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

The following report contains a discussion and analysis of the financial condition of OAO LUKOIL as of December 31, 2012 and the results of it's operations for each of the years ended December 31, 2012, 2011 and 2010, and significant factors 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 and natural gas liquids produced are translated into barrels using conversion rates characterizing the density of crude oil from each of our oilfields and actual density of liquids produced at our gas processing plants. Tonnes of crude oil purchased as well as other operational indicators expressed in barrels were translated into barrels using an average conversion rate of 7.33 barrels per tonne. Translations of cubic meters to cubic feet were made at the rate of 35.31 cubic feet per cubic meter. Translations of barrels of crude oil into barrels of oil equivalent ("BOE") were made at the rate of 1 barrel per BOE and of cubic feet – at the rate of 6 thousand cubic feet per BOE.

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 34 for a discussion of some factors that could cause actual results to differ materially.

Key financial and operational results

	2012	Change to 2011, %	2011	Change to 2010, %	2010
Sales (millions of US dollars)	139,171	4.1	133,650	27.3	104,956
Net income attributable to OAO LUKOIL (millions of US dollars)	11,004	6.2	10,357	15.0	9,006
EBITDA (millions of US dollars)	18,915	1.7	18,606	15.9	16,049
Taxes other than income taxes, excise and export tariffs (millions of US dollars)	(36,502)	3.9	(35,135)	26.1	(27,856)
Earning per share of common stock attributable to OAO LUKOIL (US dollars):					
Basic	14.47	8.8	13.30	21.4	10.95
Diluted	14.17	8.7	13.04	19.1	10.94
Hydrocarbon production by the Group including our share in equity affiliates (thousands of BOE)	794,332	0.5	790,674	(4.5)	828,098
Daily hydrocarbon production by the Group including our share in equity affiliates (thousands of BOE per day)	2,170	0.2	2,166	(4.5)	2,269
Crude oil and natural gas liquids produced by the Group including our share in equity affiliates (thousands of barrels)	677,023	(1.1)	684,522	(5.1)	721,560
Gas available for sale produced by the Group including our share in equity affiliates (millions of cubic meters)	19,934	10.5	18,038	(0.4)	18,103
Refined products produced by the Group including our share in equity affiliates (thousands of tonnes)	63,773	1.8	62,667	(1.7)	63,770
Hydrocarbon proved reserves including our share in equity affiliates (millions of BOE)	17,296	0.2	17,269	0.1	17,255

Our net income for 2012 amounted to $11,004 million, which is $647 million, or 6.2%, more than in the previous year. In 2011, our net income was $10,357 million, which is $1,351 million, or 15.0%, more than in 2010. Moreover, our net income for the fourth quarter of 2012 amounted to $2,688 million, which is nearly twice as much as in the fourth quarter of 2011. Our net income was influenced mainly by export tariffs and mineral extraction tax rates and by hydrocarbon prices. In 2011, our net income was materially affected by impairment loss in OOO Narianmarneftegaz in amount of $955 million net of tax and non-controlling interest effect, recognized in the fourth quarter of 2011.

Business overview

The primary activities of OAO LUKOIL and its subsidiaries are oil exploration, production, refining, marketing and distribution. The Company is the ultimate parent entity of a vertically integrated group of companies.

OAO LUKOIL was established in accordance with Presidential Decree 1403, issued on November 17, 1992. Under this decree, on April 5, 1993, the Government of the Russian Federation transferred to the Company 51% of the voting shares of fifteen enterprises. Under Government Resolution 861 issued on September 1, 1995, a further nine enterprises were transferred to the Group during 1995. Since 1995, the Group has carried out a share exchange program to increase its shareholding in each of 24 founding subsidiaries to 100%. From formation, the Group has expanded substantially through consolidation of interests, acquisition of new companies and establishment of new businesses. Now LUKOIL is a global energy company operating through its subsidiaries in 38 countries on four continents.

LUKOIL is one of the world's largest energy companies in terms of hydrocarbon reserves that amounted to 17.3 billion BOE as of January 1, 2013 and comprised of 13.4 billion barrels of crude oil and 23.5 trillion cubic feet of gas.

Our operations are divided into four main business segments:

- **Exploration and Production** – which includes our exploration, development and production operations relating to crude oil and gas. These activities are primarily located within Russia, with additional activities in Azerbaijan, Kazakhstan, Uzbekistan, the Middle East, South America, Northern and Western Africa and South-East Asia.
- **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.
- **Power generation** – which includes generation, transportation and sales of electricity, heat and related services.

Each of our four 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 9, 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 crude oil refining 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 22 "Segment information" to our consolidated financial statements.

Recent developments and outlook

The following has been achieved in 2012:

Exploration and production

- 7 new oil and 1 gas fields were brought into production (2011 – 4 oil and gas fields).
- In December, a Group subsidiary won the bidding for the use of a subsoil site that includes Imilorskoye, West Imilorskoye and Istochnoye fields. The site is located in Western Siberia with the oil in place and the recoverable oil reserves totaling, respectively, 855.5 million tonnes and 193.7 million tonnes in the C1 and C2 categories combined.
- The trend of crude oil production decline was broken and production volumes stabilized as a result of significant growth of drilling footage and reservoir stimulation.
- Active stage of development began on V.Filanovsky field on the Caspian seashore.
- Natural gas production volumes increased by 11.2% compared to 2011.

Refining

- Starting from July 1, all the volume of gasoline produced by Group refineries in Russia complies with Euro-5.
- In September, we increased the Group's ownership stake in the joint venture operating the ISAB refining complex ("ISAB") from 60% to 80% and obtained control over ISAB.
- In the third quarter, a new diesel fuel hydrorefining unit with rated capacity of 3 million tonnes per year was put into operation at our refinery in Volgograd that made all of the refinery's diesel fuel output compliant with Euro-5.

Marketing and distribution

- In April, a new oil product terminal with a total capacity of 1 million cubic meters was opened in the port Barcelona, Spain by a Group company and Spanish company Meroil on a 50/50 basis.

These and other achievements in 2012 are described in detail further in this report.

Changes in the Group structure

In January 2012, the Group was offered to acquire a 20% stake in the joint venture operating the ISAB. The transaction was approved by European regulatory authorities and was completed in September 2012. After final adjustments, its amount totaled €494 million (approximately $621 million). The Group's ownership in ISAB increased from 60% to 80% and the Group obtained control over the joint venture. This transaction was a partial exercise of ERG S.p.A. option to sell in full its stake in the joint venture established in 2008. In April 2011, within this option, the Group acquired an 11% stake in the joint venture for €241 million (approximately $342 million).

In August 2012, the Group acquired ConocoPhillips' investment in OOO "Narianmarneftegas" ("NMNG") and certain related assets for $604 million. ConocoPhillips group owned 30% interest in NMNG. The acquisition increased the Group's total ownership interest in NMNG to 100%.

In January 2010, the Company signed an agreement to develop the West Qurna-2 field located in the south of Iraq. Originally, the parties to the agreement were the Iraqi state-owned South Oil Company and the contracting consortium formed by the Iraqi state-owned North Oil Company, the Company and Norway's Statoil ASA. The Company's share in the project was 56.25%. In 2012, the Group increased its share it the project up to 75%. The West Qurna-2 field has recoverable crude oil reserves of about 12.9 billion barrels.

As a part of the expansion of its presence in Kazakhstan, in December 2009, the Group acquired the remaining 46.0% interest in its equity affiliate LUKARCO B.V. ("LUKARCO") for $1.6 billion, thereby increasing the ownership stake to 100%. LUKARCO is a holding company, which owns a 5.0% share in Tengizchevroil, a joint venture which develops the Tengiz and Korolevskoe fields in Kazakhstan, and a 12.5% share in Caspian Pipeline Consortium ("CPC"), which carries Kazakhstani and Russian oil to Novorossiysk marine terminal. Therefore, the Group increased the ownership in Tengizchevroil from 2.7% to 5.0% and the ownership in CPC from 6.75% to 12.5%. The first installment in the amount of $300 million was paid in December 2009. $800 million were paid in December 2010 and the remaining amount – in December 2011.

Impairment of assets in OOO Narianmarneftegaz

In 2005, the Company and ConocoPhillips, within their strategic partnership, established a joined venture based on a Group subsidiary NMNG to develop oilfields located in Northern Timan-Pechora region of Russia. The Group's share in joint venture was 70%, LUKOIL and ConocoPhillips run NMNG on a 50/50 basis. In 2008, NMNG commenced commercial production at the Yuzhnoye Khylchuyu oilfield, joint venture's major oilfield. As of December 31, 2008, proved reserves of the oilfield were estimated to be approximately 505 million barrels. In 2009 and 2010, the crude oil production from the field amounted to 7.0 and 6.9 million tonnes, respectively. In 2010, the production from the oilfield began to decline due to some unexpected geological reasons and it only reached 3.3 million tonnes in 2011. As of December 31, 2011, crude oil reserves decreased significantly and amounted to approximately 142 million barrels. In 2011, as a result of respective analysis the Company recognized an impairment loss regarding upstream and other assets of NMNG in amount of $1,261 million. An impact on our net income for 2011 net of ConocoPhillip's share in the impairment loss and deferred tax assets write-off amounted to $955 million and an impact on our EBITDA amounted to $883 million.

Resource base

The table below summarizes the net oil-equivalent proved reserves of consolidated subsidiaries and our share in equity affiliates under SEC standards (until the economic limit of commercial production is reached) that have been derived or extracted from our reserve reports audited by Miller and Lents, Ltd., our independent reservoir engineers, as of January 1, 2013 and 2012.

(millions of BOE)	January 1, 2013[1]	Changes in 2012			January 1, 2012
		Production[2]	Extensions, discoveries and changes in structure	Revision of previous estimates	
Western Siberia	9,712	(448)	337	112	9,711
Timan-Pechora	2,468	(120)	94	(56)	2,550
Ural region	2,217	(112)	69	91	2,169
Volga region	1,063	(35)	104	20	974
Other in Russia	216	(15)	7	–	224
Outside Russia	1,620	(88)	92	(25)	1,641
Proved oil and gas reserves	**17,296**	**(818)**	**703**	**142**	**17,269**
Probable oil and gas reserves	**7,723**				**8,415**
Possible oil and gas reserves	**4,272**				**3,939**

(1) Excluding reserves related to the Imilorskoye, West Imilorskoye and Istochnoye fields.
(2) Gas production shown before own consumption.

The Company's proved reserves as of January 1, 2013 amount to 17,296 million BOE and comprise of 13,381 million barrels of crude oil and 23,487 billion cubic feet of gas. Replacement of production by proved reserves increment in 2012 exceeded 100%.

In 2012, proved reserves growth as a result of geological exploration, production drilling and acquisitions, totaled 703 million BOE, largely as a result of the detailed field appraisal in the Northern Caspian and Komi Republic. Revision of previous estimates contributed 142 million BOE to the increase. In 2012, basic factors that contributed to a positive reinterpretation of proved reserves were improvement of development techniques at the existing fields, progress in the preparation for the commissioning of a number of new fields and greater gas utilization.

The Company's management expects the oil and gas volumes classified as contingent resources to be transferred to reserves as their commissioning date approaches, a program to enhance volumes of gas utilization is implemented and new advanced technologies are applied, which makes it possible to develop the hard-to-recover reserves in a cost-effective way.

Operational highlights

Hydrocarbon production

We undertake exploration for, and production of, crude oil and natural gas in Russia and internationally. In Russia, our major oil producing subsidiaries are OOO LUKOIL-Western Siberia, OOO LUKOIL-Komi and OOO LUKOIL-Perm. Exploration and production outside of Russia is performed by our 100% subsidiary LUKOIL-Overseas, that has stakes in PSA's and other projects in Kazakhstan, Azerbaijan, Uzbekistan, Iraq, Saudi Arabia, Egypt, Ghana, Cote d'Ivoire, Vietnam, Venezuela and Sierra-Leone.

The table below summarizes the results of our exploration and production activities.

	2012	2011	2010
	(thousand BOE per day)		
Daily production of hydrocarbons, including the Company's share in equity affiliates, including:	2,170	2,166	2,269
- crude oil and natural gas liquids[1]	1,850	1,875	1,977
- natural gas[2]	320	291	292
	(US dollar per BOE)		
Hydrocarbon extraction expenses	5.04	4.96	4.30
- in Russia	5.03	4.97	4.31
- outside Russia	5.07	4.85	4.29
	(millions of US dollars)		
Hydrocarbon extraction expenses	3,861	3,771	3,430
- in Russia	3,562	3,529	3,212
- outside Russia	299	242	218
Exploration expenses	364	532	336
- in Russia	205	93	96
- outside Russia	159	439	240
Mineral extraction tax	12,354	11,594	7,864
- in Russia	12,261	11,502	7,795
- outside Russia	93	92	69

[1] Natural gas liquids produced at the Group gas processing plants.

[2] Gas available for sale (excluding gas produced for our own consumption and including petroleum gas sold to third parties).

Crude oil production. In 2012, our daily crude oil production decreased to 1,813 thousand barrels, or by 1.5%, compared to 2011. In 2012, we produced (including the Company's share in equity affiliates) 663.4 million barrels, or 89.9 million tonnes of crude oil.

The following table represents our crude oil production in 2012 and 2011 by major regions.

		Change to 2011			
(thousands of tonnes)	**2012**	**Total, %**	**Change in structure**	**Organic change**	**2011**
Western Siberia	49,214	0.2	–	112	49,102
Timan-Pechora	15,634	(10.9)	–	(1,913)	17,547
Ural region	13,498	5.4	–	693	12,805
Volga region	3,603	12.5	–	400	3,203
Other in Russia	1,899	(2.7)	–	(53)	1,952
Crude oil produced in Russia	83,848	(0.9)	–	(761)	84,609
Crude oil produced internationally	3,342	(2.1)	(74)	3	3,413
Total crude oil produced by consolidated subsidiaries	**87,190**	**(0.9)**	**(74)**	**(758)**	**88,022**
Our share in crude oil produced by equity affiliates:					
in Russia	386	8.1	–	29	357
outside Russia	2,280	(10.2)	–	(258)	2,538
Total crude oil produced	**89,856**	**(1.2)**	**(74)**	**(987)**	**90,917**

The main oil producing region for the Company is Western Siberia where we produced 56.4% of our crude oil in 2012 (55.8% in 2011). Since the second half of 2011, the Company managed to stabilize crude oil production in the region that had been declining for several preceding years.

The continuing trend of increasing water cut at our Yuzhnoye Khylchuyu oilfield was the main reason for the production decrease in Russia.

The structural decrease of our international production was a result of sale of 1.5% (10.0% of our share) in Karachaganak Petroleum Operating consortium ("KPO"), an upstream project in Kazakhstan, to a state-owned KazMunayGaz in the end of the second quarter of 2012.

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. Then we either refine or export purchased crude oil. Crude oil purchased on international markets is normally used for trading activities, for supplying our international refineries or for processing at third party refineries.

	2012		2011		2010	
	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)
Crude oil purchases in Russia	1,994	272	4,010	547	2,243	306
Crude oil purchases internationally	119,883	16,355	151,753	20,703	156,759	21,386
Total crude oil purchased	**121,877**	**16,627**	**155,763**	**21,250**	**159,002**	**21,692**

Significant part of our crude oil purchases is for processing. In 2012, we purchased 12,512 thousand tonnes of crude oil to process at our and at third party refineries, compared to 12,969 thousand tonnes in 2011. The decrease was due to higher volumes of own supply. Our purchases for trading also decreased compared to 2011.

Production of gas and natural gas liquids. In 2012, we produced 19,934 million cubic meters (117.3 million BOE) of gas available for sale (including our share in equity affiliates), that is 10.5% more than in 2011.

Our major gas production field is the Nakhodkinskoe field, where we produced 8,041 million cubic meters of natural gas in 2012 (8,273 million cubic meters in 2011). Our international gas production increased by 39.7%, mostly due to growth of our production in Uzbekistan. We produced 992 million cubic meters of gas from the Gissar field (commercial production commenced in December 2011), and increased production from the Khauzak field by 635 million cubic meters, or by 24.2%.

In 2012, the output of natural gas liquids at the Group gas processing plants in Western Siberia, Ural and Volgograd regions of Russia was 13.6 million BOE, compared to 13.1 million BOE in 2011.

Refining, marketing and trading

Refining. We own and operate four refineries located in European Russia and four refineries located outside of Russia – in Bulgaria, Romania, Italy and Ukraine. Moreover, we have a 45% interest in the Zeeland Refinery in the Netherlands.

In September 2012, we increased our interest up to 80% and obtained control over ISAB, in which we previously held 60% (49% before April 2011). Therefore, starting from September 2012, ISAB became our consolidated subsidiary.

Compared to 2011, the total volume of refined products produced by the Group (including our share in equity affiliates production) increased by 1.8%. Due to scheduled overhauls, production volumes of our Russian refineries decreased by 1.8%. Production of our international refineries increased by 9.7% as a result of the increase of our share in ISAB.

We invested, and continue to invest, significant resources in our refineries aiming at taking the leading position in Russia in producing ecological fuel of high quality standards. Starting from July 1, 2012, all the gasoline and most of diesel fuel produced by the Group in Russia comply with Euro-5 standards.

Along with our own production of refined products we can refine crude oil at third party refineries depending on market conditions and other factors. In 2011, we began processing our crude oil at a third party refinery in Kazakhstan. In 2012, we restarted processing operations in Belarus.

The following table summarizes key figures for our refining activities.

	2012	2011	2010
	(millions of US dollars)		
Refining expenses at the Group refineries	1,669	1,418	1,121
- in Russia	1,141	1,112	806
- outside Russia[(1)]	528	306	315
Refining expenses at ISAB and Zeeland Refinery [(2)]	702	890	719
Refining expenses at third party refineries	96	7	5
Capital expenditures	1,406	783	702
- in Russia	988	586	542
- outside Russia	418	197	160
	(thousand barrels per day)		
Refinery throughput at the Group refineries	1,128	1,073	1,107
- in Russia	890	909	908
- outside Russia[(1) (3)]	238	164	199
Refinery throughput at ISAB and Zeeland Refinery [(2) (3)]	195	230	222
Refinery throughput at third party refineries	53	5	2
Total refinery throughput	**1,376**	**1,308**	**1,331**
	(thousands of tonnes)		
Refined products produced at the Group refineries	54,009	51,055	52,762
- in Russia	42,468	43,248	43,346
- outside Russia[(1)]	11,541	7,807	9,416
Production of ISAB and TRN[(2)]	9,764	11,612	11,008
Refined products produced at third party refineries	2,472	256	107
Total refined products produced	**66,245**	**62,923**	**63,877**

(1) Including 80% share of ISAB for September-December 2012.
(2) Including 60% share of ISAB from April 2011 to August 2012 (49% share of ISAB before April 2011) and 45% share of Zeeland Refinery.
(3) Including refined product processed.

Marketing and trading. Our marketing and trading activities mainly include wholesale and bunkering operations in Western Europe, South-East Asia, Central America and retail operations in the USA, Central and Eastern Europe, the Baltic States and other regions. In Russia, we purchase refined products on occasion, primarily to manage supply chain bottlenecks.

The Group retails its refined products in 26 countries through nearly 5.6 thousand petrol stations. Most of the stations operate under the LUKOIL brand.

The table below summarizes figures for our trading activities.

	2012	2011	2010
	(thousands of tonnes)		
Retail sales	15,424	15,249	14,336
Wholesale sales	97,558	87,337	91,020
Total refined products sales	**112,982**	**102,586**	**105,356**
Refined products purchased in Russia	1,772	2,026	1,853
Refined products purchased internationally	52,761	45,655	45,816
Total refined products purchased	**54,533**	**47,681**	**47,669**

Exports of crude oil and refined products from Russia. The volumes of crude oil exported from Russia by our subsidiaries are summarized as follows:

	2012		**2011**		**2010**	
	(thousands of barrels)	(thousands of tonnes)	(thousands of barrels)	(thousands of tonnes)	(thousands of barrels)	(thousands of tonnes)
Exports of crude oil using Transneft export routes	223,185	30,448	215,605	29,414	231,525	31,586
Exports of crude oil bypassing Transneft	31,418	4,286	38,739	5,285	65,999	9,004
Total crude oil exports	**254,603**	**34,734**	**254,344**	**34,699**	**297,524**	**40,590**

In 2012, the volume of our export of crude oil from Russia remained on the level of 2011, and we exported 41.4% of our total domestic crude oil production (41.0% – in 2011).

Almost all the volume of crude oil exported bypassing Transneft was routed through our own export infrastructure. The reduction of export through our own export infrastructure was mainly caused by a decrease in production from Yuzhnoye Khylchuyu oilfield (1,275 thousand tonnes in 2012 compared to 3,316 thousand tonnes in 2011).

In 2012, we exported from Russia 22.5 million tonnes of refined products, a decrease of 6.2%, compared to 2011. Primarily, we export from Russia diesel fuel, fuel oil and gasoil. These products account for approximately 89% of our refined products export volumes.

The decrease in refined products export was a result of a decrease in throughput at our Russian refineries together with the increase of domestic demand.

In 2012, our revenue from export of crude oil and refined products from Russia both to Group companies and third parties amounted to $25,174 million and $16,779 million, respectively ($25,022 million for crude oil and $17,725 million for refined products in 2011).

Power generation

In 2012, we continued to develop the power generation sector of our business as part of our strategic development program. This new sector encompasses all aspects of the power generation business, from generation to transmission and sale of heat and electrical power. Our power generation business sector now includes OOO LUKOIL-Volgogradenergo, OOO LUKOIL-Kubanenergo, OOO LUKOIL-Astrakhanenergo, OOO LUKOIL-Rostovenergo, OOO LUKOIL-Stavropolenergo, OOO LUKOIL-TTK, OOO LUKOIL-Ecoenergo, our own power generating facilities at our oil and gas fields in Russia and power generators in Bulgaria, Romania and Ukraine. Our total output of electrical energy was 15.4 billion kW-h in 2012 (13.1 billion kW-h in 2011). Our total output of heat energy was approximately 14.7 million Gcal in 2012 (15.5 million Gcal in 2011).

In 2012, we began construction of another two combined cycle gas turbine units in Astrakhan with a combined capacity of 235 MW. The completion is scheduled for the third quarter of 2013.

Main macroeconomic factors affecting our results of operations

Changes 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 the Group's revenues. In 2012, the Brent crude oil price fluctuated between $88 and $128 per barrel and reached its peak of $128.18 in the beginning of March.

Substantially all the crude oil the Group exports is Urals blend. The following table shows the average crude oil and refined product prices in 2012, 2011 and 2010.

	2012	Change to 2011, %	2011	Change to 2010, %	2010
	(in US dollars per barrel, except for figures in percent)				
Brent crude	111.67	0.4	111.26	39.9	79.50
Urals crude (CIF Mediterranean) [1]	110.55	1.3	109.10	39.4	78.29
Urals crude (CIF Rotterdam) [1]	110.19	1.0	109.08	39.4	78.26
	(in US dollars per metric tonne, except for figures in percent)				
Fuel oil 3.5% (FOB Rotterdam)	631.08	3.5	609.51	37.8	442.35
Diesel fuel 10 ppm (FOB Rotterdam)	980.00	2.2	958.73	39.3	688.46
High-octane gasoline (FOB Rotterdam)	1,036.14	5.3	984.12	33.9	735.24

Source: Platts.

[1] 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 2012, 2011 and 2010.

	2012	Change to 2011, %	2011	Change to 2010, %	2010
	(in US dollars per metric tonne, except for figures in percent)				
Fuel oil	320.29	0.4	318.99	30.1	245.27
Diesel fuel	832.71	9.5	760.53	36.5	557.36
High-octane gasoline (Regular)	813.94	(5.1)	857.70	20.1	714.26
High-octane gasoline (Premium)	869.33	(3.2)	897.81	20.8	743.17

Source: InfoTEK (excluding VAT).

Changes in the US dollar-ruble exchange rate and inflation

A substantial part of our revenue 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, the appreciation of the ruble against the US dollar generally causes our costs to increase in US dollar terms, and vice versa. The appreciation of the purchasing power of the US dollar in the Russian Federation calculated on the basis of the ruble-dollar exchange rates and the level of inflation in Russia was 0.7% in 2012, compared to 2011. At the same time, the nominal appreciation of the US dollar amounted to 5.8% (based on average ruble-dollar exchange rates for 2012 and 2011).

The following table gives data on inflation in Russia and the change in the ruble-dollar exchange rate.

	2012	2011	2010
Ruble inflation (CPI), %	6.6	6.1	8.7
Average exchange rate for the period (ruble to US dollar)	31.09	29.39	30.37
Exchange rate at the end of the period (ruble to US dollar)	30.37	32.20	30.48

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). In 2012, 2011 and 2010, the tax charge on the operations in Russia was approximately 88%, 88% and 85% of our total tax charge, respectively.

Apart of income tax, fundamental taxes specific to the oil industry in Russia are mineral extraction tax, excise and export tariffs. In addition to above mentioned taxes, we are subject to a number of other taxes in Russia, including social taxes, property tax, VAT and 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 2012, 2011 and 2010, respectively, were 78%, 80% and 77%. In 2012, tax expenses in Russia were about 53% of the domestic and export sales revenue of Russian companies of the Group.

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.

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

		2012(1)	Change to 2011, %	2011(1)	Change to 2010, %	2010(1)
Export tariffs on crude oil	\$/tonne	404.15	(1.2)	409.19	49.6	273.55
Export tariffs on refined products						
Middle distillates (jet fuel), diesel fuel and gasoils	\$/tonne	266.70	(2.8)	274.27	39.5	196.60
Light distillates						
gasoline	\$/tonne	363.72	6.4	341.94	73.9	196.60
straight-run gasoline	\$/tonne	363.72	9.2	333.08	69.4	196.60
Liquid fuels (fuel oil)	\$/tonne	266.70	27.9	208.46	96.8	105.91
Mineral extraction tax						
Crude oil	RUR/tonne	5,065.95	13.7	4,456.54	44.9	3,075.76
Natural gas	RUR/1,000 m^3	251.00	5.9	237.00	61.2	147.00

(1) Average values.

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

		2012(1)	Change to 2011, %	2011(1)	Change to 2010, %	2010(1)
Mineral extraction tax						
Crude oil	\$/tonne	162.93	7.4	151.65	49.7	101.28
Natural gas	\$/1,000 m^3	8.07	0.1	8.06	66.5	4.84

(1) Average values.

The rates of taxes specific to the oil industry in Russia are linked to international crude oil prices and are changed in line with them. The methods to determine the rates for such taxes are presented below.

Crude oil extraction tax rate is determined by adjusting the base rate 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 $15.00 per barrel. Each $1.00 per barrel increase in the international Urals blend price over the threshold ($15.00 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).

In 2012, the base rate was 446 rubles per metric tonne extracted (419 rubles in 2011 and 2010). The base rate for 2013 is currently set at 470 rubles per metric tonne extracted. However, the rate may be amended by the authorities later on.

The crude oil extraction tax rate varies depending on the development and depletion of a particular oilfield. The tax rate is zero for extra-heavy crude oil and for crude oil produced in certain regions of Eastern Siberia, the Caspian Sea and the Nenetsky Autonomous District, depending on the period and volume of production.

The Group produces crude oil in the Caspian Sea and benefits from application of zero extraction tax rate. We expect the amount of benefit to increase as the production volumes grow.

Natural gas extraction tax rate. The mineral extraction tax on natural gas produced by independent producers in Russia is calculated using a flat rate. In 2011, the rate was 237 rubles per thousand cubic meters and in 2012 the rate was 251 rubles per thousand cubic meters. The rate for 2013 is set at 265 rubles per thousand cubic meters.

Crude oil export duty rate is calculated on a 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 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 $15.00 results in an increase of the crude oil export duty rate by $0.35 per barrel exported. If the Urals blend price is 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 $20.00 results in an increase of the crude oil export duty rate by $0.45 per barrel exported. Each $1.00 per barrel increase in the Urals blend price over $25.00 per barrel results in an increase of the crude oil export duty rate no more than by $0.65 per barrel exported. Starting from October 1, 2011, the maximum increase of export duty rate is $0.60 per barrel for each $1.00 per barrel increase in the Urals blend price.

The crude oil export duty rate is revised monthly on the basis of the immediately preceding one-month period of crude oil price monitoring.

A special export duty regime is in place for certain greenfields. Effective from December 2010, the list of the oilfields where the reduced rate applies also includes our Yu. Korchagin and V. Filanovsky oilfields located in the Caspian Sea.

Export duty rates on refined products prior to 2011 were set by the Russian government. The rate of export duty depended on internal demand for refined products and international crude oil market conditions. Starting from 2011, export duty rates on refined products are calculated by multiplying the current crude oil export duty rate by a coefficient according to the table below.

	Before October 1, 2011	**After October 1, 2011**
Multiplier for:		
Light distillates (except for gasolines), middle distillates (jet fuel), diesel fuel and gasoils	0.670	0.660
Gasolines[1]	0.467	0.900
Liquid fuels (fuel oil)	0.467	0.660
Motor and other oils	0.467	0.660
Other products	0.467	0.660

[1] Starting from May 2011, a coefficient for gasoline export duty rate is set at 0.9.

Crude oil and refined products exported to the member countries of the Custom Union – Belarus and Kazakhstan, are not subject to export duties.

Excise on refined products. The responsibility to pay excises on refined products in Russia is imposed on refined product producers (except for straight-run gasoline). Only domestic sales volumes are subject to excises.

In other countries where the Group operates, excises are paid either by producers or retailers depending on the local legislation.

Starting from 2011, excise rates on refined products in Russia were increased and tied to the ecological class of fuel. Excise tax rates for 2012, 2011 and 2010 are listed below:

		2012	**Change to 2011, %**	**2011**	**Change to 2010, %**	**2010**
Gasoline						
Below Euro-3	RUR/tonne	7,976.37	33.1	5,995.00	105.1	2,923.00
Euro-3	RUR/tonne	7,633.37	34.6	5,672.00	42.1	3,992.00
Euro-4	RUR/tonne	6,822.00	32.6	5,143.00	28.8	3,992.00
Euro-5	RUR/tonne	5,977.91	16.2	5,143.00	28.8	3,992.00
Diesel fuel						
Below Euro-3	RUR/tonne	4,199.55	52.5	2,753.00	131.7	1,188.00
Euro-3	RUR/tonne	4,058.33	63.3	2,485.00	109.2	1,188.00
Euro-4	RUR/tonne	3,562.00	58.5	2,247.00	89.1	1,188.00
Euro-5	RUR/tonne	3,260.36	45.1	2,247.00	89.1	1,188.00
Motor oils	RUR/tonne	6,072.00	29.7	4,681.00	44.2	3,246.10
Straight-run gasoline	RUR/tonne	7,824.00	28.5	6,089.00	41.9	4,290.00

		2012	**Change to 2011, %**	**2011**	**Change to 2010, %**	**2010**
Gasoline						
Below Euro-3	$/tonne	256.53	25.8	204.00	112.0	96.25
Euro-3	$/tonne	245.50	27.2	193.01	46.8	131.45
Euro-4	$/tonne	219.41	25.4	175.01	33.1	131.45
Euro-5	$/tonne	192.26	9.9	175.01	33.1	131.45
Diesel fuel						
Below Euro-3	$/tonne	135.06	44.2	93.68	139.5	39.12
Euro-3	$/tonne	130.52	54.4	84.56	116.2	39.12
Euro-4	$/tonne	114.56	49.8	76.46	95.5	39.12
Euro-5	$/tonne	104.86	37.1	76.46	95.5	39.12
Motor oils	$/tonne	195.29	22.6	159.29	49.0	106.89
Straight-run gasoline	$/tonne	251.63	21.4	207.20	46.7	141.26

In 2013, the excise rates increase as follows:

	January 1, 2013 till June 30, 2013		**July 1, 2013 till December 31, 2013**	
	RUR/tonne	$/tonne [1]	RUR/tonne	$/tonne [1]
Gasoline				
Below Euro-3	10,100.00	332.54	10,100.00	332.54
Euro-3	9,750.00	321.01	9,750.00	321.01
Euro-4	8,560.00	281.83	8,960.00	295.00
Euro-5	5,143.00	169.33	5,143.00	169.33
Diesel fuel				
Below Euro-3	5,860.00	192.94	5,860.00	192.94
Euro-3	5,860.00	192.94	5,860.00	192.94
Euro-4	4,934.00	162.45	5,100.00	167.91
Euro-5	4,334.00	142.69	4,500.00	148.16
Motor oils	7,509.00	247.23	7,509.00	247.23
Straight-run gasoline	10,229.00	336.78	10,229.00	336.78

(1) Exchange rate as of December 31, 2012 applied.

Income tax. The Federal income tax rate is 2.0% and the regional income tax rate varies between 13.5% and 18.0%. The Group's foreign operations are subject to taxes at the tax rates applicable to the jurisdictions in which they operate.

Until January 1, 2012, there were no provisions in the taxation legislation of the Russian Federation to permit the Group to reduce taxable profits of a Group company by offsetting tax losses of another Group company against such profits. Tax losses could be fully or partially used to offset taxable profits in the same company in any of the ten years following the year of loss.

Starting from January 1, 2012, if certain conditions are met, taxpayers are able to pay income tax as a consolidated taxpayers' group ("CTG"). This allows taxpayers to offset taxable losses generated by certain participants of a CTG against taxable profits of other participants of the CTG. Certain Group companies met the legislative requirements and pay income tax as a CTG starting from the first quarter of 2012.

Losses generated by a taxpayer before joining a CTG are not available for offset against taxable profits of other participants of the CTG. However, if a taxpayer leaves a CTG, such losses again become available for offset against future profits generated by the same taxpayer. The expiration period of the losses is extended to take account of any time spent within a CTG when the losses were unavailable for use.

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 by crude oil production companies to the markets is dependent on the extent of diversification of the 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 or by railway transport.

Transportation of refined products in Russia is performed by railway transport and the pipeline system of OAO AK Transnefteproduct. The Russian railway infrastructure is owned and operated by OAO Russian Railways. Both these companies are state-owned. We transport the major part of our refined products by railway transport.

In Russia, the gas is mostly sold at the wellhead and then transported through the Unified Gas Supply System ("UGSS"). The UGSS is responsible for gathering, transporting, dispatching and delivering substantially all natural gas supplies in Russia and is owned and operated by OAO Gazprom ("Gazprom"). The Federal Service for Tariffs of the Russian Federation regulates natural gas transportation tariffs. We are not able to sell our gas other than through UGSS.

Year ended December 31, 2012, compared to years ended December 31, 2011 and December 31, 2010

The table below presents data from our consolidated statements of comprehensive income for the periods indicated.

	2012	2011	2010
	(millions of US dollars)		
Revenues			
Sales (including excise and export tariffs)	139,171	133,650	104,956
Costs and other deductions			
Operating expenses	(9,359)	(9,055)	(8,298)
Cost of purchased crude oil, gas and products	(64,148)	(59,694)	(43,250)
Transportation expenses	(6,171)	(6,121)	(5,608)
Selling, general and administrative expenses	(3,755)	(3,822)	(3,558)
Depreciation, depletion and amortization	(4,832)	(4,473)	(4,154)
Taxes other than income taxes	(13,666)	(12,918)	(8,978)
Excise and export tariffs	(22,836)	(22,217)	(18,878)
Exploration expense	(364)	(532)	(336)
Gain (loss) on disposals and impairments of assets	30	(1,663)	(363)
Income from operating activities	**14,070**	**13,155**	**11,533**
Interest expense	(538)	(694)	(712)
Interest and dividend income	257	211	174
Equity share in income of affiliates	518	690	472
Currency translation loss	(512)	(301)	(122)
Other non-operating (expense) income	(72)	58	125
Income before income taxes	**13,723**	**13,119**	**11,470**
Current income taxes	(2,738)	(2,678)	(2,104)
Deferred income taxes	(60)	(615)	(247)
Total income tax expense	**(2,798)**	**(3,293)**	**(2,351)**
Net income	**10,925**	**9,826**	**9,119**
Net loss (income) attributable to non-controlling interests	79	531	(113)
Net income attributable to OAO LUKOIL	**11,004**	**10,357**	**9,006**
Earning per share of common stock attributable to OAO LUKOIL (in US dollars):			
Basic	14.47	13.30	10.95
Diluted	14.17	13.04	10.94

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

Sales revenues

Sales breakdown	2012	2011	2010
	(millions of US dollars)		
Crude oil			
Export and sales on international markets other than CIS	24,414	30,132	25,251
Export and sales to CIS	1,622	2,390	1,091
Domestic sales	1,634	1,571	956
	27,670	**34,093**	**27,298**
Refined products			
Export and sales on international markets			
Wholesale	75,880	65,060	50,340
Retail	10,724	11,275	9,678
Domestic sales			
Wholesale	8,113	7,349	5,427
Retail	8,690	7,893	5,501
	103,407	**91,577**	**70,946**
Petrochemicals			
Export and sales on international markets	992	1,095	642
Domestic sales	418	914	728
	1,410	**2,009**	**1,370**
Gas and gas products			
Export and sales on international markets	2,385	1,878	1,565
Domestic sales	1,092	1,001	786
	3,477	**2,879**	**2,351**
Sales of energy and related services	**1,394**	**1,472**	**1,416**
Other			
Sales on international markets	962	880	890
Domestic sales	851	740	685
	1,813	**1,620**	**1,575**
Total sales	**139,171**	**133,650**	**104,956**

Sales volumes	2012	2011	2010
Crude oil	(thousands of barrels)		
Export and sales on international markets other than CIS	222,466	275,696	326,669
Export and sales to CIS	31,622	45,329	23,280
Domestic sales	33,264	32,699	26,637
	287,352	**353,724**	**376,586**
Crude oil	(thousands of tonnes)		
Export and sales on international markets other than CIS	30,350	37,612	44,566
Export and sales to CIS	4,314	6,184	3,176
Domestic sales	4,538	4,461	3,634
	39,202	**48,257**	**51,376**
Refined products	(thousands of tonnes)		
Export and sales on international markets			
Wholesale	85,917	76,313	80,043
Retail	6,568	6,945	7,314
Domestic sales			
Wholesale	11,641	11,024	10,977
Retail	8,856	8,304	7,022
	112,982	**102,586**	**105,356**
Total sales volume of crude oil and refined products	**152,184**	**150,843**	**156,732**

Realized average sales prices		2012	2011	2010
Average realized price international				
Oil (excluding CIS)	($/barrel)	109.74	109.30	77.30
Oil (CIS)	($/barrel)	51.31	52.71	46.84
Refined products				
Wholesale	($/tonne)	883.18	852.55	628.91
Retail	($/tonne)	1,632.81	1,623.53	1,323.31
Average realized price within Russia				
Oil	($/barrel)	49.12	48.06	35.90
Refined products				
Wholesale	($/tonne)	696.91	666.62	494.37
Retail	($/tonne)	981.21	950.51	783.49

In 2012, our revenues increased by $5,521 million, or by 4.1%, compared to 2011 (in 2011 increased by $28,694 million, or by 27.3%, compared to 2010).

Our revenues from crude oil sales decreased by $6,423 million, or by 18.8% (in 2011 increased by $6,795 million, or by 24.9%, compared to 2010).

Our revenues from sales of refined products increased by $11,830 million, or by 12.9% (in 2011 increased by $20,631 million, or by 29.1%, compared to 2010).

Sales of crude oil

2012 vs. 2011

Compared to 2011, our total crude oil sales revenues decreased by $6,423 million, or by 18.8%, in 2012 as a result of the decrease in sales volumes by 18.8%, or by 9,055 thousand tonnes, due to lower scale of trading operations, increase in refinery throughput and decrease in production.

In 2012, our revenue from crude oil export from Russia both to the Group companies and third parties amounted to $25,174 million.

2011 vs. 2010

Our total crude oil sales revenues increased by $6,795 million, or by 24.9%, due to growth of crude oil prices. At the same time, due to a decrease of production our sales volumes decreased by 6.1%, or by 3,119 thousand tonnes.

Compared to 2010, we significantly increased crude oil supplies to Belarus, while sales to outside the CIS decreased correspondingly.

In 2011, revenue from export of crude oil from Russia both to the Group companies and third parties amounted to $25,022 million.

Sales of refined products

2012 vs. 2011

Compared to 2011, our revenue from the wholesale of refined products outside of Russia increased by $10,820 million, or by 16.6%, as a result of an increase in sales volumes by 12.6% and prices by 3.6%.

In 2012, our revenue from international retail sales decreased by $551 million, or by 4.9%. Average prices increased by 0.6% while sales volumes decreased by 5.4%, or by 377 thousand tonnes, mainly as a result of restructuring of our retail network in the USA.

In 2012, our revenue from the wholesale of refined products on the domestic market increased by $764 million, or by 10.4%. Our average realized price increased by 4.5% and our sales volumes – by 5.6%.

Our revenue from retail sales in Russia increased by $797 million, or by 10.1%, in 2012. Domestic retail sales volumes increased by 6.6% resulting from the increase in domestic demand for motor fuels. Average retail prices in Russia increased by 3.2%, compared to 2011.

In 2012, our revenue from export of refined products from Russia both to Group companies and third parties amounted to $16,779 million.

2011 vs. 2010

Our revenue from the wholesale of refined products outside of Russia increased by $14,720 million, or by 29.2%, due to an increase in the average realized price by 35.6% in 2011. At the same time, the wholesale volumes decreased by 3,730 thousand tonnes, or by 4.7%, mainly as a result of decrease in export from Russia and the shutdown of the Odessa refinery.

Our revenue from international retail sales increased by $1,597 million, or by 16.5%, also due to an increase in average prices by 22.7%. Retail sales volumes decreased by 369 thousand tonnes, or by 5.0%, following restructuring of our retail network in the USA. At the same time, this was partially compensated by increased retail sales volumes in Europe.

Our revenue from the wholesale of refined products on the domestic market increased by $1,922 million, or by 35.4%, mainly due to an increase in the average realized price by 34.8%. The increase of sales volumes was not significant.

Our revenue from retail sales in Russia increased by $2,392 million, or by 43.5%, due to an increase in prices and sales volumes. Our retail volumes in Russia increased by 18.3% following significant increase of domestic demand.

In 2011, our revenue from the export of refined products from Russia both to Group companies and third parties amounted to $17,725 million.

Sales of petrochemical products

2012 vs. 2011

In 2012, our revenue from sales of petrochemical products decreased by $599 million, or by 29.8%, mainly as a consequence of a fire on our petrochemical plant in Stavropol, Russia in December 2011. Domestic sales volumes dropped by 55.0% compared to 2011. International sales volumes also decreased by 8.2%.

2011 vs. 2010

In 2011, our revenue from sales of petrochemical products increased by $639 million, or by 46.6%, mainly as a result of an increase in international sales volumes. In the fourth quarter of 2010, we commenced production at our petrochemical plant Karpatnaftochim Ltd. in Ukraine after modernization and construction of a chlorine and caustic production line. Our realized prices increased by 11.8%.

Sales of gas and gas products

2012 vs. 2011

Sales of gas and gas refined products increased by $598 million, or by 20.8%, in 2012.

Gas products wholesales revenue increased by $129 million, or by 10.8%, in 2012. Average realized wholesale prices for gas products decreased by 2.4%, while sales volumes increased by 13.6%.

Retail gas products revenue remained on the level of 2011.

Natural gas sales revenue increased by $422 million, or by 48.8%, in 2012. This revenue increased both domestically and internationally. At the domestic market, this was mainly a result of the increase of selling price to Gazprom by 37.0%. The main reason for the rise of revenue outside of Russia was the increase of both sales volumes and prices in Uzbekistan.

2011 vs. 2010

Sales of gas and gas refined products increased by $528 million, or by 22.5%, in 2011. Wholesale gas refined products sales revenue increased by $364 million, or by 43.6%, primarily as a result of an increase in sales prices. Retail gas products revenue increased by $112 million, or by 22.1%, also due to price growth.

Natural gas sales revenue increased by $30 million, or by 3.6%.

Sales of energy and related services

2012 vs. 2011

In 2012, our revenue from sales of electricity, heat and related services decreased by $78 million, or by 5.3%. Compared to 2011, the revenue of our power generating subsidiaries increased, among other factors, as a result of commencement of sales of energy to third parties in Ukraine and Bulgaria. At the same time, the volume of resale operations decreased.

2011 vs. 2010

In 2011, our revenue from sales of electricity, heat and related services increased by $56 million, or by 4.0%. This growth was a result of an increase in tariff rates and the ruble appreciation. At the same time, in the second half 2011, the revenue of our energy segment decreased significantly due to the reduction of resale operations.

Sales of other products

Other sales include non-petroleum sales through our retail network, rental revenue, revenue from transportation, crude oil extraction and refining services, and other revenue of our production and marketing companies from sales of goods and services not related to our primary activities.

2012 vs. 2011

In 2012, other sales increased by $193 million, or by 11.9%. This increase includes $85 million of revenue from processing operations at ISAB during September-December 2012.

2011 vs. 2010

In 2011, other sales increased by $45 million, or by 2.9%. The sales of goods and other products from our retail stations increased to $700 million, or by 15.5%. At the same time, transportation services provided to third parties decreased compared to 2010.

Operating expenses

Operating expenses include the following:

	2012	2011	2010
	(millions of US dollars)		
Hydrocarbon extraction expenses	3,861	3,771	3,430
Own refining expenses	1,669	1,418	1,121
Refining expenses at third parties and affiliated refineries	798	897	724
Cost of processing operations at ISAB	64	–	–
Expenses for crude oil transportation to refineries	1,241	1,060	1,048
Power generation and distribution expenses	619	617	654
Petrochemical expenses	303	343	221
Other operating expenses	804	949	1,100
Total operating expenses	**9,359**	**9,055**	**8,298**

The method of allocation of operating expenses above differs from the approach used in preparing the data for Note 22 “Segment information” to our consolidated financial statements. Expenditures in the segment reporting are grouped depending on the segment to which a particular company belongs. Operating expenses for the purposes of this analysis are grouped based on the nature of the costs incurred.

In 2012, our operating expenses increased by $304 million, or by 3.4%.

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, cost of extraction of natural gas liquids, property insurance of extraction equipment and other similar costs.

2012 vs. 2011

In 2012, our extraction expenses increased by $90 million, or by 2.4%. Increase in costs of artificial stimulation of reservoirs, power supply, repairs and maintenance and labor costs was largely compensated by devaluation of ruble against the US dollar. Our average hydrocarbon extraction cost increased from $4.96 per BOE in 2011 to $5.04 per BOE in 2012.

2011 vs. 2010

In 2011, our extraction expenses increased by $341 million, or by 9.9%. Our average hydrocarbon extraction cost increased from $4.30 per BOE to $4.96 per BOE, or by 15.3%, compared to 2010.

The increase was mainly a result of the real ruble appreciation against the US dollar and increased expenses for power supply, repairs and labor costs.

Own refining expense

2012 vs. 2011

Our own refining expenses increased by $251 million, or by 17.7%, in 2012.

Refining expenses at our domestic refineries increased by 2.6%, or by $29 million, compared to 2011. The increase of expenses due to higher consumption and cost of additives and overhauls was partially offset by the ruble devaluation.

Refining expenses at our international refineries increased by 72.5%, or by $222 million, compared to 2011. The increase was mainly due to obtaining control over ISAB in September 2012 (see *Refining, marketing and trading* section on page 6 for details).

2011 vs. 2010

Our own refining expenses increased by $297 million, or by 26.5%, in 2011.

Refining expenses at our domestic refineries increased by 38.0%, or by $306 million. This increase was a result of an increase in consumption and cost of additives, increased power supply costs, higher expenses on repairs and the ruble appreciation against the US dollar.

Refining expenses at our international refineries decreased by 2.9%, or by $9 million. The decrease of production volumes at our Bulgarian and Romanian refineries was partially offset by higher energy costs and overhauls. Moreover, we continued to incur operating expenses at our dormant refinery in Odessa although at a significantly lower level than in 2010 as we had to keep production facilities on line.

Refining expenses at third party and affiliated refineries

Along with our own production of refined products we refine crude oil at third party and affiliated refineries both in Russia and abroad.

2012 vs. 2011

In 2012, refining expenses at third party and affiliated refineries decreased by 11.0%, or by $99 million. The decrease to 2011 was due to obtaining control over ISAB in September 2012 (see *Refining, marketing and trading* section on page 6 for details). This was partially offset by commencement of crude oil processing at third party refineries in Belorussia in the beginning of 2012.

2011 vs. 2010

In 2011, refining expenses at third party and affiliated refineries increased by $173 million, or by 23.9%. This was due to the increase of our share in ISAB from 49% to 60% since April, 2011, resulting in the increase of our share of costs. Increased energy costs, appreciation of euro to the US dollar and overhauls performed at the ISAB complex in the first quarter of 2011 also contributed to the increase of expenses.

Expenses for crude oil transportation to refineries

Expenses for crude oil transportation to refineries include pipeline, railway, freight and other costs related to delivery of the Group's own crude oil to refineries for further processing.

2012 vs. 2011

In 2012, expenses for crude oil transportation to refineries increased by $181 million, or by 17.1%. The increase was largely due to supplies of our crude oil to the refineries in Belorussia, where we commenced crude oil processing in the first quarter of 2012.

2011 vs. 2010

Expenses for crude oil transportation to refineries in 2011 didn't change significantly. The increase in transportation tariffs compared to 2010 and the effect of ruble appreciation was compensated for by a decrease in volumes of own supply to refineries.

Petrochemical expenses

2012 vs. 2011

In 2012, operating expenses of our petrochemical plants decreased by $40 million, or by 11.7%, compared to 2011. Despite the sharp decrease in production as a result of the fire that destroyed the ethylene production unit at our plant in Stavropol, Russia, operating expenses of the plant didn't decrease significantly due to overhauls at other plant units. The effect of the decreased production at Group's other petrochemical plants and the devaluation of local currencies against the US dollar also contributed to the decrease of expenses, but were partially offset by the effect of obtaining control over ISAB, which has some petrochemical production lines, in September 2012.

2011 vs. 2010

In 2011, operating expenses of our petrochemical plants increased by $122 million, or by 55.2%, due to an increase in production volumes as a result of the commencement of production at our petrochemical plant Karpatnaftochim Ltd. in Ukraine in the fourth quarter of 2010 after modernization and construction of a chlorine and caustic production line. Additionally, the increased consumption of raw materials due to the changes in product mix and ruble appreciation contributed to the increase of expenses.

Other operating expenses

Other operating expenses include expenses of the Group's upstream and downstream entities that do not relate to their core activities, namely rendering of transportation and extraction services, costs of other services provided and goods sold by our production and marketing companies, and of non-core businesses of the Group.

2012 vs. 2011

In 2012, other operating expenses decreased by $145 million, or by 15.3%, driven largely by movements of the fair value of liabilities related to asset retirement obligations.

2011 vs. 2010

In 2011, other operating expenses decreased by $151 million, or by 13.7%. The decrease was a result of a lower volume of transportation services provided outside of Russia and the decrease of rental activities as a result of the restructuring of our retail network in the USA.

Cost of purchased crude oil, gas and products

Cost of purchased crude oil, gas and products includes cost of crude oil and refined products purchased for trading or refining, gas and fuel oil to supply our power generation entities and the result of hedging of international crude oil and refined products sales.

2012 vs. 2011

Cost of purchased crude oil, gas and products increased by $4,454 million in 2012, or by 7.5%, compared to 2011, mainly driven by the movements in refined products trading volumes.

In 2012, we recognized a $321 million loss from hedging, compared to a $657 million loss in 2011.

2011 vs. 2010

Cost of purchased crude oil, gas and products increased by $16,444 million in 2011, or by 38.0%, due to an increase in crude oil and refined products prices.

In 2011, we recognized a $657 million loss from hedging, compared to a $232 million loss in 2010.

Transportation expenses

2012 vs. 2011

Our transportation expenses did not change significantly compared to 2011.

Our actual transportation expenses related to crude oil and refined products deliveries to various export destinations, weighted by volumes transported, changed to 2011 as follows: crude oil pipeline tariffs increased by 2.8%, railway tariffs for refined products transportation decreased by 3.6%, crude oil freight rates increased by 10.6%, and refined products freight rates increased by 6.2%.

2011 vs. 2010

Our transportation expenses increased by $513 million, or by 9.1%. This increase was primarily related to Russia and resulted from the ruble appreciation, increased tariffs and change in supply directions.

Our actual transportation expenses related to crude oil and refined products deliveries to various export destinations, weighted by volumes transported, changed in 2011, compared to 2010, as follows: crude oil pipeline tariffs increased by 14.1%, railway tariffs for refined products transportation increased by 6.9%, crude oil freight rates decreased by 3.5%, and refined products freight rates decreased by 9.2%.

Selling, general and administrative expenses

Selling, general and administrative expenses include payroll costs (excluding extraction entities' and refineries' production staff costs), insurance costs (except for property insurance related to extraction and refinery equipment), costs of maintenance of social infrastructure, movement in bad debt provision and other expenses.

2012 vs. 2011

Our selling, general and administrative expenses in 2012 did not change significantly.

2011 vs. 2010

Our selling, general and administrative expenses increased by $264 million, or by 7.4%. This increase was driven mainly by higher selling expenses both in Russia and abroad. Expenses in Russia were also affected by the real ruble appreciation. At the same time, the decrease of provisions for bad debts partially offset the adverse effect of the above mentioned factors.

Equity share in income of affiliates

The Group has investments in equity method affiliates and corporate joint ventures. These companies are primarily engaged in crude oil exploration, production, marketing and distribution operations in the Russian Federation, crude oil production and marketing in Kazakhstan and refining operations in Europe. Our largest affiliates are Turgai Petroleum and Tengizchevroil, exploration and production companies operating in Kazakhstan, and Zeeland Refinery. Starting from September 2012, we do not include the results of ISAB in equity share in income of affiliates (see *Refining, marketing and trading* section on page 6 for details).

2012 vs. 2011

Compared to 2011, our share in income of affiliates decreased by $172 million, or by 24.9%. The main reasons for this were a decrease of crude oil production by our Kazakhstani affiliates as well as the provision for additional excess profit tax for prior periods accrued by Turgai Petroleum.

2011 vs. 2010

Our share in income of affiliates increased by $218 million, or by 46.2%, in 2011, mostly due to increase in income of Tengizchevroil.

Taxes other than income taxes

	2012	2011	2010
	(millions of US dollars)		
In Russia			
Mineral extraction taxes	12,261	11,502	7,795
Social security taxes and contributions	493	480	327
Property tax	511	538	479
Other taxes	82	77	93
Total in Russia	**13,347**	**12,597**	**8,694**
International			
Mineral extraction taxes	93	92	69
Social security taxes and contributions	111	107	102
Property tax	24	35	39
Other taxes	91	87	74
Total internationally	**319**	**321**	**284**
Total	**13,666**	**12,918**	**8,978**

2012 vs. 2011

Taxes other than income taxes increased by 5.8%, or by $748 million, compared to 2011. This was mainly due to the growth of mineral extraction tax expenses in Russia driven by the increase in tax rate.

In 2012, application of decreased rate for crude oil produced from depleted oilfields and zero rate for crude oil produced from oilfields with extra heavy crude oil and from greenfields led to $1,490 million tax reduction ($1,161 million in 2011). Of this amount, $129 million refer to production from the Yu. Korchagin field on the Caspian seashore.

2011 vs. 2010

In 2011, taxes other than income taxes increased by 43.9%, or by $3,940 million. This was mainly due to an increase in mineral extraction taxes in Russia as a result of the rise of the tax rate following the increase of international crude oil prices.

In 2011, application of decreased rate for crude oil produced from depleted oilfields and zero rate for crude oil produced from the fields with extra heavy crude oil and the greenfields led to $1,161 million tax reduction ($1,313 million in 2010). The major oilfield where we benefited from zero extraction tax rate was the Yuzhnoye Khylchuyu field. In early December 2010, accumulated volume of production from this field exceeded the incentive level of 15 million tonnes and since that moment we have been paying extraction tax in full.

The increase in social security taxes and contributions in Russia was due to tax legislation amendments.

Excise and export tariffs

	2012	2011	2010
	(millions of US dollars)		
In Russia			
Excise tax on refined products	1,922	1,710	951
Crude oil export tariffs	11,315	11,714	10,513
Refined products export tariffs	5,561	5,028	3,574
Total in Russia	**18,798**	**18,452**	**15,038**
International			
Excise tax on refined products	3,355	3,445	3,700
Crude oil export tariffs	274	319	136
Refined products export tariffs	409	1	4
Total internationally	**4,038**	**3,765**	**3,840**
Total	**22,836**	**22,217**	**18,878**

2012 vs. 2011

Export tariffs increased by $497 million, or by 2.9%, compared to 2011. In Russia, export tariffs for refined products increased by 10.6% despite the decrease of refined products export volumes by 6.2% as a result of sharp increase of export duty rate for fuel oil (by 27.9%). The share of fuel oil in the Group export structure in 2012 was approximately 40%. This increase was partially offset by the decrease of crude oil export tariffs, largely, due to higher share of crude oil export to Belorussia. Moreover, export tariff savings on crude oil produced from Yu. Korchagin field in the Caspian Sea amounted to $150 million in 2012. Expenses for refined products export tariffs outside of Russia refer to export from Belorussia, where we commenced crude oil processing in the beginning of 2012.

In Russia, the increase of excise expense to 2011 was driven mainly by the growth of excise rates. Although the excise rates for motor fuels increased significantly compared to 2011, the increase of share of Euro-5 motor fuels in our production let us avoid sharp increase of excise expenses in Russia. In the second half of 2012, all the gasoline produced by the Group in Russia was compliant with Euro-5 ecological class, while in 2011 the share of Euro-5 gasoline was relatively insignificant.

The decrease in excise tax expense outside of Russia to 2011 was a result of lower volume of sales subject to excises as well as of the devaluation of euro and local currencies against the US dollar.

2011 vs. 2010

In 2011, export tariffs increased by $2,835 million, or by 19.9%. The effect of increase of crude oil and refined products tariff rates was partially compensated by a decrease in crude oil export volumes by 14.5% and refined products export volumes by 6.9%, compared to 2010.

Starting from December, 2010 the Group applies reduced export duty rate for the crude oil produced from the Yu. Korchagin field in the Caspian Sea, however due to relatively small amount of crude oil export from that field the effect of this incentive on our 2011 and 2010 financial results was insignificant.

Starting from 2011, excise rates on refined products in Russia were increased and tied to the ecological class of fuel. Despite the fact that the Company produces high quality ecological motor fuel subject to lower excise rates compared to fuel of lower quality, average excise rates roughly doubled for us compared to 2010.

Exploration expenses

2012 vs. 2011

Our exploration expenses decreased by $168 million, or by 31.6%, during 2012. Dry hole costs amounted to $127 million in 2012 and $417 million in 2011. At the same time, we significantly increased the amount of seismic work in Russia.

In the fourth quarter of 2012, we charged to expense the cost of an exploratory well in Sierra-Leone in amount of $26 million. In the second quarter, we charged to expense the cost of an exploratory well in Volga region of Russia in amount of $50 million.

2011 vs. 2010

Our exploration expense increased by $196 million, or by 58.3%. Dry hole costs amounted to $417 million in 2011, compared to $225 million in 2010.

In 2011, dry hole costs were mostly related to our overseas projects, namely $181 million in Ghana, $149 million in Cote d'Ivoire, $27 million in Vietnam and $17 million in Kazakstan. Dry hole costs in Russia included $28 million and $10 million related to projects in Komi Republic and in Western Siberia, respectively.

Gain (loss) on disposals and impairments of assets

2012 vs. 2011

In the second quarter of 2012, the Group recognized a gain of $178 million from sale of 1.5% (10% of our share) in KPO to a state-owned KazMunayGaz. The tax effect of the deal amounted to $148 million of the income tax expense.

Losses on disposals and impairments of assets also includes the financial result from disposals of a number of non-core assets and individually insignificant impairments of non-performing business units.

2011 vs. 2010

Loss on disposals and impairments of assets for 2011 mainly included an impairment loss related to certain upstream and other assets of NMNG in amount of $1,261 million. For details please refer to *Impairment of assets in OOO Narianmarneftegaz*" section on page 3.

Additionally, in 2011, the Company recognized an impairment loss of $175 million for international refining, marketing and distribution assets.

Other non-operating (expense) income

In 2011, other non-operating income included the effect of the recalculation of the extraction tax incentive by certain Group companies for prior periods in the total amount of $433 million.

Income taxes

2012 vs. 2011

Our total income tax expense decreased by $495 million, or by 15.0%, compared to 2011. At the same time, our income before income tax increased by $604 million, or by 4.6%.

In 2012, our effective income tax rate was 20.4%, compared to 25.1% in 2011. The maximum statutory rate in Russia is 20%. Quarterly deviations of the effective income tax rates from the maximum statutory rate may happen due to currency translation losses and gains reported by Russian subsidiaries, that decrease or increase taxable income in the respective periods. The high level of the effective income tax rate in 2011 was mostly due to the impairment loss in NMNG. For details please refer to *Impairment of assets in OOO Narianmarneftegaz*" section on page 3.

2011 vs. 2010

In 2011, our total income tax expense increased by $942 million, or by 40.1%. At the same time, our income before income tax increased by $1,649 million, or by 14.4%.

In 2011, our effective income tax rate was 25.1%, compared to 20.5% in 2010, while the maximum statutory rate for the Russian Federation is 20%.

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

	2012	2011 (millions of US dollars)	2010
Net income	**11,004**	**10,357**	**9,006**
Add back:			
Income tax expense	2,798	3,293	2,351
Depreciation and amortization	4,832	4,473	4,154
Interest expense	538	694	712
Interest and dividend income	(257)	(211)	(174)
EBITDA	**18,915**	**18,606**	**16,049**

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 as 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. The 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

	2012	2011	2010
	(millions of US dollars)		
Net cash provided by operating activities	18,997	15,514	13,541
Net cash used in investing activities	(13,216)	(9,013)	(7,296)
Net cash used in by financing activities	(5,680)	(6,023)	(6,146)

Operating activities

Our primary source of cash flow is funds generated from our operations. During 2012, cash generated from operating activities amounted to $18,997 million, which is 22.5% more than in 2011. This increase was largely a result of a decrease in working capital by $2,474 million, compared to January 1, 2012.

The decrease in working capital was mainly caused by:

- $1,711 million net decrease in trade accounts receivable and payable
- $194 million net decrease in taxes receivable and payable
- $686 million net decrease in other assets and liabilities

At the same time, this was partially offset by a $126 million increase in inventories.

Investing activities

Our capital expenditures, including non-cash transactions, amounted to $11,850 million, which is 39.5% more than in 2011.

	2012	2011	2010
	(millions of US dollars)		
Capital expenditures[(1)]			
Exploration and production			
Russia	7,014	5,084	3,911
International	1,888	1,545	997
Total exploration and production	8,902	6,629	4,908
Refining, marketing and distribution			
Russia	1,510	1,030	945
International	568	324	375
Total refining, marketing and distribution	2,078	1,354	1,320
Chemicals			
Russia	62	55	27
International	28	34	49
Total chemicals	90	89	76
Power generation and distribution	503	196	420
Other	277	224	120
Total capital expenditures	**11,850**	**8,492**	**6,844**

(1) Including non-cash transactions and prepayments.

Capital expenditures in exploration and production segment increased by $2,273 million, or by 34.3%. In Russia, the rise was due to development of the V. Filanovsky oilfield on the Caspian seashore and increased production drilling in Western Siberia. Internationally, we increased investments in developing our projects in Iraq and Uzbekistan.

The increase in our refining, marketing and distribution capital expenditures outside of Russia was mainly due to construction of a heavy residue processing complex at our Bulgarian refinery. In Russia, it refers to construction of catalytic cracking unit and in extension of reservoir park at our Nizhny Novgorod refinery and construction of hydro cracking unit at our refinery in Volgograd.

Capital expenditures in power generation sector increased as a result of fulfillment of our investment program, namely construction of 235 MW combined cycle gas turbine in Astrakhan with a completion scheduled for the third quarter of 2013.

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

	2012	2011	2010
	(millions of US dollars)		
Yamal	476	372	162
Caspian region[1]	1,425	555	369
Ghana	13	216	87
Cote d'Ivoire	44	227	92
Iraq	924	203	172
Uzbekistan	477	480	286
Total	**3,359**	**2,053**	**1,168**

[1] Russian and international projects.

In the fourth quarter of 2012, a Group company paid $836 million as a first 50% installment for the subsoil rights for the site that includes Imilorskoye, West Imilorskoye and Istochnoye fields in Western Siberia. The second 50% payment was made in January 2013. Also, $58 million were paid for the subsoil rights for the Verkhneyangoreyski site in the Komi Republic.

	2012	2011	2010
	(millions of US dollars)		
Acquisitions of subsidiaries and associates[1]			
Exploration and production			
Russia	200	252	–
International	22	500	922
Total exploration and production	222	752	922
Refining, marketing and distribution			
Russia	25	10	7
International	658	342	3
Total refining, marketing and distribution	683	352	10
Power generation and distribution	–	–	–
Other	–	–	–
Less cash acquired	(19)	(4)	–
Total acquisitions	**886**	**1,100**	**932**

[1] Including prepayments related to acquisitions and non-cash transactions.

In 2012, the Group acquired additional 20% share in ISAB for approximately $621 million.

In 2011, we made a final payment of $500 million within the acquisition of LUKARCO, a payment of $342 million for 11% share in ISAB and a payment of $153 million for a 25.1% share in OOO "Bashneft-Polus".

Financing activities

In 2012, net movements of short-term and long-term debt generated an outflow of $1,266 million, compared to an outflow of $2,004 million in 2011.

In the first quarter of 2012, we purchased Company's stock worth $128 million and in the second quarter of 2012, we spent $740 million for purchase of equity-linked notes.

In 2011, we made an advance payment of $1,760 million for purchase of equity linked notes.

Credit rating

Standard & Poor's Ratings Services affirmed its long-term corporate credit rating and all debt ratings on the Company at BBB- with positive outlook.

Moody's affirmed the Company's long-term corporate family rating and long-term issuer rating of Baa2 with stable outlook.

Fitch Ratings affirmed the Company's long-term issuer default rating of BBB- with stable outlook.

Contractual obligations, other contingencies and off balance sheet arrangements

Capital commitments and contractual obligations

Under the terms of existing exploration and production license agreements in Russia the Group has to fulfill certain obligations: oil and gas exploration, wells drilling, fields development, etc., and the Group also has commitments to reach a defined level of extraction on the fields. Management believes that the Group's approved annual capital expenditure budgets fully cover all the requirements of the described license obligations.

In 2012, a construction agreement for a heavy-residue hydrocracking complex at Group refinery LUKOIL Neftochim Bourgas AD in Bulgaria was signed. Commissioning of the complex is expected in 2015. The amount of capital commitment under this agreement is approximately $1.1 billion.

Group companies have commitments for capital expenditure contributions in the amount of $363 million related to various production sharing agreements over the next 25 years.

The Company signed a strategic agreement for the ongoing 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 2013 to be approximately $232 million.

The Group signed a number of agreements for the years 2012-2015 for construction of offshore platforms in the Caspian region. The Group estimates the amount of this capital commitment to be approximately $1,346 million.

The Group has a commitment to execute the capital construction program of its power generation segment and under the terms of this program power plants with a total capacity of 890 MW should be constructed. Currently the Group is approving certain amendments to the capital construction program, including its extension to the end of 2014. As of December 31, 2012, the Group estimates the amount of this commitment to be approximately $303 million.

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

(millions of US dollars)	Total	2013	2014	2015	2016	2017	After
On balance sheet							
Short term debt	**126**	126	–	–	–	–	–
Long-term bank loans and borrowings	**867**	280	194	180	129	46	38
Long-term non-bank loans and borrowings	**420**	19	400	–	–	–	1
6.375% Non-convertible US dollar bonds, maturing 2014	**898**	–	898	–	–	–	–
2.625% Convertible US dollar bonds, maturing 2015	**1,436**	–	–	1,436	–	–	–
6.356% Non-convertible US dollar bonds, maturing 2017	**500**	–	–	–	–	500	–
7.250% Non-convertible US dollar bonds, maturing 2019	**596**	–	–	–	–	–	596
6.125% Non-convertible US dollar bonds, maturing 2020	**998**	–	–	–	–	–	998
6.656% Non-convertible US dollar bonds, maturing 2022	**500**	–	–	–	–	–	500
7.40% Russian ruble bonds, maturing 2013	**198**	198	–	–	–	–	–
Capital lease obligations	**82**	35	45	1	1	–	–
TOTAL	**6,621**	**658**	**1,537**	**1,617**	**130**	**546**	**2,133**
Off balance sheet							
Operating lease obligations	**475**	119	106	73	48	34	95
Capital commitments in PSAs	**363**	177	18	18	18	18	114
Capital commitments of power generating segment	**303**	226	77	–	–	–	–
Capital commitments in LUKOIL-Neftochim Bourgas AD	**1,130**	818	308	4	–	–	–
Obligation under contract with ZAO Globalstroy-Engineering	**232**	232	–	–	–	–	–
Obligation under contracts for the development of the V. Filanovsky oilfield.	**1,346**	126	1,220[1]	–	–	–	–

[1] Amount for 2014 and 2015.

Litigation and claims

On November 27, 2001, Archangel Diamond Corporation ("ADC"), a Canadian diamond development company, filed a lawsuit in the Denver District Court, 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 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 dismissed from the lawsuit. The Colorado Supreme Court found, however, that the trial court made a procedural error by failing to hold an evidentiary hearing before making its ruling concerning general jurisdiction regarding the Company and remanded the case to the Colorado Court of Appeals to consider whether the lawsuit should have been dismissed on alternative grounds (i.e., forum non conveniens). The Colorado Court of Appeals declined to dismiss the case based on forum non conveniens and the case was remanded to the District Court. In June 2009, three creditors of ADC filed an Involuntary Bankruptcy Petition putting ADC into bankruptcy. In November 2009, after adding a claim, ADC removed the case from the District Court to the US Bankruptcy Court. On October 28, 2010, the Bankruptcy Court granted the Company's Motion for Remand and Abstention and remanded the case to the Denver District Court. On October 20, 2011, the Denver District Court dismissed all claims against the Company for lack of jurisdiction. ADC filed notice of appeal on April 17, 2012. On August 23, 2012, the Court of Appeals affirmed the Denver District Court's dismissal for lack of jurisdiction. ADC filed a Petition for Rehearing which was denied on September 20, 2012. ADC then filed a petition for Writ of Certiorari in the Colorado Supreme Court on October 18, 2012. The Company filed its Response to the Writ on November 1, 2012. The Colorado Supreme Court has not indicated yet if it will consider this case. Management does not believe that the ultimate resolution of this matter will have a material adverse effect on the Group's financial condition.

On January 6, 2012, ADC filed a lawsuit in the US District Court for the District of Colorado (federal court) reasserting almost identical claims asserted in the aforementioned lawsuit and dismissed by the Denver District Court (state court) notwithstanding ADC's appeal of the state court's decision. In Federal Court case, the Company has filed a Motion to Dismiss and discovery has been stayed pending further action. The Company plans to seek dismissal of the case and vigorously defend the matter. 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.

Critical accounting policies

The preparation of financial statements in conformity with US GAAP 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 non-controlling stockholders 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 non-controlling stockholders have substantive participating rights are accounted for using the equity method of accounting. Undivided interests in oil and gas joint ventures are accounted for using the proportionate consolidation method. Investments in other companies are recorded at cost.

Revenue recognition

Revenues are recognized when title passes to customers at which point the risks and rewards of ownership are assumed by the customer and the price is fixed or determinable. Revenues include excise on petroleum products sales and duties on export sales 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 (including development dry holes and the Group’s share of operators’ expenses during the development stage of production sharing and risk service contracts) 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

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 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. The Subsoil Law of the Russian Federation states that, upon expiration, a license is subject to renewal at the initiative of the license holder provided that further exploration, appraisal, production or remediation activities are necessary and provided that the license holder has not violated the terms of the license. Since the law applies both to newly issued and old licenses and the Group has currently renewed over 50% of its licenses, management believes that licenses will be renewed upon their expiration for the remainder of the economic life of each respective field.

Impairment of long-lived assets

Long-lived assets, such as oil and gas properties (other than unproved 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 profit or loss 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.

An income tax position is recognized only if the uncertain position is more likely than not of being sustained upon examination, based on its technical merits. A recognized income tax position is measured at the largest amount that is greater than 50% likely of being realized. Changes in recognition or measurement are reflected in the period in which the change in judgment occurs.

Asset retirement obligations

Under various laws, contracts, permits and regulations, the Group 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 Group relate to wells and oil and gas production facilities and pipelines. The Group 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 Group 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 profit or loss. 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 profit or loss when warranted by circumstance.

Use of derivative instruments

The Group’s derivative activity is limited to certain petroleum products marketing and trading operations 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 profit or loss on a net basis. Unrealized gains and losses are carried as assets or liabilities on the consolidated balance sheet.

Recent accounting pronouncements

In December 2011, the FASB issued ASU No. 2011-11, *"Disclosures about Offsetting Assets and Liabilities."* This ASU requires entities to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. The scope includes derivatives, sale and repurchase agreements and reverse sale and repurchase agreements, and securities borrowing and securities lending arrangements. ASU No. 2011-11 is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods, and should be applied retrospectively.

In January 2013, the FASB issued ASU No. 2013-01 *"Balance Sheet (Topic 210): Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities,"* which clarifies that ordinary trade receivables and receivables are not in the scope of ASU No. 2011-11. The Group is evaluating the effect of the adoption of ASU No. 2011-11 and does not expect any material impact on its 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
- 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
- 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.