Management Analysis of the Financial Situation and Operating Performance for the Six Months Ended June 30, 2005 and 2004

This report reviews the financial and operating performance of OJSC Rosneft for the six month ended June 30, 2005 and 2004 and should be used together with the intermediate consolidated financial statements of OJSC Rosneft and notes thereto for the periods then ended. Such terms as "Rosneft", "Company", "Group", and "we" in its different forms in this report mean OJSC Rosneft and its consolidated subsidiaries and affiliated companies. This report contains forward-looking statements. Such words as "expect", "consider", "assume", "estimate", "intend", "plan" and the like point to such forward-looking statements. These forward-looking statements reflect the currently available forecasts and views of the Company's management concerning the future results; however, they cannot guarantee the achievement of the said results in the future.

All amounts in US dollars are given in millions, unless otherwise stipulated. Figures are rounded; however percent changes are calculated on the basis of actual indicators.

Volumes of own oil production and of acquired oil are translated from tons into barrels using the following average ratios:

1 metric ton of oil and gas condensate	*= 7.313 barrels*
1,000 cubic meters of associated gas	*= 0.900 tons of oil equivalent*
1,000 cubic meters of associated gas	*= 6.582 barrels of oil equivalent*
1 cubic meter	*= 35.3 cubic feet*

The actual translation factors differ from those given above since oil produced from different fields varies in terms of its density, and volumes of its extraction from different fields change over time. Therefore, total production volumes differ slightly on translation from the metric to the imperial measurement system.

General Information and Main Events

OJSC Rosneft is a vertically-integrated oil and gas company whose core activities include exploration and development of oil and gas fields; production of crude oil, gas condensate, and natural and associated gas; crude oil refining; and marketing of crude oil and petroleum products. As of June 30, 2005, Rosneft was the second largest oil company in Russia in terms of proved oil and gas condensate reserves[1] and the third largest in terms of their production volumes.

In December 2004, Rosneft purchased 100% of ZAO Baikalfinancegroup which had won the auction for 76.79% shares of OJSC Yuganskneftegas (100% of its ordinary shares) with a bid amounting to 260 782 million rubles (USD 9 398 million). This acquisition strengthened the competitive position of the Company and ensured expansion of its production and resource base. The results of Yuganskneftegas are fully reflected in the financial statements of the Company for the first six months of 2005; hence any historical comparisons should be made having due regard to this fact.

During the first six months of 2005, Rosneft achieved the following results, and the selected indicators[2] used by the Company for evaluating its performance were as follows:

Table 1: Main Operating Results

	6 months	
	2005	**2004**
	USD million	
Revenues	9 864	2 301
EBITDA	3 371	713
Net income	2 439	340
Adjusted net income without proceeds from divestments of Sevmorneftegas and minority interest	1 759	362
	million tons	
Oil and gas condensate production, incl. share in production of affiliated companies	35,5	10,1
	billion cubic metres	
Natural and associated gas extraction , incl. share in production of affiliated companies	6,1	4,6

Table 2: Selected Operating Indicators

	6 months	
	2005	**2004**
EBITDA margin	34,2%	31,0%
Adjusted net income margin before minority interest	17,8%	15,7%
Return on average capital employed (ROACE), annualized	22,6%	14,2%
Return on average equity (ROAE), annualized	49,2%	20,7%

The main events of the first six months of 2005, including main acquisitions and divestments, were as follows:

- Operating and logistical integration of Yuganskneftegas was completed;
- The sale of 50% stake in CJSC Sevmorneftegas by OJSC Rosneft-Purneftegas for USD 1.3 billion in cash before taxes in June 2005;
- Agreement was reached between the Company and Societe General S.A. whereby the group of banks headed by Societe General S.A. consented to amend the financial covenants contained in the current credit agreements;
- The debt facilities were re-negotiated with loosened financial covenants which translated into an increase in Company's allowed maximum borrowing capacity;

[1] Society of Petroleum Engineers (SPE) standards in accordance with reserves audit conducted by DeGolyer & McNaughton

[2] EBITDA, ROACE, ROAE and the related indicators are non-US GAAP measures. The procedure for calculating indicators and their reconciliation with US GAAP are provided in the section "Credit Rating and Selected Operating Indicators", in particular Tables 19-23.

- 44.68% of shares of OJSC Rosneft-Krasnodarneftegas were purchased for USD 109.5 million permitting Rosneft to increase its stake in the authorized capital of its subsidiary to 95.46%;
- An agreement with the minority shareholder of OJSC Selkupneftegas was signed in the 3rd quarter of 2005 to purchase a 34% stake in this enterprise thus increasing the interest of Rosneft in Selkupneftegas to 99%. The stake was bought for USD 20.1 million payable in cash.

Segments and Regions of Activities

The activities of Rosneft can be subdivided into two main operating segments in accordance with: “upstream” – geological exploration and development of fields and oil and gas production; and “downstream” – refining of oil and other raw materials, as well as purchase, transportation and sale of oil and petroleum products. Although Rosneft does not isolate its distribution and transshipment divisions into a separate segment of “midstream”, this transportation infrastructure provides certain competitive advantages in the context of transportation opportunities and constraints currently existing in Russia (see in greater detail section “Export of Oil and Petroleum Products”). Other types of activities are incorporated in the “Finance and Other Types of Activities” segment and include banking and financial services, drilling services, earnings from lease of vessels and other types of activities.

The above-mentioned main activities are interconnected because a proportion of revenues of one activity is included in expenses of another activity. In particular, the holding company buys oil from enterprises of its “upstream” segment, selling part of it to consumers and delivering the rest to refineries. Petroleum products are sold to marketing enterprises for their subsequent resale or are sold wholesale to outside organizations. It is difficult to determine comparable market prices for oil inside Russia for a number of reasons. Such reasons include regional imbalances, caused, in particular, by limited export opportunities, intragroup turnover of the biggest producers that dominate the market, and, finally, excess oil available on the Russian market that is not exported or refined. Transaction prices between the companies of the Group are mainly established with due account for market oil prices and transportation costs, as well as investment capital requirements for different enterprises of the “upstream” segment. Therefore, an analysis of individual activities in isolation from the analysis of other activities could give a distorted view of the financial and operating performance of enterprises within a certain activity. For this reason, we do not analyze each main activity in isolation, but provide financial data by segments in Note 23 to the consolidated financial statements.

The Company undertakes a number of overseas projects, in particular in Kazakhstan, Turkmenistan and Algiers. These projects are at an early stage of implementation and do not have a material influence on the operating and financial performance of the Company. All the activities of the Company are mainly carried out within the territory of the Russian Federation. Since geographic regions in the Russian Federation have essentially similar economic and regulatory conditions, the Company does not disclose information on geographic segments separately.

Main Factors Affecting Performance

Changes in Oil and Petroleum Product Prices

Sale prices of oil and petroleum products are the principle factor affecting the financial performance of the Company. They directly depend on world and Russian commodity prices. World oil prices are characterized by significant fluctuations that are determined by the global balance of oil supply and demand. The bulk of exported oil is blended in the Transneft pipeline system with oil of other producers that is of a different quality. The resulting Urals blend is traded at a discount to Brent.

In general, sale prices of oil in the domestic market primarily depend on world oil prices. However, there is no unified independent organized oil market in Russia since most transactions are conducted within the major vertically-integrated companies that comprise producing, refining and marketing subsidiaries. As a result, only a small proportion of Russian oil is traded in the open market. Its prices are below world prices because of substantial transportation costs incurred in its delivery to consumers outside of the Transneft system.

The dynamics of petroleum product prices in the Russian market are determined by a number of factors, the most important among them being the level of world prices of oil and petroleum products, supply and demand, competition in the regional markets and distances separating them from the main petroleum provinces.

Table 3: Average Crude Oil and Petroleum Products Prices in Russia and Worldwide

	6 months		
	2005	**2004**	**% change**
World market	USD/bbl		
Brent	49,64	33,66	47%
Urals (CIF Med)	45,87	30,74	49%
	USD/ton		
Fuel oil 3,5 (CIF Med)	206,26	150,49	37%
Gasoil 0,2 (CIF Med)	471,60	310,11	52%
High octane gasoline (FOB Med)	456,49	363,30	26%
Russian market*	USD/ton		
Fuel oil	104,73	75,78	38%
Diesel fuel	447,94	283,84	58%
Low octane gasoline (AI 76/80)	451,07	351,66	28%
High octane gasoline (AI 92/96)	552,65	435,19	27%

* including VAT

Ruble/US Dollar Exchange Rate and Inflation Trends

The ruble/US dollar exchange rate and inflation trends in the Russian Federation seriously affect the performance of the Company since the bulk of revenues from sales of oil and petroleum products is denominated in US dollars, while the bulk of expenses is denominated in Russian rubles. Therefore, the real appreciation of the ruble versus the US dollar negatively affects operating profit and other indicators that are connected with operating profit. Currently, Rosneft does not use currency hedging mechanisms.

Table 4: Main Macroeconomic Indicators

	6 months	
	2005	**2004**
Ruble inflation (CPI)	7,8%	6,3%
Ruble/US dollar exchange rate at the end of the period	28,67	29,03
Average ruble/US dollar exchange rate during the period	27,96	28,78
Nominal appreciation /(depreciation) of the ruble	(3,3)%	1,5%
Real appreciation/(depreciation) of the ruble	4,4%	7,8%

Changes in Tax Rates and Export Duties

According to Russian legislation, Rosneft is required to pay several federal and local taxes, many of which are frequently changed. The table below sets out the rates of the main taxes payable by Russian oil companies during the first six months of 2005 and 2004.

Table 5: Rates of Export, Excise and Mineral Production Taxes

		6 months 2005	6 months 2004	% change
Export duty				
Oil	USD/ton	101,51	35,15	189%
Light and medium distillates	USD/ton	68,96	30,6	125%
Fuel oil	USD/ton	43,29	30,6	41%
Excises				
High octane gasoline	Ruble/ton	3 629	3 360	8%
Low octane gasoline	Ruble/ton	2 657	2 460	8%
Diesel fuel	Ruble/ton	1 080	1 000	8%
Motor oils	Ruble/ton	2 951	2 732	8%
Mineral production tax				
Oil	Ruble/ton	1 625	915	78%
Natural gas	Ruble/ton	135	107	26%

Mineral production tax is the main component of the item "Taxes other than income tax". The rate of mineral production tax during the first six months of 2005 was calculated by multiplying the base rate by the adjustment ratio equal to (P - 9) * R / 261, where "P" is the average Urals price during the fiscal period, and "R" is the average ruble/dollar exchange rate established by the RF Central Bank during the fiscal period. Before December 31, 2004, the following formula was used to calculate the adjustment ratio: (P – 8) * R / 252. The base tax rate was 419 rubles per ton of oil produced during the first six months of 2005 and 347 rubles per ton of oil produced during the first six months of 2004. The rate of mineral production tax on natural gas was 135 rubles per thousand cubic meters of natural gas produced during the first six months of 2005 and 107 rubles per thousand cubic meters of natural gas produced during the first six months of 2004.

Excises and export duties account for a significant proportion of Company's expenses, and oil export duty represents the bulk of this item. The amount of duty is linked to the average Urals price expressed in US dollars per barrel of extracted oil but the rate is expressed in US dollars per metric ton. Table 6 provides the formulae for calculating oil export duty:

Table 6: Calculation of Oil Export Duty

Urals price	Export duty
USD/barrel	US dollar/ton
below 15	Export duty is not levied
15-20	35% of the difference between Urals price in USD per 1 ton and USD 109.5
20-25	USD 12.78 per 1 ton plus 45% of the difference between Urals price in USD per 1 ton and USD 146
above 25	USD 29.2 per 1 ton plus 65% of the difference between Urals price in USD per 1 ton and USD 182.5

Export duties for petroleum products are established by the Russian Federation Government depending on the price for domestic petroleum products market. Export duties are not payable on exports of crude oil and petroleum products to the CIS states, except the Ukraine.

Rosneft has never used and currently does not use tax optimization schemes in its financial activities, traditionally being one of the most diligent taxpayers in Russia. Table 7 gives the comparison between the effective income tax rate under US GAAP standards and the current income tax rate. The Company is not a consolidated taxpayer under the Russian legislation. Income tax is calculated in the subsidiaries based on the balance sheet profit under Russian Accounting Standards, which differs substantially from profit under US GAAP standards. The effective profit tax rate during the reporting period was 25%, i.e. it was higher than the maximum rate of 24% established by Russian tax legislation.

This arose because certain expenses incurred by the Company, for example, those to which norms are applied for the purposes of taxation, did not reduce the taxable base for profit tax. Therefore, the comparison is artificial; however, it gives an indication of the level of the Company's tax risks.

Table 7: Taxation Level

	6 months		12 months		
	2005	**2004**	**2004**	**2003**	**2002**
Effective income tax rate for the Group under US GAAP standards	25%	25%	25%	34%	35%
Profit tax rate under Russian legislation	24%	24%	24%	24%	35%

Main Operating Indicators

Oil, Gas Condensate and Gas Production

During the first six months of 2005, the consolidated enterprises of the Group increased their production of oil and gas condensate 3.6 times to 35.2 million tons over the first six months of 2004 as a result of the acquisition of Yuganskneftegas. Without Yuganskneftegas, the organic growth of oil production during the first six months of 2005 was 7% (increase to 10.4 million tons). This growth is largely attributable to the oil fields of the OJSC Severnaya Neft where oil production grew by 55.8% to 2.2 million tons. The results of the first six months of 2005 confirmed that Severnaya Neft is currently the fastest growing company of the Group. Daily production volumes of this enterprise increased from 5 thousand tons at the date of purchase in early 2003 to by more than 3 times at the end of October 2005.

Taking into account oil production by Yuganskneftegas during the first six months of 2004, oil production by the Company decreased by 0.3%, with a production decline at Yuganskneftegas of 3.2%, primarily due to the substantial reduction of capital expenditures by the enterprise during the second half of 2004. From January to May 2005, the Company focused significantly on integrating production of Yuganskneftegas, optimizing its logistics and improving profitability of oil production by the enterprise. As a result, the Company managed to reverse the trend of the production decline from the second quarter of 2005, and by June 30, 2005, the average daily production of Yuganskneftegas was higher 0.7% than as of January 2, 2005. Table 8 provides oil and gas condensate production volumes by the Company[1]:

Table 8: Oil and Gas Condensate Production

	6 months						
	2005	**2004**	**2005**	**2004**	**2005**	**2004**	**% change**
	million tons		million barrels		thousand barrels p.d.		
Oil and gas condensate production by consolidated enterprises	35,2	9,8	257,3	71,3	1 422	394	261%
Oil and gas condensate production, including the share in production of affiliated enterprises	35,5	10,1	259,6	73,9	1 434	408	251%

[1] These indicators may differ from the statistics provided by the Ministry of Industry and Energy and the Central Dispatching Unit of the Fuel and Energy Complex by the amount of production from the joint ventures of Rosneft. According to the Russian Federation rules, when the Russian participant of the joint venture with foreign capital owns 50% or more of shares, the whole production of the joint venture is attributed to the Russian participant under the RF statistics, while here the share of oil production in affiliated companies is taken into account according to the share of the Company in the joint ventures. Rosneft owns a 50% interest in OJSC Polar Lights and 50% in Adai Petroleum, which is developing fields in the Adaisk block in Kazakhstan.

Natural and associated gas extraction increased to 6.1 bcm, or by 33% taking into account the acquisition of Yuganskneftegas and by 19% without taking it into account, mainly due to production growth in the fields of OJSC Krasnodarneftegas. Currently, we are the second biggest gas producer among the Russian oil companies. The level of associated gas utilization was 65%. Production of commercial gas increased to 4.5 bcm, or by 25% or 8%, respectively taking into account the acquisition of Yuganskneftegas or without taking it into account.

Refining and Marketing

During the first six months of 2005, refineries of the Company processed 5 232 thousand tons of crude oil, i.e. 0.9% more than during the same period of 2004. The Company owns two major refineries, the Tuapse Refinery on the Black Sea in the South of Russia and the Komsomolsk Refinery in the Far East. The yield of light products by the Komsomolsk Refinery and by the Tuapse Refinery amounted to 60.1% and 55.7%, respectively. Output of petroleum products from crude oil of the Company, including the refineries owned by third parties, increased by a factor of 2.54, from 3 787 thousand tons during the first six months of 2004 to 9 618 thousand tons during the first six months of 2005. During the first six months of 2005, 4 935 thousand tons of oil were delivered to the refineries of third parties yielding 4 631 thousand tons of petroleum products. The section “Financial Performance” provides information on refining costs at third party refineries and procurement of petroleum products from third parties. Table 9 gives data on petroleum products output and procurement volumes.

Table 9: Petroleum Products Output

	6 months 2005	6 months 2004	% change
	thousand tons		
Petroleum products output by refineries of the Company	4 987	3 625	38%
Petroleum products output by refineries of the third parties	4 631	162	2759%
	9 618	**3 787**	**154%**
Procurement of petroleum products from the third parties	**386**	**926**	**-58%**

Export of Oil and Petroleum Products

The bulk of oil produced by the Company is transported through Transneft’s pipeline system. The throughput capacity of this system is limited; therefore Transneft applies a quota mechanism established on a quarterly basis in accordance with the rule of equal access by oil companies to the pipeline system. The Company has significant opportunities to export oil bypassing Transneft’s pipeline system or export terminals. In particular, OJSC Rosneft-Sakhalinmorneftegas exports a substantial proportion of its crude through De-Kastri port via its own oil pipeline. Severnaya Neft channels most of its produced oil for export through the port of Archangelsk with transshipment in the terminal Privodino owned by the Company. OJSC Grozneftagas exports the lion’s share of its produced oil through the Caspian Pipeline Consortium (CPC). Also, Rosneft makes substantial deliveries of oil by rail to China and Belarus. The Company owns transshipment facilities in Nakhodka and Tuapse.

In total, Rosneft exported 20.64 million tons of oil during the first six months of 2005 versus 5.42 million tons during the same period of 2004. The volume of oil exported by Rosneft during the first six months of 2005 amounted to 58.6% of its production versus 55.3% during the same period of 2004. More detailed information about allocation of oil, as well as about revenues and average delivery prices by destinations is provided in the subsection “Sales Revenues” in the “Financial Performance” section.

Financial Performance

The financial results of Yuganskneftegas, incorporated in the consolidated statements of the Company for the first six months of 2005, were the main drivers affecting individual indicators within the statements, and the financial results should therefore be considered primarily in the context of the acquisition and consolidation of this enterprise.

Table 10: Allocation of Sales Revenues

	6 months 2005	6 months 2004	% change
	USD million		
Crude oil export revenues	6 200	1 080	474%
To the "far abroad"	5 690	1 010	464%
To the "near abroad"	510	70	625%
Crude oil domestic sales revenues	434	15	2753%
Gas sales revenues	86	56	55%
Oil and gas sales	**6 720**	**1 151**	**484%**
Petroleum products export revenues	1 818	472	285%
Petroleum products domestic sales revenues	1 162	555	110%
Wholesale trade	936	402	133%
Retail trade	226	152	48%
Oil refining services	0	4	-94%
Petroleum products sales and oil refining services	**2 980**	**1 031**	**189%**
Other sales	**164**	**119**	**37%**
Total sales revenues	**9 864**	**2 301**	**329%**

Table 11: Allocation of Crude Oil and Petroleum Products Sales Volumes

	6 months 2005	6 months 2004	6 months 2005	6 months 2004	% change
	million tons		million barrels		
Crude oil export sales	20 637	5 418	150 915	39 621	281%
To the "far abroad"	17 929	4 870	131 115	35 617	268%
To the "near abroad"	2 708	548	19 800	4 004	395%
Crude oil domestic sales	3 153	138	23 059	1 009	2185%
Total crude oil sales	**23 790**	**5 556**	**173 974**	**40 630**	**328%**
Petroleum products export sales	5 983	2 508	43 755	18 338	139%
Petroleum products domestic sales	3 708	2 020	27 113	14 775	84%
Wholesale trade	3 234	1 665	23 650	12 179	94%
Retail trade	474	355	3 463	2 596	33%
Total petroleum product sales	**9 691**	**4 528**	**70 868**	**33 113**	**114%**
Total crude oil and petroleum products sales	**33 481**	**10 084**	**244 842**	**73 743**	**232%**

Table 12: Average Crude Oil and Petroleum Products Sales Prices

	6 months				% change
	2005	2004	2005	2004	
	USD per ton		USD per barrel		
Average crude oil export price	300	199	41,1	27,3	51%
The "far abroad"	317	207	43,4	28,3	53%
The "near abroad"	188	128	25,8	17,6	47%
Average crude oil domestic sale price	138	108	18,8	14,8	27%
Average crude oil sales price	**279**	**197**	**38,1**	**27,0**	**41%**
Average petroleum products export price	304	188	41,5	25,7	61%
Average petroleum products domestic price	314	275	42,9	37,5	14%
Wholesale trade	289	241	39,6	33,0	20%
Retail trade	478	427	65,3	58,5	12%
Average petroleum products sales price	**308**	**228**	**42,1**	**31,1**	**35%**

Oil and gas sales increased by a factor of 5,8 during the first six months of 2005 to reach USD 6 720 million. The key factors of this increase, in order of significance, were as follows:

- The growth of oil export sales from 5 418 thousand tons to 20 637 thousand tons had a positive impact on revenues of USD 3 034 million;
- The 51% growth in the crude oil export price resulted in an increase of revenues in the amount of USD 2 087 million;
- The growth of crude oil domestic sales from 139 thousand tons to 3 153 thousand tons had a positive impact of USD 329 million;
- The 26% growth in the crude oil domestic sales price resulted in an increase of revenues of USD 89 million;
- Increase in gas sales by USD 30 million.

Refined products sales and processing fees reached USD 2 980 million, and were 2.9 times higher than during the same period of 2004. The key factors of this increase, in order of significance, were as follows:

- An increase in petroleum products export prices by 61% had a positive impact on revenues of USD 693 million;
- An increase of petroleum products export sales from 2 508 thousand tons to 5 983 thousand tons had a positive impact of USD 660 million;
- An increase of petroleum products domestic sales to 3 708 thousand tons during the first six months of 2005 from 2 020 thousand tons during the previous period had a positive impact of USD 460 million;
- The 14% growth in petroleum products domestic sale prices had a positive impact of USD 148 million.

At the same time, revenues from oil refining services for the third parties decreased by USD 4 million.

Support services and other sales amounted to USD 164 million during the first six months of 2005 and were 37% higher than the amount of “other sales” during the first six months of 2004 (USD 119 million). The growth in “other sales” is mainly attributable to the increase in the volume and value of construction services and sales of other products and services.

Operating Expenses

Operating expenses of the Company grew by 301% during the first six months of 2005 versus the same period of 2004. The main factors of this increase were the acquisition of Yuganskneftegas, as well as an increase in the mineral extraction tax rate and export duty on crude oil and petroleum products. The table below contains the main items of operating expenses.

Table 13: Operating Expenses

	6 months 2005	6 months 2004	% change
Cost of extraction of oil and gas sold	447	148	203%
Cost of production and purchased refined products and processing fees	584	306	91%
Cost of support services and other sales	49	72	-32%
Selling and administrative expenses	176	102	73%
Pipeline tariffs and transportation costs	799	238	236%
Exploration expenses	49	38	27%
Depreciation, depletion and amortization	600	183	228%
Accretion expense	17	4	368%
Taxes other than income tax	2 200	417	427%
Excise tax and export customs duties	2 189	267	721%
Total operating expenses	**7 110**	**1 775**	**301%**

Cost of extraction of oil and gas sold includes raw materials costs, equipment maintenance and repair costs, wages and salaries, activities to enhance oil recovery, procurement of fuel and lubricants, electricity and other similar expenses. Without accounting for Yuganskneftegas, the growth in costs resulted from the 7% increase in production volumes from the first six months of 2004 level, the real appreciation of the ruble and higher electricity tariffs, costs of raw materials, as well as well workover costs and enhanced oil recovery services. Also, average salaries and allowances were raised throughout the Company during the second quarter of 2005.

Cost of production and purchased refined products, and processing fees amounted to USD 584.4 million during the first six months of 2005 versus USD 306.1 million during the same period of 2004, having increased by 91%. These costs are high in absolute terms since they are driven by the significant imbalance between oil production and refining in the company, as well as with the geographical complexity of the Company's logistics. These factors explain the high refining costs paid to third party refineries, as well as the need to buy petroleum products from third parties. The volume of products refined at third parties refineries amounted to 4.9 million tons, and refining costs amounted to USD 124 million during the first six months of 2005.

Certain distribution subsidiaries of the Company are located at considerable distances from refineries and those of the third parties that process crude oil of the Company. As a result, it is more economical for the Company to procure petroleum products from third parties to supply these subsidiaries than to transport its own petroleum products. The Company considers optimization of logistics and reduction of the proportion of crude purchased from third parties as one of its top priorities. As a result of efforts aimed at improving profitability during the first six months of 2005, the volume of petroleum products procured from third parties decreased from 926 thousand tons to 386 thousand tons. Petroleum products purchased from third parties cost USD 134 million during the first six months of 2005.

The Company buys small quantities of crude oil from third parties. Thus, less than 2 thousand tons of crude oil were purchased during the first six months of 2005 versus 35 thousand tons during the first six months of 2004. Refining costs of the Company's own refineries amounted to USD 50 million. The costs of transportation to the refineries that are also included in this item amounted to USD 184 million.

Cost of support services and other sales decreased by 32% to USD 49 million during the first six months of 2005 versus USD 72 million during the first six months of 2004 as a result of the focused efforts made by the Company to divest non-core activities.

Selling and administrative expenses include general and administrative expenses, wages and salaries, banking commissions, professional service fees, including consulting, legal and auditing services; insurance expenses, property leasing expenses, bad debts and financial investments provisions, as well as trading costs of marketing subsidiaries and other expenses. Commercial and administrative expenses amounted to USD 176 million during the first six months of 2005 and were 73% higher than during the same period of 2004, mainly due to the increase of expenses connected with the presale preparation and shipment of commodities, commissions, as well as the incorporation of Yuganskneftegas's commercial and administrative expenses.

Pipeline tariffs and transportation costs increased during the first six months of 2005. Transportation costs grew to USD 799 million during the first six months of 2005 from USD 238 million during the first six months of 2004 due to greater volume of oil transportation and higher tariffs. During the first six months of 2005, Transneft raised its tariffs by 19% and railway tariffs grew by 4% on average.

Exploration expenses include mainly geological exploration expenses. These expenses are capitalized if commercial reserves of oil and gas are discovered, or are written off as expenses of the current period in the event of unsuccessful exploration activities. The total amount of written off expenses increased by USD 11 million or 27% during the first six months of 2005 from the same period of 2004.

Depreciation, depletion and amortization include depreciation of oil and gas producing assets, other production and non-production assets, and amortization of intangible assets. Depreciation, depletion and amortization amounted to USD 600 million during the first six months of 2005 versus USD 183 million during the first six months of 2004. This 3.3-fold increase was mainly related to the incorporation of fixed assets of Yuganskneftegas into the fixed assets of the Company. The balance sheet value of these fixed assets was recalculated to reflect the fair value during the consolidation process. Depreciation of OJSC Yuganskneftegas's fixed assets amounted to USD 383 million during the first six months of 2005.

Taxes other than income tax include mineral production tax, property tax, the single social tax and other taxes. Taxes other than income tax increased 5.3-fold during the first six months of 2005 and amounted to USD 2 200 million versus USD 417 million during the same period of 2004. The basis of calculation for mineral production tax is described under "Changes in Tax Rates and Export Duties" above. The growth in taxes resulted mainly from the increase of mineral production tax by USD 1 678 million caused by higher production volumes, tax rates and oil prices.

Table 14: Taxes Other than Income Tax

	6 months		
	2005	**2004**	**% change**
Social security allocations	59	53	11%
Transportation tax	1	0	67%
Mineral extraction tax	1 985	307	547%
Land tax	7	6	17%
Property tax	41	22	91%
Excises	89	19	360%
"Russia" name tax	-	6	-100%
Fines and tax charges	8	1	603%
Other taxes and charges	10	3	215%
Total Taxes other than Income Tax	**2 200**	**417**	427%

Excise tax and export customs duties payable by the Company include taxes on sales of petroleum products, as well as oil and petroleum products export duties. Excises and export duties amounted to USD 2 189 million during the first six months of 2005 versus USD 267 million during the first six months of 2004 as a result of greater volume of oil and petroleum products exports and domestic sales of petroleum products, as well as higher rates of export duties and excises. This is discussed in greater detail in the subsection "Changes in Tax and Export Duties Rates" of the section "Main Factors Affecting Performance Indicators".

Table 15: Export Duties and Excises

	6 months 2005	6 months 2004	% change
Export duties	2143	238	801%
Excises	46	29	59%
Total excises and export duties	**2189**	**267**	**721%**

Other Income and Expenses

Interest income grew by USD 13 million to USD 33 million during the first six months of 2005.

Interest expense increased 5.4 times and amounted to USD 382 million during the first six months of 2005. This increase is connected with substantial borrowings to finance the acquisition of Yuganskneftegas in December 2004.

Other expenses, net, mainly represent expenses connected with social and charitable activities of the Company in the regions of the Russian Federation. Other expenses decreased by 9% to USD 73 million during the first six months of 2005. These expenses are not connected with the core activities of the Company and can be reduced if necessary.

Income tax expense amounted to USD 914 million in the first six months of 2005 versus USD 119 million in the first six months of 2004. Current income tax increased from USD 135 million to USD 919 million, while gains from deferred taxes decreased from USD 17 million to USD 5 million. The increase in current income tax is mainly connected with the growth of the Company's net income as a result of Yuganskneftegas' acquisition and accrual of tax on the proceeds from the divestment of its share in Sevmorneftegas.

Minority interest in subsidiaries' earnings amounted to USD 310 million in the first six months of 2005 versus USD 22 million a year before. The main changes were caused by profit generation in Yuganskneftegas where minority interest amounted to USD 122 million, and in Purneftegas where minority interest in net income increased by USD 163 million, mainly as a result of proceeds from the divestment of the 50% stake in Sevmorneftegas.

Cash Flow and Capital Expenditures Analysis

Operating Activities

Net cash generated by operating activities increased 2.9 times from USD 364 million to USD 1 051 million during the first six months of 2005. At the same time, changes in operating assets and liabilities less acquisitions (i.e. changes in the working capital) had a considerable negative impact on operating cash flow. The working capital growth is mainly attributable to the significant increase in export activities and capital expenditures connected with the acquisition of Yuganskneftegas that resulted in the one-off increase of USD 682 million in the value-added tax reimbursable from the budget after export transactions, while customs expenses grew by USD 168 million. The new scale of the Company's activities also required an increase in its inventories of USD 197 million. Despite the decrease in trade receivables of USD 241 million and the increase in income tax and other tax liabilities of USD 255 million, the growth of working capital amounted to USD 996 million in total.

Investing Activities

Cash capital expenditures increased 2.6 times to USD 860 million during the first six months of 2005 versus USD 327 million in the first half of 2004. Non-cash capital expenditures decreased by 47% from USD 39 million to USD 20 million. In total, capital expenditures grew by 141%. Distribution of capital expenditures by types of activities is given below:

Table 16: Capital Expenditures

	6 months		% change
	2005	2004	
Cash capital expenditures	860	327	163%
Non-cash capital expenditures	20	39	-47%
Total capital expenditures, including:	**880**	**366**	**141%**
Upstream	764	212	260%
Downstream	88	105	-16%
Other activities	28	49	-42%

The growth of capital expenditures was concentrated in the “upstream” segment and was mainly attributable to Yuganskneftegas. Rosneft plans to substantially increase capital expenditures in this segment for the purposes of production enhancement in the Yuganskneftegas fields and commissioning of the Vankor field.

Capital expenditures in the “downstream” segment decreased by 16% from USD 105 million to USD 88 million. An increase in this item of expenditures is expected in the short-term in connection with the beginning of upgrading certain facilities in the Tuapse and Komsomolsk refineries and sea port facilities of OJSC Rosneft – Tuapsenefteproduct, as well as with the more intensive development of the distribution network.

Capital expenditures by other types of activities decreased by 42% from USD 49 million in the first six months of 2004 to USD 28million in the first six months of 2005 in accordance with the program aimed at reducing investments in non-core activities.

The holding company of Rosneft has an ongoing program of acquiring outstanding minority interests in its most significant subsidiaries. It spent USD 159 million to acquire additional stakes in its subsidiaries during the first six months of 2005, 88% above USD 85 million spent for these purposes during the first six months of 2004.

Acquisitions and divestments of long-term and short-term financial investments are mainly related to the Company’s projects as well as trading activities of the Company’s bank in the course of its operational activities. The positive balance of acquired and divested financial investments amounted to USD 97 million in the first six months of 2005, while the negative balance amounted to USD 164 million in the first six months of 2004. The total amount of net cash used in investing activity increased by 69% from USD 537 million in the first six months of 2004 to USD 906 million in the first six months of 2005.

Financing Activities

Net cash used in financing activities during the first six months of 2005 amounted to USD 580 million, while the Company raised USD 141 million from financing activities during the first six months of 2004. The lion’s share of funds was used to repay credits raised to finance the acquisition of Yuganskneftegas in December 2004.

In the first six months of 2005, the Company’s debt facilities were re-negotiated with loosened financial covenants which translated into an increase in Company’s allowed maximum borrowing capacity. The table below provides the schedule of long-term debt repayment by the Company.

Table 17: Schedule of the Long-Term Debt Repayment

2005	628
2006	1 981
2007	1 998
2008	1 639
2009	1 471
2010 and beyond	1 842
Total long-term debt	9 559

We paid USD 8 million in the form of dividends to minority shareholders of our subsidiaries during the first six months of 2005, 21% more than the USD 7 million paid during the first six months of 2004.

Credit Rating and Selected Performance Indicators

As of June 30, 2005, the Company had a Moody's credit rating of Baa3, and a Standard & Poor's credit rating of B- with "negative" forecast. In October 2005, Moody's upgraded the Company's rating to Baa2 level. In November 2005, Fitch awarded us BB+ rating. In December 2005, Standard & Poor's upgraded the Company's rating to B+ level with "positive" forecast.

The Company monitors and evaluates its activities on an on-going basis. Selected performance indicators, as well as other significant financial ratios, are given below.

Table 18: Selected Performance Indicators

	6 months	
	2005	**2004**
EBITDA margin	34,2%	31,0%
Adjusted net income margin before interest of other shareholders in income of subsidiaries	17,8%	15,7%
Return on average capital employed (ROACE), annualized	22,6%	14,2%
Return on average equity (ROAE), annualized	49,2%	20,7%
Net debt to capital employed ratio	0,57	0,68
Net debt to EBITDA ratio, annualized	1,66	8,86
Short term assets to liabilities ratio	1,03	0,89

The Company significantly improved profitability ratios, as well as debt and liquidity ratios, during the first six months of 2005. The tables below set out calculations of these ratios.

Rosneft considers EBITDA margin, ROACE and ROAE and the related measures as important supplemental measures of our operating performance in addition to US GAAP and believes they are frequently used by financial analysts, investors and other interested parties in the evaluation of oil & gas companies. These indicators have limitations as analytical tools and should not be considered in isolation, or as a substitute for analysis of Company's operating results as reported under US GAAP. The Company compensates for their limitations by relying primarily on the US GAAP operating results and using the above indicators only as a supplement.

Table 19: Calculation of EBITDA Margin

	6 months	
	2005	**2004**
Operating income	2 754	526
Increment of liabilities connected with the divestment of assets	17	4
Depreciation, depletion and amortization	600	183
EBITDA	3 371	713
Sales revenues	9 864	2 301
EBITDA margin	**34,2%**	**31,0%**

Table 20: Calculation of Adjusted Net Income Margin before Minority Interest

	6 months	
	2005	2004
Net income	2 439	340
Interest of other shareholders in income of subsidiaries	310	22
Income from divestment of CJSC Sevmorneftegas	(1 303)	-
Tax on income from divestment of CJSC Sevmorneftegas	313	-
Adjusted net income before interest of other shareholders in income of subsidiaries	1 759	362
Sales revenues	9 864	2 301
Adjusted net income margin before interest of other shareholders in income of subsidiaries	**17,8%**	**15,7%**

Table 21: Calculation of Capital Employed and Related Indicators as of June 30, 2005 and 2004

	30.06.2005	31.12.2004	30.06.2004	31.12.2003
Short-term credits and short-term portion of the long-term debts	3 775	4 667	746	588
Long-term credits and liabilities	8 026	9 010	1 792	1 822
Cash and cash equivalents (-)	(588)	(1 043)	(205)	(235)
Net debt	11 213	12 634	2 333	2 175
Shareholders' equity	5 713	3 335	2 838	2 563
Interest of other shareholders in subsidiaries	2 718	2 535	806	789
Equity	8 431	5 870	3 644	3 352
Capital employed	**19 644**	**18 504**	**5 977**	**5 527**
Average Equity	**7 151**		**3 498**	
Average Capital employed	**19 074**		**5 752**	

Table 22: Calculation of Return on Average Capital Employed (ROACE)

	6 months	
	2005	2004
Operating profit	2 754	526
Income tax	(914)	(118)
Income tax on gain on sale of interest in CJSC Sevmorneftegaz	313	-
Return used for calculation of ROACE	2 153	408
Return used for calculation of ROACE, annualized	4 306	816
Average capital employed	19 074	5 752
ROACE, annualized	**22,6%**	**14,2%**

Table 23: Calculation of Return on Average Equity (ROAE)

	6 months	
	2005	**2004**
Adjusted net income before interest of other shareholders in income of subsidiaries	1 759	362
Adjusted net income before interest of other shareholders in income of subsidiaries, annualized	3 518	724
Average Equity, including Minority Interest	7 151	3 498
ROAE, annualized	**49,2%**	**20,7%**