MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

You should read the following discussion and analysis of our financial condition and results of operations as of 31 December 2012 and for the year then ended in conjunction with our audited consolidated financial statements as of and for the years ended 31 December 2012 and 2011. The consolidated financial statements and the related notes thereto have been prepared in accordance with International Financial Reporting Standards (IFRS).

The financial and operational information contained in this "Management's Discussion and Analysis of Financial Condition and Results of Operations" comprises information of OAO NOVATEK and its consolidated subsidiaries (hereinafter jointly referred to as "we" or the "Group").

OVERVIEW

We are Russia's largest independent natural gas producer and the second-largest producer of natural gas in Russia after Gazprom, in each case according to the Central Dispatch Administration of the Fuel and Energy Complex (the "CDU-TEK") for 2012. In terms of proved natural gas reserves, we are also the second largest holder of natural gas resources in Russia after Gazprom, under the Petroleum Resources Management System ("PRMS") reserve reporting methodology.

Our exploration, development, production and processing of natural gas, gas condensate and crude oil have been conducted primarily within the Russian Federation, and, in accordance with Russian law, we sell our produced natural gas volumes exclusively in the Russian domestic market. We export our stable gas condensate directly to international markets, while our liquefied petroleum gas ("LPG") and crude oil are generally delivered to both international (including the Commonwealth of Independent States ("CIS")) and domestic markets.

RECENT DEVELOPMENTS

In February 2013, the Group issued four-year Russian rouble denominated Eurobonds in the aggregate amount of RR 14 billion with the annual coupon rate of 7.75%.

In December 2012, the Group acquired 82% of equity interest in OOO Gazprom mezhregiongas Kostroma ("Gazprom mezhregiongas Kostroma") to support and expand natural gas sales opportunities in the Kostroma region. Gazprom mezhregiongas Kostroma is a regional natural gas trader in the Kostroma region of the Russian Federation.

In December 2012, the Group established OOO NOVATEK Moscow region, a wholly owned subsidiary, to support the Group's current natural gas deliveries to the Moscow region, as well as to expand sales in the region.

In December 2012, the Group issued ten-year USD denominated Eurobonds in the aggregate amount of USD one billion with a coupon rate of 4.422% per annum.

In November 2012, the Group acquired a 49% ownership interest in ZAO Nortgas ("Nortgas") for total consideration of USD 1,375 million. Nortgas is a Russian oil and gas production company that holds the production license for the North-Urengoyskoye field (expires in 2018), located in the Yamal Nenets Autonomous Region ("YNAO"), which is located in a close proximity to our transport and processing infrastructure. The estimated proved reserves appraised under the PRMS reserve methodology totalled 186 billion cubic meters (bcm) of natural gas and 25 million tons of liquid hydrocarbons as of 31 December 2012, for combined total of 1.4 billion barrels of oil equivalent.

In October 2012, we launched the fourth stage of the second phase development at our Yurkharovskoye field, which allows achieving design production capacity of the field. The fourth stage complex includes two gas treatment trains with total annual capacity of seven billion cubic meters. The fourth stage launch increases natural gas production at the field to a plateau level of 36.5 bcm per annum.

In 2012, the Group signed long-term natural gas purchase and sales contracts with third parties on the European market. The gas purchase and sales contracts have been signed for a period of 10 years starting from 1 October 2012 with the total volume of natural gas supplied over this period is estimated to be approximately 210 terawatt-hours (or approximately 20 bcm). The financial result from natural gas trading activities, including the effect from changes in fair value of gas contracts, was recorded in the consolidated statement of income within other operating profit (loss).

During 2012, our joint venture OOO SeverEnergia ("SeverEnergia") launched the first and the second phases of the Samburgskoye field with combined annual natural gas production capacity of approximately 4.6 bcm and 650 thousand tons of gas condensate.

In November 2011, the Group acquired OOO Gazprom mezhregiongas Chelyabinsk ("Gazprom mezhregiongas Chelyabinsk"), a regional natural gas trader, serving the Chelyabinsk region of the Russian Federation, to support and expand the Group's natural gas sales commercial operations in this region.

In September 2011, the Group increased its equity interest in OAO Yamal LNG from 51% to 100% and subsequently disposed of a 20% interest in the company in October 2011 to TOTAL S.A., the Group's strategic partner in the Yamal LNG project. The Yamal LNG project plans to construct a natural gas liquefaction plant comprising three trains of 5.5 million tons per annum to exploit the hydrocarbon resources of the South-Tambeyskoye field, located on the Yamal peninsula.

In June 2011, the Group took part in a tender organized by the Federal Agency for the Use of Natural Resources of the Russian Federation for four licenses in the YNAO: exploration and production licenses for the Salmanovskoye (Utrenneye) and Geofizicheskoye fields, as well as geological studies and production licenses for the North-Obskiy and East-Tambeyskiy license areas. In August 2011, the Russian Government approved the transfer of these licenses to us for RR 6.9 billion in total consideration. The estimated proved reserves at our Salmanovskoye (Utrenneye) and Geofizicheskoye fields appraised under the PRMS reserve methodology totalled 492 billion cubic meters (bcm) of natural gas and 14 million tons of liquid hydrocarbons as of 31 December 2012. Our combined resources at North-Obskiy and East-Tambeyskiy license areas according to the Russian reserve classification category D1 totalled 1,763 bcm of natural gas and 221 million tons of liquid hydrocarbons.

SELECTED DATA

millions of Russian roubles except as stated	Year ended 31 December: 2012	2011	Change %
Financial results			
Total revenues (net of VAT, export duties, excise and fuel taxes)	210,973	175,273	20.4%
Operating expenses	(125,775)	(96,820)	29.9%
Profit attributable to shareholders of OAO NOVATEK	69,458	119,655	(42.0%)
Normalized profit attributable to shareholders of OAO NOVATEK [(1)]	69,518	56,707	22.6%
EBITDA [(2)]	95,106	148,349	(35.9%)
Normalized EBITDA [(3)]	95,166	85,401	11.4%
Normalized EBITDAX [(4)]	97,188	87,220	11.4%
Earnings per share (in Russian roubles)	22.89	39.45	(42.0%)
Normalized Earnings per share (in Russian roubles) [(5)]	22.91	18.69	22.6%
Operating results			
Natural gas sales volumes (million cubic meters)	58,880	53,667	9.7%
Stable gas condensate sales volumes (thousand tons)	2,847	2,984	(4.6%)
Liquefied petroleum gas sales volumes (thousand tons)	905	880	2.8%
Crude oil sales volumes (thousand tons)	442	242	82.6%
Total hydrocarbons production (million barrels of oil equivalent) [(6)]	405.1	380.6	6.4%
Total daily production (thousand barrels of oil equivalent per day) [(6)]	1,107	1,043	6.1%
Cash flow results			
Net cash provided by operating activities	75,825	71,907	5.4%
Capital expenditures [(7)]	43,554	31,161	39.8%
Free cash flow [(8)]	32,271	40,746	(20.8%)

(1) Normalized profit attributable to shareholders of OAO NOVATEK represents profit attributable to shareholders of OAO NOVATEK excluding net gain (loss) on disposal of interest in subsidiaries.

(2) EBITDA represents profit (loss) attributable to shareholders of OAO NOVATEK adjusted for the add-back of net impairment expenses (reversals), income tax expense and finance income (expense) from the Consolidated Statement of Income, income (loss) from changes in fair value of derivative financial instruments from the “Financial instruments and financial risk factors” in the notes to the consolidated financial statements and depreciation, depletion and amortization from the Consolidated Statement of Cash Flows.

(3) Normalized EBITDA represents EBITDA excluding net gain (loss) on disposal of interest in subsidiaries.

(4) Normalized EBITDAX represents EBITDA as adjusted for the add-back of exploration expenses and excludes net gain (loss) on disposal of interest in subsidiaries.

(5) Normalized Earnings per share represents Earnings per share adjusted for net gain (loss) on disposal of interest in subsidiaries.

(6) Total hydrocarbons production and total daily production are calculated based on net production, including our proportionate share in the production of our joint ventures.

(7) Capital expenditures represent additions to property, plant and equipment excluding prepayments for participation in tender for mineral licenses.

(8) Free cash flow represents the excess of Net cash provided by operating activities over Capital expenditures.

Reconciliation of adjusted EBITDA and EBITDAX to profit (loss) attributable to shareholders of OAO NOVATEK is as follows:

millions of Russian roubles	Year ended 31 December: 2012	2011	Change %
Profit (loss) attributable to shareholders of OAO NOVATEK	**69,458**	**119,655**	**(42.0%)**
Depreciation, depletion and amortization	11,499	9,475	21.4%
Net impairment expenses	325	782	(58.4%)
Loss (income) from changes in fair value of derivative financial instruments	36	-	n/a
Total finance expense (income)	(2,986)	2,703	n/a
Total income tax expense	16,774	15,734	6.6%
EBITDA	**95,106**	**148,349**	**(35.9%)**
Net loss (gain) on disposal of interest in subsidiaries	60	(62,948)	n/a
Normalized EBITDA	**95,166**	**85,401**	**11.4%**
Exploration expenses	2,022	1,819	11.2%
Normalized EBITDAX	**97,188**	**87,220**	**11.4%**

SELECTED MACRO-ECONOMIC DATA

Exchange rate, Russian roubles for one US dollar [(1)]	1 quarter 2012	1 quarter 2011	2 quarter 2012	2 quarter 2011	3 quarter 2012	3 quarter 2011	4 quarter 2012	4 quarter 2011	Year 2012	Year 2011	Change Y-o-Y, %
At the beginning of the period	32.20	30.48	29.33	28.43	32.82	28.08	30.92	31.88	32.20	30.48	5.6%
At the end of the period	29.33	28.43	32.82	28.08	30.92	31.88	30.37	32.20	30.37	32.20	(5.7%)
Average for the period	30.26	29.27	31.01	27.99	32.01	29.05	31.08	31.23	31.09	29.39	5.8%
Depreciation (appreciation) of Russian rouble to US dollar	(8.9%)	(6.7%)	11.9%	(1.2%)	(5.8%)	13.5%	(1.8%)	1.0%	(5.7%)	5.6%	n/a

[(1)] According to the Central Bank of Russian Federation (CBR). The average rates are calculated as the average of the daily exchange rates on each business day (which rate is announced by the CBR for each such business day) and on each non-business day (which rate is equal to the exchange rate on the previous business day).

● ● ●

Crude oil prices, USD / bbl	1 quarter 2012	1 quarter 2011	2 quarter 2012	2 quarter 2011	3 quarter 2012	3 quarter 2011	4 quarter 2012	4 quarter 2011	Year 2012	Year 2011	Change Y-o-Y, %
WTI [(2)]											
At the end of the period	103.0	106.7	85.0	95.4	92.1	79.2	91.8	98.8	91.8	98.8	(7.1%)
Average for the period	103.0	94.6	93.5	102.3	92.2	89.5	88.2	94.1	94.2	95.1	(0.9%)
Brent [(3)]											
At the end of the period	123.5	116.9	94.5	111.5	111.0	105.2	110.0	106.5	110.0	106.5	3.3%
Average for the period	118.6	105.4	108.3	117.0	109.5	113.4	110.1	109.4	111.7	111.3	0.4%
Urals [(3)]											
At the end of the period	120.0	113.1	94.2	110.1	109.9	102.3	108.1	104.3	108.1	104.3	3.6%
Average for the period	116.9	102.6	106.6	113.7	108.9	111.5	108.8	108.7	110.4	109.1	1.2%

[(2)] Based on New York Mercantile Exchange Light Sweet prices provided by Reuters to Platts.

[(3)] Based on Brent (Dtd) prices and Russian Urals/ESPO spot assessments prices as provided by Reuters to Platts. ESPO stands for East Siberian Pipeline Ocean crude oil.

● ● ●

Propane-butane mix prices, USD / ton [(4)]	1 quarter 2012	1 quarter 2011	2 quarter 2012	2 quarter 2011	3 quarter 2012	3 quarter 2011	4 quarter 2012	4 quarter 2011	Year 2012	Year 2011	Change Y-o-Y, %
At the end of the period	837.5	740.0	612.5	814.0	812.5	890.0	840.0	808.5	840.0	808.5	3.9%
Average for the period	782.6	734.6	786.4	795.9	720.7	834.4	829.6	847.5	779.8	803.5	(2.9%)

[(4)] Based on spot prices for propane-butane mix at the Belarusian-Polish border (DAF, Brest) as provided by Argus.

● ● ●

Export duties, USD / ton [(5)]	1 quarter 2012	1 quarter 2011	2 quarter 2012	2 quarter 2011	3 quarter 2012	3 quarter 2011	4 quarter 2012	4 quarter 2011	Year 2012	Year 2011	Change Y-o-Y, %
Crude oil, stable gas condensate											
At the end of the period	411.2	365.0	419.8	462.1	393.8	444.1	396.5	406.6	396.5	406.6	(2.5%)
Average for the period	400.8	343.0	443.0	446.5	366.6	442.5	406.6	403.7	404.3	408.9	(1.1%)
LPG											
At the end of the period	157.3	150.2	237.1	189.8	76.2	192.0	197.4	221.8	197.4	221.8	(11.0%)
Average for the period	180.0	166.1	197.4	137.0	92.7	182.6	187.4	218.3	164.4	176.0	(6.6%)

[(5)] Export duties are determined by the Government of the Russian Federation in US dollars and are paid in Russian roubles.

CERTAIN FACTORS AFFECTING OUR RESULTS OF OPERATIONS

Current financial market conditions

The economic instability in the Euro-Zone has appeared to subside with the various measures taken by the respective governments, Central Banks and other quasi-governmental financial institutions. Although the main financial and economic issues plaguing the Euro-Zone over the twelve months remains in the forefront of present discussions, we will continue to monitor the credit situation very closely and take various measures, we deem necessary, to ensure the integrity of our financial condition and mitigate counter-party credit exposure from our natural gas and liquid hydrocarbon sales. In addition, we continue to take proactive steps to ensure the safety of our excess funds deposited with both domestic and international banks, as well as limit our risk exposure from prepayments to various service providers. Presently, our cash and deposits are diversified and maintained in banks that we believe are well capitalized in accordance with international capital adequacy rules.

We have reviewed our capital expenditure program for the upcoming year and have concluded that we have sufficient liquidity, through current internal cash flows and short-term borrowing facilities, to adequately fund our core natural gas business operations and planned capital expenditure program.

Management will continue to closely monitor the economic environment in Russia, as well as the domestic and international capital markets to determine if any further corrective and/or preventive measures are required to sustain and grow our business. In addition, we will continue to assess the trends in the capital markets for opportunities to access long-term funding at a reasonable cost to the Group commensurate with our investment grade credit ratings and our capital requirements.

Exchange rate volatility between the Russian rouble and the US dollar exchange rate may significantly influence the Group's reporting financial results due to the fact that a significant portion of our long-term debt is denominated in US dollars (see "Profit attributable to shareholders and earnings per share" below).

Natural gas prices

As an independent natural gas producer, we are not subject to the Russian Government's regulation of natural gas prices, except for those volumes delivered to residential customers, although the prices we can achieve on the domestic market are strongly influenced by the prices regulated by the Federal Tariffs Service ("FTS"), a governmental agency, and present market conditions.

In February 2011, the Government of the Russian Federation announced certain revisions to the domestic natural gas market liberalization plan. According to the revised plan, the target date for full liberalization of the domestic natural gas market is 1 January 2015 but there are various Governmental discussions indicating that this program may be further extended. The regulation of the domestic natural gas price prior to 2015 will be based on the netback parity of natural gas prices on the domestic and export markets.

As part of the liberalization plan, the FTS increased the regulated price for natural gas by 15% effective from 1 January 2011 and 1 July 2012, respectively.

According to the Russian Government Directive No.1205 on Improvement of State Gas Price Regulation as of 31 December 2010, starting from 2013 natural gas prices for sales to end-customers on the domestic market (excluding residential customers) are set for each region of the Russian Federation on a quarterly basis using a price formula within the range of maximum and minimum wholesale price. The maximum and minimum wholesale gas prices may be revised semiannually – as of 1 January and 1 July. In addition, the wholesale gas prices may be recalculated twice a year (as of 1 April and 1 October) based on changes in oil products prices on the European markets within a range of +/-3% from the average prices set previously.

According to the Forecast of Socio-economic Development for 2013, the regulated natural gas prices will be increased by 15% effective in 2013, 2014 and 2015.

The FTS under the Governmental decisions may modify the percentages published, as well as to potentially prolong the timetable toward market price liberalization based on market conditions and other factors.

The specific terms for delivery of natural gas affect our average realized prices. Natural gas sold “ex-field” is sold primarily to wholesale gas traders, in which case the buyer is responsible for the payment of gas transportation tariffs. Sales to wholesale gas traders allow us to diversify our natural gas sales without incurring additional commercial expenses. Historically, we have realized higher prices and net margins for natural gas volumes sold directly to end-customers, as the gas transportation tariff is included in the contract price and no retail margin is lost to wholesale gas traders. However, the historical norm may or may not prevail in the present or future market situations.

In December 2011, we commenced natural gas sales to residential customers at regulated prices in the Chelyabinsk region as a result of the acquisition of a regional gas trader Gazprom mezhregiongas Chelyabinsk. In December 2012, we acquired a regional gas trader Gazprom mezhregiongas Kostroma and commenced natural gas sales to residential customers at regulated prices in the Kostroma region in 2013. We disclose such sales within our end-customers category.

In 2012, our average natural gas price to end-customers and ex-field price increased by 7.4% and 9.1%, respectively, whereas our average transportation expense for the delivery of natural gas to end-customers increased by 2.2% primarily due to a 7.0% increase in the average transportation tariff set by the FTS effective 1 July 2012 (see “Transportation tariffs” below). As a result, our average netback price on end-customers sales increased by 11.9%, while our total average natural gas price excluding transportation expense increased by 11.3% compared to respective prices in 2011.

The following table shows our average realized natural gas sales prices (net of VAT), excluding volumes purchased for resale in the location of our end-customers:

Russian roubles per mcm	**Year ended 31 December: 2012**	**2011**	**Change %**
Average natural gas price to end-customers [(1)]	2,821	2,627	7.4%
Average natural gas transportation expense for sales to end-customers	(1,234)	(1,207)	2.2%
Average natural gas netback price on end-customer sales	1,589	1,420	11.9%
Average natural gas price ex-field (wholesale traders)	1,518	1,392	9.1%
Total average natural gas price excluding transportation expense	**1,566**	**1,407**	**11.3%**

[(1)] Includes cost of transportation.

Crude oil, stable gas condensate, liquefied petroleum gas and oil products prices

Crude oil, stable gas condensate, LPG and oil products prices on international markets have historically been volatile depending on, among other things, the balance between supply and demand fundamentals, the ability and willingness of oil producing countries to sustain or change production levels to meet changes in global demand and potential disruptions in global crude oil supplies due to war, geopolitical developments, terrorist activities or natural disasters.

The actual prices we receive for our liquid hydrocarbons on both the domestic and international markets are dependent on many external factors beyond the control of management, such as movements in international benchmark crude oil prices. Crude oil that we sell bound for international markets is transported through the OAO AK Transneft (“Transneft”) pipeline system where it is blended with other crude oil of varying qualities to produce an export blend commonly referred to as “Urals blend”, which normally (or historically) trades at a discount to the international benchmark Brent crude oil. Volatile movements in benchmark crude oil prices can have a positive and/or negative impact on the ultimate prices we receive for our liquids volumes sold on both the domestic and international markets, among many other factors.

Our stable gas condensate, LPG and crude oil and oil products’ prices on both international and domestic markets include transportation expense in accordance with the specific terms of delivery.

In 2012, our stable gas condensate export delivery terms were cost and freight (CFR), or delivery to the port of destination ex-ship (DES), or delivery at point of destination (DAP), or priced at cost, insurance and freight (CIF), while in 2011 our delivery terms were either CFR, DES, DAP, CIF or delivery at terminal (DAT). Our average stable gas condensate export contract price, including export duties, in 2012, was approximately USD 933 per ton compared to approximately USD 931 per ton in 2011.

In 2012, as well as in 2011, our crude oil export delivery terms were DAP (Feneshlitke, Hungary). Our average crude oil export contract price, including export duties, was approximately USD 786 per ton compared to USD 787 per ton in 2011.

The following table shows our average realized stable gas condensate and crude oil sales prices (net of VAT and export duties, where applicable; prices in US dollars were translated from Russian roubles using the average exchange rate for the period):

Russian roubles or US dollars per ton	**Year ended 31 December: 2012**	**2011**	**Change %**
Stable gas condensate			
Net export price, RR per ton	16,432	15,676	4.8%
Net export price, USD per ton	528.5	533.4	(0.9%)
Domestic price, RR per ton	12,489	13,818	(9.6%)
Crude oil			
Net export price, RR per ton	11,935	10,983	8.7%
Net export price, USD per ton	383.9	373.7	2.7%
Domestic price, RR per ton	10,985	9,792	12.2%

In 2012, as well as in 2011, our LPG export delivery terms were DAP at the border of the customer's country, carriage paid to (CPT) the Port of Temryuk (southern Russia) and free carrier (FCA) at terminal points in Poland. In 2012, our average export contract price for LPG produced at the Purovsky Gas Condensate Plant ("Purovsky Plant"), including export duties and excluding excise and fuel taxes expense, was approximately USD 817 per ton compared to USD 829 per ton in 2011.

In 2012, as well as in 2011, we sold 426 thousand tons of our LPG on the domestic market at an average price of RR 14,011 per ton and RR 13,458 per ton, respectively, including volumes purchased for resale and sold through our wholly owned subsidiary OOO NOVATEK-AZK ("NOVATEK-AZK").

In 2012, we sold approximately nine thousand tons of methanol produced by our production subsidiaries to our joint ventures and third parties at an average price of RR 10,659 per ton as compared to sales of approximately four thousand tons at an average price of RR 10,000 per ton in 2011.

The following table shows our average realized LPG and methanol sales prices, excluding LPG trading activities. Prices in the table below are shown net of VAT, export duties, excise and fuel taxes expense, where applicable. Prices in US dollars were translated from Russian roubles using the average exchange rate for the period.

Russian roubles or US dollars per ton	**Year ended 31 December: 2012**	**2011**	**Change %**
LPG			
Net export price, RR per ton	20,109	19,199	4.7%
Net export price, USD per ton	646.8	653.3	(1.0%)
Domestic price, RR per ton	14,009	13,458	4.1%
Methanol			
Domestic price, RR per ton	10,659	10,000	6.6%

Transportation tariffs

Natural gas

We transport our natural gas through our own pipelines into the Unified Gas Supply System ("UGSS"), which is owned and operated by OAO Gazprom, a Russian Government controlled monopoly. Transportation tariffs for the use of the UGSS by independent producers are set by the FTS.

In accordance with the methodology of calculating transportation tariffs for natural gas produced in the Russian Federation for shipments to consumers located within the customs territory of the Russian Federation and the member states of the Customs Union Agreement (Belarus, Kazakhstan, Kyrgyzstan and Tajikistan), the transportation tariff consists of two parts: a rate for the utilization of the trunk pipeline and a transportation rate per mcm per 100 kilometers (km). The rate for utilization of the trunk pipeline is based on an "input/output" function, which is determined by where natural gas enters and exits the trunk pipeline and includes a constant rate for end-customers using Gazprom's gas distribution systems. The constant rate is deducted from the utilization rate for end-customers using non-Gazprom gas distribution systems.

Effective from 1 January 2011, the FTS approved a 9.3% average increase in the transportation tariff for natural gas and the rate for utilization of the trunk pipeline averaged between RR 44.97 to RR 1,964.13 (excluding VAT) per mcm and the transportation rate was RR 11.23 (excluding VAT) per mcm per 100 km.

Effective from 1 July 2012, the FTS approved a 7.0% average increase of the transportation tariff for natural gas and the rate for utilization of the trunk pipeline averaged between RR 50.78 to RR 1,995.44 (excluding VAT) per mcm and the transportation rate was RR 12.02 (excluding VAT) per mcm per 100 km.

According to the Forecast of Socio-economic Development of the Russian Federation for 2013 announced in September 2012 by the Ministry of Economic Development of the Russian Federation, the transportation tariff for natural gas produced by independent producers will be increased in 2013, 2014 and 2015 as of the same date as the increase in the regulated natural gas prices (expected to be 1 July) and will not exceed the forecasted inflation rate (excluding the effect of possible property tax benefit cancellation for OAO Gazprom). According to preliminary estimates of the Ministry of Economic Development, the transportation tariff will be increased by 5.4% effective from 1 July 2013, by 5.0% effective from 1 July 2014 and by 4.8% effective from 1 July 2015 (excluding the effect of possible property tax benefit cancellation for OAO Gazprom).

Crude oil

We transport most of our crude oil through the pipeline network owned and operated by Transneft, Russia's state-owned monopoly crude oil pipeline operator. The FTS sets tariffs for transportation of crude oil through Transneft's pipeline network, which includes transport, dispatch, pumping, loading, charge-discharge, transshipment and other services. The FTS sets tariffs for each separate route of the pipeline network, so the overall expense for the transport of crude oil primarily depends on the length of the transport route from the producing fields to the ultimate destination, transportation direction and other factors.

Crude oil transportation tariffs were increased in September and November 2011 on average by approximately 2.9% and 5.0%, respectively, and in November 2012 on average by approximately 5.5%.

Stable gas condensate and LPG

We transport our stable gas condensate (from the Purovsky Plant to the Port of Vitino on the White Sea or to customers on the domestic markets) and LPG (from the Purovsky Plant to the customers on the domestic market) by rail which is owned and operated by Russia's state-owned monopoly railway operator – OAO Russian Railways. Our transportation tariffs for transport by rail are set by the FTS and vary depending on product and length of the transport route. For our stable gas condensate and LPG transportation purposes we use our own rail cars and rail cars rented from independent Russian transportation companies.

In 2012 and 2011, we applied the discount co-efficients to existing rail road transportation tariffs related to export deliveries of stable gas condensate and LPG shipped from the Limbey rail station. In 2011, the discount co-efficient for stable gas condensate was set at 0.89 for companies with annual shipped volumes of 2,600 thousand tons or more, and the discount co-efficient for LPG was set at 0.68 for delivered annual volumes of 415 thousand tons or more. In 2012, the discount co-efficient for stable gas condensate was set at 0.89 for companies with annual shipped volumes of 3,000 thousand tons or more, and the discount co-efficient for LPG was set at 0.71 for delivered annual volumes of 445 thousand tons or more.

We deliver our stable gas condensate to international markets using the loading and storage facilities at the Port of Vitino on the White Sea and tankers for transportation to US, European, South American and countries of the APR. The cost of tanker transportation is generally determined by the distance to the final destination, tanker availability, seasonality of deliveries and standard shipping terms, all in accordance with general industry practice.

Our tax burden and obligatory payments

We are subject to a wide range of taxes imposed at the federal, regional, and local levels, many of which are based on revenue or volumetric measures. In addition to income tax, significant taxes to which we are subject include VAT, unified natural resources production tax ("UPT", commonly referred as "MET" – mineral extraction tax), export duties, property tax, payments to non-budget funds and other contributions.

In practice, Russian tax authorities often have their own interpretation of tax laws that rarely favours taxpayers, who have to resort to court proceedings to defend their position against the tax authorities. Differing interpretations of tax regulations exist both among and within government ministries and organizations at the federal, regional and local levels, creating uncertainties and inconsistent enforcement. Tax declarations, together with related documentation such as customs declarations, are subject to review and investigation by a number of authorities, each of which may impose fines, penalties and interest charges. Generally, taxpayers are subject to an inspection of their activities for a period of three calendar years immediately preceding the year in which the audit is conducted. Previous audits do not completely exclude subsequent claims relating to the audited period. In addition, in some instances, new tax regulations have been given retroactive effect.

We have not employed any tax minimization schemes using offshore or domestic tax zones in the Russian Federation.

UPT

In 2012, according to the Russian Tax Code, the UPT rate for natural gas was set at RR 251 per mcm (consisting of base rate of RR 509 per mcm and a reducing co-efficient for independent natural gas producers of 0.493) as compared to RR 237 per mcm in 2011.

In November 2012, the amendments to the Russian Tax Code were passed into law, according to which the UPT rates were changed effective from 1 January 2013. According to these amendments, the UPT rate for natural gas produced by independent natural gas producers was set at RR 265 per mcm effective from 1 January 2013, RR 402 per mcm from 1 July 2013, RR 471 per mcm from 1 January 2014 and RR 552 per mcm from 1 January 2015. In addition, the Government of the Russian Federation is currently considering replacing the existing approach to the calculation of the UPT rate for natural gas with a formula that takes into account the category of extracted gas, field's location, access to export markets and dynamics in regulated prices and transportation tariffs. The proposed change in the tax calculation may take place in the nearest future; however, the discussions are not yet completed as of the date of the issuance of our financial statements.

In 2011, the UPT rate for gas condensate was set at 17.5% of gas condensate revenues recognized by the producing entities. Effective from 2012, the approach to the taxation of produced gas condensate was changed, and the UPT rate for gas condensate for 2012 was set at RR 556 per ton. According to the amendments to the Russian Tax Code, approved in November 2012, the UPT rate for gas condensate for 2013, 2014 and 2015 was set at RR 590, RR 647 and RR 679 per ton, respectively.

The UPT rate for crude oil is linked to the Urals benchmark crude oil price and changes every month. It is calculated in US dollar and translated and paid in Russian roubles using the monthly average exchange rate established by the Central Bank of Russia.

The Russian Tax Code provides for reduced or zero UPT rate for crude oil produced in certain geographical areas. We did not use the reduced or zero UPT rates from the production of crude oil prior to 1 January 2012. According to the amendments to the Russian Tax Code, effective from 1 January 2012, a zero UPT rate is set for crude oil produced at fields located in the YNAO to the north of the 65th degree of the northern latitude. Our East-Tarkosalinskoye and Khancheyskoye fields are located in the mentioned geographical area; therefore, we applied the allowed zero UPT rate for crude oil produced at these fields effective from 1 January 2012.

Export duties

We are subject to export duties on our exports of stable gas condensate, LPG and crude oil. The Government of the Russian Federation sets the export customs duties for exported liquids on a monthly basis.

The export duty rate for stable gas condensate and crude oil is calculated based on the average Urals crude oil price for the period from the 15th calendar day in the previous month to the 14th calendar day of the current month and is set for the following month after the current calendar month.

The export duty rate for LPG is calculated based on the average LPG price at the Polish border (DAF, Brest) for the period from the 15th calendar day in the previous month to the 14th calendar day of the current month and is set for the following month after the current calendar month (see "Selected macro-economic data" above).

Social insurance tax

Effective from 1 January 2012, the social insurance tax rate for contributions to the Pension Fund of the Russian Federation decreased from 26% to 22%, but the maximum taxable base per each employee was increased from RR 463 thousand to RR 512 thousand of annual salary. In addition, effective from 1 January 2012, a new insurance rate of 10% was implemented for amounts above the maximum taxable base of RR 512 thousand. Effective from 1 January 2013, the maximum taxable base per each employee was increased to RR 568 thousand of annual salary.

OIL AND GAS RESERVES

We do not file with the SEC nor are obliged to report our reserves in compliance with these standards. However, we have consistently disclosed proved oil and gas reserves as unaudited supplemental information in the Group's IFRS audited consolidated financial statements. We also provide additional information about our hydrocarbon reserves based on the widely-industry accepted PRMS reserves reporting classification, which in addition to total proved reserves discloses information on our probable and possible reserves.

Our proved reserves estimates are appraised by the Group's independent petroleum engineers, DeGolyer and MacNaughton ("D&M"). The Group's total proved reserves, comprised of proved developed and proved undeveloped reserves as of 31 December 2012 and 2011, were appraised using both reporting and disclosure requirements promulgated by the SEC and the PRMS reserves reporting classification.

Proved reserves disclosed in the *"Unaudited Supplemental Oil and Gas Disclosures"* in the Group's IFRS consolidated financial statements are presented under SEC reserve reporting methodology based on 100% of the reserves attributable to all consolidated subsidiaries (whether or not wholly owned), as well as our proportionate share of proved reserves accounted for by the equity method based on our equity ownership interest.

The tables below provide a comparison of the Group's estimated reserves under SEC and PRMS reserve classifications attributable to all consolidated subsidiaries and joint ventures *based on the Group's equity ownership interest in the respective fields.* Thus the proved reserves disclosure as noted above do not reconcile to the proved reserves in the consolidated financial statements.

	Natural gas			
	SEC		**PRMS**	
Based on our equity ownership interest in the fields	***Billions of cubic feet***	***Billions of cubic meters***	***Billions of cubic feet***	***Billions of cubic meters***
Total proved reserves at 31 December 2010	**40,415**	**1,144**	**46,245**	**1,310**
Changes attributable to:				
Revisions of previous estimates, extensions and discoveries	3,284	94	4,580	129
Acquisitions [(1)]	8,161	231	11,861	336
Disposals [(2)]	(3,331)	(95)	(4,841)	(137)
Production	(1,866)	(53)	(1,866)	(53)
Total proved reserves at 31 December 2011	**46,663**	**1,321**	**55,979**	**1,585**
including subsidiaries	*26,427*	*748*	*27,417*	*776*
including joint ventures	*20,236*	*573*	*28,562*	*809*
Changes attributable to:				
Revisions of previous estimates, extensions and discoveries	1,970	56	2,920	83
Acquisitions of prior periods [(3)]	12,717	360	17,386	492
Acquisitions of current period [(4)]	2,729	77	3,221	91
Production	(1,992)	(56)	(1,992)	(56)
Total proved reserves at 31 December 2012	**62,087**	**1,758**	**77,514**	**2,195**
including subsidiaries	*38,324*	*1,085*	*44,062*	*1,248*
including joint ventures	*23,763*	*673*	*33,452*	*947*

(1) Acquisitions in 2011 represent reserves attributable to increased equity interest in Yamal LNG from 51% to 100%.

(2) Disposals in 2011 represent reserves attributable to the disposal of a 20% interest in Yamal LNG to TOTAL S.A.

(3) Acquisitions of prior periods represent reserves attributable to licenses acquired in 2011 (Salmanovskoye (Utrenneye) and Geofizicheskoye fields), which were appraised in 2012 and include exploration surveys made after acquisition.

(4) Acquisitions of current period represent reserves attributable to our acquisition of a 49% equity stake in our joint venture Nortgas completed in 2012.

Based on our equity ownership interest in the fields	**Crude oil, gas condensate and natural gas liquids** **SEC** ***Millions of barrels***	***Millions of metric tons***	**PRMS** ***Millions of barrels***	***Millions of metric tons***
Total proved reserves at 31 December 2010	**604**	**73**	**761**	**93**
Changes attributable to:				
Revisions of previous estimates, extensions and discoveries	133	16	170	20
Acquisitions [(1)]	84	10	125	15
Disposals [(2)]	(34)	(4)	(51)	(6)
Production	(35)	(4)	(35)	(4)
Total proved reserves at 31 December 2011	**752**	**91**	**970**	**118**
including subsidiaries	*469*	*57*	*571*	*70*
including joint ventures	*283*	*34*	*399*	*48*
Changes attributable to:				
Revisions of previous estimates, extensions and discoveries	17	0	89	9
Acquisitions of prior periods [(3)]	78	9	119	14
Acquisitions of current period [(4)]	85	10	100	12
Production	(36)	(4)	(36)	(4)
Total proved reserves at 31 December 2012	**896**	**106**	**1,242**	**149**
including subsidiaries	*526*	*63*	*706*	*86*
including joint ventures	*370*	*43*	*536*	*63*

[(1)] Acquisitions in 2011 represent reserves attributable to increased equity interest in Yamal LNG from 51% to 100%.

[(2)] Disposals in 2011 represent reserves attributable to the disposal of a 20% interest in Yamal LNG to TOTAL S.A.

[(3)] Acquisitions of prior periods represent reserves attributable to licenses acquired in 2011 (Salmanovskoye (Utrenneye) and Geofizicheskoye fields), which were appraised in 2012 and include exploration surveys made after acquisition.

[(4)] Acquisitions of current period represent reserves attributable to our acquisition of a 49% equity stake in our joint venture Nortgas completed in 2012.

Our total SEC proved reserves, as presented in the tables above, differ from the total net proved reserves as reported in the *"Unaudited Supplemental Oil and Gas Disclosures"* in the Group's IFRS consolidated financial statements, in that total net proved reserves as presented in the Group's IFRS consolidated financial statements include net proved reserves of natural gas and liquids attributable to non-controlling interest in our subsidiaries. A reconciliation between total proved reserves at 31 December 2012 under the SEC reserve classification as reflected in the *"Unaudited Supplemental Oil and Gas Disclosures"* in the Group's IFRS consolidated financial statements and total proved reserves in the tables above is set forth below:

Under SEC classification	**Natural gas** ***Billions of cubic feet***	***Billions of cubic meters***	**Crude oil, gas condensate and natural gas liquids** ***Millions of barrels***	***Millions of metric tons***
Total proved reserves at 31 December 2012 presented in "Oil and Gas Reserves" above	62,087	1,758	896	106
Net proved reserves of natural gas and liquids attributable to non-controlling interest	128	4	17	2
Total net proved reserves per "Unaudited Supplemental Oil and Gas Disclosures"	**62,215**	**1,762**	**913**	**108**

The following table provides for our combined SEC and PRMS proved reserves on a total barrel of oil equivalent basis.

Based on our equity ownership interest in the fields	Combined natural gas, crude oil, gas condensate and natural gas liquids in millions of barrels of oil equivalent	
	SEC	**PRMS**
Total proved reserves:		
At 31 December 2010	8,088	9,325
At 31 December 2011	9,393	11,337
At 31 December 2012	12,394	15,597
including subsidiaries	*7,623*	*8,866*
including joint ventures	*4,771*	*6,731*

The PRMS reserve classification standards allows for the reporting of reserves estimates for probable and possible reserves as presented in the following table:

Under PRMS classification (based on our equity ownership interest in the fields)	**Natural gas**		**Crude oil, gas condensate and natural gas liquids**	
	Billions of cubic feet	***Billions of cubic meters***	***Millions of barrels***	***Millions of metric tons***
Probable reserves:				
At 31 December 2010	18,748	531	587	73
At 31 December 2011	18,471	523	652	81
At 31 December 2012	32,168	911	801	98
including subsidiaries	*21,515*	*609*	*456*	*56*
including joint ventures	*10,653*	*302*	*345*	*42*
Possible reserves:				
At 31 December 2010	14,867	421	915	117
At 31 December 2011	17,187	487	1,000	127
At 31 December 2012	24,664	698	1,193	146
including subsidiaries	*14,752*	*418*	*734*	*92*
including joint ventures	*9,912*	*280*	*459*	*54*

The Group's PRMS proved reserves attributable to consolidated subsidiaries and joint ventures based on the Group's equity ownership interest in the respective fields aggregated approximately 2.2 trillion cubic meters ("tcm") of natural gas and 149 million tons of crude oil, gas condensate and natural gas liquids as of 31 December 2012. Combined, these proved reserves represent approximately 15.6 billion barrels of oil equivalent.

Our total PRMS proved reserves in barrels of oil equivalent basis attributable to consolidated subsidiaries and joint ventures based on the Group's equity ownership interest in their respective fields have increased by 37.6% during 2012. The increase was primarily due to the first-time appraisal of the reserves of the Salmanovskoye (Utrenneye) and Geofizicheskoye fields acquired in 2011, which also included exploration surveys performed on these fields in 2012, and the acquisition of a 49% equity stake in Nortgas. As we continue to invest capital into the development of our fields, we anticipate that we will increase our resource base as well as migrate reserves among the reserve categories.

The increase in the Group's PRMS probable and possible reserves during 2012 was also primarily due to the appraisal in 2012 of reserves attributable to the Salmanovskoye (Utrenneye) and Geofizicheskoye fields and the acquisition of a 49% equity stake in Nortgas (holder of the production license for the North-Urengoyskoye field).

The Group's reserves are all located in the Russian Federation, in the Yamal-Nenets Autonomous Region (Western Siberia), thereby representing one geographical area.

The below table contains information about reserve/production ratios for the years ended 31 December 2012 and 2011 under both reserves reporting methodologies *based on our equity ownership interest in the fields attributable to consolidated subsidiaries and joint ventures*:

	SEC		PRMS	
	At 31 December:		**At 31 December:**	
Number of years (based on our equity ownership interest in the fields)	**2012**	**2011**	**2012**	**2011**
Total proved reserves to production	31	25	39	30
Total proved and probable reserves to production	-	-	55	40
Total proved, probable and possible reserves to production	-	-	69	51

The increase in our reserve/production ratios was primarily due to an increase in our reserves estimates at 31 December 2012 as compared to 31 December 2011. The increase was mainly attributable to the reserves acquired as previously noted, which more than offset our increase in production.

The Group's oil and gas estimation and reporting process involves an annual independent third party appraisal as well as internal technical appraisals of reserves. The Group maintains its own internal reserve estimates that are calculated by qualified technical staff working directly with the oil and gas properties. The Group periodically updates reserves estimates during the year based on evaluations of new wells, performance reviews, new technical information and other studies.

The Group provides D&M annually with engineering, geological and geophysical data, actual production histories and other information necessary for reserve determinations. The method or combination of methods used in the analysis of each reservoir is tempered by experience with similar reservoirs, stages of development, quality and completeness of basic data, and production history. Our reserves estimates were prepared using standard geological and engineering methods generally accepted in the petroleum industry. The Group's and D&M's technical staffs meet to review and discuss the information provided, and upon completion of the process, senior management reviews and approves the final reserves estimates issued by D&M.

The Reserves Management and Assessment Group ("RMAG") is comprised of qualified technical staff from various departments – geological and geophysical, gas and liquids commercial operations, capital construction, production, financial planning and analysis and includes technical and financial representatives from the Group's subsidiaries, which are the principal holders of the mineral licenses. The person responsible for overseeing the work of the RMAG is a member of the Management Board.

The approval of the final reserve estimates is the sole responsibility of the Group's senior management.

OPERATIONAL HIGHLIGHTS

Oil and Gas Production Costs

Oil and gas production costs are derived from our results of operations for oil and gas producing activities as reported in the *"Unaudited Supplemental Oil and Gas Disclosures"* in our consolidated financial statements and relate to our consolidated subsidiaries. Oil and gas production costs do not include general corporate overheads or their associated tax effects. The following tables set forth certain operating information with respect to our oil and gas production costs during the years presented in millions of Russian roubles and on a boe basis in Russian roubles and US dollars:

millions of Russian roubles	Year ended 31 December: 2012	2011	Change %
Production costs:			
Lifting costs	6,505	5,347	21.7%
Taxes other than income tax	16,546	16,307	1.5%
Transportation expenses	57,888	46,216	25.3%
Total production costs before DDA	**80,939**	**67,870**	**19.3%**
Depreciation, depletion and amortization ("DDA")	10,589	8,937	18.5%
Total production costs	**91,528**	**76,807**	**19.2%**

RR per boe	Year ended 31 December: 2012	2011	Change %
Production costs:			
Lifting costs	17.8	15.5	14.8%
Taxes other than income tax	45.3	47.2	(4.0%)
Transportation expenses	158.4	133.8	18.4%
Total production costs before DDA	**221.5**	**196.5**	**12.7%**
Depreciation, depletion and amortization	29.0	25.9	12.0%
Total production costs	**250.5**	**222.4**	**12.6%**

USD per boe (1)	Year ended 31 December: 2012	2011	Change %
Production costs:			
Lifting costs	0.57	0.53	7.5%
Taxes other than income tax	1.46	1.61	(9.3%)
Transportation expenses	5.09	4.55	11.9%
Total production costs before DDA	**7.12**	**6.69**	**6.4%**
Depreciation, depletion and amortization	0.94	0.88	6.8%
Total production costs	**8.06**	**7.57**	**6.5%**

(1) Production costs in US dollars per boe were translated from Russian roubles per boe using the average exchange rate for the period (see "Selected macro-economic data" above).

Production costs represent the amounts directly related to the extraction of natural gas and liquids, gas condensate and crude oil from the reservoir and other related costs; including production expenses, taxes other than income tax (production taxes), insurance expenses and shipping, transportation and handling costs to end-customers. The average production cost on a barrel of oil equivalent basis is calculated by dividing the applicable costs by the respective barrel of oil equivalent of our hydrocarbons produced during the year. Natural gas, gas condensate and crude oil volumes produced by our fields are converted to a barrel of oil equivalent based on the relative energy content of each fields' hydrocarbons.

Our lifting costs, as presented in the tables above, differ from lifting costs as reflected in the *"Unaudited Supplemental Oil and Gas Disclosures"* in the Group's IFRS consolidated financial statements, in that the lifting costs as presented in the Group's IFRS consolidated financial statements include changes in balances of natural gas and hydrocarbon liquids to more appropriately match costs incurred to revenues under the IFRS matching principles. A reconciliation of lifting costs as reflected in the *"Unaudited Supplemental Oil and Gas Disclosures"* in the Group's IFRS consolidated financial statements is set forth below:

millions of Russian roubles	**Year ended 31 December: 2012**	**2011**	**Change %**
Lifting costs presented in "Oil and Gas Production Costs" above	6,505	5,347	21.7%
Change in balances of natural gas and hydrocarbon liquids stated at cost in the Group's Consolidated Statement of Financial Position	1,094	56	n/a
Lifting costs per "Unaudited Supplemental Oil and Gas Disclosures"	**7,599**	**5,403**	**40.6%**

Hydrocarbon sales volumes

Our natural gas sales volumes increased primarily due to a combination of increased production at our core fields and purchases from our related party OAO SIBUR Holding ("SIBUR"), which were partially offset by an increase in natural gas inventory balances in 2012 as compared to a decrease in 2011. Liquids sales volumes increased due to the initiation of unstable gas condensate purchases from the Group's joint ventures, as well as the increase in crude oil production, which were partially offset by an increase in liquids inventory balances in 2012 as compared to a decrease in 2011. Our liquids inventory balances tend to fluctuate periodically due to loading schedules and final destinations of stable gas condensate shipments.

Natural gas sales volumes

	Year ended 31 December:		**Change**
millions of cubic meters	**2012**	**2011**	**%**
Production from (subsidiaries):			
Yurkharovskoye field	34,054	32,035	6.3%
East-Tarkosalinskoye field	12,742	12,151	4.9%
Khancheyskoye field	3,647	3,263	11.8%
Other fields	64	72	(11.1%)
Total natural gas production	**50,507**	**47,521**	**6.3%**
Purchases from the Group's joint ventures	5,335	5,384	(0.9%)
Total production and purchases from Group's joint ventures	**55,842**	**52,905**	**5.6%**
Other purchases	3,533	841	320.1%
Total production and purchases	**59,375**	**53,746**	**10.5%**
Purovsky Plant, own usage and methanol production	(126)	(109)	15.6%
Decrease (increase) in UGSF, UGSS and own pipeline infrastructure	(369)	30	n/a
Total natural gas sales volumes	**58,880**	**53,667**	**9.7%**
Sold to end-customers	*40,806*	*29,332*	*39.1%*
Sold ex-field	*18,074*	*24,335*	*(25.7%)*

In 2012, our total natural gas production increased by 2,986 mmcm, or 6.3%, to 50,507 mmcm from 47,521 mmcm in 2011 primarily due to increases in production at our core producing fields (Yurkharovskoye, East-Tarkosalinskoye and Khancheyskoye). We were able to increase natural gas production at the Yurkharovskoye field resulting from the field's ongoing development activities and the launch of the fourth stage of the second phase development in October 2012 (see "Recent developments" above). The increase in natural gas production at the East-Tarkosalinskoye and Khancheyskoye fields in 2012 was due to increased demand resulting in a greater utilization of the field's production capacity.

In January 2012, we commenced purchasing natural gas from our related party, SIBUR, and purchased 3,533 mmcm during the year. In December 2011, we purchased 841 mmcm of natural gas from third parties in the Chelyabinsk region, the price of which included the cost of transportation to this region, through our subsidiary Gazprom mezhregiongas Chelyabinsk, a regional gas trader acquired in November 2011. The purchases were made according to pre-existing contractual obligations and, effective January 2012 we did not purchase natural gas under these agreements. Purchases from SIBUR in 2012 and from third parties in 2011 are disclosed as "Other purchases" in the table above.

In 2012, we used 75 mmcm of natural gas as feedstock for the production of methanol compared to 63 mmcm in 2011. A significant portion of the methanol we produce is used for our own internal purposes to prevent hydrate formation (condensation) during the production, preparation and transportation of hydrocarbons.

Liquids sales volumes

thousands of tons	Year ended 31 December: 2012	2011	Change %
Production from (subsidiaries):			
Yurkharovskoye field	2,672	2,718	(1.7%)
East-Tarkosalinskoye field	984	808	21.8%
Khancheyskoye field	518	560	(7.5%)
Other fields	19	25	(24.0%)
Total liquids production	**4,193**	**4,111**	**2.0%**
Purchases from:			
The Group's joint ventures	259	-	n/a
Other	38	6	n/m
Total production and purchases	**4,490**	**4,117**	**9.1%**
Losses and own usage [(1)]	(49)	(37)	32.4%
Decreases (increases) in liquids inventory balances	(238)	31	n/a
Total liquids sales volumes	**4,203**	**4,111**	**2.2%**
Stable gas condensate export	*2,821*	*2,981*	*(5.4%)*
Stable gas condensate domestic	*26*	*3*	*n/m*
Subtotal stable gas condensate	***2,847***	***2,984***	***(4.6%)***
LPG export	*479*	*453*	*5.7%*
LPG CIS	*-*	*1*	*n/a*
LPG domestic	*323*	*336*	*(3.9%)*
LPG sold through domestic retail and small wholesale stations	*103*	*90*	*14.4%*
Subtotal LPG	***905***	***880***	***2.8%***
Crude oil export	*149*	*93*	*60.2%*
Crude oil domestic	*293*	*149*	*96.6%*
Subtotal crude oil	***442***	***242***	***82.6%***
Oil products domestic	*9*	*5*	*80.0%*
Subtotal oil products	***9***	***5***	***80.0%***

[(1)] Losses associated with processing at the Purovsky Plant, as well as during railroad, trunk pipeline and tanker transportation.

In 2012, our liquids production increased by 82 thousand tons, or 2.0%, primarily due to an increase in crude oil production at the East-Tarkosalinskoye field that was partially offset by a decrease in gas condensate production at our core producing fields. Natural declines in the concentration of gas condensate at our mature fields are expected due to decreasing reservoir pressure at the current gas condensate producing horizons.

Starting from 1 November 2012, we commenced purchasing of unstable gas condensate from Nortgas, which became our joint venture from the end of November 2012. Purchases from Nortgas in November 2012 are disclosed as "Other purchases" and purchases in December 2012 are disclosed as "Purchases from the Group's joint ventures" in the table above.

In April 2012, we commenced purchasing unstable gas condensate from our joint venture, SeverEnergia, after the launch of the first phase of Samburgskoye field's development activities.

RESULTS OF OPERATIONS FOR THE YEAR ENDED 31 DECEMBER 2012 COMPARED TO THE YEAR ENDED 31 DECEMBER 2011

The following table and discussion is a summary of our consolidated results of operations for the years ended 31 December 2012 and 2011. Each line item is also shown as a percentage of our total revenues.

	Year ended 31 December:			
millions of Russian roubles	**2012**	**% of total revenues**	**2011**	**% of total revenues**
Total revenues (net of VAT, export duties, excise and fuel taxes)	**210,973**	***100.0%***	**175,273**	***100.0%***
including:				
natural gas sales	142,613	*67.6%*	110,932	*63.3%*
liquids' sales	67,633	*32.1%*	63,879	*36.4%*
Operating expenses	(125,775)	*(59.6%)*	(96,820)	*(55.2%)*
Net gain (loss) on disposal of interest in subsidiaries	(60)	*(0.1%)*	62,948	*35.9%*
Other operating income (loss)	196	*0.1%*	207	*0.1%*
Profit from operations	**85,334**	***40.4%***	**141,608**	***80.8%***
Finance income (expense)	2,986	*1.5%*	(2,703)	*(1.6%)*
Share of profit (loss) of joint ventures, net of income tax	(2,105)	*(1.0%)*	(3,880)	*(2.2%)*
Profit before income tax	**86,215**	***40.9%***	**135,025**	***77.0%***
Total income tax expense	(16,774)	*(8.0%)*	(15,734)	*(8.9%)*
Profit (loss)	**69,441**	***32.9%***	**119,291**	***68.1%***
Non-controlling interest	17	*0.0%*	364	*0.2%*
Profit attributable to shareholders of OAO NOVATEK	**69,458**	***32.9%***	**119,655**	***68.3%***
Normalized profit attributable to shareholders of OAO NOVATEK	**69,518**	***33.0%***	**56,707**	***32.4%***

Total revenues

The following table sets forth our sales (net of VAT, export duties, excise and fuel taxes expense, where applicable) for the years ended 31 December 2012 and 2011:

millions of Russian roubles	Year ended 31 December: 2012	2011	Change %
Natural gas sales	**142,613**	**110,932**	**28.6%**
End-customers	*115,180*	*77,046*	*49.5%*
Ex-field sales	*27,433*	*33,886*	*(19.0%)*
Stable gas condensate sales	**46,684**	**46,778**	**(0.2%)**
Export	*46,365*	*46,732*	*(0.8%)*
Domestic	*319*	*46*	*593.5%*
Liquefied petroleum gas sales	**15,599**	**14,436**	**8.1%**
Export	*9,631*	*8,698*	*10.7%*
CIS	*-*	*10*	*n/a*
Domestic	*5,968*	*5,728*	*4.2%*
Crude oil sales	**5,000**	**2,479**	**101.7%**
Export	*1,785*	*1,021*	*74.8%*
Domestic	*3,215*	*1,458*	*120.5%*
Oil and gas products sales	**350**	**186**	**88.2%**
Domestic	*350*	*186*	*88.2%*
Total oil and gas sales	**210,246**	**174,811**	**20.3%**
Other revenues	727	462	57.4%
Total revenues	**210,973**	**175,273**	**20.4%**

Natural gas sales

In 2012, our revenues from sales of natural gas increased by RR 31,681 million, or 28.6%, compared to 2011 due primarily to an increase in our average realized natural gas price and, to a lesser extent, due to an increase in our total sales volumes. The increase in our average realized natural gas price was driven by a combination of increases in the regulated FTS price tariff for natural gas by 15% effective from 1 July 2012 and in our proportion of end-customer sales to total natural gas sales volumes.

Our proportion of natural gas sold to end-customers to total natural gas sales volumes increased to 69.3% in 2012 as compared to 54.7% in 2011. The increase was due to higher natural gas deliveries to the Chelyabinsk region through our regional natural gas trader acquired in November 2011.

In 2012, our average netback price on end-customers sales, excluding volumes purchased for resale in the location of our end-customers, increased by 11.9% as compared to 2011, while our average realized end-customers sales price increased by 7.4%. The increase in our average realized end-customers sales netback price was primarily due to a 15% increase in the regulated FTS price for natural gas effective from 1 July 2012 combined with a 7% increase in the average transportation tariff set by the FTS effective from 1 July 2012 (see “Transportation tariffs” above). Our average realized ex-field price was higher by 9.1% than in 2011.

Stable gas condensate sales

In 2012, our revenues from sales of stable gas condensate decreased by RR 94 million, or 0.2%, compared to 2011 primarily due to a decrease in volumes sold, that was partially offset by an increase in our average realized prices in Russian roubles.

Our total stable gas condensate sales volumes decreased by 137 thousand tons, or 4.6%, due to a combination of an increase in the stable gas condensate inventory balance in 2012 as compared to a decrease in 2011 (see "Change in natural gas, liquid hydrocarbons and work-in-progress" below) and a decrease in gas condensate production at our core fields, that was partially offset by unstable gas condensate purchases from our joint ventures in 2012. During 2012, we exported 2,821 thousand tons of stable gas condensate, or 99.1% of our total sales volumes, to the APR, Europe, the United States and South America with the remaining 26 thousand tons sold domestically. In 2011, we exported 2,981 thousand tons of stable gas condensate, or 99.9% of our total sales volumes, to the APR, Europe and the United States, with the remaining three thousand tons sold domestically.

In 2012, our average realized net export price for stable gas condensate, excluding export duties and translated to US dollars from Russian roubles using the average annual exchange rate, decreased by USD 4.9 per ton, or 0.9%, to USD 528.5 per ton (CFR, DES, DAP and CIF) from USD 533.4 per ton (CFR, DES, DAP, CIF and DAT) in 2011 due to an increase in average annual exchange rate of Russian rouble against the US dollar approximately by 5.8% in 2012 as compared to 2011, that was partially offset by a 0.4% decrease in our average export duty per ton and an 0.2% increase in our average export contract price in US dollars.

Liquefied petroleum gas sales

In 2012, our revenues from sales of LPG increased by RR 1,163 million, or 8.1%, compared to 2011 due to both increases in our average realized prices and volumes sold.

In 2012, we sold 479 thousand tons of LPG, or 52.9% of our total LPG sales volumes, to export markets as compared to 453 thousand tons, or 51.5%, in 2011. In 2012, as well as in 2011, our export sales volumes of LPG representing greater than 10% of total LPG export volumes were to customers located in Poland and Finland.

Our average realized LPG net export price, excluding export duties, excise and fuel taxes expense and translated to US dollars from Russian roubles using the average annual exchange rate, decreased by USD 6.5 per ton, or 1.0%, to USD 646.8 per ton in 2012 (DAP, CPT and FCA) compared to USD 653.3 per ton in 2011 (DAP, CPT and FCA) primarily due to an increase in the average annual exchange rate of Russian rouble against the US dollar, that was partially offset by a decrease in our average export duty per ton by 3.5%. The reduction in our average contract price by 1.4% was due to a decrease in the underlying benchmark prices on international markets used in the price formulation in 2012 compared to 2011.

In 2012, we sold 426 thousand tons of LPG, or 47.1% of our total LPG sales volumes, on the domestic market at an average price of RR 14,011 per ton (excluding VAT) representing an increase of RR 553 per ton, or 4.1%, compared to 2011.

Crude oil sales

In 2012, our revenues from sales of crude oil increased by RR 2,521 million, or 101.7%, compared to 2011 primarily due to an increase in sales volumes and, to a lesser extent, an increase in our average realized prices. Our crude oil sales volumes increased by 200 thousand tons, or 82.6%, to 442 thousand tons from 242 thousand tons in 2011 due primarily to an increase in crude oil production at our East-Tarkosalinskoye field.

The majority of our crude oil sales volumes, accounting for 66.3% in 2012, were sold domestically at an average price of RR 10,985 per ton (excluding VAT) representing an increase of RR 1,193 per ton, or 12.2%, compared to 2011. The remaining 33.7% of our crude oil volumes were sold to export markets at an average price of USD 383.9 per ton (DAP, excluding export duties) representing an increase of USD 10.2 per ton, or 2.7%, compared to 2011. The increase in the average realized net export price (excluding export duties and translated to US dollars from Russian roubles using the average annual exchange rate) was due to an increase in average annual exchange rate of Russian rouble against the US dollar approximately by 5.8% and a 1.7% decrease in our average export duty per ton.

Oil and gas products sales

Oil and gas products sales include trading operations with oil products on the domestic market through our retail stations and methanol sales to third parties. In 2012, our revenue from sales of oil and gas products increased by RR 164 million, or 88.2%, to RR 350 million from RR 186 million in 2011.

Our revenues from oil products trading operations through our retail stations on the domestic market increased by RR 103 million, or 70.1%, to RR 250 million in 2012 compared to RR 147 million in 2011 primarily due to an increase in volumes sold. In 2012, we sold approximately nine thousand tons of oil products (diesel fuel and petrol) for an average price of RR 29,054 per ton, compared to sales of approximately five thousand tons for an average price of RR 27,232 per ton in 2011.

In 2012, our revenue from methanol sales increased by RR 61 million, or 156.4%, to RR 100 million from RR 39 million in 2011 primarily due to an increase in volumes sold.

Other revenues

Other revenues include geological and geophysical research services, rent, sublease, transportation, handling, storage and other services. In 2012, other revenues increased by RR 265 million, or 57.4%, to RR 727 million from RR 462 million in 2011. The increase was primarily comprised of a RR 162 million increase in revenue from transportation, handling and storage services, as well as a RR 99 million increase in revenues from geological and geophysical research services provided primarily to our joint ventures. In addition, in 2012, we recognized RR 69 million of revenue by re-charging a part of icebreaking expenses to the third parties as compared to RR 131 million of revenue for the sublet of a leased tanker in 2011. The remaining increase of RR 66 million in other revenues was made up of various immaterial items.

Operating expenses

In 2012, our total operating expenses increased by RR 28,955 million, or 29.9%, to RR 125,775 million compared to RR 96,820 million in 2011 primarily due to an increase in transportation expenses and purchases of natural gas and liquid hydrocarbons. As a percentage of total operating expenses, our non-controllable expenses, such as transportation and taxes other than income tax, decreased to 61.8% in 2012 compared to 67.0% in 2011 primarily due to a significant increase in purchases of natural gas from our related party, SIBUR, and purchases of unstable gas condensate from our joint ventures in 2012 (see "Purchases of natural gas and liquid hydrocarbons" below).

In 2012, total operating expenses as a percentage of total revenues increased to 59.6% in 2012 compared to 55.2% in 2011, as shown in the table below. The increase in our operating expenses as a percentage of total revenues was caused by two main reasons. In January 2012, we commenced purchasing natural gas, which included the cost of transportation, for subsequent resale to the regions where our end-customers are located, and there was an increase in the UPT rate for natural gas effective 1 January 2012, while the regulated price for natural gas was increased effective 1 July 2012.

	Year ended 31 December:			
millions of Russian roubles	**2012**	**% of total revenues**	**2011**	**% of total revenues**
Transportation expenses	60,848	*28.8%*	48,329	*27.6%*
Taxes other than income tax	16,846	*8.0%*	16,559	*9.4%*
Subtotal non-controllable expenses	**77,694**	***36.8%***	**64,888**	***37.0%***
Purchases of natural gas and liquid hydrocarbons	17,483	*8.3%*	5,994	*3.4%*
Depreciation, depletion and amortization	11,185	*5.3%*	9,277	*5.3%*
General and administrative expenses	10,936	*5.2%*	8,218	*4.7%*
Materials, services and other	7,216	*3.4%*	5,947	*3.4%*
Exploration expenses	2,022	*1.0%*	1,819	*1.0%*
Net impairment expenses	325	*n/m*	782	*n/m*
Change in natural gas, liquid hydrocarbons and work-in-progress	(1,086)	*n/m*	(105)	*n/m*
Total operating expenses	**125,775**	***59.6%***	**96,820**	***55.2%***

Non-controllable expenses

A significant proportion of our operating expenses are characterized as non-controllable expenses since we are unable to influence the increase in regulated tariffs for transportation of our hydrocarbons or the rates imposed by federal, regional or local tax authorities. In 2012, non-controllable expenses of transportation and taxes other than income tax increased by RR 12,806 million, or 19.7%, to RR 77,694 million from RR 64,888 million in 2011. The change in transportation expenses was primarily due to an increase in the natural gas volumes sold to end-customers in which we incurred transportation expenses, and excluded volumes of natural gas purchased for resale in the location of our end-customers. Taxes other than income tax increased primarily due to an increase in natural gas production volumes, as well as a 5.9% increase in the natural gas production tax rate effective from 1 January 2012 that was partially offset by the application of a zero UPT rate for crude oil from 1 January 2012 (see "Our tax burden" above). As a percentage of total revenues, our non-controllable expenses marginally decreased to 36.8% in 2012 compared to 37.0% in 2011.

Transportation expenses

In 2012, our total transportation expenses increased by RR 12,519 million, or 25.9%, compared to 2011.

million of Russian roubles	Year ended 31 December: 2012	2011	Change %
Natural gas transportation to customers	45,925	34,441	33.3%
Liquid hydrocarbons transportation by rail	10,537	9,791	7.6%
Liquid hydrocarbons transportation by tankers	3,742	3,647	2.6%
Crude oil transportation to customers	527	281	87.5%
Other	117	169	(30.8%)
Total transportation expenses	**60,848**	**48,329**	**25.9%**

In 2012, our transportation expenses for natural gas increased by RR 11,484 million, or 33.3%, to RR 45,925 million from RR 34,441 million in 2011. The change was mainly due to a 30.8% increase in our natural gas sales volumes to end-customers, for which we incurred transportation expense, and excluding volumes of natural gas purchased for resale in the location of our end-customers, as well as a 7% average increase in the natural gas transportation tariff set by the FTS effective 1 July 2012 (see “Transportation tariffs” above). We do not incur transportation expenses in respect of natural gas volumes purchased for resale in the location of our end-customers, as the purchase price includes the cost of transportation. Our average transportation distance for natural gas sold to end-customers fluctuates period-to-period and depends on the location of end-customers and the specific routes of transportation.

In 2012, our total expenses for liquids transportation by rail increased by RR 746 million, or 7.6%, to RR 10,537 million from RR 9,791 million in 2011 due to higher average liquids transportation tariffs that was partially offset by a decrease in our stable gas condensate volumes sold and transported via rail. In 2012, our combined liquids volumes sold and transported via rail decreased by 115 thousand tons, or 3.0%, to 3,749 thousand tons from 3,864 thousand tons in 2011 due primarily to an increase in stable gas condensate inventory balance during 2012 compared to a decrease in 2011. The transportation costs incurred in respect of liquids volumes recognized as part of our inventory balance or in transit are capitalized in current assets as future period expenses until the recognition of such volumes as sold.

In 2012, our weighted average transportation tariff for liquids delivered by rail increased by 11.0% to RR 2,811 per ton from RR 2,533 per ton in 2011 primarily due to a 6.0% increase in rail tariffs for the domestic market set by the FTS effective 1 January 2012, an increase in rail tariffs for LPG transportation on the territory of CIS to export markets and a decrease in stable gas condensate share in total liquids volumes sold and transported via rail. The change in the share of stable gas condensate volumes in our total liquids volumes delivered by rail affects our weighted average rail tariff due to the relatively low transportation expense for stable gas condensate compared to other liquids. Our weighted average transportation tariff for liquids delivered by rail fluctuates period-to-period and depends on products type and the geography of deliveries.

Total transportation expense for liquids delivered by tankers to international markets increased by RR 95 million, or 2.6%, to RR 3,742 million in 2012 from RR 3,647 million in 2011. The increase was due to a change in the mix in geographical regions where we sold our stable gas condensate that was partially offset by a 5.4% decrease in volumes sold as a result of inventory movements and a decrease in unstable gas condensate production. In 2012, we sold 56.4% of our total stable gas condensate export volumes to APR, 28.7% to Europe, 10.6% to the United States and 4.3% to the South America, whereas in 2011, we sold 43.4% to APR, 34.3% to Europe and 22.3% to the United States.

Taxes other than income tax

millions of Russian roubles	Year ended 31 December: 2012	2011	Change %
Unified natural resources production tax	14,833	14,523	2.1%
Property tax	1,754	1,742	0.7%
Other taxes	259	294	(11.9%)
Total taxes other than income tax	**16,846**	**16,559**	**1.7%**

In 2012, taxes other than income tax increased by RR 287 million, or 1.7%, primarily due to an increase in the unified natural resources production tax expense.

In 2012, our UPT expense for natural gas increased by RR 1,446 million, or 12.8%, due to both a 5.9% increase in the natural gas production tax rate effective from 1 January 2012 (from RR 237 per mcm to RR 251 per mcm) and a 6.3% increase in our natural gas production volumes. In addition, our UPT for unstable gas condensate production increased by RR 119 million, or 6.2%, due primarily to a change in the UPT rate (see "Our tax burden" above).

In 2012, we applied a zero UPT rate for crude oil produced at our East-Tarkosalinskoye and Khancheyskoye fields due to changes in the Russian Tax Code effective from 1 January 2012 (see "Our tax burden" above). In 2011, we incurred RR 1,255 million of UPT expense for crude oil produced.

Purchases of natural gas and liquid hydrocarbons

millions of Russian roubles	Year ended 31 December: 2012	2011	Change %
Natural gas	14,706	5,854	151.2%
Unstable gas condensate	2,498	-	n/a
Other liquid hydrocarbons	279	140	99.3%
Total purchases of natural gas and liquids hydrocarbons	**17,483**	**5,994**	**191.7%**

In 2012, our purchases of natural gas and liquid hydrocarbons increased by RR 11,489 million, or 191.7%, to RR 17,483 million from RR 5,994 million in 2011. The increase of RR 8,852 million, or 151.2%, was related to purchases of natural gas, of which the major part related to purchases of natural gas from SIBUR, a related party, commencing from 1 January 2012.

During 2012, we commenced purchasing unstable gas condensate from our joint ventures SeverEnergia and Nortgas, which accounted for RR 2,498 million of total purchases in 2012. We had no purchases of unstable gas condensate in 2011.

In 2012, our purchases of other liquid hydrocarbons increased by RR 139 million, or 99.3%, to RR 279 million from RR 140 million in 2011 due to the expansion of trading activities at our wholly owned subsidiary NOVATEK-AZK. Other liquid hydrocarbons purchases represent our purchases of oil products (diesel fuel and petrol) and LPG.

Depreciation, depletion and amortization

In 2012, our depreciation, depletion and amortization ("DDA") expense increased by RR 1,908 million, or 20.6%, to RR 11,185 million from RR 9,277 million in 2011 as a result of an increase in our depletable cost base, as well as a 5.8% increase in our total hydrocarbon production (excluding our proportionate share in the production of joint ventures) in barrels of oil equivalent basis. The Group accrues depreciation and depletion using the "units of production" method for producing assets and straight-line method for other facilities.

In 2012, our DDA per barrel of oil equivalent was RR 26.4 compared to RR 23.1 in 2011. The increase in our DDA charge calculated on a barrel of oil equivalent basis was due to the capitalization of costs related to the launch of the fourth stage of the second phase development at our Yurkharovskoye field and ongoing crude oil development activities at the East-Tarkosalinskoye field, as well as a decrease in our proved reserves estimates as of 31 December 2012 compared to 31 December 2011, used as the denominator in the calculation of the DDA under the "units of production" method, at our core producing fields.

Our reserve base, used as the denominator in the calculation of the DDA charge under the "units of production" method, is only appraised on an annual basis as of 31 December and does not fluctuate during the year, whereas our depletable cost base does change each quarter due to the ongoing capitalization of our costs throughout the year.

General and administrative expenses

In 2012, our general and administrative expenses increased by RR 2,718 million, or 33.1%, to RR 10,936 million compared to RR 8,218 million in 2011. The main components of these expenses were employee compensation, legal, audit, and consulting services and social expenses and compensatory payments, which, on aggregate, comprised 83.6% and 80.7% of total general and administrative expenses in the years ended 31 December 2012 and 2011, respectively.

millions of Russian roubles	**Year ended 31 December: 2012**	**2011**	**Change %**
Employee compensation	6,869	4,650	47.7%
Legal, audit, and consulting services	1,274	774	64.6%
Social expenses and compensatory payments	1,001	1,212	(17.4%)
Depreciation – administrative buildings	314	198	58.6%
Business trip expenses	292	218	33.9%
Fire safety and security expenses	199	178	11.8%
Repair and maintenance expenses	168	115	46.1%
Rent expense	113	140	(19.3%)
Insurance expense	86	58	48.3%
Bank charges	82	58	41.4%
Other	538	617	(12.8%)
Total general and administrative expenses	**10,936**	**8,218**	**33.1%**

Employee compensation increased by RR 2,219 million, or 47.7%, to RR 6,869 million in 2012 as compared to RR 4,650 million in 2011. The increase was primarily due to an indexation of base salaries by 6.0% effective 1 July 2012, increases in the average number of employees, insurance contributions to the non-budget funds, as well as an increase in bonuses accrued to key management for the results achieved in 2012. The increase in average number of employees resulted from the acquisition of a regional gas trader in November 2011 and the expansion of activities at our Ust-Luga project. Our insurance contributions to the non-budget funds increased in 2012 compared to 2011 due to the change of insurance contributions to the Pension Fund of the Russian Federation effective from 1 January 2012 (see "Our tax burden" above). In addition, our expenses related to defined benefit pension plan increased by RR 401 million in 2012 compared to 2011 primarily due to an indexation of future payments, an increase in number of retirement age employees and the recognition in 2012 of additional lump sum retirement benefits. The aforementioned increases were partially offset by a decrease of RR 114 million in the recognition of charges related to NOVATEK's share-based compensation program for the Group's senior and key management.

Legal, audit, and consulting services expenses increased by RR 500 million, or 64.6%, to RR 1,274 million compared to RR 774 million in 2011 largely due to consulting services related to our recent acquisitions, as well as an increase in services to prolong and acquire software solutions for our core subsidiaries.

In 2012, our social expenses and compensatory payments decreased by RR 211 million, or 17.4%, to RR 1,001 million compared to RR 1,212 million in 2011 primarily due to the fact, that we did not consolidate compensatory payments of Yamal LNG in 2012 as a result of a disposal of a 20% interest in Yamal LNG in October 2011 and the consolidation of the company under the equity method starting from that date. Social expenses and compensatory payments in 2012 were primarily related to our donations to sport clubs and activities, educational schools, as well as continued support for charities and social programs in the regions where we operate. Social expenses and compensatory payments fluctuate period-on-period depending on the funding needs and the implementation schedules of specific programs we support in the regions where we operate.

In 2012, depreciation of administrative buildings increased by RR 116 million, or 58.6%, primarily due to the completion and opening of our new Moscow head-office in May 2011. Fixed assets of administrative nature are depreciated on a straight-line basis over their estimated useful lives.

Fire safety and security expenses increased by RR 21 million, or 11.8%, to RR 199 million in 2012 from RR 178 million in 2011 as a result of the opening of our new Moscow head-office in May 2011, as well as an increase in rates charged for security services.

Repair and maintenance expenses increased by RR 53 million, or 46.1%, to RR 168 million in 2012 from RR 115 million in 2011 primarily due to start of maintenance and repair works of administrative fixed assets rented by our subsidiaries, OOO NOVATEK-Chelyabinsk and NOVATEK-Ust-Luga.

In 2012, our rent expense decreased by RR 27 million, or 19.3%, to RR 113 million from RR 140 million in 2011 primarily due to the relocation of Moscow head-office employees to our new office building in May 2011. The decrease was partially offset by the consolidation of the regional gas trader acquired in November 2011, which rents an office space for its employees and additional office space rented by NOVATEK-Ust-Luga since May 2012.

Insurance expenses increased by RR 28 million, or 48.3%, to RR 86 million in 2012 from RR 58 million in 2011 due to insuring of recently launched fixed assets at our production subsidiaries.

Bank charges increased by RR 24 million, or 41.4%, to RR 82 million in 2012 from RR 58 million in 2011 primarily due to service charges applied to letters of credit, as well as commission services fees charged by banks for the acceptance of payments from residential customers of natural gas at our recently acquired subsidiaries, supplying natural gas in the regional markets.

In 2012, other general and administrative expenses decreased by RR 79 million, or 12.8%, to RR 538 million from RR 617 million in 2011 primarily due to a RR 63 million decrease in expenses related to the termination at the end of 2011 of the concession agreement at El-Arish concession area located in Egypt, which was partially offset by the RR 27 million increase in expenses related to our participation in international economic, geological and oil and gas forums and exhibitions, and RR 19 million increase in expenses related to the advertising. The remaining decrease of RR 62 million was made up of other immaterial expense items of an administrative nature.

Materials, services and other

In 2012, our materials, services and other expenses increased by RR 1,269 million, or 21.3%, to RR 7,216 million compared to RR 5,947 million in 2011. The main components of this expense category were employee compensation and repair and maintenance services, which on aggregate comprised 74.9% and 73.8% of total materials, services and other expenses in 2012 and 2011, respectively.

	Year ended 31 December:		**Change**
millions of Russian roubles	**2012**	**2011**	**%**
Employee compensation	3,808	2,953	29.0%
Repair and maintenance services	1,598	1,435	11.4%
Electricity and fuel	457	405	12.8%
Materials and supplies	412	309	33.3%
Security expenses	271	237	14.3%
Transportation expenses	186	184	1.1%
Processing fees	99	99	0.0%
Other	385	325	18.5%
Total materials, services and other	**7,216**	**5,947**	**21.3%**

Our employee compensation increased by RR 855 million, or 29.0%, to RR 3,808 million compared to RR 2,953 million in 2011. The increase was primarily due to a 6.0% indexation of base salaries effective from 1 July 2012 and an increase in the average number of employees. The increase in the average number of employees was the result of the acquisition of a regional gas trader Gazprom mezhregiongas Chelyabinsk in November 2011 and an expansion of our trading activities at NOVATEK-AZK. In addition, in 2012 our expenses related to defined benefit pension plan increased by RR 232 million as compared to 2011 primarily due to changes in actuarial assumptions, as well as recognition of additional lump sum retirement benefit in 2012.

Repair and maintenance services increased by RR 163 million, or 11.4%, to RR 1,598 million in 2012 compared to RR 1,435 million in 2011. The increase was primarily related to on-going repair works at our wholly owned subsidiaries OOO NOVATEK-Tarkosaleneftegas and the OOO NOVATEK-Purovsky ZPK and was consistent with our ongoing maintenance schedules.

In 2012, electricity and fuel expenses increased by RR 52 million, or 12.8%, to RR 457 million from RR 405 million in 2011. The increase was primarily due to an increase in electricity and fuel volumes used by our production subsidiaries resulting from recently completed infrastructure projects, as well as higher electricity rates in 2012 as compared to 2011.

Materials and supplies expense increased by RR 103 million, or 33.3%, to RR 412 million in 2012 from RR 309 million in 2011 mainly due to an increase in materials used for repair works of our production assets and own rail cars used for transportation of LPG.

Security expenses increased by RR 34 million, or 14.3%, to RR 271 million in 2012 from RR 237 million in 2011 largely due to additional security services related to recently completed infrastructure projects at our production subsidiaries and an increase in security services rates effective from January 2012.

Transportation expenses related to the delivery of materials and equipment to our fields marginally increased by RR two million, or 1.1%, to RR 186 million in 2012 from RR 184 million in 2011.

In 2012, other material, services and other expenses increased by RR 60 million, or 18.5%, to RR 385 million from RR 325 million in 2011 primarily due to increases in ecological and feasibility studies services provided to our production subsidiaries.

Exploration expenses

In 2012, we incurred RR 2,022 million of exploration expenses of which RR 851 million was related to the capitalized cost of two exploratory wells at the West-Urengoyskoye and North-Yubileynoye license areas, written-off in accordance with our successful efforts accounting policy. In addition, we also recognized RR 428 million as exploration expense related to 3-D seismic activities, which were not classified as development costs in accordance with our accounting policy.

In 2011, we incurred RR 1,819 million of exploration expenses of which RR 740 million related to the capitalized cost of three exploratory wells at the Raduzhniy and Yarudeiskiy licence areas, written-off in accordance with our successful efforts accounting policy.

Net impairment expense

In 2012, we recognized net impairment expense of RR 325 million, of which the significant portion was related to the impairment of trade accounts receivable for natural gas sold to small industrial companies and residential customers.

In 2011, we recognized net impairment expense of RR 782 million, of which RR 548 million was related to the write-off of assets at the Middle-Chaselskiy license area and RR 120 million to the impairment of our investments at the El-Arish project.

Change in natural gas, liquid hydrocarbons and work-in-progress

In 2012, we recorded a reversal of RR 1,086 million to change in inventory expense as compared to a reversal of RR 105 million in 2011:

	Year ended 31 December:	
millions of Russian roubles	**2012**	**2011**
Natural gas	(228)	(112)
Stable gas condensate	(897)	91
Other	39	(84)
Increase (decrease) in operating expenses due to change in inventory balances and work-in-progress	**(1,086)**	**(105)**

In 2012, we recorded a reversal to our operating expenses of RR 228 million primarily due to a 369 mmcm increase in our natural gas inventory balance. Our volumes of natural gas injected into Gazprom’s underground gas storage facilities fluctuate period-to-period depending on market conditions, storage capacity constraints and our development plans to sustain and/or grow production during periods of seasonality.

In addition, in 2012, we recorded a reversal of RR 897 million to our operating expenses due to a 233 thousand tons increase in our inventory balance of stable gas condensate in transit and storage and an increase in the cost of stable gas condensate per ton.

The following table highlights movements in our inventory balances:

Inventory balances in transit or in storage	2012 At 31 December	2012 At 1 January	2012 Increase / (decrease)	2011 At 31 December	2011 At 1 January	2011 Increase / (decrease)
Natural gas (millions of cubic meters)	**1,129**	**760**	**369**	**760**	**790**	**(30)**
including Gazprom's UGSF	*1,096*	*732*	*364*	*732*	*761*	*(29)*
Liquid hydrocarbons (thousand tons)	**563**	**325**	**238**	**325**	**356**	**(31)**
including stable gas condensate	*461*	*228*	*233*	*228*	*264*	*(36)*

Net gain (loss) on disposal of interest in subsidiaries

In 2012, we recognized a net loss of RR 60 million on the disposal of the Groups' wholly owned, non-core subsidiary OOO Purovsky Terminal in December 2012.

In 2011, we realized a net gain of RR 62,948 million on the disposal of a 20% equity interest in OAO Yamal LNG to TOTAL S.A., our strategic partner in the Yamal LNG project. The net gain is comprised of a net gain on disposal of RR 28,685 million and a gain of RR 34,263 million due to the revaluation to fair value of our remaining 80% equity interest.

Other operating income (loss)

In 2012, we recognized other operating income of RR 196 million. In October 2012, we commenced trading operations for the purchase and sale of natural gas on the European market. As a result, in the fourth quarter of 2012, we purchased and sold approximately 4.7 terawatt-hours of natural gas. The total effect from natural gas trading operations on the European market and from the changes in fair values of long-term contracts, which were classified as derivative instruments in accordance with IAS 39 *"Financial instruments: recognition and measurement"*, in 2012 resulted in the recognition of net income in the amount of RR 76 million.

The remaining other operating income of RR 120 million was primarily related to penalties charges received from our suppliers due to non-compliance of their contractual obligations and other immaterial profit and loss items.

In 2011, we recognized other operating income of RR 207 million of which RR 192 million related to insurance compensation received in respect of an insured accident in 2010.

Profit from operations

As a result of the factors discussed above, our profit from operations decreased by RR 56,274 million, or 39.7%, to RR 85,334 million in 2012, compared to RR 141,608 million in 2011. Our profit from operations, adjusted for non-recurring transactions, primarily excluding the net gain (loss) on disposal of interest in subsidiaries, increased by RR 6,734 million, or 8.6%, to RR 85,394 million in 2012 from RR 78,660 million in 2011. In 2012, our profit from operations, excluding the net gain (loss) on disposal of interest in subsidiaries, as a percentage of total revenues decreased to 40.5% compared to 44.9% in 2011 primarily due to the commencement in January 2012 of natural gas purchases for resale in the regions where our end-customers are located and the lower trading margins we received for these volumes.

In addition, our operating expenses exceeded the growth rate of our total revenues during the year due primarily to the UPT rate for natural gas, which was increased effective from 1 January 2012, while the regulated price for natural gas was increased effective from 1 July 2012.

Finance income (expense)

In 2012, we recorded net finance income of RR 2,986 million as compared to a net finance expense of RR 2,703 million in 2011 due primarily to the appreciation of the Russian rouble relative to the US dollar in 2012 compared to the depreciation of the Russian rouble relative to the US dollar in 2011.

In 2012, our total accrued interest expense on loans amounted to RR 5,702 million compared to RR 5,422 million in 2011. In 2012 and 2011, we capitalized RR 2,698 and RR 3,709 million, respectively, of interest expense to the cost of our property, plant and equipment construction account in accordance with the Group's accounting policy. In addition, we recognized as part of interest expense RR 232 million and RR 225 million related to the unwinding of the present value discount related to provisions of asset retirement obligations in 2012 and 2011, respectively, and RR 212 million related to the effect of discounting of long-term financial liabilities in 2011.

Interest income decreased by RR 1,661 million, or 49.0%, to RR 1,731 million in 2012 from RR 3,392 million in 2011 due to a decrease in loans provided to our joint ventures. In February 2012, the loan as well as the accrued interest on this loan provided to our joint venture OOO Yamal Development was converted to charter capital.

In 2012, we recorded a net foreign exchange gain of RR 4,491 million compared to a net foreign exchange loss of RR 3,945 million in 2011 due primarily to the revaluation of our US dollar denominated borrowings. The Russian rouble appreciated by 5.7% against the US dollar during 2012 compared to the depreciation of the Russian rouble by 5.6% in 2011. We will continue to record foreign exchange gains and losses each period based on the movements between exchange rates and the currency denomination of our debt portfolio.

Share of profit (loss) of joint ventures, net of income tax

In 2012, our proportionate share of loss of joint ventures decreased to RR 2,105 million compared to a loss of RR 3,880 million in 2011.

In 2012, our proportionate share of loss relating to our joint venture Yamal Development decreased by RR 1,643 million due to the conversion of loans received by the company to charter capital in February 2012, which resulted in a decrease in interest expense.

In 2012, our proportionate share of loss relating to our joint venture Sibneftegas decreased by RR 1,544 million due to increases in natural gas sales prices effective from 1 January and 1 July 2012. The losses we recognized in Sibneftegas were primarily due to the revaluation of oil and gas properties acquired to fair value and the subsequent amortization of those costs under IFRS.

In 2012, we recognized our share of the losses in our joint venture Yamal LNG amounting to RR 1,811 million as compared to a loss of RR 707 million in 2011 due primarily to an increase in compensatory payments related to the Yamal LNG project.

Income tax expense

Our overall consolidated effective income tax rates (total income tax expense calculated as a percentage of our reported IFRS profit before income tax) were 19.5% and 11.7% for the years ended 31 December 2012 and 2011, respectively.

After excluding the effect of 20% disposal of Yamal LNG, the Group's effective income tax rate for the year ended 31 December 2011 was 21.7%. The decrease in the effective income tax rate in 2012 as compared to 2011 was due to the application of a reduced income tax rate of 15.5% in respect of the Group's priority investment project in YNAO.

The Russian statutory income tax rate for both periods was 20%. The difference between our effective and statutory income tax rates is primarily due to certain non-deductible expenses or non-taxable income.

Profit attributable to shareholders and earnings per share

Our profits attributable to shareholders and earnings per share tend to fluctuate periodically due to one-off events or extraordinary items that require adjustments to exclude these events to normalize earnings and to make period-on-period comparisons more meaningful.

As a result of the factors discussed above, our profit for the period decreased by RR 49,850 million, or 41.8%, to RR 69,441 million in 2012 from RR 119,291 million in 2011. The profit attributable to shareholders of OAO NOVATEK decreased by RR 50,197 million, or 42.0%, to RR 69,458 million in 2012 from RR 119,655 million in 2011. The profit attributable to shareholders of OAO NOVATEK, adjusted to exclude the net gain (loss) on disposal of subsidiaries, increased by RR 12,811 million, or 22.6%, to RR 69,518 million in 2012 from RR 56,707 million in 2011.

Our weighted average basic and diluted earnings per share, calculated from the profit attributable to shareholders of OAO NOVATEK, decreased by approximately RR 16.56 per share, or 42.0%, to RR 22.89 per share in 2012 from RR 39.45 per share in 2011. Our weighted average basic and diluted earnings per share, calculated from the profit attributable to shareholders of OAO NOVATEK, adjusted to exclude the net gain (loss) on disposal of subsidiaries, increased by RR 4.22 per share, or 22.6%, to RR 22.91 per share in 2012 from RR 18.69 per share in 2011.

LIQUIDITY AND CAPITAL RESOURCES

The following table shows our net cash flows from operating, investing and financing activities for the years ended 31 December 2012 and 2011:

millions of Russian roubles	Year ended 31 December: 2012	2011	Change %
Net cash provided by operating activities	75,825	71,907	5.4%
Net cash provided by (used in) investing activities	(84,124)	(46,643)	80.4%
Net cash provided by (used in) financing activities	2,603	(11,735)	n/a

Liquidity and credit ratios	31 December 2012	31 December 2011	Change, %
Current ratio	1.06	1.16	(8.6%)
Total debt to total equity	0.45	0.40	12.5%
Long-term debt to long-term debt and total equity	0.25	0.24	4.2%
Net debt to total capitalization (1)	0.26	0.20	30.0%
Net debt to EBITDA (2)	1.20	0.48	150.0%
Net debt to Normalized EBITDA (2)	1.20	0.84	42.9%
Interest coverage ratio (3)	24	42	(42.9%)

(1) Net debt represents total debt less cash and cash equivalents. Total capitalization represents total debt, total equity and deferred income tax liability.

(2) Net debt to EBITDA and to Normalized EBITDA ratios are calculated as Net debt divided by EBITDA or Normalized EBITDA for the last twelve months.

(3) Interest coverage ratio is calculated as Normalized EBITDA divided by interest expense, including capitalized interest, less interest income from the Consolidated Statement of Income.

Net cash provided by operating activities

In 2012, our net cash provided by operating activities increased by RR 3,918 million, or 5.4%, to RR 75,825 million compared to RR 71,907 million in 2011 mainly due to higher natural gas sales volumes and prices that was partially offset by an increase in income tax payments.

Net cash provided by (used in) investing activities

In 2012, our net cash used in operating activities increased by RR 37,481 million, or 80.4%, to RR 84,124 million compared to RR 46,643 million in 2011, due primarily to the payment for shares of our joint venture Nortgas, which was acquired in November 2012, as well as an increase in our cash used for purchases of property, plant and equipment and ongoing development activities at our fields.

Net cash provided by (used in) financing activities

In 2012, our net cash provided by financing activities was RR 2,603 million compared to net cash used in financing activities of RR 11,735 million in 2011. In 2012, cash provided by new borrowings increased by RR 32,564 million to RR 81,149 million from RR 48,585 million in 2011, which was partially offset by an increase in repayment of debts by RR 10,539 million from RR 29,873 million in 2011 to RR 40,412 million in 2012. Our cash used to pay dividends increased by RR 4,552 million in 2012 compared to 2011. The remaining change was related to repayment of interest on debts and other miscellaneous categories.

Working capital

Our net working capital position (current assets less current liabilities) at 31 December 2012 was a positive RR 3,113 million compared to RR 8,202 million at 31 December 2011. The change of our net working capital position was primarily due to the increase in the current portion of long-term debt as of 31 December 2012. In February 2013, the Group issued four-year, Russian rouble denominated Eurobonds in the amount of RR 14 billion the proceeds from which were used to refinance our current portion of long-term debt (see "Debt obligations" below).

The Group's management believes that it presently has and will continue to have the ability to generate sufficient cash flows (from operating and financing activities) to repay all current liabilities and to finance the Group's capital construction programs.

Capital expenditures

Our total capital expenditures on property, plant and equipment for the years ended 31 December 2012 and 2011 were as follows:

millions of Russian roubles	Year ended 31 December: 2012	2011	Change %
Capital expenditures	43,554	31,161	39.8%
Prepayments for participation in tender for mineral licenses per consolidated statement of cash flows	-	6,870	n/a
Total additions to property, plant and equipment per Note "Property, plant and equipment" in the Group's IFRS Consolidated Financial Statements	**43,554**	**38,031**	**14.5%**

Our total capital expenditures (including capitalized 3-D seismic surveys) represent our investments in developing our oil and gas properties. The following table shows the expenditures at our main fields and processing facilities for the years ended 31 December 2012 and 2011:

millions of Russian roubles	Year ended 31 December: 2012	2011
Yurkharovskoye field	14,067	11,403
Gas Condensate Fractionation Complex and Transshipment Facility (Ust-Luga)	11,801	3,923
East-Tarkosalinskoye field	7,157	2,430
Purovsky Plant	1,443	1,369
Khancheyskoye field	1,017	612
North-Khancheyskiy license area	982	147
Salmanovskoye (Utrenneye) field	819	-
North-Russkiy license area	657	574
Olimpiyskiy license area	599	345
Geofizicheskoye field	343	30
West-Urengoiskiy license area	327	515
North-Yamsoveiskiy license area	316	169
South-Tambeyskoye field	-	4,148
Other	4,026	5,496
Capital expenditures	**43,554**	**31,161**

Total capital expenditures on property, plant and equipment in 2012 increased by RR 12,393 million, or 39.8%, to RR 43,554 million from RR 31,161 million in 2011. The increase was primarily related to the construction of processing assets at Ust-Luga, ongoing development activities and the launch of the fourth stage of the second phase development at our Yurkharovskoye field, as well as further field development on the crude oil layers at the East-Tarkosalinskoye and Khancheyskoye fields. The increase was partially offset by the fact, that we did not consolidate capital expenditures related to South-Tambeyskoye field in 2012 as a result of the disposal of a 20% equity interest in Yamal LNG in October 2011, which is accounted for under the equity method starting from that date.

Debt obligations

We utilize a variety of financial instruments to ensure the flexibility of our financing strategy. This includes maintaining a debt portfolio with a balance of short-term and long-term financing, a mix of fixed and floating interest rate instruments and a debt portfolio denominated in either Russian roubles or US dollars.

Subsequent events

In February 2013, the Group placed Russian rouble denominated Eurobonds in the amount of RR 14 billion with a four-year maturity and an annual coupon rate of 7.75%.

In February 2013, we repaid a RR 15 billion loan from OAO Sberbank ahead of its maturity schedule.

In March 2013, we repaid a USD 200 million loan from OAO Nordea Bank ahead of its maturity schedule.

Overview

Our total debt increased from RR 95,478 million at 31 December 2011 to RR 132,487 million at 31 December 2012, or by RR 37,009 million. We periodically utilize credit facilities to supplement our internally generated cash flows for the financing of capital expenditures related to the development of our fields and to construct and/or expand processing assets such as the Purovsky Plant and Ust-Luga, as well as acquisitions of new oil and gas assets. The increase in our total debt was largely due to the placement of a ten-year, US dollar denominated Eurobond in December 2012 to finance the Nortgas acquisition.

Our total debt position (net of unamortized transaction costs) at 31 December 2012 and 31 December 2011 was as follows:

Facility	Amount	Maturity	Interest rate	Year ended 31 December: 2012	2011
Eurobonds Ten-Year	USD 1 billion	December 2022	4.422%	30,232	-
Russian rouble Bonds	RR 20 billion	October 2015	8.35%	19,969	-
Eurobonds Ten-Year	USD 650 million	February 2021	6.604%	19,620	20,776
Eurobonds Five-Year	USD 600 million	February 2016	5.326%	18,146	19,206
Sberbank	RR 15 billion	December 2013	7.5%	14,984	14,966
Russian rouble Bonds	RR 10 billion	June 2013	7.5%	9,991	9,971
Sberbank	RR 10 billion	December 2014	8.9%	9,837	-
Nordea Bank	USD 200 million	November 2013	LIBOR+1.9%	6,075	6,439
Sumitomo Mitsui (1)	USD 300 million	December 2013	LIBOR+1.45%	3,633	7,685
UniCredit Bank	USD 200 million	October 2012	LIBOR+3.25%	-	6,435
Gazprombank (2)	RR 10 billion	November 2012	8.0%	-	10,000
Total				**132,487**	**95,478**

(1) Sumitomo Mitsui Banking Corporation Europe Limited.
(2) The loan from OAO Gazprombank was repaid ahead of maturity schedule in January 2012.

Maturities of long-term loans

Scheduled maturities of our long-term debt at 31 December 2012 were as follows:

Maturity schedule:	RR million
1 January to 31 December 2014	9,837
1 January to 31 December 2015	19,970
1 January to 31 December 2016	18,146
1 January to 31 December 2017	-
After 31 December 2017	49,852
Total long-term debt	**97,805**

Available credit facilities

At 31 December 2012, the Group had available funds under short-term credit lines in the form of bank overdrafts with various international banks in the aggregate amount of RR 7,327 million (USD 175 million and EUR 50 million) on variable interest rates subject to the specific type of credit facility.

At 31 December 2012, the Group also had funds available under credit facilities with interest rates predetermined or negotiated at time of each withdrawal:

		Expiring	
	Par value	**Within one year**	**Between 1 and 3 years**
BNP PARIBAS Bank	USD 100 million	3,037	-
Credit Agricole Corporate and Investment Bank	USD 100 million	3,037	-
UniCredit Bank	USD 350 million	-	10,630
Sberbank [(1)]	RR 30 billion	30,000	-
Total available credit facilities		**36,074**	**10,630**

(1) The period of availability of the credit line facility ended 31 January 2013.

Management believes it has sufficient internally generated cash flows, as well as access to available external borrowings (both short- and long-term) to fund its capital expenditure program, service its existing debt and meet its current obligations as they become due.

QUALITATIVE AND QUANTITATIVE DISCLOSURES AND MARKET RISKS

We are exposed to market risk from changes in commodity prices, foreign currency exchange rates and interest rates. We are exposed to commodity price risk as our prices for crude oil and stable gas condensate destined for export sales are linked to international crude oil prices and other benchmark price references. We are exposed to foreign exchange risk to the extent that a portion of our sales, costs, receivables, loans and debt are denominated in currencies other than Russian roubles. We are subject to market risk from changes in interest rates that may affect the cost of our financing. From time to time we may use derivative instruments, such as commodity forward contracts, commodity price swaps, commodity options, foreign exchange forward contracts, foreign currency options, interest rate swaps and forward rate agreements, to manage these market risks, and we may hold or issue derivative or other financial instruments for trading purposes.

Foreign currency risk

Our principal exchange rate risk involves changes in the value of the Russian rouble relative to the US dollar. As of 31 December 2012, the total amount of our long-term debt denominated in US dollars was RR 67,987 million, or 51.3% of our total borrowings at that date. Changes in the value of the Russian rouble relative to the US dollar will impact our foreign currency-denominated costs and expenses and our debt service obligations for foreign currency-denominated borrowings in Russian rouble terms, as well as receivables at our foreign subsidiaries. We believe that the risks associated with our foreign currency exposure are partially mitigated by the fact that a portion of our total revenues, approximately 24.8% in 2012, is denominated in US dollars. As of 31 December 2012, the Russian rouble appreciated by approximately 5.7% against the US dollar since 31 December 2011.

A hypothetical and instantaneous 10% depreciation in the Russian rouble in relation to the US dollar as of 31 December 2012 would have resulted in an estimated non-cash foreign exchange loss of approximately RR 7,771 million on foreign currency denominated borrowings held at that date.

Commodity risk

Substantially all of our crude oil, stable gas condensate and LPG export sales are sold under spot market contracts, and our export prices are primarily linked to international crude oil prices. External factors such as geopolitical developments, natural disasters and the actions of the Organization of Petroleum Exporting Countries affect crude oil prices and thus our export prices.

The weather is another factor affecting demand for natural gas. Changes in weather conditions from year to year can influence demand for natural gas and to some extent gas condensate and oil products.

From time to time we may employ derivative instruments to mitigate the price risk of our sales activities. In our consolidated financial statements all derivative instruments are recorded at their fair values. Unrealized gains or losses on derivative instruments are recognized within other operating income (loss), unless the underlying arrangement qualifies as a hedge.

The Group purchases and sells natural gas on the European market under long-term contracts based on formulas with reference to benchmark natural gas prices quoted for the North-Western European natural gas hubs, crude oil and oil products prices and/or a combination thereof. Therefore, the Group’s financial results from natural gas trading activities are subject to commodity price volatility based on fluctuations or changes in the respective benchmark reference prices.

Pipeline access

We transport substantially all of our natural gas through the Unified Gas Supply System (“UGSS”) owned and operated by OAO Gazprom, which is responsible for gathering, transporting, dispatching and delivering substantially all natural gas supplies in Russia. Under existing legislation, Gazprom must provide access to the UGSS to all independent suppliers on a non-discriminatory basis provided there is capacity available that is not being used by Gazprom. In practice, Gazprom exercises considerable discretion over access to the UGSS because it is the sole owner of information relating to capacity. There can be no assurance that Gazprom will continue to provide us with access to the UGSS; however, we have not been denied access in prior periods.

Ability to reinvest

Our business requires significant ongoing capital expenditures in order to grow our production and meet our strategic plans. An extended period of reduced demand for our hydrocarbons available for sale and the corresponding revenues generated from these sales would limit our ability to maintain an adequate level of capital expenditures, which in turn could limit our ability to increase or maintain current levels of production and deliveries of natural gas, gas condensate, crude oil and other associated products; thereby, adversely affecting our financial and operating results.

Off balance sheet activities

As of 31 December 2012, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which are typically established for the purpose of facilitating off-balance sheet arrangements.