# Management's Discussion and Analysis

*The following discussion should be read in conjunction with the unaudited consolidated interim condensed financial statements, 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.*

*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 June 30, 2007 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, including 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.

## Key financial and operational results

| | Six months ended June 30, 2007 | Change | Six months ended June 30, 2006 |
|---|---|---|---|
| Sales (millions of RR) | 157,185 | (2.3%) | 160,860 |
| Net income (millions of RR) | 16,493 | (8.0%) | 17,922 |
| EBITDA (*) (millions of RR) | 29,050 | (6.6%) | 31,094 |
| Income per share of common stock | | | |
| Basic income (RR) | | | |
| Common…………………………… | 7.44 | (10.9%) | 8.35 |
| Preferred………….................... | 7.21 | (12.7%) | 8.26 |
| Diluted income (RR) | | | |
| Common…………………………… | 7.43 | (10.7%) | 8.32 |
| Preferred………….................... | 7.20 | (12.5%) | 8. 23 |
| Crude oil production by the Group (thousand of tons)……………………………………………… | 13,063 | 1.5% | 12,866 |
| Gas production by the Group (millions of cubic meters)…………………………………………… | 409.6 | 1.3% | 404.5 |
| Refined gas products produced (thousand of tons)……………………………………………… | 568.1 | 5.1% | 540.3 |

(*) As defined on page 16

During the first half of 2007 our net income was RR 16,493 million, which is RR 1,429 million, or 8.0%, less than in the same period of 2006.

Our performance was influenced by overall market price conditions and decrease in export duties and unified production tax, which are linked to international crude oil price. The growth of our net income was bounded by the increase of transportation tariffs, the decrease in average crude oil prices and appreciation of Russian ruble against US dollar. 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, 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 OJSC Taneko, previously named as ZAO Nizhnekamsk Oil Refinery, a project company established to build and operate a refining and petrochemical complex with a throughput capacity of seven million tones of crude oil per year in Nizhnekamsk, Tatarstan; our gas production, transportation and refining division Tatneftegaspererabotka, OOO Tatneft-AZS-Center and OOO Tatneft-AZS-Zapad, management companies for Tatneft-branded gas station network; and certain other oil trading and ancillary companies;

- **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, for procuring supplies and marketing products produced by the companies within this segment, respectively.

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, as well as the disposal of our entire interest in Bank Ak Bars in May 2007, we no longer consider our banking activities to be significant to our operations.

These segments are 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 goals is to maintain current levels of crude oil production on its licensed fields in Tatarstan. In the first half of 2007 the Company increased production by 2.2% from its fields in Tatarstan. Due to the relative maturity of the Company's main producing fields, a significant portion of our crude oil was produced using various enhanced recovery techniques. In the first half of 2007, 177 new production wells were put into operation.

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 the first half of 2007 the Group obtained three new E&P licenses in the Nenets Autonomous Region of Russia.

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 to selectively establish strategic alliances to develop and operate such 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 and the first half of 2007 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. On September 27, 2007 OAO Tatneft and Shell Exploration Company concluded Agreement on Principles of Strategic Partnership. Under the terms of the agreement, the two companies will devise a program for heavy oil development in Tatarstan, which includes conducting a feasibility study and assessing technologies for extraction and processing (upgrading) of heavy oil.

*Crude oil refining and marketing*

During 2006 and throughout first half of 2007 the Company financed (in form of loans) works relating to the permitting and construction by OJSC Taneko of a new refining and petrochemicals complex in Nizhnekamsk, Tatarstan, in which the Company has a direct 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 the first half of 2007 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 June 30, 2007 the Group operated 553 retail petrol stations in Russia and Ukraine.

## Changes in the Group Structure

*Banking*

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%.

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 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 disposed of its entire interest in Bank AK Bars for RR 6.8 billion to parties unrelated to the Group. Accounts receivable in the consolidated balance sheet at June includes RR 6,121 million for the sale of the Group's interest in Bank AK Bars, which was repaid in full in August 2007.

*Other*

In June 2006, additional investors contributed ownership interests in Bank Zenit to International Petro-Chemical Growth Fund ("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%. Therefore in June 2006, the Group deconsolidated IPCG Fund and began accounting for its investments into IPCG Fund under the equity method.

## Operational highlights

| | Six months ended June 30, 2007 | Six months ended June 30, 2006 |
|---|---|---|
| Crude oil production (millions of metric tons)……………… | 13.1 | 12.9 |
| Crude oil production (millions of barrels)…………………... | 93.0 | 91.6 |
| Refining and tolling of crude oil throughput (millions of metric tons)………………………………………………. | 0.3 | 0.3 |
| Refining and tolling of crude oil throughput (millions of barrels)…………………………………………………… | 1.9 | 1.9 |
| Gas production by the Group (million of cubic meters)…………………………………………………… | 409.6 | 404.5 |
| Refining of gas products throughput (million of cubic meters)…………………………………………………… | 329.0 | 315.6 |

### Crude oil and gas production

Crude oil production of the Group (including production of consolidated subsidiaries OAO Ilekneft, ZAO Adbulinskneftegaz, ZAO Tatneft-Samara, ZOO Tatneft-Severny and ZAO Kalmtatneft) increased by 1.5% to 13.1 million metric tons in the first halt of 2007. Increase of crude oil production is mainly the result of implementing modern secondary and tertiary methods and new technologies. Our gas production increased by 1.3% to 409.6 million cubic meters in the first half of 2007 from 404.5 million cubic meters in the same period of 2006.

### Refining

Refining throughput remains at the same level of 0.3 million tons of crude oil in the first half of 2007 compared to the same period of 2006. Refining of gas products increased by 4.2% in the first half of 2007 compared to the same period of 2006 due to the increase in gas production as described above.

### Export of crude oil from Russia

During the first half of 2007, the Group exported from Russia approximately 64.8% of its crude oil production compared with approximately 62.8% in the respective period of 2006. The Group continues exporting substantially all its crude oil volumes through Transneft, the state-owned monopoly owner and operator of Russia's trunk crude oil and export pipelines.

The Group increased the volumes of crude oil exported from Russia in the first half of 2007 by approximately 5.8% compared to 2006 in order to obtain the benefit of higher export prices compared to domestic prices as wells as lower export duties payable on crude exports during the period.

## 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 the respective periods of 2007 and 2006.

| *World market* | **Six months ended June 30, 2007, US $/ bbl** | **Change** | **Six months ended June 30, 2006, US $/bbl** |
|---|---|---|---|
| Brent crude | 63.3 | (3.7%) | 65.7 |
| Urals crude (CIF Mediterranean)* | 59.8 | (2.9%) | 61.5 |
| Urals crude (CIF Rotterdam)* | 59.7 | (2.8%) | 61.4 |

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* | **Six months ended June 30, 2007, RR per ton*** | **Change** | **Six months ended June 30, 2006, RR per ton*** |
|---|---|---|---|
| Crude oil | 5,325 | (14.6%) | 6,232 |

Source: Kortes
*(excluding 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 US Dollar 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 many other oil companies due to the relatively high sulfur content.

A significant portion 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.

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.

According to the Federal Statistics Service of the Russian Federation, during the six-month period ended June 30, 2007 transportation tariffs increased as follows: transportation of crude oil by pipeline – 7.4%, transportation of refined products by pipeline – 16.0%, transportation by railway – 7.7%. These amounts differ from actual changes in tariffs for transportation of crude oil and refined products by the Group for this period 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 Rubles.

Accordingly, the relative movements of ruble inflation and Ruble/US Dollar exchange rates can significantly affect the results of operations of the Group. In particular, operating margins are generally adversely affected by an appreciation of the Ruble against the US Dollar (i.e., by an inflation rate that is higher than the rate at which the Ruble 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 Ruble/US Dollar exchange rates, the rates of nominal devaluation of the Ruble against the US Dollar, and the rates of real change in the value of the Ruble against the US Dollar for the periods indicated.

| | **Six months ended June 30, 2007** | **Six months ended June 30, 2006** |
|---|---|---|
| Ruble inflation | 5.7% | 6.2% |
| US $ period-end exchange rate | 25.82 | 27.08 |
| Average US $ exchange rate | 26.08 | 27.68 |
| Nominal appreciation (devaluation) of the Ruble | 1.9% | 5.9% |
| Real Ruble appreciation | 7.8% | 12.9% |

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

At present, the Ruble is not a convertible currency outside the Commonwealth of Independent States. Exchange restrictions and controls still exist related to converting Rubles 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 Rubles. 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, except for value added taxes, are reflected in taxes other than income tax in the Group's consolidated interim condensed 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 Company and the majority of its subsidiaries were subject to for the respective periods:

| Tax | Six months ended June 30, 2007 | Six months ended June 30, 2006 | Taxable base |
|---|---|---|---|
| Income tax – maximum rate……… | 24% | 24% | Taxable income |
| VAT………………………………. | 18% | 18% | Added value |
| Unified production tax, average rates [1]…………………………… | RR 2,121 | RR 2,312 | 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 domestically [2] |
| Motor oils……………………… | RR 2,951 | RR 2,951 | |
| Straight run gasoline……......... | RR 2,657 | RR 2,657 | |
| Crude oil export duty, average rates……………………………… | US $175.6 | US $179.0 | Metric ton exported |
| *Refined products export duty, average rates:* | | | |
| Light refined products (gasoline products) and mid refined products (diesel fuel)…………… | US $130.6 | US $132.9 | |
| Fuel oil (mazut)………………... | US $70.3 | US $71.6 | Metric ton exported |
| Property tax – maximum rate…….. | 2.2% | 2.2% | Taxable property |

[1] Without taking into account differentiated taxation
[2] 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 first half of 2007, the tax rates specific to the oil industry decreased compared to the first half of 2006. Unified production tax decreased by 8.3%, average crude oil export duty by 1.9%, an average refined products export duty by 1.8%. The decrease of the above taxes is explained by a decrease in the Urals blend price by 2.2%. Excise taxes on refined products remained at the same level as in the respective period of 2006.

**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 Ruble 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 the 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 related oil fields as determined under Russian resource classification guidelines. Such formula will benefit producers with oil fields having a depletion level in excess of 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%.

Under the new rules, the Company receives a benefit of 3.5% per field for each percent of depletion in excess of the 80% threshold. As Romashkinskoye field, the Company's largest, along with certain other fields are more than 80% depleted, the Company received a benefit in the current period of approximately RR 2.2 billion.

**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.

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.

**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 used for petrochemical production.

**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 is 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.

## Six months ended June 30, 2007 compared to six months ended June 30, 2006

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

| **RR millions** | **Six months ended June 30, 2007 (unaudited)** | **Six months ended June 30, 2006 (unaudited)** | **Change** |
|---|---|---|---|
| **Sales and other operating revenues** | **157,185** | **160,860** | **(2.3%)** |
| **Costs and other deductions** | | | |
| Operating | 27,083 | 23,571 | 14.9% |
| Purchased oil and refined products | 17,269 | 17,750 | (2.7%) |
| Exploration | 559 | 837 | (33.2%) |
| Transportation | 4,041 | 3,438 | 17.5% |
| Selling, general and administrative | 11,317 | 9,013 | 25.6% |
| Depreciation, depletion and amortization | 5,397 | 5,560 | (2.9%) |
| Loss on disposals of property, plant and equipment and investments and impairments | 1,905 | 3,443 | (44.7%) |
| Taxes other than income taxes | 64,403 | 72,323 | (11.0%) |
| Maintenance of social infrastructure and transfer of social assets | 851 | 58 | - |
| **Total costs and other deductions** | **132,825** | **135,993** | **(2.3%)** |
| Earnings from equity investments | 430 | 876 | (50.9%) |
| Foreign exchange loss | (484) | (1,404) | (65.5%) |
| Interest income | 1,189 | 917 | 29.7% |
| Interest expense | (110) | (367) | (70.0%) |
| Other (expense) / income, net | (651) | 1,195 | - |
| **Total other income** | **374** | **1,217** | **(69.3%)** |
| **Income before income taxes, minority interest and cumulative effect of change in accounting principle** | **24,734** | **26,084** | **(5.2%)** |
| Current income tax expense | (8,748) | (8,201) | 6.7% |
| Deferred income tax benefit | 999 | 353 | - |
| **Total income tax expense** | **(7,749)** | **(7,848)** | **(1.3%)** |
| Minority interest | (492) | (314) | 56.7% |
| **Net income** | **16,493** | **17,922** | **(8.0%)** |

The analysis of the main financial indicators of the above financial information is provided below.

## Sales and other operating revenues

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

| RR millions | Six months ended June 30, 2007 | Six months ended June 30, 2006 |
|---|---|---|
| Crude oil | 116,726 | 123,571 |
| Refined products | 20,232 | 21,492 |
| Petrochemicals | 10,206 | 8,715 |
| Corporate and other sales | 10,021 | 7,080 |
| **Total sales and other operating revenues** | **157,185** | **160,858** |

Sales and other operating revenues decreased in first half of 2007 by 2% to RR 157,185 million from RR 160,860 million in the same period of 2006. The decrease is mainly attributable to a decrease in average crude oil and petrochemical products selling prices.

### *Sales of crude oil*

Sales of crude oil decreased by 6% to RR 116,726 in first half of 2007 from RR 123,571 million in the same period of 2006. The table below provides an analysis of the changes in sales of crude oil:

| | Six months ended June 30, 2007 | Change | Six months ended June 30, 2006 |
|---|---|---|---|
| **Domestic sales of crude oil** | | | |
| Revenues (RR millions) | 25,600 | (10.1%) | 28,461 |
| Volume (thousand tons) | *4,695* | *(2.9%)* | *4,835* |
| Realized price (RR per ton) | *5,453* | *(7.4%)* | *5,886* |
| **CIS export sales of crude oil [(1)]** | | | |
| Revenues (RR millions) | 30,304 | 1.9% | 29,733 |
| Volume (thousand tons) | *3,056* | *15.0%* | *2,658* |
| Realized price (RR per ton) | *9,916* | *(11.3%)* | *11,185* |
| **Non-CIS export sales of crude oil** | | | |
| Revenues (RR millions) | 60,822 | (7.0%) | 65,377 |
| Volume (thousand tons) | *5,589* | *1.4%* | *5,513* |
| Realized price (RR per ton) | *10,882* | *(8.2%)* | *11,859* |

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

***Sales of refined products***

Sales of refined products decreased by 6% to RR 20,232 million in the first half of 2007 from RR 21,492 million in the same period of 2006. The table below provides an analysis of the changes in sales of refined products.

| | Six months ended June 30, 2007 | Change | Six months ended June 30, 2006 |
|---|---|---|---|
| **Domestic sales of refined products** | | | |
| Revenues (RR millions) | 16,491 | 5.4% | 15,641 |
| Volume (thousand tons) | *1,393* | *14.9%* | *1,212* |
| Realized price (RR per ton) | *11,839* | *(8.3%)* | *12,905* |
| **CIS export sales of refined products** | | | |
| Revenues (RR millions) | 2,057 | (17.7%) | 2,501 |
| Volume (thousand tons) | *120* | *(26.6%)* | *164* |
| Realized price (RR per ton) | *17,096* | *12.1%* | *15,250* |
| **Non-CIS export sales of refined products** | | | |
| Revenues (RR millions) | 1,683 | (49.8%) | 3,350 |
| Volume (thousand tons) | *173* | *(25.6%)* | *232* |
| Realized price (RR per ton) | *9,752* | *(32.5%)* | *14,440* |

***Sales of petrochemical products***

Sales of petrochemical products increased by 17% to RR 10,206 million in the first half of 2007 from RR 8,715 million in the same period of 2006. The increase was primarily attributable to a 17% increase in tire sales to RR 9,825 million in the first half of 2007 from RR 8,426 million in the same period of 2006 due to the combined effect of increased prices and higher volume of tires sold. The Group increased production of tires by 3% to 5.96 million tires in the first half of 2007.

***Corporate and other sales***

Corporate and other sales increased by 42% to RR 10,021 million in the first half of 2007 from RR 7,080 million in the first half of 2006. 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 equipment sales.

## Costs and other deductions

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

| RR millions | Six months ended June 30, 2007 | Six months ended June 30, 2006 |
|---|---|---|
| Crude oil extraction expenses | 9,722 | 8,875 |
| Petrochemical production expenses | 8,099 | 7,075 |
| Other operating expenses | 9,262 | 7,621 |
| **Total operating expenses** | **27,083** | **23,571** |

Operating expenses include the following main categories: lifting expenses connected with extraction of crude oil, refining and processing expenses, cost of petrochemicals production, cost of materials other than oil and gas, and other direct costs.

Operating expenses increased by 15% to RR 27,083 million in the first half of 2007 from RR 23,571 million in the same period of 2006.

***Crude oil extraction expenses.*** The Group's extraction ("lifting") expenses relate to oil and gas production and are 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 consisting of the sale of services and goods (such as electricity, heat, etc.) that are unrelated to core activities, accretion of the Company's asset retirement obligations, and the change in crude oil and refined products inventory, have been excluded from extraction expenses and are included in other operating costs.

Lifting expenses averaged to RR 104.5 per barrel in the first half of 2007 compared to RR 96.8 per barrel in the corresponding period of 2006. The increase of 8% is primarily a result of increases in electricity tariffs, wages and other service costs.

***Petrochemical production expenses.*** Petrochemical production expenses primarily include the costs of raw materials, labour, maintenance and electricity consumed in the production of petrochemical products. Cost of petrochemicals production increased by 14% to RR 8,099 million primarily due to increases in the cost of raw materials, electricity tariffs and other services costs, as well as an increase in the sales of tires by 17%.

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

Other operating expenses increased to RR 9,262 million, or by 22%, compared to the first half of 2006. 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 the first half of 2007 and 2006, respectively is as follows:

| **RR millions** | **Six months ended June 30, 2007** | **Six months ended June 30, 2006** |
|---|---|---|
| Purchased refined products (RR millions) | 13,906 | 15,411 |
| Volume (thousand tons) | *1,210* | *1,546* |
| Average price per ton (RR) | *11,491* | *9,967* |
| Purchased crude oil (RR millions) | 3,363 | 2,339 |
| Volume (thousand tons) | *510* | *412* |
| Average price per ton (RR) | *6,592* | *5,684* |
| **Total purchased oil and refined products** | **17,269** | **17,750** |

Purchases of refined products decreased by 10% to RR 13,906 million in the first half of 2007 from RR 15,411 million in the same period of 2006 due to a 22% decrease in volume of purchased refined products for trading which is partly offset by an increase in the average purchase price per ton.

Purchases of crude oil increased by 44% to RR 3,363 million in the first half of 2007 from RR 2,339 million in the same period of 2006 due to increase in the average purchase price per ton as well as increase in volumes of purchased crude oil for trading.

**Exploration expenses.** Exploration expenses consisit primarily of exploratory drilling, geological and geophysical costs, and the costs of carrying and retaining undeveloped properties. Exploration expenses decreased to RR 559 million in the first half of 2007 from RR 837 million in the same period of 2006. The decrease is the result of a reorganization of Group entities who perform exploration services on the Group's behalf resulting in a decrease in certain overhead expenses.

**Transportation expenses**. Transportation expenses relate to the delivery of our own crude oil production as well as purchased crude and refined products, which are primarily incurred using Transneft pipeline for deliveries of crude oil to our customers. Transportation costs increased by 18% to RR 4,041 million in the first half of 2007 from RR 3,438 million in the corresponding period of 2006 due to increase in transportation tariffs and overall increase in sales volumes.

**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, charity and other expenses, including bad debt provisions. Selling, general and administrative expenses increased by 26% to RR 11,317 million in the first half of 2007 from RR 9,013 million in the corresponding period of 2006 mainly caused by increase in charity and sponsorship expenses, an increase in our bad debt provision and an increase in share based compensation program for senior management.

**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 the first half of 2007 amounted to RR 1,905 million compared to RR 3,443 million in the corresponding period of 2006.

The 2007 loss includes the loss on disposal of Bank Ak Bars (RR 936 million) (see Change in the Group structure above), and the cost of transferring our treasury shares to the National Non-governmental Pension Fund (RR 1,289 million).

In order to secure future stability of the Pension Fund, Tatneft contributed its 10.8 millions ordinary shares to the Fund, for which the Group recorded a one-time loss of RR 1,289 million.

Other losses include losses on the disposal of a number of non-core assets.

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

| | **Six months ended June 30, 2007** | **Six months ended June 30, 2006** |
|---|---|---|
| Unified production tax | 25,652 | 29,928 |
| Export duties | 37,467 | 41,187 |
| Excise taxes | 121 | 30 |
| Property tax | 686 | 696 |
| Penalties and interest | 24 | - |
| Other | 453 | 482 |
| **Total taxes other than income taxes** | **64,403** | **72,323** |

Taxes other than income taxes decreased by 11% to RR 64,403 million in the first half of 2007 from RR 72,323 million in the corresponding period of 2006. The decrease was primarily a result of the decrease in export duty and unified production tax rates, which are linked to crude oil market prices and the introduction of differentiated rates of unified production taxes. Export duties decreased by 9% to RR 37,467 million from RR 41,187 million and the unified production tax decreased by 14% to RR 25,652 million from RR 29,928 million. Excise tax increased to RR 121 million from RR 30 million, which is the result of the 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.** Social infrastructure expenses relate primarily to housing, schools and cultural buildings in Tatarstan. Maintenance of social infrastructure expenses increased to RR 848 million in the first half of 2007 from RR 23 million in the corresponding period of 2006 due to the increased expenses related to housing.

Transfer of social assets constructed after privatization decreased to RR 3 million in the first half of 2007 from RR 35 million in the same period of 2006. 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 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 430 million in the first half of 2007 from RR 876 million in the corresponding period of 2006 due to an increase in our share of the IPCG Fund operating losses (RR 248 million) and lower income received from the Company's other equity affiliates and joint ventures, specifically ZAO Tatex (RR 105 million).

The foreign exchange loss amounted to RR 484 million in the first half of 2007 compared with a loss of RR 1,404 million in the corresponding period of 2006 due to appreciation of the Russian Ruble against the US Dollar.

Interest income increased to RR 1,189 million in the first half of 2007 from RR 917 million in the corresponding period of 2006 due to an increase in loans issued. Interest expense decreased to RR 110 million in the first half of 2007 from RR 356 million in the corresponding period of 2006, which is the result of repayment of Credit Suisse and BNP Paribas long-term loans in the first half of 2007.

Other expense, net in the first half of 2007 amounted to RR 651 million compared with RR 807 million of other income, net in the first half of 2006. The change is primarily due to realized and unrealized losses recorded on our trading investments.

## Income taxes

The decrease in our income tax expense is a result of an increase in our effective tax rate to 31% in the first half of 2007 from 30% in the first half of 2006 as a result of an increase in non-deductible expenses, primarily relating to charitable contributions.

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

| RR millions | Six months ended June 30, 2007 | Six months ended June 30, 2006 |
|---|---|---|
| Net income | 16,493 | 17,922 |
| Add back: | | |
| Minority interest | 492 | 314 |
| Income tax expense | 7,749 | 7,848 |
| Depreciation, depletion and amortization | 5,397 | 5,560 |
| Interest expense | 110 | 367 |
| Interest and dividend income | (1,189) | (917) |
| **EBITDA** | **29,050** | **31,094** |

EBITDA is a non-US GAAP financial measure, 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 consider our need to replace our capital equipment over time.

## Financial Condition Summary Information

The following table shows certain key financial indicators:

| RR millions | Six months ended June 30, 2007 | Year ended December 31, 2006 |
|---|---|---|
| Current assets | 125,580 | 102,604 |
| Long-term assets | 216,337 | 216,820 |
| **Total assets** | **341,917** | **319,424** |
| | | |
| Current liabilities | 47,193 | 32,747 |
| Long-term liabilities | 52,413 | 51,800 |
| **Total liabilities** | **99,606** | **84,547** |
| | | |
| **Shareholders' equity** | **238,775** | **231,703** |
| | | |
| Working capital | 78,387 | 69,857 |
| Current ratio | 2.66 | 3.13 |

### Working capital position

As of June 30, 2007 working capital of the Group amounted to RR 78,387 million compared to RR 69,857 million as of December 31, 2006. The increase in the working capital is primarily attributable to an increase in cash and cash equivalents and accounts receivable.

## Liquidity and Capital Resources

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

| RR millions | Six months ended June 30, 2007 | Six months ended June 30, 2006 |
|---|---|---|
| Net cash provided by operating activities | 25,601 | 17,433 |
| Net cash used for investment activities | (13,001) | (15,937) |
| Net cash provided by (used for) financing activities | (750) | (3,281) |
| Increase (decrease) in cash and cash equivalents | 11,850 | (1,785) |

### Net cash provided by operating activities

Our primary source of cash flow is funds generated from our operating activities. Net cash provided by operating activities increased by 47% to RR 25,601 million in the first half of 2007 from RR 17,433 million in the corresponding period of 2006 due primarily to an increase in working capital items.

### Net cash used for investing activities

Net cash used for investing activities decreased by 18% to RR 13,001 million in the first half of 2007 from RR 15,937 million in 2006, which is primarily due to decrease in the spending for purchase of investments and certificates of deposit partly offset by an increase in additional loans granted during the period.

## Net cash provided by financing activities

Cash flow used for financing decreased by 81% to RR 750 million in the first half of 2007 from RR 3,281 million in the same period of 2006. This is primarily due to net debt repayments of RR 110 million in the first haft of 2007 compared with net debt repayments of RR 2,803 million in 2006.

***Analysis of Debt.*** At June 30, 2007, long-term debt, including the current portion of long-term debt, amounted to RR 596 million as compared to RR 1,696 million at December 31, 2006. The related decrease is due to scheduled repayments of long-term debt to BNP Paribas and Credit Suisse First Boston, during the first half of 2007.

The aggregate maturities of total long-term debt, including current portion as of June 30, 2007 are as follows:

| RR millions | Six months ended June, 30 2007 |
|---|---|
| June 2007- June 2008 | - |
| June 2008- June 2009 | 152 |
| June 2009- June 2010 | 380 |
| June 2010- June 2011 | 27 |
| June 2011- June 2012 | 7 |
| Thereafter | 30 |
| **Total long-term debt** | **596** |

Short-term debt increased by 34% to RR 3,744 million as of June 30, 2007 from RR 3,207 million as of December 31, 2006, primarily due to an increase in the outstanding amount of our one month revolving credit facility with BNP Paribas.