Management's Discussion and Analysis

The following discussion should be read in conjunction with the audited consolidated financial statements prepared in accordance with US GAAP and the related notes, published simultaneously with this MD&A. This discussion includes forward-looking statements that involve risks and uncertainties. Actual results could differ materially from those anticipated in the forward–looking statements as a result of numerous factors, including certain factors discussed later in this MD&A (please see more defined information regarding forward-looking statements at the end of this document).

For financial reporting purposes, Tatneft converts metric tons of crude oil to barrels using a conversion factor of 7.123. This factor represents a blend of varying conversion factors specific to each of Tatneft's fields. Because the proportion of actual production by field varies from period to period, total reserves and production volumes for the Group in barrels converted from tons using the blended rate may differ from total reserves and production calculated on a field by field basis.

Background

OAO Tatneft (the "Company") and its subsidiaries (jointly referred to as the "Group" or "Tatneft") is one of the largest vertically integrated oil companies in Russia in terms of crude oil production and proved oil reserves. The Company is an open joint-stock company organized under the laws of the Russian Federation with the headquarters located in City of Almetyevsk, Tatarstan. The principal business of the Group is to explore for, develop, produce and market crude oil and refined products. The Group is also expanding its activities to further develop its refining, petrochemicals and oil and gas services segments.

As of December 31, 2006 OAO Svyazinvestneftekhim, a company wholly owned by the government of Tatarstan, together with its subsidiary, held approximately 36% of the Company's voting stock. These shares were contributed to Svyazinvestneftekhim by the Ministry of Land and Property Relations of Tatarstan in 2003. Tatarstan also holds a "Golden Share", a special governmental right, in the Company. The exercise of its powers under the Golden Share enables the Tatarstan government to appoint one representative to the Board of Directors and one representative to the Revision Committee of the Company as well as to veto certain major decisions, including those relating, to changes in the share capital, amendments to the Charter, liquidation or reorganization and "major" and "interested party" transactions as defined under Russian law. The Golden Share currently has an indefinite term. The Tatarstan government, through OAO Svyazinvestneftekhim, also controls or exercises significant influence over a number of the Company's suppliers and contractors, such as the electricity producer OAO Tatenergo and the petrochemicals company OAO Nizhnekamskneftekhim.

Substantially all of the Group's crude oil and gas production and other operations are located in Tatarstan, a republic of the Russian Federation situated between the Volga River and the Ural Mountains and located approximately 750 kilometers southeast of Moscow.

The Group currently holds most of the exploration and production licenses and produces substantially all its crude oil in Tatarstan.

As of December 31, 2006, the Group's total proved reserves (SPE/WPC) of crude oil and condensate were 830 million tons (5,911 million barrels).

Key financial and operational results

	Year ended December 31, 2006	Change to 2005, %	Year ended December 31, 2005
Sales (millions of RR)	318,284	6.0%	300,358
Net income (millions of RR)	29,773	5.4%	28,242
EBITDA (millions of RR)	51,508	(4.1%)	53,684
Income per share of common stock			
Basic income (RR)			
Common……………	13.65	3.5%	13.19
Preferred……………..	13.58	4.9%	12.94
Diluted income (RR)			
Common……………	13.60	3.6%	13.13
Preferred……………..	13.53	5.0%	12.88
Crude oil production by the Group (thousand of tons)	25,741	0.5%	25,609
Gas production by the Group (millions of cubic meters)	738.5	0.2%	736.7
Refining and tolling throughput (thousand of tons)	553	(86.5%)	4,097
Crude oil proved reserves (millions of bbl)	5,911	0.7%	5,872

During 2006 our net income was RR 29,773 million, which is RR 1,531 million, or 5.4%, more than in 2005. The improvement of our performance resulted from overall favorable price conditions and production volumes in 2006. However, the growth of our sales and net income was bounded by substantial decrease in refining throughput compared to 2005, the growth of taxes linked to international crude oil price and increasing operating expenses. These factors, as well as other drivers impacting the results of our operations, are considered below in detail.

Segment information

Our operations are currently divided into the following main segments:

- **Exploration and production** – which consists of oil extraction production divisions of the Company, consisting of well repair and reservoir oil yield improvement subdivisions, two pumping equipment repair centers, security and logistics. Most oil and gas exploration and production activities are concentrated within OAO Tatneft;

- **Refining and marketing** – which consists of our participation in ZAO Nizhnekamsk Oil Refinery (“NNPZ”), a project company established to build and operate a refining and petrochemical complex with the throughput capacity of seven million tones of crude oil per year in Nizhnekamsk, Tatarstan; our gas production, transportation and refining division Tatneftegaspererabotka, OOO Tatneft-Centernefteproduct and OOO Tatneft-Moskvanefteproduct, management companies for Tatneft-branded gas station network; and certain other oil trading and ancillary companies (in 2005 this segment included the results of the OAO Nizhnekamsk NPZ sold to TAIF in September 2005);

- **Petrochemicals -** our petrochemicals segment has been consolidated under a management company, Tatneft-Neftekhim, which manages OAO Nizhnekamskshina, one of the largest tire manufacturers in Russia, and the companies technologically integrated with it, including OAO Nizhnekamsk Industrial

Carbon Plant and ZAO Yarpolymermash. OOO Tatneft-Neftekhimsnab and OOO Trading House Kama are responsible, respectively, for procuring supplies and marketing products produced by the companies within this segment.

Until recently, our operations also included a banking segment. Following the sale of a significant part of our participation in Bank Zenit in April 2005 and of all our participation in Bank Devon-Credit in December 2005, we no longer consider our banking activities to be significant to our operations.

The segments were determined by the way management recognizes the segments within the Group for making operating decisions and how they are evident from the Group structure.

Executive overview

Recent developments and outlook

E&P activities in Tatarstan

One the Company's primary strategic goal is to maintain current levels of crude oil production on its licensed fields in Tatarstan. In 2006 the Company increased production by 0.2% from its fields in Tatarstan. Due to the relative maturity of the Company's main producing fields, approximately 44.3% (11.3 million tones) of all crude oil was produced using various enhanced recovery techniques. In 2006 the Company obtained nine new licenses for E&P activities in Tatarstan and put into operation 348 new production wells. Average crude oil flow rates in 2006 for the Company's wells in Tatarstan were 4.1 tones per day.

Effective from January 1, 2007 the Company benefits from the differentiated taxation of crude oil production from some of its fields in Tatarstan, including the Company's largest field - Romashkinskoye (more fully discussed in the Taxation subsection of Certain Macroeconomic Factors Affecting the Group's Results of Operations below).

E&P activities outside of Tatarstan

The Group continues to expand its operations outside of Tatarstan. In 2006 the Group obtained three new E&P licenses and one exploration license in the Samara region and three new E&P licenses in the Nenets Autonomous Region.

Tatneft is planning to continue expansion and diversification of its reserves base by gaining access to reserves outside Tatarstan, particularly in Kalmykia, the Ulyanovsk, Samara, Orenburg and Krasnoyarsk regions, Nenets Autonomous Region and the Chuvash Republic. The Group intends selectively to establish strategic alliances to develop and operate oil fields in order to facilitate this process. Outside the Russian Federation, Tatneft participates in projects in Libya, Syria and other countries.

Natural bitumen production

During 2006 the Company actively worked on a pilot project of natural bitumen production from the Ashalchinskoye field in Tatarstan using parallel steam injection and producing wells. Tatneft believes that untapped resources of natural bitumen in Tatarstan have a great potential and should be considered for commercial production in the current economic and technological environment. In 2006 the Company announced its plan to seek a strategic partner having natural bitumen/oil sands production experience to produce natural bitumen reserves in Tatarstan. In 2007 the Company continues testing various technologies relating to natural bitumen production, including by drilling new wells, and anticipates finding a strategic partner for the project.

Crude oil refining and marketing

In 2005 the Group disposed of its production assets that were part of OAO Nizhnekamsk Refinery, to TAIF (see OAO Nizhnekamsk NPZ subsection under Changes in the Group Structure below). As a result of that disposal, in 2006 the Group's sales of refined products decreases substantially compared to 2005.

In 2006 the Company financed (in form of loans) works relating to the permitting and construction of NNPZ, a new refining and petrochemicals complex in Nizhnekamsk, Tatarstan, in which we have a 40% participating interest. The new facility's projected throughput capacity is seven million tones of crude oil per year. In 2006 the Russian Government resolved to allocate RR 16.5 billion from the Russian Federation Investment Fund to finance external infrastructure for the facility.

On October 23, 2006, the Group entered into a five-year fiduciary management agreement with the Tatarstan government for the fiduciary management of 426,293,985 ordinary shares, or 28.78%, of ZAO Ukrtatnafta held by the Tatarstan government. Under this agreement, the Group is entitled to manage these shares subject to the written approval of the Tatarstan government. The Group's investment of 8.6% in Ukrtatnafta is accounted for under cost method in the accompanying consolidated financial statements as management believes the Group does not have the ability to exercise significant influence over ZAO Ukrtatnafta.

In 2006 the Company continued the expansion and optimization of its retail petrol stations network, pursuant to a program approved by its Board of Directors. As of December 31, 2006 the Group operated 557 retail petrol stations in Russia and Ukraine, which sold 1.1 million tones of fuel in 2006.

Changes in the Group Structure

International Petro-Chemical Growth Fund

In December 2005, Tatneft Oil AG, a subsidiary of the Company, acquired participation shares with a total value of US $394 million in an open-ended investment company International Petro-Chemical Growth Fund Limited ("IPCG Fund"), incorporated in Jersey, Channel Islands, by contributing 116 million ordinary shares of Tatneft and US $1 million in cash into the fund. IPCG Fund invests in debt and equity securities of companies operating in the Russian Federation in general, and the Republic of Tatarstan in particular with priority given to those entities operating in the oil and chemicals industry and, to a lesser extent, the banking sector. IPCG Fund is managed by MARS Capital Management Limited, a company regulated by Jersey Financial Services Limited. The Fund is an indirect shareholder of NNPZ and is expected to participate in the financing of the new refinery and petrochemical facility. At December 31, 2005, the Company owned approximately 93.81% of the total participation shares in IPCG Fund, and its equity investee Bank Zenit owned the remaining 6.19%.

In June 2006, additional investors contributed ownership interests in Bank Zenit to IPCG Fund in exchange for participation shares in the fund. As a result of these transactions, the Group's ownership interest in IPCG Fund decreased to 44.88%.

In December 2006, the Group contributed an additional 18.5 million of Tatneft ordinary shares to IPCG Fund in exchange for US $86.8 million in participation shares.

In December 2006, the Group contributed all its shares (50% of all issued shares) of Tatoilgas, a Russian joint stock company, which was fair valued at US $30 million, into IPCG Fund in exchange for US $30 million in participation shares of the fund.

Subsequent to these transactions, the Company's ownership interest in IPCG Fund was increased to 47.39%.

At December 31, 2006, IPCG Fund owned 142.2 million Tatneft ordinary shares, of which 47.39% are accounted for as treasury shares of the Group.

Banking

In April 2005, the Group sold its 26.75% stake in Bank Zenit to three Cyprus based companies unrelated to the Group. The sales price of RR 1,214 million was determined based on the results of an independent valuation. This transaction reduced the Group's ownership interest in Bank Zenit to 25.95%.

In May 2006, the Group increased its shareholding in Bank Zenit from 25.95% to 39.73% as a result of acquiring 2,935.3 million newly issued shares of the bank at their par value for RR 2,935.3 million. In March 2007, the Group disposed of 1,138 million of Bank Zenit shares for RR 1,787 million, decreasing the Company's ownership in Bank Zenit to 28.35%.

Also, in June 2007 Bank Zenit carried out a private placement of 1,545 million newly issued ordinary shares to a private investor unrelated to the Group, resulting in the dilution of the Group's ownership in Bank Zenit to 24.56%.

In December 2005, the Group sold its 92% interest in Bank Devon-Credit for RR 858 million, to Bank Zenit.

In June 2006 the Company increased its shareholding in Bank AK Bars from 29.46% up to 32.19% as a result of acquiring newly issued shares at their par value for RR 3,825 million. In May 2007, the Company subsequently disposed of its entire interest in Bank AK Bars for RR 6.8 billion to third parties; as of the date of MD&A title to these shares has not yet passed to the purchasers, which will happen upon full payment for the shares in accordance with the terms of respective sale and purchase agreement.

OAO Nizhnekamsk NPZ

In 2003 OAO Tataro-American Investments and Finance ("TAIF"), then a related party to the Group, brought a case before the Arbitration Court of the Republic of Tatarstan claiming a return of crude distilling unit (the "CDU") leased to OAO Nizhnekamsk NPZ, a subsidiary of the Group operating a refinery in Nizhnekamsk, Tatarstan (the "Refinery"), because of breach by OAO Nizhnekamsk NPZ of several provisions of the lease agreement dated December 29, 2001. The CDU was installed at the Refinery in 2002 and represents vital assets of the Refinery's operations. On October 6, 2003 the Arbitration Court ruled in favor of TAIF and this decision was reinforced by the instance of appeals of the Arbitration Court of Republic of Tatarstan on January 13, 2004. Following a court order the CDU was returned to TAIF. As a result, in September 2005, the Group signed agreements to sell its share of the production assets and inventory of the Refinery to TAIF, including the refining units, for approximately RR 7.2 billion, net of VAT. The sales agreements provided TAIF the ability to repay the Company over a period not to exceed 18 months, incurring interest monthly on any unpaid portion based on the Russian Central Bank of Russia (the "Central Bank") Refinancing Rate. During 2005, TAIF paid approximately RR 7.5 billion, net of VAT, including RR 265 million in interest and performance penalties. As part of this transaction, TAIF also agreed to provide the Company's subsidiary OAO TKNK with a RR 344 million interest free loan maturing on December 31, 2007. In October 2005, the Group entered into a three year supply contract with TAIF in order to supply up to 650,000 tons per month of crude oil to TAIF at market price to be refined at the Refinery. In February 2006, the Company signed an additional sales agreement with TAIF, providing for the sale of additional refining assets for RR 198 million, net of VAT.

Other

In April 2006, the Group acquired from a third party 100% of the outstanding shares of OAO "LDS-1000", the owner of the ice hockey arena in the city of Kazan, for RR 2.9 billion.

Resource base

As determined by the Group's independent reservoir engineers, Miller and Lents, Ltd., the following information presents the balances of our oil and gas reserves as of December 31, 2006 and 2005 under the Society of Petroleum Engineers and the World Petroleum Congress definitions.

Net volumes (in mmbbl)	Year ended December 31, 2006	Changes in 2006		Year ended December 31, 2005
		Production	Revision	
Total proved reserves	5,911	(183)	222	5,872
Total probable reserves	1,994			2,227
Total possible reserves	453			395

Most evaluated properties are located in the Volga-Ural Oil Basin and include approximately 120 developed and producing oil fields, containing approximately 28,600 active completions. In addition, in 2006, estimated possible reserves for 17 bitumen oil fields were recorded.

The process of estimating reserves is inherently judgmental. Proved oil and natural gas reserves are estimated quantities of crude oil and natural gas which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic and operating conditions (i.e., prices and costs as of the date that the estimate is made). Prices include consideration of changes in existing prices provided only by contractual arrangements, but not on escalations based upon judgments about future conditions. Actual prices and costs are subject to change due, in significant part, to factors beyond the Group’s control. These factors include world oil prices, energy costs and increases or decreases of oil field service costs. Due to inherent uncertainties and the limited nature of reservoir data, estimates of underground reserves are subject to changes over time as additional information becomes available.

The determination of estimated proved reserves is a significant element in arriving at the results of operations of exploration and production activities. The Company uses independent reservoir engineers to estimate all of our oil and gas reserves. The estimates of proved reserves impact well capitalization, undeveloped lease impairments and the depreciation rates of proved properties, wells and equipment. Reduction in reserve estimates may result in the need for impairments of proved properties and related assets.

Operational highlights

	Year ended December 31, 2006	Year ended December 31, 2005
Crude oil production (millions of metric tons)	25.7	25.6
Crude oil production (millions of barrels)	183	182
Refining and tolling throughput (millions of metric tons)	0.6	4.1
Refining and tolling throughput (millions of barrels)	3.9	29
Gas production by the Group (millions of cubic meters)	738.5	736.7

Crude oil production

Crude oil production of the Group (including production of consolidated subsidiaries ZAO Tatoilgas (see Changes in the Group Structure above), OOO Promyshlennaya Ecologia, OAO Ilekneft, ZAO Adbulinskneftegaz, ZAO Tatneft-Samara, ZOO Tatneft-Severny and ZAO Kalmtatneft) increased by 0.5% to 25.7 million metric tons in 2006. Increase of crude oil production is mainly the result of implementating modern secondary and tertiary methods and new technologies. Our gas production increased 0.2% to 738.5 million cubic meters in 2006 from 736.7 million cubic meters in 2005.

Refining

Refining throughput decreased by 86.5% to 0.6 million tons in 2006 from 4.1 million tons in 2005 primarily due to the sale of refining assets to TAIF (see OAO Nizhnekamsk NPZ sub-section under Changes in the Group Structure above).

Export of crude oil from Russia

During 2006, the Group exported from Russia approximately 63% of its crude oil production, compared with approximately 71% in 2005. Through Transneft, the state-owned monopoly owner and operator of Russia's trunk crude oil and export pipelines, the Group exported substantially all its crude oil export volumes in 2006, compared with 93% in 2005. The increase in export volumes through Transneft was a result of eliminating our use of railway transportation in 2005.

The Group decreased the volume of crude oil exported from Russia in 2006 by approximately 11% compared to 2005. The decreased is attributable to the increase in export tariffs on crude oil sales in 2006 resulting in favorable domestic prices, and our requirements to meet a significant domestic supply contract. In October 2005, the Group entered into a three year supply contract with OAO TAIF to supply up to 650,000 tons per month of crude oil at market prices.

Certain Macroeconomic Factors Affecting the Group's Results of Operations

The Group's results of operations and the period to period changes therein have been and will continue to be affected by various factors outlined below.

Crude oil and refined product prices

The Group's operations are significantly affected by changes in crude oil and refined product prices, both in export markets and in Russia. These prices are affected by external factors over which the Group has no control, such as global economic conditions, demand growth, inventory levels, weather, competing fuel prices and global and domestic supply. Export and domestic prices for crude oil and refined products have been highly volatile, depending, inter alia, on the balance between supply and demand and on OPEC production levels.

Historically, crude oil prices in the Russian market have been substantially below prices in the international market. Moreover, there is no independent or uniform market price for crude oil in Russia primarily because a significant portion of crude oil destined for sale in Russia is produced by vertically integrated Russian oil companies and is refined by the same vertically integrated companies. Crude oil that is not exported from Russia, refined by the producer or otherwise sold is offered for sale in the domestic market at prices determined on a transaction-by-transaction basis.

The table below represents average crude oil prices worldwide and in Russia in 2006 and 2005.

World market	**2006 US$/ bbl**	**Change from 2005**	**2005 US$/bbl**
Brent crude	65.1	19.8%	54.4
Urals crude (CIF Mediterranean)*	61.3	20.9%	50.7
Urals crude (CIF Rotterdam)*	61.2	21.9%	50.2

Source: Platts.

* The company sells crude oil on foreign markets on various delivery terms. Thus, our average sale price differs from average reported market prices.

Russian market	**2006 RR per ton***	**Change from 2005**	**2005 RR per ton***
Crude oil	6,825	14.6%	5,958

Source: Kortes.
*(including VAT)

Transportation of crude oil and refined products

The Group transports substantially all of the crude oil that it sells in export and local markets through trunk pipelines in Russia that are controlled by Transneft. The Russian government is expected to retain control over Transneft for the foreseeable future. Although pipeline capacity in Russia has increased in recent years, this capacity has not kept up with increases in production experienced by Russian oil and gas companies and therefore the capacity of the pipeline network still acts as a constraint on exports and indirectly on oil production in Russia. Currently, there are government-sponsored and private programs to increase pipeline capacity.

Transportation of oil is based on contracts with Transneft and its subsidiaries, which set forth the basic obligations of the contracting parties, including the right of Transneft to blend or substitute a company's oil with oil of other producers. Transneft establishes and collects on prepayment terms a ruble tariff on domestic shipments and an additional hard currency tariff on exports. The Federal Tariff Service is authorized to periodically review and set the tariff rates applicable for each segment of the pipeline.

The Group's crude oil is blended in the Transneft pipeline system with other crude oil of varying qualities to produce an export blend commonly referred to as Urals. The Group benefits from this blending since the quality of its crude oil is generally lower than that produced by other oil companies due to the relatively high sulfur content.

The Group also uses the Russian rail network to transport the crude oil and refined products that it sells in export markets. However, the Russian rail network also has limited capacity and the Russian government may allocate use of the Russian railway system on a preferential basis to domestic deliveries. Moreover, the system is subject to disruption as a result of its declining physical condition, a shortage of railcars, the limited capacity of border stations and spills and leakages, including those due to poorly maintained tank cars.

A significant proportion of crude oil and refined products transported by pipeline and rail are delivered to marine terminals for onward transportation. There are significant constraints present in Russia's oil shipment terminals due to geographic location, weather conditions, and port capacity limitations. However, government sponsored and private programs are seeking to improve port facilities.

The Group incurs transportation costs for the delivery of crude oil to refineries and for the delivery of crude oil and refined products to export markets. Transneft collects, on a prepayment basis, a Rouble tariff on domestic crude oil shipments and a combined Rouble and hard currency tariff on exports. A significant amount of refined products are transported using the Transnefteproduct pipeline system. Transnefteproduct is a state-controlled company, which specializes in transportation of refined products and is expected to be merged with Transneft shortly. However, the Transnefteproduct system is not as extensive as the Transneft system for transporting crude oil.

Prior to March 2004, the Russian Federal Energy Commission periodically reviewed and set the tariff rates for each segment of the Transneft and Transnefteproduct pipelines. In March 2004, the Federal Energy Commission was reorganized into the Federal Tariffs Service. In addition, the Group is subject to tariffs for crude oil and refined products that are transported by railway.

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

Inflation and foreign currency exchange rate fluctuations

A significant part of the Group's revenues are derived from export sales of crude oil and refined products which are denominated in US Dollars. The Group's operating costs are primarily denominated in Roubles.

Accordingly, the relative movements of rouble inflation and Rouble/US Dollar exchange rates can significantly affect the results of operations of the Group. In particular, operating margins are generally adversely affected by a real appreciation of the Rouble against the US Dollar (i.e., by an inflation rate that is higher than the rate at which the Rouble is devaluing against the US Dollar) because this will generally cause costs to increase relative to revenues. The Group has not historically used financial instruments to hedge against foreign currency exchange rate fluctuations.

The following table shows the rates of inflation in Russia, the period-end and average Rouble/US Dollar exchange rates, the rates of nominal devaluation of the Rouble against the US Dollar, and the rates of real change in the value of the Rouble against the US Dollar for the periods indicated.

	Year ended December 31, 2006	**Year ended December 31, 2005**
Rouble inflation	9.0%	10.9%
US $ period-end exchange rate	26.33	28.78
Average US $ exchange rate	27.17	28.31
Nominal appreciation (devaluation) of the Rouble	8.5%	(3.7%)
Real Rouble appreciation	19.1%	6.9%

Sources: Federal Service of State Statistics and the Central Bank of Russia

At present, the Rouble is not a convertible currency outside the Commonwealth of Independent States. Exchange restrictions and controls exist related to converting Roubles into other currencies. For instance, between March 1999 and the first half of August 2001, the Group was required to sell 75% of its hard currency export proceeds to authorized banks in exchange for Roubles. Between the second half of August 2001 and July 2003 this rate was decreased to 50%. In July 2003 the Central Bank of the Russian Federation was given the authority to set this rate between 0% and 30% and the rate was set at 25%. On November 26, 2004 the Central Bank adopted regulations that reduced the requirement to 10%, effective from December 27, 2004. In May 2006, the Central Bank abolished the requirement to convert hard currency proceeds.

Most provisions of the new Federal Law "On currency regulation and currency control" (the "Exchange Control Law") came into effect in June 2004. The Exchange Control Law significantly liberalized the exchange control regime in Russia and expanded the ability of Russian individuals and legal entities to engage in banking and financial transactions outside of Russia. Effective from January 1, 2007, the Exchange Control Law removed certain restrictions previously imposed by the Russian Government and the Central Bank on the transactions between Russian individuals and companies and non-Russian residents. However, under the Exchange Control Law, the Russian Government and the Central Bank are able to impose mandatory reserve requirements and require use of special accounts for certain transactions of Russian residents with non-residents.

Taxation

The Group is subject to numerous taxes that have had a significant effect on its results of operations. Russian tax legislation is and has been subject to varying interpretations and frequent changes.

In addition to income taxes, the Group is also subject to:

- unified natural resources production tax;
- export duties;
- excise taxes on refined products;
- value added taxes;
- property taxes;
- land tax;
- vehicle tax;
- other local taxes and levies; and
- tax penalties and interest.

These taxes are reflected in taxes other than income tax in the Group's consolidated statements of operations and comprehensive income. In addition, the Group is subject to payroll-based taxes, which are included as salary costs within selling, general and administrative expenses or operating expenses, as appropriate.

The table below presents a summary of statutory tax rates that the majority of the Company's subsidiaries were subject to for the years ended December 31, 2006 and 2005:

Tax	Year ended December 31, 2006	Year ended December 31, 2005	Taxable base
Income tax – maximum rate	24%	24%	Taxable income
VAT	18%	18%	Added value
Unified production tax, average rates	RR 2,264	RR 1,873	Metric ton produced (crude oil)
Refined products excise tax:			
High octane gasoline	RR 3,629	RR 3,629	
Low octane gasoline	RR 2,657	RR 2,657	
Diesel fuel	RR 1,080	RR 1,080	Metric ton produced and sold
Motor oils	RR 2,951	RR 2,951	domestically (1)
Straight run gasoline	RR 2,657	-	
Crude oil export duty, average rates	US $196.9	US $130.6	Metric ton exported
Refined products export duty, average rates:			
Light refined products (gasoline products) and mid refined products (diesel fuel)	US $145.0	US $92.3	
Fuel oil (mazut)	US $78.1	US $52.7	Metric ton exported
Property tax – maximum rate	2.2%	2.2%	Taxable property

(1) Excise taxes are paid on refined products produced and sold domestically. Excise taxes are paid by the companies that sell refined products to the end customers, while producers and intermediary re-sellers accrue excise tax and subsequently recover it subject to certain conditions set by the legislation.

During 2006, the tax rates specific to the oil industry rose significantly compared to the previous year. Unified production tax increased by 21%, average crude oil export duty by 51%, an average refined products export duty by 55%.

Increase of unified production tax is explained by increase of the Urals blend price 21% year-on-year. Excise taxes on refined products remained at the same level as in 2005, except excise tax for straight run gasoline, which was introduced effective from January 2006. Accrued excise tax for straight run gasoline could be subsequently recovered if it is used for petrochemical production.

Unified production tax rate. Effective from January 1, 2005, the base rate for the unified production tax was set at RR 419 per ton of crude oil produced and adjusted monthly depending on the market price of Urals blend and the Rouble exchange rate. The tax becomes zero if the Urals blend price falls to or below US $9.00 per barrel. Each $1.00 per barrel increase in the international Urals blend price over the threshold ($9.00 per barrel) results in an increase of the tax rate by $1.61 per tonne extracted (or $0.226 per barrel extracted using a conversion factor of 7.123). This method of determining of unified production tax was applied until December 31, 2006.

Pursuant to the Federal Law No.151-FZ ‘‘On Amendments in Chapter 26 of Part II of the Tax Code of the Russian Federation and Considering Certain Expired Legislative Acts of the Russian Federation’’ dated July 27, 2006 (the ‘‘New Natural Resources Production Tax Law’’) effective from January 1, 2007, the rate for the unified production tax is differentiated. Under the New Natural Resources Production Tax Law, the tax rate for the production of oil is set at RR 419 per ton (unchanged from 2005). This tax rate will be applied with a discount based on the levels of the international oil prices and the levels of depletion of the oil fields. Such formula will benefit producers of oil fields having a depletion level superior to 80%, such as the Company, with a 30% decrease in tax expenses compared to the current expenses for oil fields having a depletion level of 100%.

In addition, the New Natural Resources Production Tax Law sets the tax rate at 0% up to a total of 25 million tons of oil produced in the region referred to as Eastern-Siberian Oil and Gas Province (which include Yakutia, the Irkutsk region and Krasnoyarskyi Krai), in order to stimulate development of new oil fields. Development of such fields has a 10-year term for production and exploration licenses and a 15-year term for licenses for production and geological survey.

The New Natural Resources Production Tax Law also establishes a 0% tax rate for highly viscous oil production from resources containing oil with viscosity over 200 Megapascal second in layer conditions.

Crude oil export duties. Maximum rates of export duties for crude oil depend on a lagged average of Urals blend prices. The rates are zero when the lagged Urals blend price is at or below US $109.5 per metric ton. They then increase by US $0.35 per ton for each US $1.00 increase in the lagged Urals blend price when the lagged Urals blend price is between US $109.5 and US $146.0 per ton, by US $0.45 per ton for each US $1.00 increase in the lagged Urals blend price when the lagged Urals blend price is between US $146.0 and US $182.5 per ton, and by US $0.65 per ton for each US $1.00 increase in the lagged Urals blend price when the lagged Urals blend price is above US $182.5 per ton.

Export duty rates are set by the Russian Government with regard to the average Urals blend price on international crude oil markets (Mediterranean and Rotterdam) during the latest monitoring period and are effective from the first date of the second calendar month following the monitoring period. Each monitoring period consists of two calendar months starting from November 1, 2001.

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

Excise tax on refined products. In accordance with Russian legislation effective from January 1, 2005 the excise tax rates are set at RR 2,657 per metric ton for gasoline with octane numbers not exceeding “80” (low octane gasoline), RR 3,629 per metric ton for gasoline with octane numbers exceeding “80” (high octane gasoline), RR 1,080 per metric ton for diesel fuel and RR 2,951 per metric ton for motor oils. Effective from January 1, 2006 excise tax for straight run gasoline was introduced. The rate was set at RR 2,657 per metric ton. Accrued excise tax for straight run gasoline could be subsequently recovered if it is used for petrochemical production.

In 2006 crude oil and refined products exported to CIS countries, other than Ukraine, were not subject to export duties. On January 1, 2007, customs regulations between Russia and Belorussia were changed. Crude oil exported from Russia to Belorussia is now subject to export duties. The latest amendments made by customs authorities set a multiplier of 0.293 to be applied from February 1, 2007 to the regular export duty rate set by the Russian Government for calculation of export duty on crude oil exports from Russia to Belorussia.

Property tax. In accordance with the amendments to Russian legislation effective from January 1, 2004 the maximum property tax rate was set to 2.2%. Exact tax rates are set by the local authorities.

Value added tax (VAT). The Group was subject to value added tax (or VAT) of 18% on most purchases. VAT payments are recoverable against VAT received on domestic sales. Export sales are not subject to VAT. Input VAT related to export sales is recoverable from the Russian government. The Group's results of operations exclude the impact of VAT.

Year Ended December 31, 2006 Compared to Year Ended December 31, 2005

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

RR millions	Year ended December 31, 2006	Year ended December 31, 2005	Change
Sales and other operating revenues	**318,284**	**300,358**	**6.0%**
Costs and other deductions			
Operating	57,099	44,846	27.3%
Purchased oil and refined products	33,882	49,704	(31.8%)
Exploration	1,555	1,375	13.1%
Transportation	6,650	8,493	(21.7%)
Selling, general and administrative	20,510	19,323	6.1%
Depreciation, depletion and amortization	10,673	11,013	(3.1%)
Loss on disposals of property, plant and equipment and investments and impairments	3,438	6,894	(50.1%)
Taxes other than income taxes	144,976	116,381	24.6%
Maintenance of social infrastructure and transfer of social assets	328	516	(36.4%)
Total costs and other deductions	**279,111**	**258,545**	**8.0%**
Earnings from equity investments	621	1,279	(51.4%)
Foreign exchange (loss) / gain	(1,829)	67	-
Interest income	2,036	1,057	92.6%
Interest expense	(247)	(1,151)	(78.5%)
Other income / (loss), net	2,870	(488)	-
Total other income	**3,451**	**764**	**-**
Income before income taxes, minority interest and cumulative effect of change in accounting principle	**42,624**	**42,577**	**0.1%**
Current income tax expense	(13,088)	(15,097)	(13.3%)
Deferred income tax benefit	982	1,416	(30.6%)
Total income tax expense	**(12,106)**	**(13,681)**	**(11.5%)**
Minority interest	(745)	(654)	13.9%
Net income	**29,773**	**28,242**	**5.4%**

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

Sales and other operating revenues

A breakdown of sales and other operating revenues is provided in the following table:

RR millions	Year ended December 31, 2006	Year ended December 31, 2005
Crude oil	237,869	203,935
Refined products	43,468	66,381
Petrochemicals	20,747	16,147
Corporate and other sales	16,200	12,562
Net banking interest income	-	1,333
Total sales and other operating revenues	**318,284**	**300,358**

Sales and other operating revenues increased in 2006 by 6% to RR 318,284 million from RR 300,358 million in 2005. The increase is mainly attributable to an increase in crude oil prices as well as increased volumes of crude oil sales and petrochemicals sales. As a result of the sale of a significant part of the Group's participation in Bank Zenit at the end of 2005 and of all participation in Bank Devon-Credit, the Group is not accounting for net banking interest income in 2006.

Sales of crude oil

Sales of crude oil increased by 17% to RR 237,869 in 2006 from RR 203,935 million in 2005. The table below provides an analysis of the changes in sales of crude oil:

	Year ended December 31, 2006	Year ended December 31, 2005
Domestic sales of crude oil		
Revenues (RR millions)	52,551	31,143
Volume (thousand tons)	*9,235*	*5,964*
Price (RR per ton)	*5,690*	*5,222*
CIS export sales of crude oil [(1)]		
Revenues (RR millions)	63,605	45,385
Volume (thousand tons)	*5,767*	*5,168*
Price (RR per ton)	*11,028*	*8,782*
Non-CIS export sales of crude oil		
Revenues (RR millions)	121,713	127,407
Volume (thousand tons)	*10,507*	*13,107*
Price (RR per ton)	*11,584*	*9,721*

[(1)] CIS is an abbreviation for Commonwealth of Independent States

Domestic sales of crude oil increased by 69% to RR 52,551 million in 2006 from RR 31,143 million in 2005 due to 55% increase in volumes of crude oil sold domestically and 9% increase in selling prices.

CIS export sales of crude oil increased by 40% to RR 63,605 million in 2006 from RR 45,385 million in 2005 due to 12% increase in volumes sold and 26% increase in average selling prices. The Group continued to make regular deliveries to the Kremenchug refinery in Ukraine and also sold crude oil to customers in Belorussia.

Revenues from non-CIS export sales of crude oil decreased by 4% to RR 121,713 million in 2006 from RR 127,407 million in 2005 due to a 20% decrease in volumes of crude oil sold which is partly offset by a 19% increase in selling price. In contrast to earlier years, domestic prices are consistent with year-to date export netback prices. This change reflects the incentive to domestic sales provided by the tax regime, which taxes sales of products much more benignly than crude oil exports.

Sales of refined products

Sales of refined products decreased by 35% to RR 43,468 million in 2006 from RR 66,381 million in 2005. The table below provides an analysis of the changes in sales of refined products.

	Year ended December 31, 2006	**Year ended December 31, 2005**
Domestic sales of refined products		
Revenues (RR millions)	32,687	42,174
Volume (thousand tons)	*2,997*	*5,897*
Price (RR per ton)	*10,908*	*7,152*
CIS export sales of refined products		
Revenues (RR millions)	6,487	4,955
Volume (thousand tons)	*392*	*356*
Price (RR per ton)	*16,552*	*13,916*
Non-CIS export sales of refined products		
Revenues (RR millions)	4,294	19,252
Volume (thousand tons)	*304*	*1,979*
Price (RR per ton)	*14,123*	*9,728*

Domestic sales of refined products decreased by 22% to RR 32,687 million in 2006 from RR 42,174 million in 2005 due to a 49% decrease in volumes sold partly offset by a 53% increase in average selling price. Average selling price increased due to a more favorable market environment in 2006.

CIS export sales of refined products increased by 31% to RR 6,487 million in 2006 from RR 4,955 million in 2005 resulting from a 19% increase in average selling price of refined products to RR 16,552 in 2006, compared to RR 13,916 in 2005, while volumes of refined product sold increased by 10% to 392 thousand tons in 2006 compared to 356 thousand tons in 2005.

Non-CIS export sales of refined products decreased by 78% to RR 4,294 million in 2006 from RR 19,252 million in 2005 primarily due to an 85% decrease in volumes sold, while refined product prices on non-CIS sales increased by a 45% year-on-year.

The overall decrease in volumes sold was due to cessation of refining at OAO Nizhnekamsk NPZ, which was sold to TAIF in September 2005. The Group also decreased refined products purchases for re-sale by 6% in 2006 compared to 2005.

Sales of petrochemical products

Sales of petrochemical products increased by 28% to RR 20,747 million in 2006 from RR 16,148 million in 2005. The increase was primarily attributable to a 35% increase in tire sales to RR 19,943 million in 2006 from RR 14,780 million in 2005 due to the combined effect of increased prices and higher volume of tires sold. The Group increased production of tires by 7% to 12.2 million tires in 2006.

Corporate and other sales

Corporate and other sales increased by 29% to RR 16,200 million in 2006 from RR 12,562 million in 2005. Other sales primarily represent sales of materials and equipment and various field services provided by the Company’s production subsidiaries to third parties (such as drilling, lifting, construction, repairs, and geophysical works). Increase in other sales was mainly attributable to increased sales of drilling and transportation services, and other equipment sales.

Due to the disposal of the controlling stake in Bank Zenit and Devon Credit Bank in April and November 2005, respectively, the Group no longer considers banking as one of its core activities.

Costs and other deductions

Total costs and other deductions increased by 8% to RR 279,111 million in 2006 from RR 258,545 million in 2005. This is primarily attributable to the increase in taxes other than income taxes, increase in operating expense, exploration expenses, selling, general and administrative expenses and maintenance of social infrastructure and partly offset by lower transportation costs, lower transfer of social assets constructed after privatization, purchased oil and refined products and loss on disposals of property, plant and equipment and impairment of investments.

Operating expenses. Operating expenses include the following type of costs:

RR millions	Year ended December 31, 2006	Year ended December 31, 2005
Crude oil extraction expenses	19,195	15,152
Petrochemical expenses	17,513	13,005
Refining and marketing expenses	4,231	4,561
External processing fees	99	176
Other operating expenses	16,161	11,952
Total operating expenses	**57,099**	**44,846**

Operating expenses include the following main categories: lifting expenses connected with extraction of crude oil, refining and processing expenses, cost of petrochemical products, cost of materials other than oil and gas, refined products purchased for re-sale and other direct costs.

Operating expenses increased by 27% to RR 57,099 million in 2006 from RR 44,846 million in 2005.

Crude oil extraction expenses. The Group's extraction ("lifting") expenses are expenses related to oil and gas production and incurred by the Company's oil and gas producing divisions and subsidiaries. They include expenditures related to repairs of extraction equipment, labor costs, expenses on artificial stimulation of reservoirs, fuel and electricity costs, materials and goods consumed in oil and gas production, and other similar costs.

Expenses of the Company's oil and gas production units and subsidiaries related to the sale of services and goods (such as electricity, heat, etc.) that do not relate to core activities and accretion of the Company's asset retirement obligations, and the change crude oil and refined products inventory, have been excluded from extraction expenses and are included in other operating costs.

Lifting expenses averaged to RR 104.7 per barrel in 2006 compared to RR 83.1 per barrel in 2005. The increase of 27% is primarily a result of increases in electricity tariffs, wages and other service costs.

Petrochemical expenses. Petrochemical expenses include primarily costs of raw materials used, cost of electricity consumed, and maintenance activity performed in petrochemical products production. Cost of petrochemical products increased by 35% to RR 17,513 million primarily due to increases in the cost of raw materials, electricity tariffs and other services costs, as well as increase in production and sales of tires by 7% and 35% respectively.

Refining and marketing expenses decreased by 7% to RR 4,231 million in 2006 from RR 4,561 million in 2005 due to respective decrease in refining throughput and associated costs of RR 2,082 (see Changes in the Group structure above), offset by an increase of RR 1,408 million in purchased products from various marketing entities of the Group and an increase in other marketing costs.

External processing fee. Processing fees paid to external refineries decreased by 44% to RR 99 million in 2006 from RR 176 million in 2005 primarily due to cessation of processing activities at OAO Nizhnekamsk NPZ.

Other operating expenses include accretion of the asset retirement obligation, change in operating expenses in crude oil and refined products inventory, land rent on which the Company's oil wells and related procuction infrastructure are located, and the costs of other services, goods and materials received not related to the core oil-gas activities of the Group.

Other operating expenses increased to RR 20,206 million, or by 40%, compared to 2005. The increase is primarily due to an increase in other non core business activities including selling other goods and services.

Cost of purchased crude oil and refined products. A summary of purchased oil and refined products for 2006 and 2005 is as follows:

RR millions	**Year ended December 31, 2006**	**Year ended December 31, 2005**
Purchased refined products (RR millions)	29,557	31,326
Volume (thousand tons)	*2,402*	*3,276*
Average price per ton (RR)	*12,303*	*9,353*
Purchased crude oil (RR millions)	4,325	18,378
Volume (thousand tons)	*739*	*3,126*
Average price per ton (RR)	*5,851*	*5,879*
Total purchased oil and refined products	**33,882**	**49,704**

Purchases of refined products decreased by 6% to RR 29,557 million in 2006 from RR 31,326 million in 2005 due to a 27% decrease in volume of purchased refined products trading which is partly offset by an increase in average purchase price per ton. Average price per ton increased due to increased domestic market prices and significant purchases in Ukraine, where purchase prices are higher than in Russia.

Purchases of crude oil decreased by 76% to RR 4,325 million in 2006 from RR 18,378 million in 2005 which is in line with the decrease by 76% in volumes of purchased crude oil trading. Before 2006 we purchased crude oil for further refining at OAO Nizhnekamsk NPZ. As a result of disposal of OAO Nizhnekamsk NPZs assets in September 2005, the need to purchase crude oil to meet our refinery needs decreased accordingly.

Exploration expenses. Exploration expenses mainly represent expenses relating to exploratory drilling, geological, geophysical costs and the costs of carrying and retaining undeveloped properties. Exploration expenses increased by 13% to RR 1,555 million in 2006 from RR 1,375 million in 2005. This increase was due to increased exploration activities by the Group within and outside Tatarstan.

Transportation expenses. Transportation expenses included expenses, related to the delivery of our own crude oil production as well as purchased crude and refined products, which are incurred primarily while using pipeline and rail transportation (2005 only). Transportation costs decreased by 22% to RR 6,650 million in 2006 from RR 8,493 million in 2005, primarily as a result of the decrease in transportation of refined products, which is due to lower sales volumes following the disposal of OAO Nizhnekamsk NPZ assets in 2005.

Selling, general and administrative expenses. Certain selling, general and administrative expenses are by nature fixed costs, which are not directly attributable to production, such as payroll, general business costs, insurance, advertising, share based compensation, legal fees, consulting and audit services and others. Compounding fees and bad debt provision and write-offs are also included into this line. Selling, general and administrative expenses increased by 6% to RR 20,510 million in 2006 from RR 19,323 million in 2005 which is consistent with real ruble appreciation.

Depreciation, depletion and amortization. Depreciation, depletion and amortization includes depreciation of oil and gas producing assets, and other production and non-production assets. Depreciation, depletion and amortization decreased by 3% to RR 10,673 million in 2006 from RR 11,013 million in 2005.

Loss on disposals of property, plant and equipment and impairment of investments. Loss on disposals of property, plant and equipment and impairment of investments in 2006 amounted to RR 3,438 million compared to RR 6,894 million in 2005. The 2006 losses include the impairment of Tatoilgas (RR 2,014 million) and the 2005 losses include the disposal of OAO Nizhnekamsk NPZ (RR 3,000 million). Other losses relate to the disposal of a number of non-core assets.

Taxes other than income taxes. Taxes other than income taxes include the following:

	Year ended December 31, 2006	**Year ended December 31, 2005**
Unified production tax	56,843	46,600
Export duties	85,358	65,667
Excise taxes	602	408
Property tax	1,322	1,488
Penalties and interest	102	1,166
Other	749	1,052
Total taxes other than income taxes	**144,976**	**116,381**

Taxes other than income taxes increased by 25% to RR 144,976 million in 2006 from RR 116,381 million in 2005. The increase was primarily a result of the increased export duty and unified production tax rates, which are linked to market crude oil prices. Export duties increased by 30% to RR 85,358 million from RR 65,667 million and the unified production tax increased by 22% to RR 56,843 million from RR 46,600 million. Excise tax increased by 48% to RR 602 million from RR 408 million, which is explained by increase in purchases of taxable refined products (diesel fuel and petrol fuels). Other taxes include land tax and non-recoverable VAT.

Maintenance of social infrastructure and transfer of social assets. Maintenance of social infrastructure expenses increased by 76% to RR 288 million in 2006 from RR 164 million in 2005. Social expenses are a cost of doing business and are necessary to attract and keep qualified people.

Transfer of social assets constructed after privatization decreased by 89% to RR 40 million in 2006 from RR 352 million in 2005. The decrease is a result of a majority of social assets previously held on the balance sheet of the Group having been transferred to the local authorities in the previous years. The decrease in transfers of social assets is consistent with the decrease in the social assets of the Group.

Other income and expenses

Earnings from equity investments decreased by 51% to RR 621 million in 2006 from RR 1,279 million in 2005 due to our share of the IPCG Fund operating losses, after consideration for the Fund’s income on Tatneft ordinary shares, and lower income received from the Company’s equity affiliates and joint ventures in 2006 (especially ZAO Tatex) which are partly offset by higher income received from our share the earnings from our Bank Zenit and Bank Ak Bars investments.

The foreign exchange loss amounted to RR 1,829 million in 2006 compared with gain of RR 67 million in 2005 due to appreciation of the Russian Rouble against the US Dollar.

Interest income increased to RR 2,036 million in 2006 from RR 1,057 million in 2005 due to increased loans issued. Interest expense decreased to RR 247 million in 2006 from RR 1,151 million in 2005, which is a result of debt repayment (average debt decreased in 2006 compared with 2005 by 65%), offset by an increase in capitalized interest related to the construction of NNPZ.

Other net income in 2006 amounted to RR 2,870 million compared with RR 488 million net expense in 2005 due primarily to realized and unrealized gains recording from our trading investments.

Income taxes

Income taxes decreased by 12% to RR 12,106 million in 2006 from RR 13,681 million in 2005 and our related effective income tax rate decreased to 28% in 2006 from 32% in 2005. The changes are due to a decrease of non-deductible expenses by 59% offset by an increase in non-taxable income to RR 273 million in 2006 from RR 59 million in 2005.

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

RR millions	Year ended December 31, 2006	Year ended December 31, 2005
Net income	29,773	28,242
Add back:		
Minority interest	745	654
Income tax expense	12,106	13,681
Depreciation, depletion and amortization	10,673	11,013
Interest expense	247	1,151
Interest and dividend income	(2,036)	(1,057)
EBITDA	**51,508**	**53,684**

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

Financial Condition Summary Information

The following table shows certain key financial indicators:

RR millions	Year ended December 31, 2006	Year ended December 31, 2005
Total assets	319,424	282,144
Total liabilities	84,547	79,734
Current ratio	3.19	3.13
Total bank loans payable	4,481	8,570
Shareholders' equity	231,703	198,721

Working capital position

As of December 31, 2006 working capital of the Group amounted to RR 71,759 million compared to RR 62,032 million as of December 31, 2005, an increase of 16% compared with prior year. The increase in the working capital is primarily attributable to an increase in short-term investments from RR 5,116 to RR 15,825 due to increase in certificates of deposit and trading securities, which are held by the Group with the objective of earning profits on short-term price differences.

Liquidity and Capital Resources

The following table shows a summary from the Consolidated Statements of Cash Flows:

RR millions	Year ended December 31, 2006	Year ended December 31, 2005
Net cash provided by operating activities	32,943	34,532
Net cash used for investment activities	(34,593)	(21,751)
Net cash provided by (used for) financing activities	(8,180)	(12,971)
Increase (decrease) in cash and cash equivalents	(9,830)	(190)

Net cash provided by operating activities

Our primary source of cash flow is funds generated from our operations. Net cash provided by operating activities decreased by 5% to RR 32,943 million in 2006 from RR 34,532 million in 2005 which is explained mainly by an increase in the amount of taxes other then income taxes paid, which is partly offset by other positive change in working capital.

Net cash used for investing activities

Net cash used for investing activities increased by 59% to RR 34,593 million in 2006 from RR 21,751 million in 2005, which is primarily explained by increase in capital expenditures, mainly associated with the Refining as explained below.

Net cash provided by financing activities

Cash flow used for financing decreased by 37% to RR 8,180 million in 2006 from RR 12,971 million in 2005. This is primarily due to net debt repayments of RR 4,263 million in 2006 compared with net debt repayments of RR 11,502 million in 2005.

Analysis of Debt. At December 31, 2006, long-term debt, including the current portion of long-term debt, amounted to RR 1,696 million as compared to RR 6,201 million at December 31, 2005. The related decrease is due to scheduled repayments of long-term debt to BNP Paribas and Credit Suisse First Boston with the latter being fully repaid in March 2007.

The aggregate maturities of total long-term debt, including current portion as of December 31, 2006 and 2005 are as follows:

RR millions	**Year ended December 31, 2006**	**Year ended December 31, 2005**
2006		4,436
2007	1,391	1,516
2008	157	150
2009 and thereafter	148	99
Total long-term debt	**1,696**	**6,201**

Short-term debt increased by 18% to RR 2,800 million as of December 31, 2006 from RR 2,369 million as of December 31, 2005, primarily due to an increase in the outstanding amount of one month revolving overdraft facility with Credit Suisse Zurich.

The Group believes it has sufficient crude oil export volumes available for further debt facilities should they be needed.

Contractual obligations, other contingencies and off balance sheet arrangements

Social commitments

The Group contributes significantly to the maintenance of local infrastructure and the welfare of its employees within Tatarstan, which includes contributions towards the construction, development and maintenance of housing, hospitals and transport services, recreation and other social needs. Such funding is periodically determined by the Board of Directors after consultation with governmental authorities and recorded as expenditures when incurred.

Off balance sheet arrangements

At December 31, 2005 the Group guaranteed a third party's debt obligations to Bank Zenit in the amount of RR 526 million. As of December 31, 2005, the Group had not recorded any liability in its consolidated financial statements in connection with these guarantees as the Group did not believe, based on information available, that it was probable any amounts would be paid under these guarantees. These guarantees expired in 2009 and the Group's total exposure including interest on the underlying loans was RR 526 million at December 31, 2005. The obligations were subsequently repaid during 2006. The Group has no outstanding guarantees at December 31, 2006.

Litigation and claims

The Group is subject to various lawsuits and claims arising in the ordinary course of business. The outcomes of such contingencies, lawsuits or other proceedings cannot be determined at present. In the case of all known contingencies the Group accrues a liability when the loss is probable and the amount is reasonably estimable. Based on currently available information, management believes that it is remote that future costs related to known contingent liability exposures would have a material adverse impact on the Group's consolidated financial statements.

Quantitative and qualitative disclosures about market risks

We are exposed to market risk from changes in both foreign currency exchange rates and interest rates. We are exposed to foreign exchange risk to the extent that our costs are denominated in currencies other than rubles. We are subject to market risk from changes in interest rates that may affect the cost of our financing. Other than our banking subsidiaries, we do not use financial instruments, such as foreign exchange forward contracts, foreign currency options, interest rate swaps and forward rate agreements, to manage these market risks. We also do not hold or issue derivative or other financial instruments for trading purposes.

Interest rate risk

We are exposed to interest rate risk on our indebtedness that bears interest at floating rates and to a lesser extent, on our indebtedness that bears interest at fixed rates. At December 31, 2006 we had approximately RR 4,074 million in loans outstanding, of which approximately RR 1,584 million bore interest at fixed rates and approximately RR 2,490 million bore interest at floating rates determined by reference to the LIBOR for US dollar deposits (for details please refer to Note 12 “Debt” of the consolidated financial statement).

We undertake debt obligations to support general corporate purposes including capital expenditures and working capital needs. Upward fluctuations in interest rates increase the cost of new debt and the interest cost of outstanding variable rate borrowings. Fluctuations in interest rates can also lead to significant fluctuations in the fair value of our debt obligations. However, our sensitivity to decreases in interest rates and corresponding increases in the fair value of our debt portfolio would unfavorably affect our results and cash flows only to the extent that we elected to repurchase or otherwise retire all or a portion of our fixed-rate debt portfolio at prices above carrying value.

Foreign currency risk

Our principal exchange rate risk involves changes in the value of the ruble relative to the US dollar. At December 31, 2006, approximately RR 2,494 million of our indebtedness was denominated in US dollars (out of approximately RR 4,074 million of our total indebtedness at that date). Depreciation in the value of the ruble relative to the US dollar will increase the cost in rubles of our foreign currency denominated costs and expenses and of our debt service obligations for foreign currency denominated indebtedness. A depreciation of the ruble relative to the US dollar will also result in foreign exchange losses as the ruble value of our foreign currency denominated indebtedness is increased. We believe that the risks associated with our foreign currency exposure are mitigated by the fact that a significant portion of our revenues, are US dollar denominated, and thus more closely match our foreign currency costs and debt service obligations. Furthermore, total accounts receivable of RR 18,924 million at December 31, 2006 were also US dollar based, and serve to mitigate our exposure to foreign currency fluctuations. As of December 31, 2006, the ruble had appreciated against the US dollar by approximately 8.5% since December 31, 2005. We recognized a net foreign currency translation loss of RR 1,829 million in 2006.

Commodity instruments

Substantially all of our crude oil and refined products are sold on the spot market or under short-term contracts at market sensitive prices. Market prices for export sales of crude oil and refined products are subject to volatile trading patterns in the commodity futures market. Average selling prices can differ from quoted market prices due to the effects of uneven volume distributions during the period, quality differentials, different delivery terms compared to quoted benchmarks, different conditions in local markets and other factors. Domestic prices generally follow the trend of world market prices but are volatile due to the nature of the Russian market. We do not use any derivative instruments to hedge our production in order to decrease our price risk exposure. However, since we do not engage in futures and forward contracts, we do not believe that our value at risk is material.

Critical accounting policies

The preparation of consolidated 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 and the disclosure of contingent assets and liabilities. For a full description of our significant accounting policies, please refer to Note 3 to our audited consolidated financial statements.

Forward-looking statements

Certain statements in this report are not historical facts and are ‘‘forward-looking’’ (as such term is defined in the US Private Securities Litigation Reform Act of 1995). 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:

- projections of revenues, income (or loss), earnings (or loss) per share, dividends, capital structure or other financial items or ratios;
- statements of our plans, objectives or goals, including those related to products or services;
- statements of future economic performance; and
- statements of assumptions underlying such statements.

Words such as ‘‘believes,’’ ‘‘anticipates,’’ ‘‘expects,’’ ‘‘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. We caution readers 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 effect of, and changes in, Russian or Tatarstan government policy;
- the effect of terrorist attack or other geopolitical instability, either within Russia or elsewhere;
- 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 and control expenses;
- acquisitions or divestitures;
- technological changes; and
- our success at managing the risks of the aforementioned factors.

This list of important factors is not exhaustive; when relying on forward-looking statements to make decisions with respect to our GDSs, investors and others should carefully consider the foregoing factors and other uncertainties and events, especially in light of the difficult political, economic, social and legal environment in which we operate. Such forward-looking statements speak only at the date on which they are made, and 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.