) on disposals and impairments of assets	52	(213)	–
Income from operating activities	**9,388**	**6,034**	**55.6**
Interest expense	(275)	(300)	(8.3)
Interest and dividend income	96	180	(46.7)
Currency translation (loss) gain	(134)	135	–
Other non-operating (expense) income	(44)	21	–
Minority interest	(121)	(62)	95.2
Income before income taxes	**8,910**	**6,008**	**48.3**
Current income taxes	(2,301)	(1,614)	42.6
Deferred income taxes	(166)	(146)	13.7
Total income tax expense	**(2,467)**	**(1,760)**	**40.2**
Net income	**6,443**	**4,248**	**51.7**
Basic earnings per share of common stock (in US dollars)	7.91	5.20	52.1
Diluted earnings per share of common stock (in US dollars)	7.79	5.13	51.9

The analysis of the main financial indicators of the financial statements is provided below.

Sales revenues

Sales breakdown	2005 (millions of US dollars)		2004	
Crude oil				
Export and sales on international markets other than CIS	15,589	28.0%	10,338	30.5%
Export and sales to CIS	778	1.4%	602	1.8%
Domestic sales	120	0.2%	181	0.5%
	16,487	**29.6%**	**11,121**	**32.8%**
Refined products				
Export and sales on international markets				
Wholesale	22,923	41.1%	11,403	33.7%
Retail	6,293	11.3%	3,914	11.6%
Domestic sales				
Wholesale	4,753	8.5%	3,429	10.1%
Retail	1,972	3.5%	1,236	3.7%
	35,941	**64.4%**	**19,982**	**59.1%**
Petrochemicals				
Export and sales on international markets	1,134	2.0%	1,021	3.0%
Domestic sales	469	0.9%	332	1.0%
	1,603	**2.9%**	**1,353**	**4.0%**
Other	**1,743**	**3.1%**	**1,389**	**4.1%**
Total sales	**55,774**	**100.0%**	**33,845**	**100.0%**

Sales volumes	2005 (thousands of barrels)		2004	
Crude oil				
Export and sales on international markets other than CIS	312,712		307,523	
Export and sales to CIS	23,852		29,877	
Domestic sales	4,926		11,999	
Crude oil		(thousands of tonnes)		
Export and sales on international markets other than CIS	42,662	34.7%	41,954	38.6%
Export and sales to CIS	3,254	2.6%	4,076	3.7%
Domestic sales	672	0.5%	1,637	1.5%
	46,588	**37.8%**	**47,667**	**43.8%**
Refined products		(thousands of tonnes)		
Export and sales on international markets				
Wholesale	49,549	40.2%	35,946	33.1%
Retail	7,117	5.8%	5,480	5.0%
Domestic sales				
Wholesale	16,421	13.3%	16,981	15.6%
Retail	3,549	2.9%	2,743	2.5%
	76,636	**62.2%**	**61,150**	**56.2%**
Total sales volume of crude oil and refined products	**123,224**	**100.0%**	**108,817**	**100.0%**

Realized average sales prices	2005 ($/barrel)	2005 ($/tonne)	2004 ($/barrel)	2004 ($/tonne)
Average realized price international				
Oil (excluding CIS)	49.85	365.41	33.62	246.42
Oil (CIS)	32.63	239.20	20.13	147.57
Refined products				
Wholesale		462.61		317.24
Retail		884.30		714.19
Average realized price within Russia				
Oil	24.44	179.15	15.09	110.58
Refined products				
Wholesale		289.41		201.94
Retail		555.80		450.64

During 2005, our revenues increased by $21,929 million, or by 64.8%, compared to 2004.

The total volume of crude oil and refined products sold amounted to 123.2 million tonnes, which is 13.2% more than in 2004. Our revenues from crude oil sales increased by $5,366 million, or by 48.3%. Our sales of refined products increased by $15,959 million, or by 79.9%.

Sales of crude oil and refined products on the international markets, including the CIS, accounted for 83.3% of total sales volume in 2005, compared to 80.4% in 2004.

The increase in sales was principally due to the following:

- favorable price conditions
- increase in total volume of crude oil production
- increase in trading activities
- increase in crude oil refining

Sales of crude oil

During 2005, the Company decreased its sales of crude oil on the domestic market compared to 2004 by 965 thousand tonnes, or by 58.9%, due to increased volume of refining in Russia.

In order to obtain benefits from increased refined products prices in Russia and on international markets and due to a higher level of export tariff on crude oil compared to export tariffs on refined products we reduced the volume of crude oil exported from Russia by 481 thousand tonnes, or by 1.0%, compared to 2004.

Sales of refined products

Sales of refined products made up 64.4% of our total revenues (62.2% in terms of volumes sold) compared to 59.1% (56.2% – in terms of volumes) in 2004. The portion of our domestic refined product sales in 2005 was 16.2% of the total tonnes sold (2004: 18.1%), but represented 12.0% of our total revenues (2004: 13.8%). The decrease in our domestic refined products sales as a percentage of total refined products sales is due to a significant expansion of trading activities outside Russia.

The average realized wholesale price on refined products outside Russia increased by $145.37 per tonne, or by 45.8%, compared to 2004. Volumes of refined products sold outside Russia increased by 13,603 thousand tonnes, or by 37.8%. As a result, our revenue from the wholesale of refined products outside Russia increased by $11,520 million, or by 101.0%.

In 2005, retail sales of refined products outside Russia increased by 1,637 thousand tonnes, or by 29.9%, compared to 2004. The increase was a result of the continuing development of our existing retail chains outside Russia and structural changes in the retail networks we operate. In particular, in May 2004, we acquired an additional retail network in the USA, and in March 2005 we acquired a retail network in Finland. Average retail prices increased up to $884.30 per tonne, or by 23.8%. As a result, our revenue from retail sales increased by $2,379 million, or by 60.8%. In 2005, revenue from retail sales was 21.5% (in 2004 – 25.6%) of total refined products sales outside Russia. Our international retail sales include sales of refined products to third party retail networks within the bounds of long-term contracts with pricing similar to retail pricing.

Wholesale of refined products within Russia in 2005 slightly decreased compared to 2004 because of growth in retail sales and exports of refined products from Russia. The average domestic realized price on refined products increased by $87.47 per tonne, or by 43.3%. As a result, our revenue from wholesale of refined products on the domestic market increased by $1,324 million, or by 38.6%.

Retail sales within Russia in 2005 increased by 806 thousand tonnes, or by 29.4%, compared to 2004. Average retail prices increased up to $555.80 per tonne, or by 23.3%. As a result, our revenue from retail sales increased by $736 million, or by 59.5%. Revenue from retail sales was 29.3% of total refined products sales in Russia in 2005 (in 2004 – 26.5%).

Sales of petrochemical products

Revenue from sales of petrochemical products increased by $250 million, or by 18.5%, during 2005. This was mainly due to an increase in average realized prices.

Sales of other products

Other sales include revenues from sales of gas, gas refined products and other services provided and goods not related to our primary activities (such as electricity, heat, etc.) sold by our production and marketing companies. Other sales increased by $354 million, or by 25.5%, as a result of sales of other products produced by the Company, primarily gas and gas refined products, and increased activity in providing other services to third parties.

Equity share in income of affiliates

Our share in the income of affiliates in 2005 increased by $228 million, or by 107.0%, compared to 2004 due to a general increase in the profitability of our crude oil production affiliates in particular due to an increase in the net income of ZAO Turgai-Petroleum. ZAO Turgai-Petroleum, of which we own 50%, is a partner in the Turgai-Petroleum joint venture developing the Kumkol oil field in Kazakhstan. The Group's share in the net income of ZAO Turgai-Petroleum in 2005 was $198 million, which represents an increase of $153 million as compared to the previous year.

Operating expenses

Operating expenses include the following types of costs:

	2005	2004
	(millions of US dollars)	
Hydrocarbon extraction expenses	1,764	1,556
Refining expenses	644	532
Petrochemical expenses	214	207
Other operating expenses	865	585
Total operating expenses	**3,487**	**2,880**
Cost of purchased crude oil, petroleum and chemical products	**19,398**	**10,124**

Compared to 2004, operating expenses increased by $607 million, or by 21.1%. Real appreciation of the ruble against the US dollar is still a significant factor affecting our operating expenses in Russia. In 2005 the real ruble appreciation was 6.9%.

Hydrocarbon extraction expenses. Our extraction expenses include expenditures related to repairs of extraction equipment, labor costs, expenses of artificial stimulation of reservoirs, fuel and electricity costs, property insurance of extraction equipment and other similar costs.

Expenses of the Company's oil and gas production enterprises related to the sale of services and goods (such as electricity, heat, etc.) that do not relate to core activities have been excluded from extraction expenses and are included in other operating costs.

In 2005 our extraction expenses rose by $208 million, or by 13.4%, compared to 2004. The increase resulted from growth of hydrocarbons production by our subsidiaries up to 665.6 million BOE, or by 4.9%, compared to 2004, and increased expenses on repairs, overhaul and artificial stimulation of reservoirs in our production subsidiaries. Moreover, extraction costs were affected by the real ruble appreciation. However, the impact of these factors was partly mitigated by an increase in average well production from 10.70 tonnes a day in 2004 to 11.07 tonnes a day in 2005. As a result our average extraction cost per barrel of oil equivalent increased from $2.46 to $2.66 per barrel, or by 8.1%.

Refining expenses at our refineries increased by $112 million, or by 21.1%, in 2005 compared to 2004.

Refining expenses of our domestic refineries increased by 13.8%, or by $55 million, as a result of our increased production volume and due to the effect of the real ruble appreciation. Moreover, in late 2004, we began changing our product mix in order to produce higher quality and more profitable products (in particular, Euro 4 quality standard diesel fuel), which led to an increase of our refinery expenses.

Refining expenses of our international refineries increased by 43.2%, or by $57 million, as a result of the recommencement of operations of our Romanian refinery Petrotel-LUKOIL after modernization, and due to growth in heating and power costs at our Bulgarian refinery.

Operating expenses of petrochemical companies increased by $7 million, or by 3.4%, compared to 2004.

Other operating expenses include operating expenses of our gas processing plants, and the costs of other services provided and goods not related to our core activities (such as electricity, heat, etc.) sold by our production and marketing companies, and operating expenses of other non-core businesses of the Group. Other operating expenses also include transportation costs associated with the delivery of crude oil from the Group's exploration and production entities to the Group's refineries, processing fees paid to third party refineries, and the change in our crude oil and refined products inventory originated within the Group. Other operating expenses increased by $280 million compared to 2004. The increase was due to increased volumes of our crude oil refined at third party refineries, growth of sales volume of other products (primarily gas refined products), and as a result of change in our crude oil and refined product inventory originated within the Group in the fourth quarter of 2005.

Cost of purchased crude oil, petroleum and chemical products increased by $9,274 million in 2005, or by 91.6%, compared to the previous year due to a significant increase in volumes of sales of purchased crude oil and refined products in 2005 by 10,094 thousand tonnes, or about 29.5%, compared to 2004 and growth of market prices on crude oil and petroleum products.

Transportation expenses

The increase in the total volume of sales together with the increase in transportation tariffs led to an increase in our transportation expenses in 2005 by $735 million, or by 26.4%, compared to 2004.

According to the Federal Statistics Service of the Russian Federation, in 2005 transportation tariffs increased as follows: transportation of oil by pipeline transport – 33.3% (including certain specific tariffs established for individual parts of the Transneft pipeline which did not have a material impact on transportation expenses of the Group), transportation of refined products by pipeline transport – 24.8%, railway transport – 13.3%.

Sea shipping tariffs decreased in 2005 by 14.9%, compared to 2004 (calculated as weighted average by volumes transported to different locations). At the same time, a significant increase in tariffs and demurrage costs in the fourth quarter of 2005 led to an increase of transportation expenses of approximately $70 million.

Selling, general and administrative expenses

In 2005, our selling, general and administrative expenses increased by $554 million, or by 27.4%, compared to 2004. The above-mentioned expenses include general business expenses, payroll costs (excluding extraction entities' and refineries' production staff costs), insurance costs (except for property insurance related to oil and gas, and refinery equipment), costs of maintenance of social infrastructure, movement in bad debt provision and other expenses.

The increase in selling, general and administrative expenses was a result of the general expansion of our operations primarily outside Russia. Also, the expenses were affected by an increase in expenses related to our share-based compensation program for management in 2005, which was $263 million compared to $65 million in 2004. At the same time we partially mitigated the effect of the real ruble appreciation through general cost control.

Selling, general and administrative expenses for 2005 also included $66 million of expenses related to our Finnish subsidiaries acquired in March 2005 and $20 million of expenses related to Nelson, which we acquired in October-December of 2005.

Depreciation, depletion and amortization

Depreciation, depletion and amortization expenses include depletion of assets fundamental to production, depreciation of other productive and non-productive assets and certain intangible assets. Our depreciation, depletion and amortization expenses increased by $240 million, or by 22.3%, compared to 2004. The increase was a result of the Company's capital expenditures and the corresponding increase in depreciable assets, and $41 million of depreciation, depletion and amortization expenses related to Nelson acquired in 2005.

Exploration expenses

During 2005, the amount charged to exploration expense increased in comparison with the previous year by $146 million, or by 85.4%. This is attributable to the fact that during 2005 the Group completed drilling the first two exploratory wells of the Yalama (D-222) and Tyub-Karagan exploration projects. Both exploratory wells were dry and the costs of $105 million were charged to expense. Notwithstanding the fact that the initial exploratory wells were not successful, the Group continues to perform further geological studies and is using the results of the first exploratory drilling in its analysis to assess the potential placement of hydrocarbon deposits and to determine drilling programs for the second exploratory wells in both fields.

Gain (loss) on disposals and impairments of assets

Gain on disposals of assets in 2005 amounted to $52 million compared to a $213 million loss in 2004.

In 2005 we recognized an $152 million gain on the sale of our 30% interest in OOO Narianmarneftegaz to ConocoPhillips, a gain of $4 million on the sale of our 38% interest in ZAO Globalstroy-Engineering and a gain of $25 million on the sale of our interest in ZAO Arktikneft. Also in 2005 the Group recognized an additional impairment loss of $12 million related to sale of our ownership interests in OAO Bank Petrocommerce.

In 2004 we recognized an impairment loss in relation to the disposal of our ownership interests in OAO Bank Petrocommerce in the amount of $35 million and an impairment loss of $70 million in relation to the disposal of our ownership interest in OOO LUKOIL-Burenie.

Other losses relate to disposals of a number of non-core assets and individually insignificant impairments on non-performing business units.

Interest expense

Interest expense in 2005 decreased by $25 million compared to 2004 primarily due to the sale of our ownership interest in OAO Bank Petrocommerce in the third quarter of 2004. However the decrease was compensated in the fourth quarter of 2005 by accrued interest expense related to a loan of $1,934 million, which the Group obtained to finance the acquisition of Nelson.

Taxes other than income taxes

Taxes other than income taxes include the mineral extraction taxes, property tax and social taxes.

	2005		2004	
	In Russia	**International**	**In Russia**	**International**
	(millions of US dollars)			
Mineral extraction taxes	5,590	–	2,971	–
Social security taxes and contributions	284	40	302	28
Property tax	210	23	91	20
Other taxes	162	25	60	33
	6,246	**88**	**3,424**	**81**
Total		**6,334**		**3,505**

The increase in taxes other than income taxes resulted primarily from a $2,619 million increase in mineral extraction taxes, which are linked to international crude oil prices. Property tax in Russia increased in 2005 primarily due to the recalculation of domestic property tax related to 2002 and 2003. In 2005 the Group recognized an expense of $163 million in relation to the results of tax audits of the Group companies for periods prior to the 2004 financial year. The amount of such additional taxes recognized as other taxes was approximately $150 million.

Excise and export tariffs

Our excise and export tariffs include taxes on sales of refined products and export tariffs on the export of crude oil and refined products. Excise and export tariffs increased by $4,683 million, or by 89.2%, compared to 2004. The increase in export tariff expenses resulted from an increase in export tariff rates. The increase in international excise taxes on refined products resulted from an increase in volumes of products sold across our international group, primarily in the USA, and due to the commencement of our operations in Finland.

	2005		2004	
	In Russia	**International**	**In Russia**	**International**
	(millions of US dollars)			
Excise tax and sales taxes on refined products..........	654	2,679	547	1,774
Export tariffs..	6,590	8	2,913	14
	7,244	**2,687**	**3,460**	**1,788**
Total...		**9,931**		**5,248**

Income taxes

Our total income tax expense increased by $707 million, or by 40.2%, compared to 2004, due to an increase of income before income tax by $2,902 million, or by 48.3%.

Our effective income tax rate in 2005 was 27.7% (in 2004 it was 29.3%), which is higher than the maximum statutory rate for the Russian Federation (24%). This is attributable to the fact that some costs incurred during the period are not tax deductible or only deductible to a certain limit.

Reconciliation of net income to EBITDA (earnings before interest, income taxes, depreciation and amortization)

	2005	2004
	(millions of US dollars)	
Net income...	**6,443**	**4,248**
Add back:		
Income tax expense..	2,467	1,760
Depreciation and amortization	1,315	1,075
Interest expense..	275	300
Interest and dividend income	(96)	(180)
EBITDA	**10,404**	**7,203**

EBITDA is a non-US GAAP financial measure. EBITDA is defined as net income before interest, taxes and depreciation and amortization. The Company believes that EBITDA provides useful information to investors because it is an indicator of the strength and performance of our business operations, including our ability to finance capital expenditures, acquisitions and other investments and our ability to incur and service debt. While depreciation and amortization are considered operating costs under US GAAP, these expenses primarily represent the non-cash current period allocation of costs associated with long-lived assets acquired or constructed in prior periods. Our EBITDA calculation is commonly used as a basis for some investors, analysts and credit rating agencies to evaluate and compare the periodic and future operating performance and value of companies within the oil and gas industry. EBITDA should not be considered in isolation as an alternative to net income, operating income or any other measure of performance under US GAAP. EBITDA does not include our need to replace our capital equipment over time.

Liquidity and capital resources

	2006	2005	2004
		(million US dollars)	
Net cash provided by operating activities	7,639	6,097	4,180
Net cash used in investing activities	(7,515)	(6,225)	(3,741)
Net cash (used in) provided by financing activities	(1,059)	539	(650)

Our primary source of cash flow is funds generated from our operations. During 2006 cash generated by operating activities was $7,639 million, an increase of $1,542 million compared to 2005. In 2006 cash inflow from operating activities was impacted by the following factors:

- an increase in revenue
- an increase in the amount of income tax paid
- an increase in the volume of export sales and, consequently, prepayment of custom fees, export duties and transportation expenses.

Moreover, in 2006 our operating cash inflows were significantly affected by an increase of working capital by $1,621 million compared to January 1, 2006. This was mainly caused by:

- an increase of inventory by $816 million, resulting from increased volumes of crude oil and refined products held and increased purchase prices
- a net increase by $733 million of VAT receivable and payable balances
- a net increase by $239 million of income tax receivable and payable balances
- net increase by $94 million of accounts receivable and payable related to taxes other than income taxes, excises and export tariffs.

At the same time, the increase in working capital was partly offset by a $180 million net decrease in trade accounts receivable and payable.

In 2006 we spent $1,374 million on acquisitions of interests in other companies, $1,500 million less compared to 2005. We paid $847 million for the acquisition of KMOC, and $300 million as an advance for the acquisition of the remaining 34% of OOO Geoilbent. In 2005 we spent $2,874 million mainly for the acquisitions of Nelson, OAO Primorieneftegaz, Oy Teboil Ab and Suomen Petrooli Oy, the remaining interest in ZAO SeverTEK, an equity interest in OOO Geoilbent and increase of our share in LUKOIL Neftochim Burgas.

The outflow from financing activities in 2006 resulted from the payment of $782 million for the purchase of the Company's stock under our capital management program. At the same time, in 2006 net movements of short term and long term debt generated an inflow of $715 million, compared to an inflow of $1,132 million in the respective period of 2005. This inflow included:

- 14 million non-convertible rouble bonds with a face value of 1,000 Russian rubles each issued in December 2006 ($532 million)
- $530 million of borrowings related to our KMOC acquisition
- $381 million of loans received from ConocoPhillips as its part of financing our joint venture in the Timan-Pechora region (previously this loan was accounted for as equity contribution) (for details see Note 18 "Consolidation of Variable Interest Entity" to our consolidated financial statements).

Also in 2006 the Company paid $1,007 million in dividends ($746 million in 2005). These factors resulted in a net cash outflow from financing activities of $1,059 million in 2006 compared to an inflow of $539 million in 2005.

The Company has sufficient borrowing capacity to meet unanticipated cash requirements. As of December 31, 2006 the Company had available unutilized short-term credit facilities with a number of banks of $1.6 billion.

During 2006 the Group systematically worked at decreasing the level of secured debt, mainly represented by the pledge of export receivables and fixed assets. As of December 31, 2006 the level of secured debt was about 14% of total debt, while as of December 31, 2005 it was 35%.

Credit rating

The Company has a long-term corporate credit rating of BB+ by Standard and Poor's. Our Russian ruble bonds are rated RuAA+.

In 2006, Moody's increased the Company's senior implied rating by two grades from Ba1 to Baa2.

In 2006 Fitch Ratings assigned the Company foreign currency and local currency issuer default ratings of BBB- and a short-term rating of F3.

A rating is not a recommendation to buy, sell or hold securities and may be subject to revision, suspension or withdrawal at any time by the assigning rating organization. Similar ratings on the Company and/or on different types of securities do not necessarily mean the same thing. The ratings do not address the marketability of any of our securities or their market price. Any change in the credit ratings of the Company or our securities could adversely affect the price that a subsequent purchaser will be willing to pay for our securities. We recommend that you analyze the significance of each rating independently from any other rating.

Analysis of capital expenditures

	2006	2005	2004
	(millions of US dollars)		
Exploration and production			
Russia	4,334	2,487	2,100
International	786	431	189
Total exploration and production	5,120	2,918	2,289
Refining, marketing and distribution			
Russia	916	654	677
International	559	475	393
Total refining, marketing and distribution	1,475	1,129	1,070
Chemicals			
Russia	121	59	55
International	51	18	16
Total chemicals	172	77	71
Other	119	53	17
Total capital expenditures*	**6,886**	**4,177**	**3,447**
Acquisitions of subsidiaries**			
Exploration and production			
Russia	1,469	778	23
International	91	1,959	143
Total exploration and production	1,560	2,737	166
Refining, marketing and distribution			
Russia	122	27	1
International	–	229	305
Total refining, marketing and distribution	122	256	306
Other	32	–	5
Less cash acquired	**(26)**	**(119)**	**–**
Total acquisitions of subsidiaries	**1,688**	**2,874**	**477**

* Including non-cash transactions.

**Including prepayments related to acquisitions of subsidiaries and minority shareholding interest and non-cash transactions.

Capital expenditures, including non-cash transactions, during 2006 amounted to $6,886 million, $2,709 million more than in the previous year. The growth was mainly caused by expenditures in our exploration and production segment, which increased by $2,202 million compared to 2005. The growth in exploration and production capital expenditures in new regions amounted to $725 million. The capital expenditures in traditional exploration regions of Western Siberia and European Russia increased by $483 million and $366 million, respectively. Growth of the capital expenditures in our overseas exploration projects (excluding Caspian region) amounted to $459 million in 2006. The Company estimates its 2007 capital expenditures in our exploration and production segment at approximately $5.4 billion, with $0.7 billion of that outside Russia. Refining, marketing and distribution capital spending is estimated to be $1.4 billion, with $0.5 billion of that outside Russia.

The table below shows our exploration and production capital expenditures in new promising oil regions.

	2006	2005	2004
	(millions of US dollars)		
Northern Timan-Pechora	1,526	673	379
Yamal	135	216	325
Caspian region*	212	259	77
Total	**1,873**	**1,148**	**781**

* Russian and international projects.

Contractual obligations, other contingencies and off balance sheet arrangements

Capital commitments and contractual obligations

The Company and its subsidiaries have significant capital commitments in respect to development of oil and gas fields in Russia. These commitments are regulated by law and described in the individual license agreements. Management believes that a significant portion of these commitments will be fulfilled by the services to be performed by Eurasia Drilling Company and ZAO Globalstroy-Engineering as discussed below.

In connection with the sale of LUKOIL-Burenie (now named Eurasia Drilling Company) in 2005 the Group signed a five year contract for drilling services. Under the terms of the contract drilling services will be provided by Eurasia Drilling Company during the next three years totaling $2,172 million.

In 2005 the Company has signed a four-year agreement for the provision of construction, engineering and technical services with ZAO Globalstroy-Engineering. The volume of these services is based on the Group’s capital construction program, which is re-evaluated on an annual basis. The Group estimates the amount of capital commitment under this agreement for 2007 to be approximately $1,255 million.

Group companies have investment commitments relating to oil deposits in Iraq of $495 million to be spent within 3 years from when exploitation becomes possible. Due to significant changes in the political and economic situation in Iraq the future of this contract is not clear, however, the Group is actively pursuing its legal right to this contract in Iraq in alliance with ConocoPhillips.

The Group owns and operates refineries in Bulgaria (LUKOIL Neftochim Bourgas AD) and Romania (Petrotel-LUKOIL). As a result of Bulgaria and Romania joining the European Union in 2007, LUKOIL Neftochim Bourgas AD and Petrotel-LUKOIL are required to upgrade their refining plants to comply with the requirements of European Union legislation in relation to the quality of produced petroleum products and environmental protection. These requirements are stricter than existing Bulgarian and Romanian legislation. The Group estimates the amount of future capital commitment required to upgrade LUKOIL Neftochim Bourgas AD and Petrotel-LUKOIL to be approximately $750 million and $57 million, respectively.

The Group also has certain commitments to minimal rentals of petroleum distribution outlets in the USA and vessels over the next 9 years.

The following table displays our total contractual obligations and other commitments:

Millions of dollars	Total	2007	2008	2009	2010	2011	After
On balance sheet							
Short term debt	**1,001**	1,001	–	–	–	–	–
Long-term bank loans and borrowings	**3,204**	311	2,249	128	270	86	160
Long-term non-bank loans and borrowings	**73**	29	22	6	7	7	2
Long-term loans and borrowings from related parties	**1,043**	–	–	–	–	–	1,043
3.5% Convertible US dollar bonds, maturing 2007	**4**	4	–	–	–	–	–
7.25% Russian ruble bonds, maturing 2009	**228**	–	–	228	–	–	–
7.10% Russian ruble bonds, maturing 2011	**304**	–	–	–	–	304	–
7.40% Russian ruble bonds, maturing 2013	**228**	–	–	–	–	–	228
Capital lease obligations	**99**	32	29	18	11	7	2
TOTAL	**6,184**	**1,377**	**2,300**	**380**	**288**	**404**	**1,435**
Off balance sheet							
Capital commitments under oil and gas license agreements in Russia*	**1,731**	372	401	330	126	150	352
Operating lease obligations	**1,451**	341	267	215	124	122	382
Capital commitment in LUKOIL-Neftochim Bourgas AD	**750**	136	250	141	149	74	–
Capital commitment in LUKOIL-Petrotel	**57**	2	–	18	1	1	35
Commitment for modernization of the petrochemical refinery in Ukraine	**156**	97	52	7	–	–	–
Capital commitments in PSAs	**343**	224	64	12	2	2	39
Obligation under contract with Eurasia Drilling Company	**2,172**	773	697	702	–	–	–
Obligation under contract with ZAO Globalstroy-Engineering	**1,255**	1,255	–	–	–	–	–

* Management believes that a significant portion of these commitments will be fulfilled by the services to be performed by Eurasia Drilling Company and ZAO Globalstroy-Engineering.

Off balance sheet arrangements

We record our 54% interest in LUKARCO, our joint venture with BP plc, under the equity method of accounting. LUKARCO has a loan facility under which $678 million was outstanding as of December 31, 2006. The amounts outstanding under this loan bear interest at LIBOR plus 2.5% and matures on May 1, 2012. To enhance the credit standing of LUKARCO, the Company guaranteed 54% of the interest payments and principal under the loan. As of December 31, 2006, the total amount of the Company's guarantee was $410 million, which includes $44 million related to accrued interest on the outstanding amount. The Company's guarantee is secured by its 54% interest in LUKARCO with a carrying value of $358 million and $259 million as of December 31, 2006 and 2005, respectively. The amount of the guarantee is not reflected on our balance sheet. The table below sets out the amount of the guarantee that expires in each year until maturity.

		Commitment Expiration by Period					
Millions of dollars	Total	2007	2008	2009	2010	2011	After
Guarantees of equity affiliate's debt	**410**	42	135	76	92	65	–

Other than our guarantee of LUKARCO's debt described above, we do not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.

Litigation and claims

On November 27, 2001, Archangel Diamond Corporation ("ADC"), a Canadian diamond development company, filed a lawsuit in the District Court of Denver, Colorado against OAO "Arkhangelskgeoldobycha" ("AGD"), a Group company, and the Company (together the "Defendants"). ADC alleged that the Defendants interfered with the transfer of a diamond exploration license to Almazny Bereg, a joint venture between ADC and AGD. ADC claimed total damages of approximately $4.8 billion, including compensatory damages of $1.2 billion and punitive damages of $3.6 billion. On October 15, 2002, the District Court dismissed the lawsuit for lack of personal jurisdiction. This ruling was upheld by the Colorado Court of Appeals on March 25, 2004. On November 21, 2005, the Colorado Supreme Court affirmed the lower courts' ruling that no specific jurisdiction exists over the Defendants. By virtue of this finding, AGD (the holder of the diamond exploration license) was completely dismissed from the lawsuit. The Supreme Court found, however, that the trial court made a procedural error by not holding an evidentiary hearing before making its ruling concerning general jurisdiction, which is whether the Company had systematic and continuous contacts in the State of Colorado at the time the lawsuit was filed. In a modified opinion dated December 19, 2005, the Colorado Supreme Court remanded the case to the Colorado Court of Appeals (instead of the District Court) to consider whether the lawsuit should have been dismissed on alternative grounds (i.e., forum non conveniens). On June 29, 2006, the Colorado Court of Appeals declined to dismiss the case based on forum non conveniens. The Company filed a petition for certiorari on August 28, 2006 asking the Colorado Supreme Court to review this decision. On March 5, 2007 the Colorado Supreme Court remanded the case to the District Court. The District Court has not set a pretrial schedule, but should do so shortly. Management does not believe that the ultimate resolution of this matter will have a material adverse effect on the Group's financial condition.

On February 20, 2004, the Stockholm District Court overturned the decision of the Arbitral Tribunal of the Arbitration Institute of the Stockholm Chamber of Commerce ("Arbitration Tribunal") made on June 25, 2001 dismissing ADC's action against AGD based on lack of jurisdiction. ADC's lawsuit against AGD was initially filed with the Arbitral Tribunal claiming alleged non-performance under an agreement between the parties and its obligation to transfer the diamond exploration license to Almazny Bereg. This lawsuit claimed compensation of damages amounting to $492 million. In March 2004, AGD filed an appeal against the Stockholm District Court decision with the Swedish Court of Appeals. On November 15, 2005, the Swedish Court of Appeals denied AGD's appeal and affirmed the Stockholm District Court decision. On December 13, 2005, AGD filed an appeal against the Swedish Court of Appeals decision with the Swedish Supreme Court. On April 13, 2006 the Swedish Supreme Court denied the application of AGD for appeal against the Swedish Court of Appeal's decision dated November 15, 2005. On May 6, 2006 a Notice of Arbitration was received on behalf of ADC. On December 20, 2006 the first session of the Arbitration Tribunal with participation of both parties took place in order to define procedural issues related to the tribunal. As a result of the hearing the Arbitration Tribunal issued a detailed procedural order setting out the rules and timetable for the conduct of the arbitration. The hearing in relation to issues primarily relating to liability, if any, is currently scheduled to take place in June 2008. Management does not believe that the ultimate resolution of this matter will have a material adverse effect on the Group's financial condition.

The Group is involved in various other claims and legal proceedings arising in the normal course of business. While these claims may seek substantial damages against the Group and are subject to uncertainty inherent in any litigation, management does not believe that the ultimate resolution of such matters will have a material adverse impact on the Group's operating results or financial condition.

Quantitative and qualitative disclosures about market risks

Interest rate risk

We are exposed to changes in interest rates, primarily associated with our variable rate short-term and long-term borrowings. We do not utilize any interest rate swaps or other derivatives to hedge against the risk of changes in interest rates on our variable rate debt. As of December 31, 2006 our long-term borrowings that are sensitive to changes in interest rates totaled $3,029 million (for details please refer to Note 12 "Long-term debt" of the consolidated financial statement). Utilizing the actual interest rates in effect and the balance of our variable rate debt as of December 31, 2006 and assuming a 10% change in interest rates and no change in the balance of debt outstanding, the potential effect on our annual interest expense would not be material to our results of operations.

The following tables represent principal cash flows and related weighted-average interest rates by expected maturity times.

	Fixed rate borrowings		Floating rate borrowings	
2006	(millions of US dollars)	%	(millions of US dollars)	%
2007	1,022	5.43	271	6.94
2008	47	3.54	2,224	6.15
2009	283	6.49	79	7.29
2010	35	2.94	242	6.61
2011	341	6.68	56	7.87
After	233	4.70	157	9.40
Total*	**1,961**	**5.62**	**3,029**	**6.49**

2005	(millions of US dollars)	%	(millions of US dollars)	%
2006	408	5.30	422	6.69
2007	161	3.89	422	6.55
2008	63	3.99	2,336	5.33
2009	308	7.48	149	6.74
2010	41	3.25	296	6.35
After	64	3.67	180	9.16
Total*	**1,045**	**5.47**	**3,805**	**5.93**

* Excluding capital lease obligations and loans and borrowings from related parties.

Foreign currency risk

The countries in which our principal operations are located have been subject to hyperinflation and during the last 10 years the local currency has been subject to large devaluations. As a result we are subject to the risk that the local currency may suffer future devaluation that may subject us to losses, depending on our net monetary asset position. We currently do not use any formal hedging arrangements to minimize the effect of these potential losses. Additionally, because we have operations in a number of other countries we are required to conduct business in a variety of foreign currencies and, as a result, we are subject to foreign exchange rate risk on cash flows related to sales, expenses, financing and investment transactions. The impacts of fluctuations in foreign currency exchange rates on our geographically diverse operations are varied. We recognized a net foreign currency translation gain of $169 million in 2006, a loss of $134 million in 2005 and a gain of $135 million in 2004.

Appreciation of the ruble against the US dollar in 2006 had a negative impact on our operating profit and cash flows since it lead to an increase of our ruble costs in US-dollar terms and a decrease in the amount of our export cash revenue in ruble terms. As mentioned above, a substantial part of our revenue is denominated in US dollars or, to some extent, linked to oil prices quoted in US dollars, while a significant part of our costs is ruble denominated. Should the ruble appreciation against US dollars in 2007 be at a level of 10% our free cash flows will decrease by approximately $0.5 billion (taking into account that other macroeconomic factors will remain constant).

Commodity instruments

The Group participates in certain petroleum products marketing and trading activity outside of its physical crude oil and petroleum products businesses. The Group's derivative activity is limited to these marketing and trading activities and hedging of commodity price risks. Currently this activity involves the use of futures and swap contracts together with purchase and sale contracts that qualify as derivative instruments. The Company maintains a system of controls over these marketing and trading activities that includes policies covering the authorization, reporting and monitoring of derivative activity. We do not believe our derivative activities pose material credit or market risks to our operations, financial condition or liquidity. The Group recognized an income of $183 million in 2006, an expense of $171 million in 2005 and an expense of $55 million in 2004 from the use of derivative instruments. The fair value of derivative contracts outstanding and recorded on the consolidated balance sheet as of December 31, 2006 was a net asset of $43 million (compared to a net liability of $26 million and a net asset of $28 million in 2005 and 2004, respectively).

Critical accounting policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to select appropriate accounting policies and to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. See Note 2 “Summary of significant accounting policies” to our consolidated financial statements for descriptions of the Company's major accounting policies. Certain of these accounting policies involve judgments and uncertainties to such an extent that there is a reasonable likelihood that materially different amounts would have been reported under different conditions, or if different assumptions had been used.

Business combinations

Purchase price allocation
Accounting for the acquisition of a business requires the allocation of the purchase price to the various assets and liabilities of the acquired business. For most assets and liabilities, purchase price allocation is accomplished by recording the asset or liability at its estimated fair value. The most difficult estimations of individual fair values are those involving property, plant and equipment and identifiable intangible assets. We use all available information to make these fair value determinations and, for major business acquisitions, typically engage an outside appraisal firm to assist in the fair value determination of the acquired long-lived assets. We have, if necessary, up to one year after the acquisition closing date to finish these fair value determinations and finalize the purchase price allocation.

Principles of consolidation
Our consolidated financial statements include the financial position and results of the Company, controlled subsidiaries of which the Company directly or indirectly owns more than 50% of the voting interest, unless minority interest shareholders have substantive participating rights, and variable interest entities where the Group is determined to be the primary beneficiary. Other significant investments in companies of which the Company directly or indirectly owns between 20% and 50% of the voting interest and over which it exercises significant influence but not control, are accounted for using the equity method of accounting. Investments in companies of which the Company directly or indirectly owns more than 50% of the voting interest but where minority interest shareholders have substantive participating rights are accounted for using the equity method of accounting. Investments in other companies are recorded at cost. Equity investments and investments in other companies are included in “Investments” in the consolidated balance sheet.

Revenue recognition

Revenues from the production and sale of crude oil and petroleum products are recognized when title passes to customers. Revenues include excise on petroleum products sales and duties on export sale of crude oil and petroleum products.

Revenues from non-cash sales are recognized at the fair market value of the crude oil and petroleum products sold.

Successful efforts accounting for oil and gas activities

Accounting for oil and gas activities is subject to special accounting rules that are unique to the oil and gas industry. Property acquisitions, successful exploratory wells, all development costs and support equipment and facilities are capitalized. Artificial stimulation and well work-over costs are included in operating expenses as incurred.

Property acquisition costs
For individually significant undeveloped properties, management periodically performs impairment test based on exploration and drilling efforts to date. For undeveloped properties that individually are relatively small, management exercises judgment and determines a periodic property impairment charge as required that is reported in loss on disposals and impairments of assets.

Exploratory costs

For exploratory wells, drilling costs are temporarily capitalized, or "suspended", on the balance sheet, pending a judgmental determination of whether potentially economic oil and gas reserves have been discovered by the drilling effort. If a judgment is made that the well did not encounter potentially economic oil and gas quantities, the well costs are expensed as a dry hole and are reported in exploration expense. Exploratory wells that are judged to have discovered potentially economic quantities of oil and gas and that are in areas where a major capital expenditure would be required before production could begin, remain capitalized on the balance sheet as long as additional exploratory appraisal work is under way or firmly planned. There is no periodic impairment assessment of suspended exploratory well costs. Management continuously monitors the results of the additional appraisal drilling and seismic work and expenses the suspended well costs as dry holes when it judges that the potential field does not warrant further exploratory efforts in the near term.

Other exploratory expenditures, including geological and geophysical costs are expensed as incurred.

Proved oil and gas reserves

Reserves are estimated using the definitions of reserves prescribed by the US Society of Petroleum Engineers and the World Petroleum Congress requirements. Due to the inherent uncertainties and the necessarily limited nature of reservoir data, estimates of reserves are inherently imprecise, require the application of judgment and are subject to change as additional information becomes available. The estimates are made using all available geological and reservoir data as well as historical production data. Estimates are reviewed and revised as appropriate. Revisions occur as a result of changes in prices, costs, fiscal regimes, reservoir performance or a change in the Company's plans.

Proved oil and gas reserves are the estimated quantities of crude oil, natural gas liquids including condensate and natural gas that geological and engineering data demonstrate with reasonable certainty can be recovered in future years from known reservoirs under existing economic and operating conditions. Reserves are considered proved if they can be produced economically as demonstrated by either actual production or conclusive formation tests. Proved reserves do not include additional quantities of oil and gas reserves that may result from extensions of currently proved areas or from applying secondary or tertiary recovery techniques not yet tested and determined to be economic. The proved reserves include volumes which are recoverable up to and after license expiry dates. Proved developed reserves are the quantities of proved reserves expected to be recovered through existing wells with existing equipment and operating methods.

Management has included within proved reserves significant quantities which the Group expects to produce after the expiry dates of certain of its current production licenses in the Russian Federation. These licenses expire between 2011 and 2026, with the most significant expiring between 2011 and 2014. Management believes the licenses will be extended to produce subsequent to their current expiry dates. The Group is in the process of extending all of its production licenses in the Russian Federation. The Group has already extended a portion of these licenses and expects to extend the remaining licenses for indefinite periods. To date there have been no unsuccessful license renewal applications.

The SEC permits oil and gas companies, in their filings with the SEC, to disclose only proved reserves that a company has demonstrated by actual production or conclusive formation tests to be economically and legally producible under existing economic and operating conditions. This document contains data, such as reserves and resources presented in accordance with SPE standards (and, in particular, proved and possible reserves), that the SEC's guidelines would prohibit us from including in filings with the SEC.

Impairment of long-lived assets

Long lived assets, such as oil and gas properties, other property, plant, and equipment, and purchased intangibles subject to amortization, are assessed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset group may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset group to the estimated undiscounted future cash flows expected to be generated by that group. If the carrying amount of an asset group exceeds its estimated undiscounted future cash flows, an impairment charge is recognized by writing down the carrying amount to the estimated fair value of the asset group, generally determined as discounted future net cash flows. Assets to be disposed of are separately presented in the balance sheet and reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated. The assets and liabilities of a disposed group classified as held for sale are presented separately in the appropriate asset and liability sections of the balance sheet.

Deferred income taxes

Deferred income tax assets and liabilities are recognized in respect of future tax consequences attributable to temporary differences between the carrying amounts of existing assets and liabilities for the purposes of the consolidated financial statements and their respective tax bases and in respect of operating loss and tax credit carryforwards. Deferred income tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to reverse and the assets be recovered and liabilities settled. The effect on deferred income tax assets and liabilities of a change in tax rates is recognized in the consolidated statement of income in the reporting period which includes the enactment date.

The ultimate realization of deferred income tax assets is dependent upon the generation of future taxable income in the reporting periods in which the originating expenditure becomes deductible. In assessing the realizability of deferred income tax assets, management considers whether it is more likely than not that the deferred income tax assets will be realized. In making this assessment, management considers the scheduled reversal of deferred income tax liabilities, projected future taxable income, and tax planning strategies.

Asset retirement obligations

Under various laws, contracts, permits and regulations, the Company has legal obligations to remove tangible equipment and restore the land or seabed at the end of operations at production sites. The largest asset retirement obligations of the Company relate to wells and oil and gas production facilities and pipelines. In accordance with SFAS No. 143, *"Accounting for Asset Retirement Obligations"*, the Company records the fair value of liabilities associated with such obligations when incurred. Estimating the future asset retirement obligations costs necessary for this accounting calculation involves significant estimates and judgments by management. Most of these obligations are many years in the future and the contracts and regulations often have vague descriptions of what removal practices and criteria will have to be met when the removal event actually occurs. Asset removal technologies and costs are constantly changing, as well as political, environmental, safety and public relations considerations.

Contingencies

Certain conditions may exist as of balance sheet dates that may result in losses, but the impact of which will only be resolved when one or more future events occur or fail to occur. The Company is required to both determine whether a loss is probable based on judgment and interpretation of laws and regulations and determine whether the loss can be reasonably estimated. If our assessment of a contingency indicates that it is probable that a material loss will arise, and the amount of the liability can be estimated, then the estimated liability is accrued and charged to the consolidated statement of income. If our assessment indicates that a potentially material loss is not probable, but is only reasonably possible, or is probable but cannot be estimated, then the nature of the contingent liability is disclosed in the notes to our consolidated financial statements. Loss contingencies considered remote are generally not disclosed unless they involve guarantees, in which case the nature of the guarantee is disclosed. The Company's management continually monitor known and potential contingent matters and make appropriate charges to the consolidated statement of income when warranted by circumstance.

Use of derivative instruments

The Group's derivative activity is limited to certain petroleum products marketing and trading outside of its physical crude oil and petroleum products businesses and hedging of commodity price risks. Currently this activity involves the use of futures and swaps contracts together with purchase and sale contracts that qualify as derivative instruments. The Group accounts for these activities under the mark-to-market methodology in which the derivatives are revalued each accounting period. Resulting realized and unrealized gains or losses are presented in the consolidated statement of income on a net basis. Unrealized gains and losses are carried as assets or liabilities on the consolidated balance sheet.

Recent accounting pronouncements

In February 2007, FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities". This Statement expands the possibility of using fair value measurements and permits enterprises to choose to measure certain financial assets and financial liabilities at fair value. Enterprises shall report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent period. The Statement is effective in the first quarter 2008. The Group is currently assessing the effect of adoption of SFAS No. 159.

In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans – an amendment of FASB Statements No. 87, 88, 106 and 132(R)". This Statement requires an employer that sponsors one or more single-employer defined benefit plans to: (a) Recognize the funded status of a benefit plan in its statement of financial position; (b) Recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost; (c) Measure defined benefit plan assets and obligations as of the date of the employer's fiscal year-end statement of financial position (with limited exceptions); (d) Disclose in the notes to financial statements additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation. The provisions of this Statement are effective December 31, 2006, except for the requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end, which is effective December 31, 2008. The adoption of the provisions of SFAS No. 158 did not have a material impact on the Group's results of operations, financial position or cash flows (refer to Note 14 "Pension benefits" to our consolidated financial statements).

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" which establishes a single authoritative definition of fair value, sets out a framework for measuring fair value and requires additional disclosures about fair value measurements. This Statement does not require any new fair value measurements but is expected to increase the consistency of those measurements. The Group is required to adopt the provisions of SFAS No. 157 in the first quarter 2008 and does not expect any material impact on its financial statements upon adoption.

In June 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109" (FIN 48). This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes." The Group is required to adopt the provisions of FIN 48 in the first quarter 2007 and is currently assessing the effect of adoption.

In June 2006, the FASB ratified the consensus reached by the EITF on Issue No. 06-3, "How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)." The consensus requires disclosure of either the gross or net presentation, and any such taxes reported on a gross basis should be disclosed in the interim and annual financial statements. The Group adopted the provisions of EITF Issue No. 06-3 in 2006. The adoption of the Issue did not have a material impact on the Group's financial statements.

In December 2004, the FASB issued SFAS No. 123(R), "Share-Based Payment," which revises SFAS No. 123 and supersedes Accounting Principles Board (APB) Opinion No. 25 regarding stock-based employee compensation plans. SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be valued at fair value on the date of grant and as of each reporting date, and to be expensed over the applicable vesting period. The adoption of the provisions of SFAS No. 123(R) during 2006 did not have a material impact on the Group's results of operations, financial position or cash flows.

Forward-looking statements

Certain statements in this document are not historical facts and are "forward-looking." We may from time to time make written or oral forward-looking statements in reports to shareholders and in other communications. Examples of such forward-looking statements include, but are not limited to:

- statements of our plans, objectives or goals, including those related to products or services;
- statements of future economic performance; and
- statements of assumptions underlying such statements.

Forward looking statements that may be made by us from time to time (but that are not included in this document) may also include projections or expectations of revenues, income (or loss), earnings (or loss) per share, dividends, capital structure or other financial items or ratios. Words such as "believes," "anticipates," "expects," "estimates," "intends" and "plans" and similar expressions are intended to identify forward-looking statements but are not the exclusive means of identifying such statements. By their very nature, forward-looking statements involve inherent risks and uncertainties, both general and specific, and risks exist that the predictions, forecasts, projections and other forward-looking statements will not be achieved. You should be aware that a number of important factors could cause actual results to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward-looking statements.

These factors include:

- inflation, interest rate and exchange rate fluctuations;
- the price of oil;
- the effects of, and changes in, Russian government policy;
- the effects of competition in the geographic and business areas in which we conduct operations;
- the effects of changes in laws, regulations, taxation or accounting standards or practices;
- our ability to increase market share for our products and control expenses;
- acquisitions or divestitures;
- technological changes; and
- our success at managing the risks of the aforementioned factors.

This list of important factors is not exhaustive. When relying on forward-looking statements, you should carefully consider the foregoing factors and other uncertainties and events, especially in light of the political, economic, social and legal environment in which we operate. Such forward-looking statements speak only as of the date on which they are made, and, subject to any continuing obligations under the Listing Rules of the U.K. Listing Authority, we do not undertake any obligation to update or revise any of them, whether as a result of new information, future events or otherwise. We do not make any representation, warranty or prediction that the results anticipated by such forward-looking statements will be achieved, and such forward-looking statements represent, in each case, only one of many possible scenarios and should not be viewed as the most likely or standard scenario.