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 December 31, 2004, 2003 and 2002 and the years then ended in conjunction with our audited financial statements as of and for the years ended December 31, 2004 and 2003 included elsewhere herein. All RR amounts related to financial information for periods prior to 2003 are expressed in constant RR as of December 31, 2002 purchasing power, unless otherwise noted. As the characteristics of the economic environment of the Russian Federation indicate that hyperinflation has ceased, effective from January 1, 2003, we no longer apply the provisions of IAS 29, "Financial Reporting in Hyperinflationary Economies." Accordingly, no adjustment for the effects of changes in general purchasing power has been made for periods starting from January 1, 2003. The U.S. dollar amounts, except as indicated, have been translated from the RR amounts at the rate of RR27.75 = U.S.$1.00, which was the rate published by the CBR on December 31, 2004.

Overview

We are the world's largest natural gas company, and the world's largest publicly-traded hydrocarbons company, in terms of reserves, transportation and production volumes. Our revenues are primarily derived from sales of natural gas to western and central Europe, Russia and other former Soviet Union countries.

We divide our operations into the following four main business segments:

- Production: exploration, development and production operations relating to natural gas and other hydrocarbons.
- Refining: processing and refining of natural gas, gas condensate and other hydrocarbons, and sale of hydrocarbon products.
- Transportation: transportation of natural gas through the world's largest high-pressure trunk pipeline system (152,800 km). We own and operate a single centrally controlled system for natural gas production, processing, transportation, storage and deliveries. Beginning in the late 1990s, we began acquiring interests in gas distribution companies that own and operate medium- and low-pressure pipelines.
- Distribution: domestic and export sale of natural gas. We are the world's largest exporter of natural gas.

Other businesses primarily comprise banking, insurance, construction and media. These businesses are not separately reflected in our financial statements because they do not represent individually material segments.

Our four main business segments are mutually dependent, with a significant portion of the revenues of one segment comprising a part of the costs of another segment. In particular, our Distribution and Refining segments purchase natural gas from our Production segment and transportation services from our Transportation segment. We establish internal transfer prices with reference to the specific funding requirements of the individual subsidiaries within each segment. Accordingly, the results of operations of these segments on a stand-alone basis do not necessarily represent that segment's underlying financial position and results of operations as if it were a stand-alone business. For this reason, we do not analyze any of our main segments separately in the discussion that follows.

Critical Accounting Policies

Our financial statements reflect the selection and application of accounting policies that require management to make significant estimates and assumptions. We believe that the following are the most critical accounting policies that currently affect our financial condition and results of operations.

Gas and oil exploration and production activities

Gas and oil exploration and production activities are accounted for in accordance with the successful efforts method as it provides timely accounting of the success or failure of our exploration and production activities. Under the successful efforts method, costs of successful development and exploratory wells are capitalized. Costs of unsuccessful exploratory wells are expensed upon determination that the well does not justify commercial development. Other exploration costs are expensed as incurred.

Assets associated with exploration and production activities are depreciated on a straight-line basis calculated on the basis of cost. IFRS do not specifically require the use of the units-of-production method for the depreciation, depletion and amortization of gas production assets, primarily because there is no specific accounting standard for the depreciation of oil and gas producing assets. In making our estimates of depreciation, and considering the corresponding asset lives, we include in proved reserves those reserves that relate to quantities that will be produced beyond the initial license period date in circumstances where we have both the right to request and the intent to renew the license. A significant increase or decrease in reserves or the terms of our licenses could result in shorter or longer estimated useful lives for depreciation of assets.

Impairment provision for accounts receivable

The impairment provision for accounts receivable is based on our assessment of the collectibility of specific customer accounts. If there is deterioration in a major customer's creditworthiness or actual defaults are higher than our estimates, the actual results could differ from these estimates.

Impairment of other assets and accounting for provisions

At each balance sheet date we assess whether there is any indication that the recoverable amount of our assets has declined below the carrying value. The recoverable amount is the higher of an asset's fair value less costs to sell and its value in use. When such a decline is identified, the carrying amount is reduced to the recoverable amount. The amount of the reduction is recorded in the consolidated statement of operations in the period in which the reduction is identified. If conditions change and management determines that the asset value has increased, the impairment provision will be fully or partially reversed.

Our accounting for impairment includes provisions against capital construction projects, investments, other long-term assets and inventory obsolescence. The provisions for liabilities and charges primarily include provisions for environmental and pension liabilities. We record impairment or accrue these provisions when our assessments indicate that it is probable that a liability has been incurred or an asset will not be recovered, and an amount can be reasonably estimated. Our estimates for provisions for liabilities and charges are based on currently available facts and our estimates of the ultimate outcome or resolution of the liability in the future. Actual results may differ from our estimates, and our estimates can be revised in the future, either negatively or positively, depending upon the outcome or expectations based on the facts surrounding each exposure.

Because of our operating cycle, certain significant decisions about capital construction projects are made after the end of our fiscal year. Accordingly, we typically have larger impairment charges or releases in the fourth quarter of our fiscal year as compared to other quarters. For example, in 2004 we recorded a fourth quarter impairment provision release of RR4,529 million related to assets under construction compared to a RR178 million impairment provision for the first nine months of 2004. In 2003 we recorded a fourth quarter impairment provision release of RR5,701 million related to assets under construction compared to a RR3,923 million impairment provision for the first nine months of 2003. In 2002 we recorded a fourth quarter impairment provision release of RR6,883 million related to assets under construction compared to a nil impairment provision for the first nine months of 2002.

Interest costs on borrowings

We capitalize interest costs on borrowings for qualifying assets as part of the cost of assets under construction during the period required to prepare the assets for their intended use. All other borrowing costs are expensed. IFRS permits but does not require the capitalization of borrowing costs for qualifying assets. We capitalize borrowing costs that relate to funds borrowed specifically for, and funds borrowed generally and deemed to be used for, the purpose of assets under construction. For general borrowings, the borrowing costs eligible for capitalization are determined by applying a capitalization rate to the cumulative expenditures on assets under construction. This rate represents the weighted average of the borrowing costs applicable to the general borrowings. The amount of interest costs capitalized is primarily affected by the level of capital expenditures for assets under construction, interest rates and total borrowings.

Tax contingencies

Russian tax and customs legislation is subject to varying interpretations and changes, which can occur frequently. Our interpretation of such legislation as applied to the transactions and activity of the Group may be challenged by the relevant regional and federal authorities. Recent events within the Russian Federation suggest that the tax authorities may be taking a more assertive position in their interpretation of the legislation and assessments, and it is possible that transactions and activities that have not been challenged in the past may be challenged in the future. As a result, significant additional taxes, penalties and interest may be assessed. Fiscal periods remain open to review by the authorities in respect of taxes for three calendar years preceding the year of review. Under certain circumstances reviews may cover longer periods. Where we believe it is probable that our interpretation of the relevant legislation and our tax and customs positions cannot be sustained, an appropriate amount is accrued for in the IFRS financial information.

Site restoration and environmental costs

Site restoration costs that may be incurred by us at the end of the operating life of certain of our facilities and properties are recognized when we have a present legal or constructive obligation as a result of past events, and it is probable that an outflow of resources will be required to settle the obligation, and a reliable estimate of the amount of the obligation can be made. The cost is depreciated through our statement of income on a straight-line basis over the asset’s productive life.

IFRS prescribes the recording of liabilities for these costs. Estimating the amounts and timing of those obligations that should be recorded requires significant judgment. This judgment is based on cost and engineering studies using currently available technology and is based on current environmental regulations. Liabilities for site restoration are subject to change because of change in laws and regulations, and their interpretation.

Recent accounting pronouncements

During the period from December 2003 to December 2004, the International Accounting Standards Board (“IASB”) revised a number of its existing standards and issued a number of new standards. These standards are effective for accounting periods commencing on or after January 1, 2005 but may be adopted early. We have not adopted early these revised and new standards in preparing the consolidated financial statements as of and for the year ended December 31, 2004, except for IFRS 3 “Business Combinations,” IAS 36 (revised 2004) “Impairment of Assets” and IAS 38 (revised 2004) “Intangible Assets,” none of which had a significant impact on our results of operations or financial position.

Certain Factors Affecting our Results of Operations

The primary factor that affects our results of operations is the price for which we can sell our natural gas and other hydrocarbon products, both internationally and in Russia. Other factors affecting our results are:

- the impact of fluctuations in RR exchange rates against the U.S. dollar and euro and, prior to 2003, of changes in the purchasing power of the RR resulting from inflation in Russia;
- our high historically tax burden;
- interest rates;
- non-cash settlements; and

- impairment of assets.

The export price of natural gas

Our results of operations are heavily reliant on natural gas export prices. U.S. dollar prices for the natural gas we export declined during the first six months of 2002, increased for the last six months of 2002 and in 2003 and 2004, and have continued to increase in 2005. Export gas prices to European countries are indexed mainly to oil product prices as stipulated in long-term contracts and, therefore, fluctuate based on world oil prices. Due to the formulae underlying our long-term contracts, our prices are not as volatile on a short-term basis as spot oil prices and tend to lag upward and downward movements in oil product prices by approximately six to nine months.

Our business requires significant ongoing capital expenditures in order to maintain our production and transportation systems. An extended period of low gas prices would limit our ability to maintain an adequate level of capital expenditures, which in turn could limit our ability to maintain current levels of production and deliveries of gas, thereby adversely affecting our results.

The European Union Gas Directive of June 22, 1998, and the new Gas Directive of June 26, 2003 that replaced it, have established common rules for the transmission, distribution, supply and storage of natural gas in the European market and may cause substantial changes to existing European market structures and to the overall level and volatility of prices.

Natural gas export prices for sales to FSU countries are generally based on one-year fixed price contracts. Average natural gas export prices to FSU countries are more than 50% below the level of those for European countries. This is partly due to lower transportation costs and excise tax burdens but is principally due to the impact of intergovernmental agreements, which effectively limit the prices we can charge to FSU countries.

The weather is another factor affecting demand for and, therefore, the price of 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.

We do not enter into any significant hedging arrangements to mitigate the price risk of our sales activities.

The following table shows our average natural gas export price to Europe and FSU countries for the years ended December 31, 2004, 2003 and 2002 (including excise tax, customs duties and net of VAT):

	Year ended December 31,		
	2004	**2003**	**2002**
	(Including excise tax and customs duties, net of VAT)		
Our natural gas export price to Europe (average actual realized U.S.$ per mcm)[(1)]	137.7	131.6	107.8
Our natural gas export price to Europe (average actual realized U.S.$ per mcf)[(1)]	3.9	3.7	3.1
Our natural gas export price to Europe (average nominal RR per mcm, except for 2002 amount which is in constant RR)	3,967.4	4,037.9	3,536.6
Our natural gas export price to FSU countries (average actual realized U.S.$ per mcm)[(2)]	46.7	43.6	48.0
Our natural gas export price to FSU countries (average actual realized U.S.$ per mcf)[(2)]	1.3	1.2	1.4
Our natural gas export price to FSU countries (average nominal RR per mcm, except for 2002 amount which is in constant RR)	1,345.8	1,336.7	1,525.9

Notes:

(1) Average actual realized nominal prices and not convenience translations of constant RR prices.

(2) Average actual realized nominal prices and not convenience translations of constant RR prices, except sales to Belarus, which are made in RR and for the purposes hereof converted to dollars at the end of each month at the exchange rate then in effect.

Regulation of domestic natural gas prices and transportation tariffs

Natural gas prices and transportation tariffs in Russia are regulated by the Natural Monopoly Law and the Gas Supply Law, as well as by a number of supplemental Government resolutions, and do not currently fluctuate based on supply and demand. The Federal Tariffs Service ("FTS"), which was, prior to March 2004, called the Federal Energy Commission of the Russian Federation, regulates natural monopolies, including the establishment and regulation of natural gas prices and transportation tariffs.

Natural gas prices in Russia have remained significantly below export prices (even after netting back export tariffs and transportation costs) primarily due to Governmental regulation by the FTS. Since 1997 the FTS has reset domestic gas tariffs at rates that, on a cumulative basis, failed to recover fully the effects of inflation. As of December 31, 2004, the domestic natural gas price was 269% higher in nominal RR terms than in 1997, whereas cumulative inflation over the period from December 31, 1997 to December 31, 2004 was 418%.

Since 2000, however, domestic natural gas prices have increased at a rate greater than inflation. Our average domestic natural gas sales prices were equivalent to RR826.2 per mcm in 2004, RR669.9 per mcm in 2003 and RR535.7 per mcm in 2002, all expressed in nominal RR, except for 2002 data which is in constant RR.

The following table shows our average domestic natural gas price (including excise tax and net of VAT) for the years ended December 31, 2004, 2003 and 2002:

	Year ended December 31,		
	2004	2003	2002
	(Including excise tax, net of VAT)		
Our domestic natural gas price (average nominal RR per mcm, except for 2002 amount which is in constant RR)	826.2	669.9	535.7 (1)
Our domestic natural gas price (average nominal RR per mcf, except for 2002 amount which is in constant RR)	23.4	19.0	15.2 (1)
Our domestic natural gas price (average U.S.$ per mcm)(2)	28.7	21.8	16.0
Our domestic natural gas price (average U.S.$ per mcf) (2)	0.8	0.6	0.5

Notes:

(2) Prices in nominal RR for 2002 were RR505.0 per mcm and RR14.3 per mcf, respectively.

(2) Translated from average actual realized RR price for convenience only using period-end exchange rates.

The Government has allowed domestic gas prices to increase and may continue to do so in the foreseeable future. The Government is considering the introduction of an unregulated wholesale domestic market where some natural gas can be sold at prices determined by market forces. However, concerns about inflation and political considerations constrain the Government's ability to move rapidly in this direction. For example, we proposed that natural gas prices should increase by 38% on average in 2003 (40% for industrial consumers and 20% for household consumers), but the Government approved an average increase of only 20% (a 20% increase for industrial consumers commencing January 1, 2003 and a 23% increase for household consumers commencing February 1, 2003). Prices for both industrial and household consumers were increased by a further 20% with effect from January 1, 2004, prices for industrial consumers were increased by a further 22% with effect from January 1, 2005 and prices for household consumers were increased by a further 24% with effect from January 1, 2005 and a further 8% with effect from April 1, 2005. We have proposed a further 22% price increase for 2006. The Government is currently recommending an increase of 11% in 2006, 8% in 2007 and 7% in 2008. We believe that this rate of increase is insufficient to support efficient supplies of natural gas and further price increases are required in order to reach economically sustainable levels. We believe that further increases in regulated domestic natural gas prices are necessary to provide adequate financing for investment in developing new natural gas fields and our transportation network, establishing the conditions for a competitive domestic fuel market and encouraging consumers to adopt energy-saving technologies and equipment.

During the years ended December 31, 2004, 2003 and 2002 our sales revenues derived from transportation tariffs arising from the transport of gas produced by third parties were relatively small, though increasing.

Impact of fluctuations in RR exchange rates against the U.S. dollar and the euro and of change in purchasing power of the RR

Impact of inflation and changes in exchange rates on export sales and operating margins. 57%, 63% and 64% of our gross sales (including excise tax and net of VAT and customs duties) for the years ended December 31, 2004, 2003 and 2002, respectively, were denominated in U.S. dollars or euro, while most of our costs were denominated in RR. The relative movements of inflation and exchange rates therefore significantly affect our results of operations. In particular, our operating margins are generally adversely affected by appreciation of the RR against the U.S. dollar or euro, because this will generally cause our costs to increase relative to our sales revenues. The pressure on operating margins arising from RR appreciation is intensified by the relatively high inflation rate in Russia, which can further increase our costs, though this can be offset by domestic price rises when permitted by the FTS. Conversely, our operating margins are generally positively affected by depreciation of the RR against the U.S. dollar or euro, because this will generally cause our costs to decrease relative to our sales revenues.

The following table sets forth the rates of inflation in Russia, the rates of nominal appreciation or depreciation of the RR against the U.S. dollar and euro (calculated using the exchange rates at the end of each period) and the rates of real change in the value of the RR against the U.S. dollar and euro for the periods shown:

	Year ended December 31,		
	2004	**2003**	**2002**
Inflation (CPI)	11.7%	12.0%	15.1%
Nominal (appreciation) depreciation of the RR against the U.S.$	(5.8)%	(7.3)%	5.4%
Real appreciation of the RR against the U.S.$	18.6%	20.9%	9.2%
Nominal depreciation of the RR against the euro	2.7%	11.2%	25.0%
Real appreciation (depreciation) of the RR against the euro	8.8%	0.7%	(7.9)%

Impact of inflation accounting and presentation in our financial statements of constant RR. Until December 31, 2002, our financial results, including comparatives, include a restatement for changes in the general purchasing power of the RR in accordance with IAS 29. IAS 29 requires that financial statements prepared in the currency of a hyperinflationary economy be stated in terms of the measuring unit current at the balance sheet date. The restatement is calculated from the conversion factors derived from the Russian Federation Consumer Price Index, published by the Russian State Committee on Statistics ("Goskomstat"), and from indices obtained from other published sources for years prior to 1992. As the Russian economy is no longer considered to be hyperinflationary, from January 1, 2003, we no longer apply IAS 29.

The impact of stating our financial information in terms of the measuring unit current at the balance sheet dates, prior to and as of December 31, 2002, was to:

- inflate the current period transactions recorded in the statement of operations of the local statutory books by the average rate of inflation for the period in order to state them in terms of the purchasing power of the RR as of the balance sheet date (i.e., using the average inflation factor of 1.0638 for all relevant transactions in the year ended December 31, 2002); and

- restate the period end non-monetary assets and liabilities and shareholders' equity, including share capital, in terms of the measuring unit current as of the period-end.

Impact of Monetary Effects. Our results of operations were also substantially affected prior to 2003 by the impact of nominal devaluation and inflation on the value of our monetary assets and liabilities. Nominal devaluation of the RR generally resulted in foreign exchange gains on monetary assets denominated in foreign currencies and foreign exchange losses on monetary liabilities denominated in foreign currencies. These gains and losses were recorded on a net basis in our statements of operations under the caption "Exchange gain (loss)." Inflation resulted in purchasing-power gains on monetary liabilities and purchasing power losses on monetary assets; because our financial statements for periods and as of dates prior to 2003 are price-level restated, these gains and losses are recorded on a net basis in our statements of operations for periods prior to 2003 under the caption "Monetary gain." There was no monetary gain for the years ended December 31, 2004 and 2003 as the characteristics of the economic environment of the Russian Federation indicated that hyperinflation had ceased, and effective from January 1, 2003 we no longer apply the provisions of IAS 29. Accordingly, no adjustments for the effects of changes in general purchasing power are recorded in the financial statements beginning January 1, 2003.

Our historically high tax burden

We are subject to a wide range of taxes imposed at federal, regional, and local levels and are one of the largest sources of tax revenue to the federal authorities in Russia, as well as to the regional and local authorities in those regions and localities in which we operate. The combination of political pressure on the federal, regional and local authorities to address social and economic issues and the difficulties associated with collecting taxes from companies and enterprises in financial difficulties, all increase the risk that the Government, as well as regional and local governments, will seek to mitigate these problems by increasing our already substantial tax burden.

Given the relative size of our activities in Russia, our tax burden is largely determined by the taxes payable in Russia.

In addition to profits tax, we are subject to a number of other taxes in Russia, many of which are based on revenue or volumetric measures. Natural resources production tax for gas is calculated based on the volume of natural gas produced and for gas condensate based on the revenue generated from exploration and production activities. Social taxes and contributions are a function of salaries and wages. Significant taxes to which we have been subject in the period under review include:

- excise tax (abolished effective January 1, 2004 for gas produced after January 1, 2004; effective January 1, 2005 excise tax rates for certain oil products increased);
- VAT (reduced from 20% to 18% effective January 1, 2004; effective January 1, 2005 a zero VAT rate became effective for sales of natural gas and gas condensate to certain countries of the Commonwealth of Independent States ("CIS")) and sales tax (abolished effective January 1, 2004);
- natural resources production tax, which replaced royalty taxes and mineral extraction taxes effective January 1, 2002 (effective January 1, 2004 the natural resources production tax rate for gas changed from 16.5% of the value of gas produced to a fixed rate of RR107/mcm, and for gas condensate from 16.5% of the value of gas condensate produced from gas condensate fields and RR340 per ton of gas condensate produced from oil and gas condensate fields (the latter rate being subject to adjustments depending on fluctuations of oil prices and the RR exchange rate) to a single rate of 17.5% of the value of gas condensate produced; effective January 1, 2005 natural resources production tax rate for natural gas changed from a fixed rate of RR107/mcm to a fixed rate of RR135/mcm);
- gas customs duty (increased from 5% to 30% effective January 1, 2004, at the same time the excise tax was abolished);
- property tax (increased from 2.0% to 2.2% effective January 1, 2004);
- road users tax (abolished effective January 1, 2003); and
- social taxes and contributions (a new scale of Unified Social Tax ("UST") rates became effective January 1, 2005).

Our overall effective profit tax rates (current and deferred tax expense as a percentage of IFRS profit before profit tax and minority interest) for the years ended December 31, 2004, 2003 and 2002 were 27.8%, 31.6% and 82.1%, respectively, while the statutory income tax rate in Russia was 24% in each of 2004, 2003 and 2002, respectively. The significant difference between our effective profit tax rates and the statutory rates and the volatility of those rates since 2002 has been the result of:

- significant non-taxable income recognized in 2004, primarily relating to a reassessment of the impairment provision against the trade accounts receivable due from NAK Naftogaz Ukraine described in further detail below;

- significant deferred tax benefits and expenses. In each period, temporary differences primarily relate to property, plant and equipment;
- the impact of accounting for inflation, which increased our effective tax rate in periods before 2003; and
- changes in Russian tax legislation.

Current profit tax expense for the years ended December 31, 2004, 2003 and 2002 was RR57,949 million, RR42,368 million and RR54,187 million, respectively. This represents effective current profit tax rates (current profit tax expense as a percentage of IFRS profit before tax and minority interest) for the years ended December 31, 2004, 2003 and 2002 of 20.1%, 17.9% and 32.7%, respectively. In the year ended December 31, 2004 our current profit tax rate increased compared to the year ended December 31, 2003 primarily as a result of our ability to benefit in all of 2003 from the tax loss carry forward of OAO Gazprom which was fully utilized by the end of the first part of the year ended December 31, 2004. The general reduction of the current profit tax rate in the year ended December 31, 2003 was primarily due to the shorter depreciation lives of fixed assets for tax purposes effective January 1, 2002, which increased depreciation for tax purposes and consequently reduced our current tax expense in those periods. The reduction of the current profit tax rate from the year ended December 31, 2002 to the year ended December 31, 2003 was primarily due to the effect of "transition period" profit tax charged as a one time expense in 2002 resulting from changes in tax legislation. See "—Results of Operations—Year ended December 31, 2003 versus year ended December 31, 2002—Profit tax."

We expect that our overall effective profit tax rate as a percentage of IFRS profit will continue to be higher than the statutory profit tax rate for the foreseeable future.

On September 3, 1999 the Government issued regulation #1002 allowing certain companies to restructure over ten years various overdue taxes, interest and fines due to the federal government authorities. During the year ended December 31, 2002, certain of our subsidiaries signed such restructuring agreements. This resulted in the recognition of a gain in each of the respective periods based on the difference between the estimated fair value of the new agreements (based on discounted future cash flows) and the carrying amount of the old payables. This gain is reflected as gain on restructured taxes. Following the restructurings, we recognize the amortization of the discount (representing the difference between the nominal and discounted value of the restructured taxes) as interest expense on taxes payable. Interest accrues on the restructured tax payables (excluding interest and fines) at a rate of 5.5% per annum, representing 1/10 of the CBR's annual financing rate (55%) as specified in the regulation, and is paid quarterly. This interest is also included in interest expense on taxes payable. If the terms of the restructuring are violated, the original nominal value of the tax payable (including interest and fines) becomes due with additional interest of 1/300 of the CBR refinancing rate accruing daily. If we are able to settle restructured payables in accordance with the accelerated schedule, we would be eligible to partial extinguishment of the restructured interest and fines. In the years ended December 31, 2004, 2003 and 2002 a number of our subsidiaries were able to extinguish part of the restructured interest and fines, having complied with the terms of the accelerated repayment schedules of such payables provided for by the regulation.

Interest rates

We have significant short-term and long-term debt obligations with both fixed and variable interest rates. We are exposed to the effects of fluctuations in the prevailing levels of market interest rates on our financial position and cash flows. Interest rate risk is measured by the extent to which changes in market interest rates impact margins and net income. To the extent the term structure of interest bearing assets differs from that of liabilities, net interest expense will increase or decrease as a result of movements in interest rates. We do not have any significant hedging arrangements to mitigate interest rate risks resulting from our financing activities.

Non-cash settlements

Historically, in common with other Russian companies, we have entered into agreements to settle a number of transactions by the transfer of goods and services, or promissory notes, instead of cash. This practice has resulted principally from the following factors:

- high inflation in Russia;
- unreliable banking services;
- gas that we produce is required for the day-to-day operations of a number of our key suppliers; and
- contractual arrangements.

As the general economic climate in Russia has improved, the volume and value of these transactions has decreased significantly. In the years ended December 31, 2004, 2003 and 2002, approximately 18%, 24% and 31%, respectively, of our settlements of accounts payable and accrued charges were settled via non-cash settlements. Approximately 14%, 17% and 18% of our settlements of accounts receivable during the years ended December 31, 2004, 2003 and 2002, respectively, were settled via mutual settlements or other non-cash settlements.

Non-cash settlements primarily represent mutual cancellations using promissory notes. We receive promissory notes from our customers (both issued by customers and third parties) as settlement of receivables. Promissory notes issued by customers are recorded in the same manner as accounts receivable we originate (i.e., at estimated fair value). Promissory notes issued by other third parties are recorded as available-for-sale investments. We give promissory notes, mainly those of Gazprom, to our suppliers in exchange for services or products. Such promissory notes are relatively liquid in the Russian market and are commonly traded by other Russian companies. The difference between the carrying value of the payables being settled and the face value of the promissory notes is recorded as interest expense within net finance costs. Promissory notes are shown separately in our balance sheet. See "—Liquidity and Capital Resources—Debt obligations."

Impairment of assets

Historically, our results have been affected by impairment provisions on accounts receivable, inventory, property, plant and equipment (including assets under construction), investments and other long-term assets. For the years ended December 31, 2004, 2003 and 2002, net release and expenses for such impairment provisions were RR22,452 million release, and expenses of RR15,298 million and RR7,104 million, respectively.

Our provisions for accounts receivable are significant. As of December 31, 2004, the aggregate balance sheet provision for accounts receivable and prepayments was RR114,811 million, or 20% of the gross receivable balance. Such provisions for accounts receivable relate mainly to non-payment for natural gas sold to Moldova, Serbia and Montenegro and certain domestic consumers.

In August 2004, we signed agreements to settle RR47,479 million (including RR36,922 million of principal and RR10,557 million interest and fines) of accounts receivable due from NAK Naftogaz Ukraine for gas shipments made from 1997 to 2000, for RR36,548 million. Only the principal amount of the accounts receivable from Naftogaz Ukraine of RR36,922 million had previously been recognized and this amount had a full impairment provision against it in our consolidated IFRS financial records. We also signed an addendum to the existing transit agreement with Naftogaz Ukraine, under which we will be provided with gas transit services from 2005 to 2009, RR36,548 million of which, in effect, will be provided in settlement of the accounts receivable for gas shipments made from 1997 to 2000. The net effect on profit after tax of the transactions in the year ended December 31, 2004 was a net profit of RR20,134 million, which reflected our reassessment of the future recoverability of the accounts receivable balance based on discounted future cash benefits of the accounts receivable settlement in accordance with the August 2004 agreements.

Our provisions for property, plant and equipment are also significant. As of December 31, 2004, the aggregate balance sheet provision related to property, plant and equipment was RR88,625 million, or 3.9% of gross property, plant and equipment. Of this aggregate balance sheet provisions, RR86,640 million relates specifically to assets under construction, representing 20.6% of gross assets under construction. The impairment provision for assets under construction primarily relates to the following projects: RR20,279 million for part of the Obskaya-Bovanenkovo railroad construction; RR15,974 million for certain development projects in the Bovanenkovskoye and Kharasaveiskoye fields; and RR21,457 million for the Novy Urengoi Chemical Complex. Although these projects have not been abandoned, under the current investment program we do not believe they will generate positive cash flows in the future.

Since 2002, the cumulative balance sheet provision against assets under construction has decreased. The decrease, generally caused by the release of impairment provisions, primarily reflects the strategy of current management to focus systematically on priority projects and begin to fund certain projects which had previously been frozen. As a result, the release of impairment provisions related to assets under construction generated income totalling RR4,351 million, RR1,788 million and RR6,883 million for the for the years ended December 31, 2004, 2003 and 2002, respectively. Because of our operating cycle, certain significant decisions about capital construction projects are made after the end of our fiscal year. Accordingly, we typically have larger charges (releases) in the fourth quarter of our fiscal year as compared to other quarters. For a discussion of our impairment provisions in the years ended December 31, 2004, 2003 and 2002, see "—Results of Operations—Year ended December 31, 2004 versus year ended December 31, 2003" and "—Results of Operations—Year ended December 31, 2003 versus year ended December 31, 2002."

Certain Acquisitions and Dispositions

Acquisitions and dispositions to 2004

In 1999 we began participating in the creation of regional gas sales companies involved in the distribution of gas in Russia. In 2002 our interest in the majority of such companies increased from 20% to 51% of their share capital and these companies were consolidated as subsidiaries.

In January 2001, we exchanged a 57% interest in Lebedinsky GOK ("LGOK"), a mining and ore enrichment company operating in the Russian Federation, and a 17% interest in the Oskolsky EMK for a 48% interest in ZAO Gazmetall ("Gazmetall"). Gazmetall is a metallurgical holding company with controlling interests in LGOK and the Oskolsky EMK. In March 2002, we sold our 48% interest in Gazmetall for U.S.$70 million to OAO Oskolsky Metallurgical Plant, a subsidiary of Gazmetall. The financial effect of these transactions was not material to our financial position or results of operations.

In January 2001, we acquired 50.7% of the voting shares of Sibur, a leading marketer of petrochemical products in Russia. The consideration of RR3,015 million consisted of a combination of cash, promissory notes issued by companies in our Group and other securities. Sibur was consolidated as a subsidiary effective from January 1, 2001. In the first quarter of 2002, external supervision was introduced, at our initiative, in respect of Sibur pursuant to a decision of the arbitration court. On September 10, 2002, a creditors' meeting approved an amicable settlement agreement, which was subsequently approved by the court. The agreement provided for the restructuring and rescheduling of Sibur debts generally over a period of eight years, with first payments due in 2004. In the third quarter of 2002, we signed agreements to acquire additional interests in a number of Russian petrochemical companies, the majority of which were already affiliated with Sibur. From April 2003, following the completion of legal procedures, we established control over the majority of these companies, consolidating throughout the period, and thereby increased our controlling interest in the share capital of Sibur from 50.7% to 75.7%. In respect of this acquisition, we issued long-term promissory notes with a nominal value of RR17,587 and an estimated fair value of approximately RR6,770 million. In September 2003, we acquired an additional 2.4% interest in Sibur for RR102 million. In April 2004, we acquired a further 14.23% interest in Sibur pursuant to an agreement with ZAO Gazoneftekhimicheskaya kompania. The nominal value of the long-term promissory note we issued in connection with this transaction was RR669 million as of December 31, 2004. As a result of these transactions we increased our controlling interest in the charter capital of Sibur from 78.1% to 92.3%. Related to the previous acquisitions, in August 2004 we acquired a 100% interest in OOO Triodecor, a shareholder of Sibur, at a nominal value of RR8,400 paid in cash and thereby increased our controlling interest in Sibur to 99.9%. Our management revised its estimation of the fair value of the above-mentioned long-term promissory notes we issued to RR2,745 million as of December 31, 2004.

In 2000 OAO Zapsibgazprom ("Zapsibgazprom"), a production subdsidiary, issued additional shares, thereby decreasing our interest in its share capital from 51.1% to 34%. In April 2002, the Federal Securities Commission cancelled the registration of such additional stock and our interest in the ordinary share capital of Zapsibgazprom returned to 51.1%. In December 2002, we sold our 12% interest in OAO Arcticgas with a carrying value of RR1 million to Yukos in exchange for 25.6% of the shares of Zapsibgazprom with a nominal value of RR300,000 and additional cash consideration of U.S.$2.95 million. We thereby increased our interest in the share capital of Zapsibgazprom from 51.1% to 76.7%.

In April 2002, we completed the repurchase of 32% of the shares in ZAO Purgaz ("Purgaz") from Itera pursuant to a repurchase option provided by the 1999 share purchase agreement under which we had sold the shares to Itera for their nominal value. As a result, our interest in Purgaz rose from 19% to 51%. Purgaz holds a license for the development of the Gubkinskoye gas field in Western Siberia. In connection with the acquisition of these Purgaz shares, we paid Itera RR33,000 in cash (the nominal value of the shares) and financed Purgaz's repayment of RR6,594 million of financing originally provided by Itera to Purgaz to finance development work, thereby satisfying all of Purgaz's outstanding liabilities to Itera. Subsequent to its consolidation in April 2002, Purgaz contributed 11.2 bcm to our natural gas production volumes in 2002, 15.2 bcm in 2003 and 15.1 bcm in 2004.

In April 2002 we acquired an additional 32.8% of the voting shares in our production subsidiary OAO Vostokgazprom for RR2 million, increasing our interest from 51.0% to 83.8%. We hold these additional shares through our subsidiary Gazprom UK Ltd. In April 2004 we purchased all of the 2,275,000 newly issued ordinary shares of Vostokgazprom. The new shares were purchased for cash as a contribution into the equity of Vostokgazprom in the amount of RR2,275 million. The issue was registered by the Federal Service for Financial Markets in May 2004, as a result of which our ownership interest in Vostokgazprom increased from 83.8% to 99.9%.

During 2000, ZAO Media-Most ("Media-Most"), a media holding company, defaulted on its payment obligation under certain loans, which we had guaranteed. We fulfilled our obligations under the guarantee, and in November 2000, signed agreements with Media-Most to change the collateral under the guarantees to obtain a 46% interest in OAO TV Company NTV ("NTV") and 25% plus one share interests in various other Media-Most operating companies. In July 2001 Media-Most defaulted on another loan, which we had guaranteed. After fulfilling our obligation under this loan guarantee, we obtained a further 19% interest in NTV and additional 25% interests in the other Media-Most operating companies. In July 2002, we acquired additional interests in Media-Most, in NTV and in certain of our other media subsidiaries, as well as payables and promissory notes to third parties due by these companies. The consideration was paid partly in cash and partly through the forgiveness of debt owed to Gazprom. As a result of this transaction we increased our interest in NTV from 65.0% to 95.6% and in Media-Most from 14.3% to 38.6%. In October 2002, we signed a framework agreement to sell non-controlling interests in certain media companies, including NTV, to Eurofinance Group (as nominee), the consideration for which was partially settled in cash and partially through the settlement of certain debt obligations of Media-Most and its media companies to us. The interests to be sold primarily comprised those acquired in July 2002. As a result, our interest in NTV was reduced to 65.0%.

In January 2003 in accordance with an option provided for by the NTV global depositary receipts ("GDRs") purchase agreement dated April 1, 2001, we acquired GDRs from the SmallCap World Fund Inc. for U.S.$32.0 million paid in cash. In February 2003 these GDRs were exchanged for common shares of NTV and OAO TNT-Teleset. As a result of this transaction the Group increased its interest in NTV from 65.0% to 69.4% and in OAO TNT-Teleset from 50.0% to 51.7%.

In February 2003 the management of our wholly-owned subsidiary OOO Mezhregiongaz ("Mezhregiongaz"), acting in violation of our internal procedures, sold 40.1% (out of our total 46.4% interest) of the share capital of ZAO Agrochemical Corporation Azot ("Azot") at its carrying value of RR394 million for cash, reducing our interest to 6.3%. The shares were sold to the other shareholders of Azot as a result of the latter taking advantage of their pre-emptive purchase rights. In April 2003, a part of this transaction was cancelled by an agreement of the shareholders. As a result, we received back a 33.9% interest in Azot and returned RR333 million of the cash received in February 2003. In July 2003 we acquired an additional 7.2% interest in Azot at par value from the existing shareholders of Azot for RR71 million in cash. Accordingly, as of December 31, 2003 we had a 47.4% interest in Azot. In an action we brought to recover the remaining 6.2% of our prior interest, the Moscow Region Arbitration Court has ruled in our favor, and the process for the execution of this decision have been initiated.

In February 2003 we acquired a 51.0% additional interest in OAO Severneftegazprom ("Severneftegazprom") from Itera at the nominal value of the shares (RR102,000) for cash and thereby increased our interest in the share capital of Severneftegazprom to 100%. In connection with the acquisition of this interest, we paid RR369 million in cash to Itera to settle the amount owed by Severneftegazprom to finance development work. Severneftegazprom, a production company, holds a license for the development of the Yuzhno-Russkoye field. At the same time we sold to Itera a 10.0% interest in OAO Sibirsky Oil and Gas Company at its carrying value of RR2.55 million plus a 7.8% interest in OAO Tarkosaleneftegaz at its carrying value of RR356 million for cash.

In September 2002 we entered into an agreement with OAO Stroytransgaz to establish a joint activity which was formally established in October 2002. We contributed promissory notes of Gazprom with a fair market value of RR4,759 million (face value RR5,719 million) payable in January 2004 and Stroytransgaz contributed 1,144 million of ordinary shares of Gazprom (4.83% of our shares). We controlled voting rights for the ordinary shares of Gazprom held by the joint activity. In March 2003 Stroytransgaz terminated its participation in the joint activity agreement in return for the promissory notes contributed by us into the joint activity. In April 2003 we acquired 25.9% of the ordinary shares of Stroytransgaz for consideration with a fair value of RR3,336 million, including primarily promissory notes and cash. In August 2003 we acquired 15.54% of preferred shares and an additional 0.2% of ordinary shares in Stroytransgaz for RR152 million.

Initially, we and ZAO Rosshelf, our 53% owned subsidiary, had 99.1% and 0.9% direct interests, respectively, in a joint activity established to develop the Arctic shelf (Shtokmanovskoye and Prirazlomnoye fields) in the Barents and Pechora Seas. In October 2002, we and ZAO Rosshelf signed an amendment to the joint activity agreement that provided for the addition of ZAO Sevmorneftegaz to our joint activity agreement. ZAO Sevmorneftegaz was jointly controlled by ZAO Rosshelf and OAO NK Rosneft-Purneftegaz ("Rosneft-Purneftegaz"), a subsidiary of OAO NK Rosneft ("Rosneft"). Under the agreement, in February 2003 ZAO Sevmorneftegaz made a non-cash contribution valued at RR4,334 million, thereby obtaining a 48.9% interest in the assets of the joint activity. As a result of the transaction we and ZAO Rosshelf held 48.7% and 2.4% direct interests in the joint activity, respectively, and our total effective interest decreased from 99.6% to 62.9%. In July 2003 Rosneft signed an agreement to acquire a 49.95% direct interest in the joint activity in recognition of its prior investment into the joint activity. The effect of this transaction was to decrease our total effective interest in the joint activity from 62.9% to 48.85% and to establish joint control over the assets of the joint activity with Rosneft. In December 2004 we signed agreements and paid RR6,291 million in cash to acquire from Rosneft its 49.95% interest in the joint activity. In December 2004 we purchased from Rosneft-Purneftegaz an 8.0% interest in the share capital of ZAO Sevmorneftegaz for RR5,968 million paid in cash. As a result of these transactions we increased our interest in ZAO Sevmorneftegaz from 50.0% to 58.0% and became the only participant in the joint activity. As of 31 December 2004 the assets and liabilities of the joint activity and ZAO Sevmorneftegaz were consolidated in our balance sheet. In March 2005 we acquired the remaining 42% interest in ZAO Sevmorneftegaz from Rosneft-Purneftegaz, for RR31,335 million paid in cash in December 2004. In total, we paid RR43,594 million in December 2004 to Rosneft and Rosneft- Purneftegaz to acquire these interests, net of cash paid for promissory notes of ZAO Sevmorneftegaz.

In May 2003, Gazprombank acquired a 15.76% interest in Mosenergo for RR10,900 million. In the year ended December 31, 2004, we acquired an additional 9.25% interest in Mosenergo for RR7,455 million paid in cash, increasing our interest in Mosenergo to 25.01%. As a result of this acquisition we obtained significant influence over Mosenergo and our investment in Mosenergo was reclassified from short-term investments to investments in associated undertakings.

In January 2004, Gazprombank acquired a 5.2% direct interest in RAO UES for RR19,800 million. We have also concluded a preliminary agreement that enables us to vote up to 10.5% of UES's shares.

In March 2004, we acquired a 34% interest in AO Lietuvos Dujos from the State Property Fund of the Lithuanian Republic for RR1,020 million. In November 2004, we acquired 57,949,232 newly issued shares of AO Lietuvos Dujos at their nominal value of 1 Lithuanian Litas per share and thus increased our interest in AO Lietuvos Dujos to 37.1%. Lietuvos Dujos engages primarily in the distribution and the transportation of natural gas in Lithuania.

In March 2004, ZMB, our subsidiary in Germany, acquired a 40.0% interest in Bosphorus Gas Corporation AS for U.S.$0.6 million paid in cash. Bosphorus Gas Corporation AS distributes natural gas in Turkey.

In March 2004, we acquired a 20% interest in Odex Exploration Ltd. (Cyprus) for U.S.$10.5 million. The company is involved in the exploration and development of oil and gas fields in North Africa.

In June 2004, we acquired an additional 12.8% interest in ZAO Stimul, for RR548 million paid in cash. As a result of this transaction we increased our interest in the charter capital of ZAO Stimul from 38.2% to 51.0%. ZAO Stimul, a production company, holds a license for the development of the Eastern part of the Orenburg oil and gas condensate deposit. In December 2004 we acquired an additional 49.0% interest in ZAO Stimul for RR2,821 million, paid in cash. As a result of this transaction we increased our interest in the charter capital of ZAO Stimul from 51.0% to 100%.

In July 2004, we sold a 49.98% interest in our subsidiary insurance company, OAO Sogaz ("Sogaz"), for RR1,690 million. In August 2004 we sold an additional 25.99% interest in Sogaz for RR800 million. As a result of these transactions our interest in Sogaz decreased from 99.98% to 24.01%. As of December 31, 2004, Sogaz was included within investments in associated undertakings.

In November 2004, we sold an 8.34% interest in OAO Purneftegazgeologiya and simaltenously acquired a 99.99% effective interest in OOO Purgazdobycha. OOO Purgazdobycha is a production company that holds a license for the development of the Zapadno-Tarkosalinskoye gas field in Western Siberia.

Recent developments

In January 2005, we acquired a further 9% interest in AO Latvias Gaze from OOO Itera Latvia for U.S.$58 million, increasing our interest to 34% plus one share.

In March 2005, we finalized the acquisition of a 53.8% stake in ZAO Atomstroiexport for a total consideration of RR731 million, paid in cash. ZAO Atomstroiexport is a major general contractor for the construction of nuclear power plants and other nuclear projects outside of Russia.

In June 2005 we acquired a 50.19% interest in OAO Redaktsia gazety Izvestia from KM Technologies (Overseas) Ltd. for U.S.$25 million.

We initially held a 51% stake in ZAO Northgaz, a company that holds licenses for the development of the North Urengoiskoye field. Our initial stake was reduced to 0.5% in 2001 as a result of a court decision invalidating our participation in a share issuance by Northgaz in 1999 on the basis that the value of the property that we contributed to ZAO Northgaz had not been approved by its Board of Directors. On June 10, 2005, we concluded an agreement with the shareholders of ZAO Northgas that provides for our interest in Northgas to be increased to 51% and for all litigation in respect of our stake in ZAO Northgas to be terminated without payment of additional compensation. The agreement also provides for how ZAO Northgas is to be managed by its shareholders following our acquisition of such additional shares, and in certain circumstances requires us to sell the 51% of the shares that we own or to purchase the remaining 49% of the shares. We currently expect that the acquisition of these shares will be completed in August 2005.

From June 20 to June 22, 2005, we concluded agreements for the sale of 10.74% of our shares that were held by our subsidiaries Gazprom Finance B.V., NPF Gazfund (our pension fund), OOO Gazprominvestholding and AB Gazprombank (ZAO) to OAO Rosneftegaz, which is wholly state-owned, for total consideration of RR203,501.7 million (U.S.$7,085.7 million at the exchange rate of July 12, 2005). These shares were transferred to OAO Rosneftegaz between June 23, 2005 and July 1, 2005. The agreements provide that we are to be paid RR16,235.3 million (U.S.$565.3 million at the exchange rate of July 12, 2005) by July 23, 2005; an additional RR20,895.3 million (U.S.$727.6 million at the exchange rate of July 12, 2005) by October 25, 2005; and the remaining RR166,371.1 million (U.S.$5,792.9 million at the exchange rate of July 12, 2005) by December 25, 2005. We estimate that approximately RR22,572.5 million (U.S.$786.0 million at the exchange rate of July 12, 2005) will be required to pay the total estimated profit tax liabilities of our subsidiaries arising in respect of the transactions.

Results of Operations

The following table summarizes our consolidated results of operations for the years ended December 31, 2004, 2003 and 2002. Each line-item is also shown as a percentage of our total sales. In the discussion that follows all RR amounts related to financial information for periods prior to January 1, 2003 are expressed in constant RR as of December 31, 2002 purchasing power, unless otherwise noted. No adjustment for the effects of changes in general purchasing power has been made for period starting from January 1, 2003.

	Year ended December 31,					
	2004		**2003**		**2002**	
	RR million	**% of sales**	**RR million**	**% of sales**	**RR million**	**% of sales**
Sales (net of excise tax, VAT and customs duties)	976,776	100%	819,753	100%	644,687	100%
Operating expenses	(708,943)	(73)%	(593,415)	(72)%	(496,713)	(77)%
Operating profit	**267,833**	**27%**	**226,338**	**28%**	**147,974**	**23%**
Net monetary effects and financing items	10,628	1%	2,141	0%	17,224	3%
Share of net income of associated undertakings	8,151	1%	3,478	0%	4,285	1%
Gains (losses) on available-for-sale investments	1,253	0%	5,017	1%	(3,729)	(1)%
Profit before profit tax and minority interest	**287,865**	**29%**	**236,974**	**29%**	**165,754**	**26%**
Current profit tax expense	(57,949)	(6)%	(42,368)	(5)%	(54,187)	(8)%
Deferred profit tax expense	(21,939)	(2)%	(32,449)	(4)%	(81,945)	(13)%
Total profit tax expense	(79,888)	(8)%	(74,817)	(9)%	(136,132)	(21)%
Profit before minority interest	**207,977**	**21%**	**162,157**	**20%**	**29,622**	**5%**
Minority interest	(2,293)	0%	(3,062)	(0)%	(667)	(0)%
Net profit	**205,684**	**21%**	**159,095**	**19%**	**28,955**	**4%**

Year ended December 31, 2004 versus year ended December 31, 2003

Sales

The following table sets out our volumes and realized prices for the years ended December 31, 2004 and 2003.

	Year ended December 31, 2004	Year ended December 31, 2003
Sales of gas	**(RR millions unless indicated otherwise)**	
Europe		
Gross sales [1]	607,695	567,855
Excise tax	(1,025)	(125,065)
Customs duties	(158,420)	(26,522)
Net sales	448,250	416,268
Volumes in billion cubic meters (bcm)	153.2	140.6
Average price, U.S.$ per mcm [2] (including excise tax and customs duties) [3]	137.7	131.6
Gross average price, RR per mcm [2] (including excise tax and customs duties)	3,967.4	4,037.9
FSU		
Gross sales (net of value added tax (VAT))	88,440	58,945
Excise tax	(571)	(9,542)
Customs duties	(19,106)	(2,821)
Net sales	68,763	46,582
Volumes in bcm	65.7	44.1
Average price, U.S.$ per mcm [2] (including excise tax and customs duties, net of VAT) [3]	46.7	43.6
Gross average price, RR per mcm [2] (including excise tax and customs duties, net of VAT)	1,345.8	1,336.7
Russia		
Gross sales (net of VAT)	252,552	207,056
Excise tax	(2,107)	(19,444)
Net sales	250,445	187,612
Volumes in bcm	305.7	309.1
Gross average price, RR per mcm [2] (including excise tax, net of VAT)	826.2	669.9
Total sales of gas		
Gross sales (net of VAT)	948,687	833,856
Excise tax	(3,703)	(154,051)
Customs duties	(177,526)	(29,343)
Net sales	767,458	650,462
Volumes in bcm	524.6	493.8
Sales of gas condensate and oil and gas products (net of excise tax, VAT and customs duties)	122,248	92,180
Gas transportation sales (net of excise tax and VAT)	29,027	28,226
Other sales (net of VAT)	58,043	48,885
Total sales (net of excise tax, VAT and customs duties)	**976,776**	**819,753**

Notes:

(1) VAT is not charged on sales to Europe.

(2) One mcm is equivalent to 35,316 cubic feet.

(3) Average actual prices and not a convenience translation.

Net sales revenue increased by RR157,023 million, or 19%, to RR976,776 million in 2004 compared to 2003. Net sales of gas accounted for 79% of total net sales in each of 2004 and 2003 and were RR116,996 million, or 18%, higher than in 2003.

Net sales of natural gas to Europe increased by RR31,982 million, to RR448,250 million in 2004 compared to 2003. This was due to a 9%, or 12.6 bcm increase in sales volumes, which more than offset a 1% decrease in average net prices in RR terms. Average net prices in RR terms decreased as a result of the 6% appreciation of the RR against the U.S. dollar and the increase in the customs duties rate from 5% to 30% effective January 1, 2004, the effect of which more than offset the 5% increase in the average realized U.S. dollar export gas prices (including excise and customs duties), and the decrease in excise tax as a result of the abolishment of excise tax on natural gas produced after January 1, 2004. The increase in sales volumes was primarily due to increased volumes sold to Germany, Italy and France under existing long-term contracts, an additional short-term contract for gas supplies to France signed in 2004, and increased sales to the United Kingdom.

Net sales of natural gas to FSU countries increased by RR22,181 million, or 48%, to RR68,763 million in 2004 compared to 2003. This was due to a 49%, or 21.6 bcm, increase in volumes, which more than offset a 1% decrease in net prices in RR terms. The 1% decrease in the net average RR prices resulted primarily from the 6% appreciation of the RR against the U.S. dollar for 2004 compared to 2003 and the increase in customs duties, which together more than offset a 7% increase in average realized U.S. dollar price (including excise tax and customs duties) to U.S.$46.7 per mcm, and the effect of excise tax being abolished. The increase in volumes of gas sold to FSU countries was primarily due to an increase in shipments of gas to Ukraine, Kazakhstan, Belarus and shipments of gas to Armenia, Georgia and Azerbaijan.

Net sales of natural gas in the domestic market increased by RR62,833 million, or 33%, to RR250,445 million in 2004 compared to 2003. This was primarily due to the increase in domestic gas tariffs set by the Federal Tariffs Service, which was slightly offset by the 1%, or 3.4 bcm, decrease in sales volumes. Average domestic prices, including excise tax, increased by 23%, from RR669.9 per mcm in 2003 to RR826.2 per mcm in 2004; however, as excise tax was abolished for natural gas produced after January 1, 2004, average domestic prices net of excise tax increased by 35% in 2004 compared to 2003. The 1% decrease in domestic sales volumes was primarily due to a generally milder winter.

Total excise taxes on natural gas sales decreased by RR150,348 million, or 98%, to RR3,703 million in 2004 from RR154,051 million in 2003, representing 0.4% and 18.5% of gross sales of natural gas (including excise tax and customs duties and net of VAT), respectively. The decrease was due to the fact that excise tax on natural gas produced after January 1, 2004 was abolished. This decrease slightly more than offset the RR148,183 million increase in customs duties to RR177,526 million in 2004 compared to RR29,343 million in 2003.

Sales of gas condensate and oil and gas products increased by RR30,068 million, or 33%, to RR122,248 million in 2004 compared to RR92,180 million in 2003. This increase was primarily due to the acquisition of controlling interests in additional petrochemical companies in the six months ended December 31, 2003 and increased volumes and prices for sales on the domestic market. Sibur and its affiliated petrochemical companies accounted for 59% and 63% of sales of gas condensate and oil and gas products in 2004 and 2003, respectively. Net sales of gas condensate and oil and gas products accounted for 13% and 11% of total net sales in 2004 and 2003, respectively.

Gas transportation sales increased by RR801 million, or 3%, to RR29,027 million in 2004 from RR28,226 million in 2003. This was primarily due to a RR1,448 million increase in transportation sales to Trans Nafta (which provided gas to Belarus during our contract disputes with Belarus in the first six months of 2004), and increased prices and volume of transportation services for gas transportation sales to a number of Russian gas producers, which together more than offset a reduction in the gas transportation sales to Eural Trans Gas and Itera.

Other sales increased by RR9,158 million, or 19%, to RR58,043 million in 2004 compared to RR48,885 million in 2003. Other sales represent activities including media, construction works, refinery services, and sales of other services and goods.

Operating expenses

Operating expenses increased by 19% in 2004 to RR708,943 million from RR593,415 million in 2003. Operating expenses as a percentage of sales increased from 72% in 2003 to 73% in 2004. The table below presents a breakdown of operating expenses in each period:

	Year ended December 31,			
	2004		2003	
	RR million	**% of net sales**	**RR million**	**% of net sales**
Staff costs	122,853	13%	100,122	12%
Depreciation	110,264	11%	99,648	12%
Transit costs	103,853	11%	108,711	13%
Taxes other than on income	72,280	7%	35,088	4%
Purchased gas	66,546	7%	25,666	3%
Materials	64,890	7%	44,395	5%
Repairs and maintenance	40,662	4%	36,533	4%
Electricity	28,882	3%	24,300	3%
Cost of goods for resale, including refined products	18,173	2%	14,302	2%
Social expenses	13,335	1%	11,724	1%
Insurance	13,110	1%	2,384	0%
Transportation services	9,207	1%	5,684	1%
Provisions for liabilities and charges	8,501	1%	13,528	2%
Equipment maintenance	8,349	1%	6,422	1%
Rental expenses	6,247	1%	3,685	0%
Research and development	5,845	1%	6,083	1%
(Release of) charge for provisions for impairment of assets	(22,452)	(2%)	15,298	2%
Other	38,398	3%	39,842	6%
Total operating expenses	**708,943**	**73%**	**593,415**	**72%**

Staff costs

Staff costs increased by 23% to RR122,853 million in 2004 from RR100,122 million in 2003. The increase was primarily due to the increase in the number of employees following the acquisition of controlling interests in a number of petrochemical companies in 2003, new framework of management compensation from the fourth quarter of 2003 and increases in average base salaries in June 2003, December 2003 and April 2004, as a result of which average salary and social contributions increased by approximately 19% within the Group. Sibur together with these petrochemical companies accounted for RR5,942 million of the increase.

Depreciation

Depreciation increased by 11% to RR110,264 million in 2004 from RR99,648 million in 2003. The increase primarily resulted from our growing fixed assets base.

Transit costs

Transit costs decreased by 4% to RR103,853 million in 2004 from RR108,711 million in 2003. Transit costs relate principally to fees charged by Ukraine, Poland and other Eastern Europe and Central Asian countries for the transit of gas to markets in Europe. The decrease primarily resulted from a decrease in transit costs for transportation of gas across Ukraine and Poland primarily due to the appreciation of the RR against the U.S. dollar, as these costs are U.S. dollar denominated, and for Poland, a lower U.S. dollar denominated effective average gas transportation tariff from January 2004. The factors decreasing transit costs more than offset an increase in the transit costs through Belarus due to an increase in the tariff as agreed through intergovernmental agreements in May 2004, an increase in volumes of gas transit following increases in sales to European countries, and increased transit costs through Turkey due to the fact that Blue Stream Pipeline company B.V. was operating for the full year ended December 31, 2004 compared to only nine months of the year ended December 31, 2003.

Taxes other than on income

Taxes other than on income consist of:

	Year ended December 31,	
	2004	2003
	(RR million)	
Natural resources production tax	57,507	19,644
Property tax	9,724	10,646
Other taxes	5,049	4,798
Taxes other than on income	**72,280**	**35,088**

Taxes other than on income increased by 106% to RR72,280 million in 2004 from RR35,088 million in 2003. The increase was primarily attributable to the change in tax legislation. From January 1, 2004, the natural resources production tax rate changed for natural gas from 16.5% of the value of the natural gas produced to a fixed rate of 107 roubles per mcm, and for gas condensate from 16.5% of the value of the gas condensate produced from gas condensate fields and RR340 per ton of the gas condensate produced from oil and gas condensate fields (the latter rate being subject to adjustments depending on fluctuations of oil prices and the RR exchange rate) to a single rate of 17.5% of the value of the gas condensate produced. Also, effective January 1, 2004, the maximum property tax rate increased from 2.0% to 2.2%.

Purchased gas

Cost of purchased gas increased by 159% to RR66,546 million in 2004 from RR25,666 million in 2003. The increase was primarily related to increased volumes of purchases of gas by ZGG group companies, including purchases of Central Asian gas, both in Central Asia and in Europe, for resale to customers in Western Europe and the FSU, and purchases of gas by Sibur. ZGG group companies and Sibur accounted for RR31,651 million and RR2,757 million of the RR40,880 million total increase in the cost of purchased gas, respectively.

Materials

Cost of materials increased by 46% to RR64,890 million in 2004 from RR44,395 million in 2003. The increase was primarily related to the acquisition of controlling interests in a number of petrochemical companies in 2003, increased volumes of purchases and higher prices of materials. The acquisition of controlling interests in a number of petrochemical companies together with the increased level of activity of Sibur resulted in RR16,654 million of the total increase in the cost of materials. In prior periods, before these companies became subsidiaries, such costs were incurred primarily as costs of processing services. In 2003, cost of processing services amounted to RR16,243 million a significant part of which related to materials.

Repairs and maintenance

Cost of repairs and maintenance increased by 11% to RR40,662 million in 2004 from RR36,533 million in 2003. The increase was primarily due to an increase in the volume of repairs and maintenance services rendered by external providers primarily in the transportation segment.

Electricity

Electricity expense increased by 19% to RR28,882 million in 2004 from RR24,300 million in 2003, primarily due to the acquisition of controlling interests in additional petrochemical companies in 2003, the increased activity of Sibur and higher electricity tariffs, which are set by the FTS, in 2004 compared to 2003.

Insurance

Insurance expense increased by 450% to RR13,110 million in 2004 from RR2,384 million in 2003. This was primarily due to the decrease of our interest in the charter capital of OAO Sogaz from 99.98% to 24.01% and its subsequent de-consolidation in 2004.

Provisions for liabilities and charges

Provisions for liabilities and charges decreased by RR5,027 million, or 37%, to RR8,501 million in 2004 from RR13,528 million in 2003. The decrease in pension expense was primarily due to lower interest cost resulting from the decrease in nominal discount rate at the beginning of 2004 compared to 2003, following the decline in corporate and government debt yields in Russia during 2003.

Provisions for impairment of assets

We recognized a net release of provisions for impairment of assets of RR22,452 million in 2004 compared to a net charge of RR15,298 million in 2003. This was primarily due to a RR16,692 million net release of impairment provisions for accounts receivable and prepayments in 2004 compared to RR16,159 million of net charges in 2003, and higher net release of impairment provision for assets under construction, which increased from RR1,778 million in 2003 to RR4,351 million in 2004. The release of impairment provision for accounts receivable and prepayments resulted primarily from the reassessment of the impairment provision for accounts receivable due from NAK Naftogaz Ukraine for gas shipments made from 1997 to 2000, which resulted in a RR19,671 million net release to income in 2004. Reassessment of the impairment provision was based on the future recoverability of the accounts receivable balance by applying discounted future cash benefits of the accounts receivable settlement in accordance with agreements signed with Naftogaz Ukraine in August 2004. See " – Certain Factors Affecting our Results of Operations – Impairment of Assets". The release of impairment provision for assets under construction of RR4,351 million in 2004 primarily related to projects that were previously frozen but are now included in our investment program.

Other operating expenses

Other expenses decreased by 4% to RR38,398 million in 2004 from RR39,842 million 2003. Other expenses include bank charges, financial aid and charity, transfer of social assets to municipal authorities, security services, legal and consulting services and advertising.

Operating profit

As a result of the factors discussed above, our operating profit increased by RR41,495 million, or 18%, from RR226,338 million in 2003 to RR267,833 million in 2004. Our operating profit margin decreased from 28% in 2003 to 27% in 2004.

Net finance income

	Year ended December 31,	
	2004	**2003**
	(RR million)	
Net exchange gain	15,254	15,140
Interest income	15,605	15,295
Interest expense	(25,165)	(32,301)
Gains on and extinguishment of restructured liabilities	4,934	4,007
Net finance income	**10,628**	**2,141**

We recognized a net exchange gain of RR15,254 million in 2004 compared to RR15,140 million in 2003. The change reflects primarily the impact on higher foreign currency denominated borrowings of a 5.8% appreciation of the RR against the U.S. dollar in 2004 compared to a 7.3% appreciation and 2003.

Interest expense decreased by RR7,136 million to RR25,165 million in 2004 compared to RR32,301 million in 2003 primarily due to higher interest capitalized, in line with an increase in assets under construction, and decreased interest expense on promissory notes as we continue to reduce the use of promissory notes.

Share of net income of associated undertakings

Share in net income of associates increased by RR4,673 million to RR8,151 million in 2004 compared to RR3,478 million in 2003. The increase was due to higher net profits of associated undertakings recorded primarily by SGT EuRoPol GAZ S.A., Blue Stream Pipeline company B.V. ("BSPC") and WINGAS GmbH. In addition, we included OAO Mosenergo as an associate for the first time in 2004.

Gains on available-for-sale investments

Gains on available-for-sale investments decreased by RR3,764 million to RR1,253 million in 2004 compared to RR5,017 million in 2003. The gain of RR1,253 million recognized in 2004 primarily relates to the disposal of promissory notes. The gains in 2003 were primarily due to the reduction in provisions made in prior years against long-term available-for-sale equity investments.

Profit tax

	Year ended December 31,	
	2004	**2003**
	(RR million)	
Profit before profit tax and minority interest	287,865	236,974
Theoretical tax charge at the statutory rate thereon	(69,088)	(56,874)
Tax effect of items which are not deductible or assessable for taxation purposes:		
Non-deductible expenses	(23,425)	(23,993)
Non-taxable income from settlement of accounts receivable due from NAK Naftogaz Ukraine	6,287	-
Other non-temporary differences	6,338	6,050
Profit tax expense	**(79,888)**	**(74,817)**

Profit tax expense increased by RR5,071 million, or 7%, to RR79,888 million in 2004 compared to RR74,817 million in 2003.

Our current profit tax expense increased by RR15,581 million, or 37%, to RR57,949 million in 2004 from RR42,368 million in 2003. Our effective current profit tax rate increased to 20% in 2004 compared to 18% in 2003 primarily as a result of our ability to benefit in all of 2003 from the tax loss carry forward of OAO Gazprom which was fully utilized by the end of the first part of the year ended December 31, 2004 and a decrease in taxable temporary difference in respect of property, plant and equipment which resulted in higher current profit tax expense in 2004 compared to 2003. These factors more than offset a one-off reduction in current profit tax in the amount of RR2,003 million upon partial write off of the accounts receivable principal due from NAK Naftogaz Ukraine and non-recurring non-taxable gain recognized in the three months ended September 30, 2004 as a result of the agreements signed in August 2004 with NAK Naftogaz Ukraine.

Our overall effective profit tax rate decreased to 28% in 2004 from 32% in 2003, primarily due to the one-off reduction in current profit tax upon partial write off of the accounts receivable principle due from NAK Naftogaz Ukraine and non-recurring non-taxable gain recognized in the three months ended September 30, 2004 as a result of the agreements signed in August 2004 with NAK Naftogaz Ukraine, which more than offset the factors increasing our effective current profit tax rate.

Minority interest

Minority interest deducted from our results of operations decreased by 25% to RR2,293 million in 2004 compared to RR3,062 million in 2003. The decrease was primarily due to a reduction in the minority interest in OAO Vostokgazprom, OAO AK Sibur and other petrochemical companies in which we acquired additional interests, which was partially offset by higher net profit of OAO AK Sibur in the year ended December 31, 2004.

Net profit

As a result of the factors discussed above, our net profit increased by RR46,589 million, or 29%, from RR159,095 million in 2003 to RR205,684 million in 2004.

Year ended December 31, 2003 versus year ended December 31, 2002

Sales

The following table sets out our volumes and realized prices for the years ended December 31, 2003 and 2002.

	Year ended December 31,	
	2003	**2002**
	(RR million, unless otherwise indicated)	
Sales of gas		
Europe		
Gross sales (including excise tax)[1]	541,333	433,085
Excise tax	(125,065)	(97,970)
Net sales	416,268	335,115
Excise tax as a percentage of sales	23%	23%
Volumes in bcm	140.6	128.6
Average price, U.S.$ per mcm[2] (including excise tax and customs duties)[3]	131.6	107.8
Average price, constant RR per mcm[2] as of December 31, 2002 purchasing power, except for 2003 amount which is in nominal RR (including excise tax and customs duties)	4,037.9	3,536.6
FSU		
Gross sales (including excise, net of VAT)	56,124	61,506
Excise tax	(9,542)	(10,437)
Net sales	46,582	51,069
Excise tax as a percentage of sales	17%	17%
Volumes in bcm	44.1	42.6
Average price, U.S.$ per mcm[2] (including excise tax and customs duties and net of VAT)[3]	43.6	48.0
Average price, constant RR per mcm[2] as of December 31, 2002 purchasing power, except for 2003 amount which is in nominal RR (including excise tax and customs duties and net of VAT)	1,336.6	1,525.9
Russia		
Gross sales (including excise, net of VAT)	207,056	159,642
Excise tax	(19,444)	(16,788)
Net sales	187,612	142,854
Excise tax as a percentage of sales	9%	11%
Volumes in bcm	309.1	298.0
Average price, nominal RR per mcm[2] (including excise tax and net of VAT)	669.9	505.0
Average price, constant RR per mcm[2] as of December 31, 2002 purchasing power, except for 2003 amount which is in nominal RR (including excise tax and net of VAT)	669.9	535.7
Total sales of gas		
Gross sales (including excise tax, net of VAT and customs duties)	804,513	654,233
Excise tax	(154,051)	(125,195)
Net sales	650,462	529,038
Excise tax as a percentage of sales	19%	19%
Volumes in bcm	493.8	469.2
Sales of gas condensate and other oil and gas products (net of excise tax and VAT)	92,180	56,647
Gas transportation sales (net of VAT)	28,226	18,028
Other sales (net of VAT)	48,885	40,974
Total sales (net of excise tax, VAT and customs duties)	**819,753**	**644,687**

Notes:

(1) VAT is not charged on sales to Europe.

(2) One mcm is equivalent to 35,316 cubic feet.

(3) Average actual prices and not a convenience translation.

Net sales revenues increased by RR175,066 million, or 27%, to RR819,753 million in 2003 compared to 2002. Net sales of gas accounted for 79% of total sales in 2003 (82% in 2002) and were RR121,424 million, or 23%, higher than in 2002.

Net sales of natural gas to Europe increased by RR81,153 million, or 24%, to RR416,268 million in 2003 compared to 2002. This was primarily due to a 14% increase in prices (comparing nominal prices for the year ended December 31, 2003 to prices in constant RR terms as of December 31, 2002 purchasing power for the year ended December 31, 2002), and a 9%, or 12 bcm, increase in sales volumes. Following the increase in U.S. dollar oil prices, average U.S. dollar export gas prices (including excise tax and customs duties) increased by 22% in 2003 to U.S.$131.6 per mcm compared to 2002. Nevertheless, our reported average RR export gas prices to Europe (including excise tax and customs duties) increased by only 14% to RR4,037.9 per mcm as a result of a 7.3% nominal appreciation of the RR against the U.S. dollar for 2003 compared to 2002. The increase in sales volumes was primarily due to increased volumes sold to Germany, Hungary, Turkey and Holland under existing long-term contracts.

Net sales of natural gas to FSU countries decreased by RR4,487 million, or 9%, to RR46,582 million in 2003 compared to 2002. This was due to a 12% decrease in the average prices of natural gas (comparing nominal prices for 2003 to prices in constant RR terms as of December 31, 2002 purchasing power for 2002). Sales volumes remained approximately the same. The 12% decrease in our reported average RR price (including excise tax and customs duties) to RR1,336.6 per mcm resulted from a 9% decrease in the average realized U.S. dollar price (including excise tax and customs duties) to U.S.$43.6 per mcm, which was primarily due to lower prices in the Ukraine set by intergovernmental agreements, and to the nominal appreciation of the RR against the U.S. dollar. In 2003 we continued to restrict our shipments to Ukraine to those required to cover transportation services, so-called "transit gas", which mitigates our collection risk. Shipments to Ukraine in 2003 were 26.0 bcm compared to 26.1 bcm in 2002.

Net sales of natural gas in the domestic market increased by RR44,758 million, or 31%, to RR187,612 million in 2003 compared to 2002. This was due to the increase in domestic gas tariffs set by the Federal Energy Commission and a 4%, or 11.1 bcm, increase in sales volumes. The nominal average domestic price increased by 33% from RR505.0 per mcm in 2002 to RR669.9 per mcm in 2003. The 4% increase in domestic sales volumes reflects increased sales by Sibur (from 3.7 bcm in 2002 to 8.3 bcm in 2003), sales to Itera (from 8.1 bcm in 2002 to 15.5 bcm in 2003) and gas sales through an electronic terminal by our subsidiary Mezhregiongaz, which commenced at the end of 2002 (from 0.5 bcm in 2002 to 1.3 bcm in 2003). Sales volumes by Sibur increased in 2003 due to the fact that Sibur increased its level of operations following the completion of bankruptcy procedures in September 2002. Sales volumes to Itera increased because following our reacquisition of a controlling interest in Purgaz, Itera was no longer able to fulfill certain of its long-term supply obligations and thus reached an agreement with us to purchase additional natural gas.

Total excise taxes on natural gas sales increased by 23%, to RR154,051 million, in 2003 from RR125,195 million in 2002, representing 19% and 19% of gross sales of natural gas (net of customs duties), respectively. The increase was primarily due to higher natural gas sales to customers in Europe and Russia.

Sales of gas condensate and oil and gas products increased by RR35,533 million, or 63%, to RR92,180 million in 2003 compared to RR56,647 million in 2002. This increase was primarily due to higher oil and gas product prices, the increased level of operations at Sibur following the completion of bankruptcy procedures in September 2002, and the consolidation by Sibur of additional petrochemicals in 2003. Sibur and these petrochemical companies accounted for 63% of sales of gas condensate and oil and gas products in 2003, compared to 48% in 2002.

Gas transportation sales increased by RR10,198 million, or 57%, to RR28,226 million, in 2003 from RR18,028 million in 2002. This was primarily due to the commencement of transportation sales to Eural Trans Gas starting from January 2003, which amounted to RR14,759 million in 2003 and more than offset the RR6,458 million reduction in transportation sales to Itera. Eural Trans Gas is engaged in purchasing gas from Central Asia for resale to customers in Europe. The volume of gas transported under the contract with Eural Trans Gas in 2003 was 34.9 bcm.

Other sales increased by RR7,911 million, or 19%, to RR48,885 million in 2003 compared to RR40,974 million in 2002. Other sales represent activities such as construction work, gas storage services, refining services, sales by our media subsidiaries and sales of other services and goods.

Operating Expenses

Operating expenses increased by 19%, to RR593,415 million, in 2003 from RR496,713 million in 2002. Operating expenses decreased as a percentage of sales from 77% in 2002 to 72% in 2003. The table below presents a breakdown of operating expenses in each year:

	Year ended December 31,			
	2003		2002	
	RR million	**% of net sales**	**RR million**	**% of net sales**
Transit costs	108,711	13%	102,632	16%
Staff costs	100,122	12%	65,717	10%
Depreciation	99,648	12%	93,454	14%
Materials	44,395	5%	47,310	7%
Repairs and maintenance	36,533	4%	24,218	4%
Taxes other than on income	35,088	4%	43,975	7%
Purchased gas	25,666	3%	9,957	2%
Electricity	24,300	3%	13,449	2%
Processing services	16,243	2%	13,226	2%
Provisions for impairment of assets	15,298	2%	7,104	1%
Cost of goods for resale, including refined products	14,302	2%	17,900	3%
Provisions for liabilities and charges	13,528	2%	6,804	1%
Social expenses	11,724	1%	7,013	1%
Research and development	6,083	1%	4,464	1%
Transportation services	5,684	1%	3,423	1%
Other	36,090	5%	36,067	5%
Total operating expenses	**593,415**	**72%**	**496,713**	**77%**

Transit costs

Transit costs increased by 6%, to RR108,711 million, in 2003 from RR102,632 million in 2002. Transit costs relate principally to fees charged by Ukraine, Poland and other Eastern European and Central Asian countries for the transit of gas to markets in Europe. The increase was primarily due to the increased volume of gas sales to Europe, new transit contracts in Central Asia and higher transportation tariffs in Poland. These increases more than offset the RR6,226 million decrease in transit costs in Ukraine, following the decrease in transportation tariffs in line with the decrease in gas prices to Ukraine.

In 2003, ZGG, our wholly-owned subsidiary in Germany, started to purchase gas for resale to customers in Western Europe and incur transit costs primarily in the Ukraine. Also, in January 2003 we began to provide gas transportation services to Eural Trans Gas relating to the transportation of gas from fields in Central Asia to the Russian border with Ukraine, resulting in increased transit costs payable by us to third parties for the transportation of gas across Kazakhstan and Uzbekistan. Our increased transit cost in Poland resulted from an increase in the U.S. dollar denominated gas transportation tariff by U.S.$1.35, to U.S.$2.68, per mcm per 100 km in January 2003. The effect of the increased tariffs, largely U.S. dollar denominated, was partially offset by the nominal appreciation of the RR against the U.S. dollar in 2003 compared to 2002.

Staff costs

Staff costs increased by 52%, to RR100,122 million, in 2003 from RR65,717 million in 2002. The increase was primarily due to the rise in the average base salaries in January 2003 and June 2003, the bonus paid for the 10th anniversary of Gazprom in February 2003 and the increase in the number of employees following the acquisition of controlling interests in a number of Russian petrochemical companies, which accounted for RR6,862 million of the increase.

Depreciation

Depreciation increased by 7%, to RR99,648 million, in 2003 from RR93,454 million in 2002. The increase primarily resulted from our growing fixed asset base.

Materials

Cost of materials decreased by 6%, to RR44,395 million, in 2003 from RR47,310 million in 2002. The decrease was primarily related to lower prices for material purchases as we reduced the use of non-cash settlements, which are generally made at higher prices relative to purchases for cash.

Repairs and maintenance

Cost of repairs and maintenance increased by 51%, to RR36,533 million, in 2003 from RR24,218 million in 2002. The increase was primarily related to increased volume and higher cost of repair and maintenance activities in the transportation segment due to the ageing of the pipeline assets.

Taxes other than on income

Taxes other than on income consist of:

	Year ended December 31,	
	2003	**2002**
	(RR million)	
Natural resources production tax	19,644	20,485
Property tax	10,646	9,371
Road users tax	—	10,369
Other taxes	4,798	3,750
Taxes other than on income	**35,088**	**43,975**

Taxes other than on income decreased by 20% to RR35,088 million in 2003 from RR43,975 million in 2002. The decrease was primarily attributable to road users tax, which was abolished effective January 1, 2003.

Purchased gas

Cost of purchased gas increased by 158%, to RR25,666 million, in 2003 from RR9,957 million in 2002. The increase was primarily related to purchases of gas from Central Asia for resale to customers in Western Europe, which commenced in January 2003. Purchases of gas from Naftogaz Ukraine and Eural Trans Gas in Europe accounted for approximately RR9,150 million and RR2,400 million, respectively, of the total increase of RR15,709 million.

Electricity

Electricity expense increased by 81%, to RR24,300 million, in 2003 from RR13,449 million in 2002. The increase resulted primarily from increased usage due to the increased volume of gas transported in Russia, in line with the increased volume of gas sales, the impact of the acquisition of controlling interests in petrochemical companies, an increase in electricity tariffs set by the FEC, and increased electricity consumption due to the higher proportion of electricity-driven equipment used for gas transportation. The proportion of electricity-driven equipment increased from approximately 15% of the total capacity of the equipment used for gas transportation in 2002 to approximately 23% in 2003. The increase in electricity tariffs incurred by us exceeded the average increase in electricity tariffs set by the FEC for the whole of Russia, which was 18% for 2003, as the tariffs differ by region and increases in tariffs set by the FEC in different regions ranged from 15% to 80%. For our five subsidiaries incurring the highest amount of electricity expense in 2003, which accounted for 47% of total electricity expense in 2003 and 57% in 2002, tariffs increased between 15% and 47%.

Processing services

Processing services for refined products increased by 23%, to RR16,243 million, in 2003 from RR13,226 million in 2002. These processing services, which are provided by third parties, primarily pertain to the operations of Sibur, which increased its level of operations following the completion of bankruptcy procedures in September 2002.

Provisions for impairment of assets

Provision expense for the impairment of assets increased by 115%, to RR15,298 million, in 2003 compared to RR7,104 million in 2002. The increase was primarily a result of a charge in respect of property, plant and equipment in 2003 compared to a net release in 2002, and higher impairment provisions for investments and other long-term assets. These adverse changes were partly offset by a decrease in the impairment provision expense for accounts receivable and prepayments.

The impairment provision for property, plant and equipment resulted in a net charge of RR207 million in 2003 compared to a net release of RR6,883 million for 2002. The charge for 2003 consists of a RR1,778 million net release for assets under construction and a RR1,985 million charge against production assets on the Severo-Vasyuganskoe gas condensate field following a decrease in recoverable reserves. Releases in the impairment provision primarily reflects the strategy of management to focus on priority projects in a systematic way and once again fund projects, which had previously been frozen. In 2003, the release primarily relates to the Long-Yugan-Labytnangi-Salekhard-Kharp pipeline, which was put into operation in the fourth quarter of 2003.

The impairment provision expense for investments and other long-term assets increased by RR3,382 million from a provision release of RR224 million in 2002 to a provision expense of RR3,158 million in 2003. The provision expense in 2003 primarily relates to equity investments in petrochemical companies acquired in the fourth quarter of 2003 and investments in a number of small joint ventures, which had minimal activity and low returns.

The impairment provision expense for accounts receivable and prepayments decreased by RR1,252 million, or 7%, to RR16,159 million in 2003 from RR17,411 million in 2002. The decrease was primarily a result of lower provisions for non-recurring items mainly related to other debtors, which offset increased provisions against older domestic gas receivables. As of December 31, 2003, the aggregate provision related to accounts receivable and prepayments was RR141,975 million or 30% of the gross accounts receivable and prepayments balance.

Provisions for liabilities and charges

Provision expense for liabilities and charges increased by 99%, to RR13,528 million, in 2003 compared to RR6,804 million in 2002. The increase was primarily a result of a higher expense for pension liabilities, which increased by RR5,994 million, or 103%, to RR11,807 million in 2003 from RR5,813 million in 2002. Pension liabilities represent our obligations under our defined benefit plan, which is administered by our subsidiary, NPF Gazfund. The increase was primarily due to higher interest costs and vested prior service costs. Higher interest costs were primarily due to a decrease in the weighted average discount rate used to discount the defined benefit obligation, which resulted from the decline in corporate and government debt yields in Russia during 2003 and 2002. The higher vested prior service cost resulted from a voluntary increase by us in vested pensions to provide an inflationary increase in pensions for our current pensioners.

Other operating expenses

Other operating expenses decreased by RR23 million to RR36,090 million, in 2003 compared to RR36,067 million in 2002. Other operating expenses include costs related to rental of equipment and vehicles, telecommunications, advertising, and other expenses attributable to the newly consolidated petrochemical subsidiaries.

Operating profit

As a result of the factors discussed above, our operating profit increased by RR78,364 million, or 53%, from RR147,974 million in 2002 to RR226,338 million in 2003. Our operating profit margin increased from 23% in 2002 to 28% in 2003.

Net monetary effects and financing items

	Year ended December 31,	
	2003	2002
	(RR million)	
Net exchange gain (loss)	15,140	(9,435)
Interest income	15,295	10,636
Interest expense	(32,301)	(29,265)
Monetary gain	—	31,380
Gains on and extinguishment of restructured liabilities	4,007	13,908
Net monetary effects and financing items	**2,141**	**17,224**

We incurred a net exchange gain of RR15,140 million in 2003 compared to a net exchange loss of RR9,435 million in 2002. The change reflects primarily the impact on foreign currency denominated borrowings of a 7.3% appreciation of the RR against the U.S. dollar in 2003 compared to a 5.4% depreciation in 2002.

Interest expense increased by RR3,036 million in 2003 compared to 2002 primarily due to interest incurred on the debt restructured by Sibur in September 2002 and increase in interest paid by Gazprombank in line with growth in deposits, which more than offset the increased capitalized interest resulting from increased capital expenditures.

Gains on and extinguishment of restructured liabilities decreased by RR9,901 million to RR4,007 million in 2003. This was primarily due to the fact that there were no tax payables eligible for restructuring in 2003, and there was a RR3,124 million gain on the restructuring of Sibur's debts, following the approval of the settlement agreement with Sibur's creditors in 2002. We recognized RR4,007 million of gains in 2003 due to the forgiveness by certain tax authorities of penalties relating to overdue taxes that had previously been restructured.

There was no monetary gain in 2003 as the characteristics of the economic environment of the Russian Federation indicated that hyperinflation had ceased; effective from January 1, 2003 we no longer apply the provisions of IAS 29. Accordingly, no adjustments for the effects of changes in general purchasing power are recorded in the financial statements subsequent to December 31, 2002.

Share of net income of associated undertakings

Share in net income of associated undertakings decreased by RR807 million to RR3,478 million in 2003 compared to 2002. The decrease was primarily due to lower net profits recorded by WINGAS, due to changes in German tax regulations, increased provisions against non-core associated undertakings and the loss of net income following the sale of our 37% interest in OAO AKB National Reserve Bank in July 2002. These decreases offset higher net profits recorded by EuRoPol GAZ S.A. and the impact of the consolidation as a subsidiary of Sibur-Tyumen in 2003 with respect to which we had recorded losses in 2002 when it was an associated undertaking.

Gains (losses) on available-for-sale investments

In 2003 we recognized gains on available-for-sale investments of RR5,017 million compared to losses of RR3,729 million in 2002. The gains in 2003 were primarily due to the reduction in provisions made in prior years against long-term available-for-sale equity investments. In 2002 we incurred losses primarily due to decreases in the estimated fair value of third party promissory notes held by Sibur and its subsidiaries.

Profit tax

	Year ended December 31,	
	2003	**2002**
	(RR million)	
Profit before profit tax and minority interest	236,974	165,754
Theoretical tax charge at the statutory rate thereon	(56,874)	(39,781)
Tax effect of items which are not deductible or assessable for taxation purposes:		
Inflationary effects	—	(63,278)
Non-deductible expenses	(23,993)	(31,644)
Other non-temporary differences	6,050	(1,429)
Profit tax expense	**(74,817)**	**(136,132)**

Profit tax expense decreased by RR61,315 million, or 45%, to RR74,817 million in 2003 compared to RR136,132 million in 2002.

Our overall effective profit tax rate decreased from 82% in 2002 to 32% in 2003. The decrease primarily resulted from the fact that from January 1, 2003 we no longer apply the provisions of IAS 29, which eliminated the inflationary increase of the financial reporting base for fixed assets and therefore, reduced the deferred tax expense related to fixed assets. The deferred tax expense resulting from the effect of inflation on our fixed assets for 2002 totaled RR59,160 million.

Our current profit tax expense decreased by RR11,819 million, to RR42,368 million, in 2003 from RR54,187 million in 2002. Our effective current profit tax rate decreased to 18% in 2003 compared to 33% for 2002, primarily resulting from the effect of a "transition period" profit tax in the year ended December 31, 2002 and the impact of increased tax depreciation and the utilization of tax losses at Gazprom in 2003. The transition period profit tax was a one time current tax charge of RR22,637 million resulting from the change in tax legislation, effective January 1, 2002, to recognize profit tax on an accrual rather than a cash basis. Transition period profit tax is payable over a period of up to five years.

Minority interest

Minority interest deducted from results from operations increased by RR2,395 million to RR3,062 million in 2003 compared to RR667 million in 2002. The increase was primarily due to increased earnings of consolidated subsidiaries Purgaz and Sibur.

Net profit

As a result of the factors discussed above, our net profit increased by RR130,140 million, or 449%, from RR28,955 million in 2002 to RR159,095 million in 2003.

Liquidity and Capital Resources

We make significant capital expenditures to explore for natural gas, to develop our natural gas fields and to produce natural gas, gas condensate and crude oil and their products, and to maintain and expand the UGSS and international pipelines. Our capital expenditures (including cash advances to contractors and suppliers, which are recorded within long-term accounts receivable and prepayments, and excluding the effect of acquisitions of subsidiaries and reclassifications) were RR241,437 million in 2004, RR204,235 million in 2003 and RR180,268 million in 2002.

We make a significant portion of our capital expenditures using consideration other than cash. See "—Capital expenditures." For the year ended December 31, 2002, our operating cash flows exceeded our cash capital expenditures by significant margins, but were not sufficient to cover our combined cash and non-cash capital expenditures. For the years ended December 31, 2004 and 2003, however, our operating cash flows were insufficient to cover our cash capital expenditures.

Our business requires significant ongoing capital expenditures in order to maintain our production and transportation systems. An extended period of low gas prices would limit our ability to maintain an adequate level of capital expenditures, which in turn could limit our ability to maintain current levels of production and deliveries of gas, adversely affecting our results.

Other significant uses of our cash flows include servicing our debt and paying dividends. Interest paid and expensed was RR19,456 million, RR19,204 million and RR22,379 million in 2004, 2003 and 2002, respectively. Interest paid and capitalized was RR16,373 million, RR13,807 million and RR12,998 million in 2004, 2003 and 2002, respectively. Total interest paid, both expensed and capitalized, was RR35,829 million, RR33,011 million and RR35,377 million for 2004, 2003 and 2002, respectively. We paid dividends of RR14,626 million, RR8,479 million and RR10,328 million in 2004, 2003 and 2002, respectively.

In each of the years ended December 31, 2004, 2003 and 2002, our borrowings exceeded our repayments of debt. Our borrowings net of repayments (including bonds and promissory notes) were RR124,839 million, RR43,308 million and RR41,803 million for 2004, 2003 and 2002, respectively. Our total borrowings increased from RR495,028 million as of December 31, 2002 to RR615,743 million as of December 31, 2004. Our cash and cash equivalents and certain restricted cash (i.e., cash balances restricted under certain borrowings) increased from RR90,979 million as of December 31, 2002 to RR117,717 million as of December 31, 2004.

Our plan for 2005 is to finance our budgeted capital expenditures, interest and dividends mainly out of operating cash flows, which we expect to increase through higher domestic tariffs for sales of natural gas and higher prices for, and increased volumes of, the natural gas we export, and, to a smaller extent, from borrowings. At the same time, we intend to improve our debt profile. For this purpose, we intend to continue replacing short-term borrowings with long-term borrowings, decreasing the percentage of our secured debt and decreasing the charges associated with our debt.

Cash flows

The following table summarizes the statements of cash flows for the years ended December 31, 2004, 2003 and 2002:

	Year ended December 31,		
	2004	2003	2002
		(RR million)	
Net cash provided by operating activities	149,462	140,070	160,111
Net cash used for investing activities	(229,749)	(143,387)	(160,688)
Net cash provided by financing activities	116,434	17,555	3,017

Net cash provided by operating activities

Net cash provided by operating activities amounted to RR149,462 million in the year ended December 31, 2004 compared to RR140,070 million in the year ended December 31, 2003. This was primarily due to higher profit before profit tax and minority interest (RR287,865 million in 2004 compared to RR236,974 million in 2003) derived from our higher sales and operating profit. Adjustments for non-cash items had a negative impact in 2004 (due in part to the release of impairment provisions and other provisions described above) and a positive impact in 2003, the combined effect of which more than offset the 2004 profit increase. Nonetheless, a smaller negative impact arising from working capital changes in 2004 compared to 2003 resulted in the overall 2004 operating cash flow increase of RR9,392 million. See " – Working Capital".

Net cash provided by operating activities decreased to RR140,070 million in 2003 from RR160,111 million in 2002, despite the significantly higher operating income generated by our gas sales during 2003. The positive impact of higher gas prices on our cash flow was more than offset by cash outflows caused by working capital changes and higher profit tax paid compared to 2002. See "—Working capital."

Net cash used for investing activities

Net cash used for investing activities amounted to RR229,749 million in the year ended December 31, 2004 compared to RR143,387 million in the year ended December 31, 2003. This increase was primarily due to the acquisition of a 5.2% interest in RAO UES in January 2004, the acquisition of an additional 9.25% interest in OAO Mosenergo during the year ended December 31, 2004, the acquisition of additional interests in ZAO Sevmorneftegaz and joint activity to develop Shtokmanovskoye and Prirazlomnoye fields in December 2004, prepayment for the remaining 42% interest in ZAO Sevmorneftegaz in December 2004, and an increase in cash capital expenditures for a number of major construction projects.

Net cash used for investing activities decreased to RR143,387 million in 2003 from RR160,688 million in 2002. This 11% decrease was primarily due to the net change in long-term loans and reduced net outflows related to the acquisition and disposal of subsidiaries.

Net cash provided by financing activities

Net cash provided by financing activities amounted to RR116,434 million in the year ended December 31, 2004 compared to RR17,555 million in the year ended December 31, 2003. This was primarily due to higher proceeds from long-term borrowings, net proceeds from the purchase and sale of treasury shares, a reduction of cash restricted on borrowings in the year ended December 31, 2004, lower net repayment from short-term borrowings and net proceeds from issue of promissory notes in the year ended December 31, 2004 compared to net redemption in 2003, partially offset by higher repayments of long-term borrowings and higher dividends paid.

Net cash provided by financing activities increased to RR17,555 million in 2003 from RR3,017 million in 2002. The increase was primarily due to an increase in net long-term borrowings and reduction in restricted cash, which more than offset the net cash outflow from the net redemption of promissory notes and repayment of short-term borrowings.

Working capital

Our working capital surplus (current assets less current liabilities) was RR290,253 million as of December 31, 2004 and RR174,335 million as of December 31, 2003. The RR115,918 million increase in our working capital in the year ended December 31, 2004 was primarily due to an increase in accounts receivable and prepayments, inventory, VAT recoverable and other current assets, and a decrease in taxes payable, current portion of long-term borrowings, short-term borrowings and short-term promissory notes payable, which more than offset an increase in accounts payable and accrued charges and a decrease in short-term investments and restricted cash. Accounts receivable and prepayments increased by RR81,780 million, primarily due to the RR31,335 million prepayment for the remaining 42% interest in ZAO Sevmorneftegaz made in December 2004 and an increase in advances to customs authorities following the increase in the rate of customs duties from 5% to 30% effective January 2004. Other receivables increased primarily due to increased lending activity by AB Gazprombank (ZAO) to third parties. The increase in trade accounts receivable is primarily attributable to an increase in both prices and volumes of gas sales to Europe and the reassessment of the impairment provision against trade accounts receivable due from Naftogaz Ukraine and the resulting release of the impairment provision. See " – Certain Factors Affecting our Results of Operations – Impairment of assets". Inventory increased by RR19,070 million, primarily due to higher volumes and unit costs of gas in storage, and higher cost of materials and supplies to be used for operations. Short-term promissory notes payable decreased by RR6,588 million in line with our strategy of eliminating the issuance of promissory notes. Short-term investments decreased by RR16,641 million, primarily as a result of reclassification of our investment in OAO Mosenergo to investments in associated undertakings following our acquisition of an additional 9.25% interest in the year ended December 31, 2004. Accounts payable and accrued charges increased by RR 50,160 million primarily due to increased lending activity by AB Gazprombank (ZAO) to third parties, increased trading activity of ZGG group and increased payables in respect of acquisition of property plant and equipment, primarily in relation to Yamal-Europe project. We believe that we have sufficient working capital to meet our requirements for at least the next twelve months; however, we are dependent on the short-term credit markets to finance our working capital. We depend on regular access to the domestic rouble bank loan and rouble debt markets to meet a significant portion of our financing requirements.

Our working capital surplus (current assets less current liabilities) was RR174,335 million as of December 31, 2003 and RR56,221 million as of December 31, 2002. The RR118,114 million increase in our working capital in 2003 was primarily due to an increase in short-term investments, accounts receivable and prepayments and inventory, and a decrease in short-term promissory notes payable, which more than offset the increase in accounts payable and accrued charges. Short-term investments increased by RR28,174 million, primarily due to higher purchases of trading investments by our subsidiary, Gazprombank, and higher purchases of third party promissory notes. Accounts receivable and prepayments increased by RR42,887 million, primarily due to an increase in advances for equipment purchases and higher loans provided by Gazprombank. Inventory increased by RR22,769 million, primarily due to higher volumes and unit costs of gas in storage, higher cost of materials and supplies to be used for operations, partially due to a release of the inventory provision, and higher goods for resale as we follow a program to sell off our excess of unused inventories. Short-term borrowings and short-term promissory notes payable decreased by RR14,201 million and RR13,951 million, respectively, in line with our strategy of refinancing short-term debt with long-term borrowings and eliminating the issuance of promissory notes.

Capital expenditures

Total capital expenditures (including cash advances to contractors and suppliers, which are recorded within long-term accounts receivable and prepayments, and excluding the effect of acquisitions of subsidiaries and reclassifications) by segment for the years ended December 31, 2004, 2003 and 2002 in nominal RR terms, except for data as of December 31, 2002 which is in constant RR, amounted to the following:

	Year ended December 31,					
	2004		**2003**		**2002**	
	RR million	**%**	**RR million**	**%**	**RR million**	**%**
Transportation	110,699	46%	81,819	40%	86,176	48%
Production	95,519	40%	100,541	49%	76,985	43%
Refining	12,158	5%	4,899	2%	7,125	4%
Distribution	9,890	4%	9,762	5%	1,663	0%
Other [(1)]	13,171	5%	7,214	4%	8,319	5%
Total	**241,437**	**100%**	**204,235**	**100%**	**180,268**	**100%**

Note:
(1) Primarily includes expenditures for service activities such as drilling, transportation services and repair.

Total capital expenditures (including cash advances to contractors and suppliers, which are recorded within other long-term assets, and excluding the effect of acquisitions of subsidiaries and reclassifications) increased by RR37,202 million, or 18%, from RR204,235 million in the year ended December 31, 2003 to RR241,437 million in the year ended December 31, 2004. The increase was primarily due to renewed focus on investing in transportation projects, including the construction of a pipeline from the Pestsovoe field to the Yamburg trunk pipeline. Total capital expenditures (including cash advances to contractors and suppliers, which are recorded within long-term accounts receivable and prepayments, and excluding the effect of acquisitions of subsidiaries and reclassifications) increased from RR180,268 million in the year ended December 31, 2002 to RR204,235 million in the year ended December 31, 2003. The increase was primarily due to increased funding of new production projects including the development of Yamburgskoye, Pestsovoye, Vyngayakhinskoye and Yen-Yakhinskoe fields and Aneryakhinskoe area of the Yamburgskoye field.

Following is a table of our cash and non-cash capital expenditures (including cash advances to contractors and suppliers, which are recorded within long-term accounts receivable and prepayments, and excluding the effect of acquisitions of subsidiaries and reclassifications):

	Year ended December 31,		
	2004	2003	2002
		(RR million)	
Cash capital expenditures	164,981	144,370	141,124
Interest paid and capitalized	16,373	13,807	12,998
Mutual cancellations and barter settlements	46,862	42,469	42,639
Other[(1)]	13,221	3,589	(16,493)
Total capital expenditures [(2)]	**241,437**	**204,235**	**180,268**

Notes:

(1) Includes changes in accounts payable related to capital construction and changes in promissory notes related to capital construction.

(2) Data presented in this table includes all of our consolidated subsidiaries. Our budgeted capital expenditures for 2005 described below exclude expenditures by certain subsidiaries, including ZAO Purgaz, OAO AK Sibur, ZAO Stimul, OAO Vostokgazprom and OAO Zapsibgazprom.

We have budgeted capital expenditures of RR187.9 billion for 2005, which, together with allocations of such expenditures, remains subject to the final approval of the Board of Directors. The actual amount and timing of capital expenditures made are subject to adjustment. Our initial budgeted total capital expenditures by segment for the year ending December 31, 2005 were as follows (excluding expenditures for certain of our subsidiaries, namely ZAO Purgaz, OAO AK Sibur, ZAO Stimul, OAO Vostokgazprom and OAO Zapsibgazprom):

	Year ending December 31, 2005	
	RR million	%
Transportation	119,519	64%
Production	53,735	28%
Refining	5,915	3%
Distribution	3,032	2%
Other	5,739	3%
Total	**187,940**	**100%**

Debt obligations

Our borrowings net of repayments (including bonds and promissory notes) were RR124,839 million, RR43,308 million and RR41,803 million, for the years ended December 31, 2004, 2003 and 2002, respectively. Our total borrowings increased from RR495,028 million at December 31, 2002 to RR615,743 million at December 31, 2004.

Over the period, our strategy has been to refinance short-term debt with long-term borrowings. Our long-term borrowings (excluding the current portion of long-term borrowings but including long-term promissory notes payable), which are predominantly denominated in convertible currencies (mainly the U.S. dollar and the euro), increased from RR268,821 million at December 31, 2002 to RR438,726 million at December 31, 2004. Our short-term borrowings (including the current portion of long-term borrowings and short-term promissory notes payable) decreased from RR226,207 million at December 31, 2002 to RR177,017 million at December 31, 2004. The following table shows our borrowings at December 31, 2004, 2003 and 2002:

	As of December 31,		
	2004	2003	2002
		(RR million)	
Long-term borrowings			
Fixed interest rate borrowings	323,544	247,763	138,612
Weighted average interest rates for fixed rate borrowings	8.6%	8.8%	9.2%
Variable interest rate borrowings	190,475	150,759	207,754
Weighted average interest rates for variable rate borrowings	4.4%	4.2%	4.7%
Total long-term borrowings	**514,019**	**398,522**	**346,366**
RR denominated borrowings	31,996	34,285	33,191
Foreign currency denominated borrowings	482,023	364,237	313,175
Total long-term borrowings	**514,019**	**398,522**	**346,366**
Less: current portion of long-term borrowings	(86,933)	(94,767)	(97,763)
Add: long-term promissory notes, net of discount	11,640	13,715	20,218
Average discount on promissory notes	10.2%	12.8%	18.7%
Total long-term debt obligations	**438,726**	**317,470**	**268,821**
Short-term debt borrowings			
Fixed interest rate borrowings	48,582	61,982	85,421
Weighted average interest rates for fixed rate borrowings	7.1%	8.2%	10.1%
Variable interest rate borrowings	20,657	13,873	1,639
Weighted average interest rates for variable rate borrowings	3.8%	5.3%	6.8%
Total short-term borrowings	**69,239**	**75,855**	**87,060**
RR denominated borrowings	33,395	25,905	41,370
Foreign currency denominated borrowings	35,844	49,950	45,690
Total short-term borrowings	**69,239**	**75,855**	**87,060**
Plus: Current portion of long-term borrowings	86,933	94,767	97,763
Short-term promissory notes, net of discount	20,845	27,433	41,384
Average discount on promissory notes	9.6%	8.9%	16.3%
Total short-term debt obligations	**177,017**	**198,055**	**226,207**
Total borrowings	**615,743**	**515,525**	**495,028**

The following table shows our actual U.S. dollar and euro denominated long-term borrowings (expressed in U.S. dollars) as of December 31, 2004, 2003 and 2002 as well as the same balances expressed in RR:

	As of December 31,		
	2004	2003	2002
		(RR million)	
U.S. dollar denominated (expressed in U.S. dollars)	14,609	9,690	8,280
Euro denominated (expressed in U.S. dollars)(1)	2,762	2,676	1,625
Total long-term convertible-currency-denominated borrowings expressed in U.S. dollars	**17,371**	**12,366**	**9,905**
Total long-term convertible-currency-denominated borrowings expressed in RR	**482,023**	**364,237**	**313,175**

Note:
(1) Converted at the euro to U.S. dollar exchange rate of 1.36, 1.25 and 1.04 as of December 31, 2004, 2003 and 2002, respectively.

From December 31, 2002 to December 31, 2004, our long-term borrowings denominated in convertible currencies grew, as we increasingly met our financing requirements with long-term borrowings in the international capital markets and began to refinance our short-term obligations.

A significant, although decreasing, portion of our long-term borrowings denominated in convertible currencies are collateralized by receivables under certain of our export contracts. As of December 31, 2004, 2003 and 2002 borrowings of RR147,634 million, RR154,858 million and RR219,700 million, respectively, inclusive of current portion of long-term borrowings, were secured by revenues from export supplies of gas to Europe. We have not increased our borrowings secured by revenues from export supplies of natural gas to Europe since December 31, 2004, and we expect to reduce them through the refinancing descrived herein.

The following table shows our schedule of repayments for long-term borrowings (excluding long-term promissory notes) as of December 31, 2004 and December 31, 2003:

	As of December 31,		
	2004	2003	2002
		(RR million)	
Between one and two years	54,487	68,253	92,378
Between two and five years	182,623	109,521	132,010
After five years	189,976	125,981	24,215
Total	**427,086**	**303,755**	**248,603**

Contractual obligations and other commitments

The amount of outstanding guarantees issued to third parties decreased by RR14,753 million to RR75,011 million as of December 31, 2004 as compared to December 31, 2003 primarily as a result of a decrease in the outstanding amounts of existing guarantees issued to Eural Trans Gas (by RR6,274 million), Albustan Investments Ltd. (by RR2,396 million), Itera (by RR1,731 million) and NAK Naftogaz Ukraine (by RR2,201 million).

The amount of outstanding guarantees issued to third parties increased by RR2,057 million to RR89,764 million as of December 31, 2003 as compared to December 31, 2002 primarily as a result of guarantees issued to Eural Trans Gas in the amount of RR6,274 million and to NAK Naftogaz Ukraine in the amount of RR2,945 million, which more than offset decreases in the outstanding amounts of existing guarantees.

We have significant obligations to supply gas under long-term contracts with European customers.

Qualitative and Quantitative Disclosures and Market Risks

We are exposed to market risk from changes in commodity prices, foreign currency exchange rates, interest rates and prices of marketable securities. We are exposed to commodity risk as we are a commodity business and our natural gas export sales are linked to oil product prices. We are exposed to foreign exchange risk to the extent that our sales revenues, costs, receivables for gas sales and debt are denominated in currencies other than RR. We are subject to market risk from changes in interest rates that may affect the cost of our financing. Other than in our banking subsidiaries, we do not use financial instruments, such as foreign exchange forward contracts, foreign currency options, interest rate swaps and forward rate agreements, to manage these market risks and we do not 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 RR relative to the U.S. dollar and euro. At December 31, 2004, approximately RR438,782 million and RR79,085 million of our borrowings were denominated in U.S. dollars and euro, respectively (out of approximately RR583,258 million of our total borrowings, excluding promissory notes, at that date). Decreases in the value of the RR relative to the U.S. dollar or euro will increase our foreign currency denominated costs and expenses and our debt service obligations for foreign currency denominated borrowings in RR terms. A depreciation of the RR relative to the U.S. dollar or euro will also result in a decrease in the value of our foreign currency borrowings in RR terms. We believe that the risks associated with our foreign currency exposure are mitigated by the fact that a significant portion of our revenues, approximately 57% for the year ended December 31, 2004, are U.S. dollar or euro denominated. As of December 31, 2004 the RR had appreciated against the U.S. dollar by approximately 6% and depreciated against the euro by approximately 3% since January 1, 2004.

A hypothetical, instantaneous and unfavorable 10% change (appreciation of the foreign currency in a net foreign currency liability position) in currency exchange rates on December 31, 2003 would have resulted in additional interest expense, including default interest, of approximately RR3,377 million and RR3,183 million (nominal) for the years ended December 31, 2004 and 2003, respectively, reflecting the increased costs in RR of servicing our foreign currency denominated borrowings held as of December 31, 2004 and 2003. A hypothetical, instantaneous and unfavorable 10% change (appreciation of the foreign currency in a net foreign currency liability position) in currency exchange rates as of December 31, 2004 and 2003 would have resulted in an estimated foreign exchange loss of approximately RR51,787 million and RR41,419 million (nominal) on foreign currency denominated borrowings held as of December 31, 2004 and 2003, respectively. Such effects would be at least partially off-set by increased revenues generated by export contracts denominated in U.S. dollars and euro.

Interest Rate Risk

We are exposed to interest rate risk in our borrowings that bear interest at floating rates. As of December 31, 2004 and 2003, respectively, we had approximately RR583,258 million and RR474,377 million in total borrowings (excluding promissory notes), of which approximately RR372,126 million and RR309,745 million bore interest at fixed rates and approximately RR211,132 million and RR164,632 million bore interest at floating rates determined by reference to the London inter-bank offered rate ("LIBOR") for U.S. dollar and euro deposits, respectively.

A hypothetical, instantaneous and unfavorable change (increase) of 100 basis points in the interest rate applicable to floating rate financial liabilities held as of December 31, 2004 and 2003 would have resulted in additional net interest expense of approximately RR1,879 million and RR1,860 million (nominal) for the years ended December 31, 2004 and 2003, respectively. This sensitivity analysis is based on the assumption of an unfavorable 100 basis point movement of the interest rate applicable to each homogeneous category of financial liabilities. A homogeneous category is defined according to the currency in which financial liabilities are denominated and assumes the same interest rate movement within each homogeneous category (e.g., U.S. dollars and euro).

A hypothetical, instantaneous and unfavorable change (decrease) of 100 basis points in the interest rate would have resulted in an increase of fair value of fixed rate financial liabilities held as of December 31, 2004 and December 31, 2003 to RR15,278 million and RR10,773 million, respectively.

Derivatives

For the purpose of reducing currency risk, our banking subsidiaries use a number of derivative instruments. These comprise forward foreign exchange contracts and written foreign currency option contracts. The objective, when using any derivative instrument, is to ensure that the risk to reward profile of any transaction is optimized. The normal policy is to measure these instruments at their fair value, using the spot rate at the year end as the basis for the fair value measurement with resultant gains or losses being reported within gains less losses arising from dealing in foreign currencies within the statement of operations. These derivatives are not material to us.

Commodity risk

Substantially all of our natural gas, gas condensate and other hydrocarbon export sales to Europe are sold under long-term contracts. Our natural gas export prices to Europe are based on a formula linked to world oil product prices, which in turn are linked to world crude oil prices. Worldwide political developments and the actions of OPEC affect crude oil prices and thus our natural gas export prices. We do not use any significant derivative instruments to hedge our production in order to decrease our price risk exposure.

Securities price risk

We are exposed to movements in the prices of marketable securities that we hold in our investment portfolio. Specifically, as of December 31, 2004, we held RR12,577 million of corporate shares and bonds and RR8,215 million of state and municipal securities. A change in Russia's sovereign credit rating, or an external event that impacts Russian debt and equity prices, could have an impact on the market value of our trading securities.