

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

You should read the following management discussion in conjunction with our audited consolidated financial statements as of and for the year ended December 31, 2005 prepared in accordance with International Financial Reporting Standards ("IFRS").

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 (155,000 km). We own and operate a single centrally controlled system for natural gas production, processing, transportation, storage and deliveries.
- **Distribution:** domestic and export sale of natural gas. We are the world's largest exporter of natural gas.

Beginning in October 2005 with the acquisition of AO Siberian Oil Company (hereinafter, OAO Sibneft), recently renamed OAO Gazprom neft, we have substantially increased our production, processing and marketing of crude oil and refined products.

Other businesses primarily comprise banking, construction and media.

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.

RESULTS OF OPERATIONS

(RR million)	Year ended December 31,	
	2005	2004
Sales (net of excise tax, VAT and customs duties)	1,383,545	976,776
Operating expenses	(929,561)	(714,165)
Operating profit	453,984	262,611
Finance income	53,890	69,332
Finance expense	(69,926)	(53,482)
Share of net income of associated undertakings and jointly controlled entities.	11,782	8,151
Gains on disposal of available-for-sale financial assets	385	5,018
Profit before profit tax	450,115	291,630
Current profit tax expense	(118,028)	(57,949)
Deferred profit tax expense	(16,156)	(21,939)
Total profit tax expense	(134,184)	(79,888)
Profit for the period	315,931	211,742
Attributable to:		
Equity holders of OAO Gazprom	311,125	209,449
Minority interest	4,806	2,293

Sales

The following table sets out our volumes and realized prices for the years ended December 31, 2005 and 2004.

(RR millions unless indicated otherwise)	Years ended December 31,	
	2005	2004
Sales of gas		
<i>Europe</i>		
Gross sales ⁽¹⁾	850,017	607,695
Excise tax	(133)	(1,025)
Customs duties	(230,785)	(158,420)
Net sales	619,099	448,250
Volumes in billion cubic meters (bcm)	156.1	153.2
Average price, U.S.\$ per mcm ⁽²⁾ (including excise tax and customs duties) ⁽³⁾	192.4	137.7
Gross average price, RR per mcm ⁽²⁾ (including excise tax and customs duties)	5,443.6	3,967.4
<i>FSU</i>		
Gross sales (net of value added tax (VAT))	131,393	88,440
Excise tax	(2,975)	(571)
Customs duties	(20,027)	(19,106)
Net sales	108,391	68,763
Volumes in bcm	76.6	65.7
Average price, U.S.\$ per mcm ⁽²⁾ (including excise tax and customs duties, net of VAT) ⁽³⁾	60.7	46.7
Gross average price, RR per mcm ⁽²⁾ (including excise tax and customs duties, net of VAT)	1,716.1	1,345.8
<i>Russia</i>		
Gross sales (net of VAT)	311,336	252,552
Excise tax	(1,351)	(2,107)
Net sales	309,985	250,445
Volumes in bcm	307.0	305.7
Gross average price, RR per mcm ⁽²⁾ (including excise tax, net of VAT)	1,014.1	826.2
<i>Total sales of gas</i>		
Gross sales (net of VAT)	1,292,746	948,687
Excise tax	(4,459)	(3,703)
Customs duties	(250,812)	(177,526)
Net sales	1,037,475	767,458
Volumes in bcm	539.7	524.6
Sales of gas condensate and oil and gas products (net of excise tax, VAT and customs duties)	213,445	122,248
Net sales of crude oil (net of VAT and customs duties)	38,591	-
Gas transportation sales (net of VAT)	25,050	29,027
Other sales (net of VAT)	<u>68,984</u>	<u>58,043</u>
Total sales (net of excise tax, VAT and customs duties)	<u>1,383,545</u>	<u>976,776</u>

Notes:

- ⁽¹⁾ VAT is not charged on sales to Europe.
- ⁽²⁾ One mcm is equivalent to 35,316 cubic feet.
- ⁽³⁾ Calculated on the basis of average rate.

Net sales revenue increased by RR406,769 million, or 42%, to RR1,383,545 million in 2005 compared to 2004.

Net sales of gas accounted for 75% of total net sales in 2005 (79% in 2004). Net sales of gas increased from RR767,458 million in 2004 to RR1,037,475 million in 2005, or by 35%.

Net sales of natural gas to Europe increased in 2005 compared to 2004 by RR170,849 million, or 38%. This increase resulted primarily from a 40% increase in gross average realized U.S. dollar export gas prices, as well as a 2% increase in sales volumes. The increase in export gas prices was caused by increase in world prices for hydrocarbons, that are used as price-determinants in gas supply contracts. The increase in sales volumes was primarily due to increased volumes sold to customers in Turkey, Netherlands and Belgium.

Net sales of natural gas to FSU countries increased compared to 2004 by RR39,628 million, or 58%, to RR108,391 million in 2005. This was due to a 35% increase in prices in RR terms (net of excise tax, customs duties and VAT) and a 17%, or 10.9 bcm, increase in volumes. The 35% increase in the average net RR price (net of excise tax, customs duties and VAT) of gas to RR1,415.7 per mcm was primarily due to the change in the VAT rate to zero (from 18%) on sales to the countries of CIS, to which we sell gas (except for Moldova) and increase in sales prices to Ukraine, that was caused by sales of gas from underground gas storage facilities (UGS) in Ukraine. The increase in volumes of gas sold to FSU countries was primarily due to a 6.4 bcm increase in volumes of gas sales to Belarus in 2005 comparing to 2004 due to contract disputes in the six months, ended 30 June 2004 and 3.3 bcm increase in volumes of gas sold to Ukraine due to sales of gas from UGS in Ukraine.

Net sales of natural gas in the domestic market increased by RR59,540 million, or 24%, to RR309,985 million in 2005 compared to 2004. This was primarily due to the increase in domestic gas tariffs set by the FTS and slight increase in sales volumes by 0.4% or 1.3 bcm.

Sales of gas condensate and oil and gas products increased by RR91,197 million, or 75%, to RR213,445 million in 2005 compared to RR122,248 million in 2004. The increase was primarily due to consolidation of OAO Sibneft and its subsidiaries (Sibneft) from October 2005. The acquired subsidiary contributed revenue of RR52,091 million, or 24% of the total net sales of gas condensate and oil and gas products for the period from the date of acquisition to 31 December 2005. The increase in the domestic and export prices of oil and gas products also contributed to the increase. Sibur and its affiliated petrochemical companies accounted for 43% and 59% of the total sales of gas condensate and oil and gas products in 2005 and 2004, respectively. Sales of gas condensate and oil and gas products (net of excise tax, VAT and customs duties) accounted for 15% and 13% of our total sales (net of excise tax, VAT and customs duties) in 2005 and 2004, respectively.

Subsequent to the acquisition of OAO Sibneft in October 2005 the Group's crude oil production significantly increased and became one of its principal activities. Sales of crude oil (net of VAT and customs duties) amounted to RR38,591 million.

Gas transportation sales decreased by RR3,977 million, or 14%, to RR25,050 million in 2005 from RR29,027 million in 2004. This decrease primarily resulted from the termination of sales of gas transportation services to Eural Trans Gas from January 2005 and due to a RR1,841 million decrease in transportation sales to Trans Nafta, which supplied gas to Belarus during our contract disputes with Belarus in the first half of 2004. In 2004 gas transportation sales to Eural Trans Gas amounted to RR11,068 million. These factors more than offset the amount of transportation services of RR6,508 million in 2005, to RosUkrEnergo AG, a jointly controlled entity, engaged from January 2005 in the sales of gas, produced in Russia and Central Asia to Ukraine and other countries.

Other sales increased by RR10,941 million, or 19%, to RR68,984 million in 2005 compared to RR58,043 million in 2004. Other sales represent activities including media, construction works, refinery services, and sales of other services and goods.

Operating expenses

Operating expenses increased by 30% in the year ended December 31, 2005 to RR929,561 million from RR714,165 million in the year ended December 31, 2004. Operating expenses as a percentage of sales decreased from 73% in the year ended December 31, 2004 to 67% in the year ended December 31, 2005. The table below presents a breakdown of operating expenses in each period:

(RR million)	Years ended December 31,	
	2005	2004
Staff costs	168,076	131,453
Depreciation	124,783	110,264
Taxes other than on income	113,966	72,280
Transit of gas, oil and refined products	110,863	103,853
Purchased oil and gas	87,723	66,546
Materials	73,779	64,890
Repairs and maintenance	55,266	40,662
Electricity and heating expenses	33,031	28,882
Cost of goods for resale, incl. refined products	24,540	18,173
Social expenses	15,674	13,335
Insurance expenses	11,800	13,110
Equipment maintenance	11,564	8,349

(RR million)	Years ended December 31,	
	2005	2004
Rental expenses	9,727	6,247
Charge (release) for impairment provision	8,774	(22,551)
Transportation services	9,344	9,207
Research and development	6,544	5,845
Other	<u>64,107</u>	<u>43,620</u>
Total operating expenses	929,561	714,165

Staff costs

Staff costs (including RR21,503 million and RR8,600 million of expenses associated with pension obligations for the years ended December 31 2005 and 2004) increased by 28% to RR168,076 million in the year ended December 31, 2005 from RR131,453 million in the year ended December 31, 2004. The increase primarily resulted from an increase in average base salaries by 10% effective from April 1, 2004 and 2005 and from the increase in expenses associated with pension obligations due to increase in average base pensions. Staff costs, related to Sibneft, amounted to RR4,339 million for the period from the acquisition date to December 31, 2005.

Depreciation

Depreciation increased by 13% to RR124,783 million in the year ended December 31, 2005 from RR110,264 million in the year ended December 31, 2004. The increase primarily resulted from our growing fixed assets base and consolidation of Sibneft, that stands for RR4,723 million of the increase.

Taxes other than on income

Taxes other than on income consist of:

(RR million)	Years ended December 31,	
	2005	2004
Natural resources production tax	87,229	57,507
Property tax	15,269	9,724
Other taxes	<u>11,468</u>	<u>5,049</u>
Taxes other than on income	113,966	72,280

Natural resources production tax increased by 52% to RR87,229 million in the year ended December 31, 2005 from RR57,507 million in the year ended December 31, 2004 due to Sibneft consolidation by RR14,302 million and due to the change in tax legislation. From January 1, 2005, the natural resources production tax rate for natural gas increased from RR107 per mcm to RR135 per mcm. The increase in property tax can be explained by the increase of tax base for the revaluation of fixed assets for statutory reporting purposes, which we performed as of January 1, 2005 (except for the revaluation of trunk pipelines, which are exempted from the property tax base).

Transit of gas, oil and refined products

Transit of gas, oil and refined products increased by 7% to RR110,863 million in the year ended December 31, 2005 from RR103,853 million in the year ended December 31, 2004. The increase is explained by the increase in oil and oil products transit costs by RR8,679 million due to Sibneft consolidation from the fourth quarter of 2005, that was slightly offset by the decrease in gas transportation costs. Transit gas costs relate principally to fees charged by Ukraine, Poland and other eastern European countries and by some Central Asian countries. The decrease in gas transportation costs primarily resulted from a decrease in volumes of gas transportation through Kazakhstan and Uzbekistan, partially offset by an increase in volumes of transportation through Poland. The decrease of expenses for the transportation through Kazakhstan and Uzbekistan resulted from a change in the arrangements by which gas of middle Asia origin is transported to Ukraine. Starting from January 1, 2005 gas of middle Asia origin is sold to Ukraine by RosUkrEnergo AG, a jointly controlled entity, which incurs transit costs on the territories of Kazakhstan and Uzbekistan. Prior to January 1, 2005, we incurred expenses for the transportation of gas of middle Asia origin, that Eural Trans Gas sold to Ukraine and included these costs in the amounts that we charged to Eural Trans Gas for transportation services.

Purchased oil and gas

Cost of purchased oil and gas increased by 32% to RR87,723 million in the year ended December 31, 2005 from RR66,546 million in the year ended December 31, 2004. Consolidation of Sibneft contributed RR10,648 million related to costs of oil purchases for the year ended December 31, 2005. The rest of the increase is primarily related to purchases of gas from RosUkrEnergO AG for resale in European countries.

Materials

Cost of materials increased by 14% to RR73,779 million in the year ended December 31, 2005 from RR64,890 million in the year ended December 31, 2004. The increase was primarily related to increased volumes of purchases by the transportation and refining segments and higher prices of materials. The consolidation of Sibneft accounts for RR1,976 million of the increase.

Repairs and maintenance

Cost of repairs and maintenance increased by 36% to RR55,266 million in the year ended December 31, 2005 from RR40,662 million in the year ended December 31, 2004. The increase was primarily due to an increase in the volume of repairs and maintenance services rendered by third-party providers mainly in the transportation segment.

Charge (release) for impairment provision

Charge for impairment provisions increased by 139% or by RR31,325 million to RR8,774 million for the year ended December 31, 2005, compared to the release of impairment provision of RR22,551 million for the year ended December 31, 2004. The release of impairment provision for 2004 was primarily due to the reassessment of the impairment provision for accounts receivable due from NAK Naftogaz Ukraine for gas shipments made from 1997-2000, which resulted in a RR19,312 million net release to income in 2004.

Other operating expenses

Other expenses increased by 47% to RR64,107 million in the year ended December 31, 2005 from RR43,620 million in the year ended December 31, 2004. Other expenses include bank charges, security services, legal and consulting services and advertising. The increase in these expenses is caused by the increase in our activities.

Other items of operating expenses

Other items of operating expenses which individually comprise less than 3% of net sales changed for a number of factors, none of which is individually significant. For example, electricity heating expenses increased mainly due to the rise in tariffs, equipment maintenance expenses increased due to the increase in the share of sophisticated equipment, required professional maintenance.

Operating profit

As a result of the factors discussed above, our operating profit increased by RR191,373 million, or 73%, from RR262,611 million in 2004 to RR453,984 million in 2005. Our operating profit margin increased from 27% in 2004 to 33% in 2005.

Finance income and expense

(RR million)	Years ended December 31,	
	2005	2004
Exchange gain	27,530	48,793
Exchange loss	(33,724)	(28,317)
Interest income	25,202	15,605
Interest expense	(36,202)	(25,165)
Gains on and extinguishment of restructured liabilities	<u>1,158</u>	<u>4,934</u>
Net finance (expense) income	(16,036)	15,850

Exchange gain decreased by 44% to RR27,530 million in 2005, compared to RR48,793 million in 2004. Exchange loss increased by 19% to RR33,724 million from RR28,317 million in 2004. The change reflects the impact of the 3.7% depreciation of the RR against the U.S. dollar (in which a major part of our borrowings are denominated) and a 9.7% appreciation of the RR against the euro in 2005 compared to a 5.8% appreciation of the RR against the U.S. dollar and 2.7% depreciation of the RR against euro in 2004.

Interest income increased by 61% to RR25,202 million for the year, ended December 31, 2005 from RR15,605 million for the year, ended December 31, 2004 mainly due to an increase in our deposits held in external banks and bank current accounts. Interest expense increased by 44% from RR25,165 million for the year, ended December 31, 2004 to RR36,202 million for the year, ended December 31, 2005 due to increased borrowings.

Share in net income of associated undertakings and jointly controlled entities

Share of net income of associated undertakings and jointly controlled entities increased by RR3,631 million to RR11,782 million in 2005 compared to RR8,151 million in 2004. The increase was due to share in net profit of OAO NGK Slavneft which became an associate with acquisition of OAO Sibneft in 2005 and due to share in net profit of RosUkrEnergo, a jointly controlled entity of OAO Gazprom.

Gains on disposal of available-for-sale financial assets

Gains on disposal of available-for-sale financial assets decreased from RR5,018 million in 2004 to RR385 million in 2005 primarily due to decrease in realized gains on the disposal of promissory notes held by our subsidiaries.

Profit tax

Total profit tax expense increased by RR54,296 million, or 68%, to RR134,184 million in the year ended December 31, 2005 compared to RR79,888 million in the year ended December 31, 2004 primarily due to increased profit before tax.

Our overall effective profit tax rate in the year ended December 31, 2005 compared to the year ended December 31, 2004 has increased from 27% to 30% and our effective current profit tax rate increased to 26% in the year ended December 31, 2005 compared to 20% in the year ended December 31, 2004 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 2004 as a result of the agreements signed in August 2004 with NAK Naftogaz Ukraine.

Profit for the period attributable to equity holders of OAO Gazprom

As a result of the factors discussed above, our profit for the period attributable to equity holders of OAO Gazprom increased by RR101,676 million, or 49%, from RR209,449 million in the year ended December 31, 2004 to RR311,125 million in the year ended December 31, 2005.

Profit for the period attributable to minority interest

Minority interest increased by 110% to RR4,806 million in the year ended December 31, 2005 compared to RR2,293 million in the year ended December 31, 2004. The increase was primarily due to earnings of OAO Sibneft, the 75.68% interest of which was acquired by us in September and October 2005.

LIQUIDITY AND CAPITAL RESOURCES

The following table summarizes our statements of cash flows for the years ended December 31, 2005 and 2004:

(RR million)	Year, ended December 31,	
	2005	2004
Net cash provided by operating activities	272,617	182,150
Net cash used for investing activities	(653,410)	(262,437)
Net cash provided by financing activities	422,706	116,434

Net cash provided by operating activities

Net cash provided by operating activities amounted to RR272,617 million for the year ended December 31, 2005 compared to RR182,150 million for the year ended December 31, 2004. This was primarily due to higher sales and operating profit, which rose mainly due to the upward trend in gas prices, partially offset by an increase in profit tax paid.

Net cash used for investing activities

Net cash used for investing activities amounted to RR653,410 million for the year ended December 31, 2005 compared to RR262,437 million for the year ended December 31, 2004. This increase was primarily due to the acquisition of a 75.68% interest in Sibneft and due to a significant increase in cash capital expenditures for a number of major construction projects.

Net cash provided by financing activities

Net cash provided by financing activities amounted to RR422,706 million for the year ended December 31, 2005 compared to RR116,434 million for the year ended December 31, 2004. This increase was primarily due to net cash inflows of RR210,356 million related to treasury shares transactions for the year ended December 31, 2005 compared to an inflow of RR8,795 million for the year ended December 31, 2004 as well as a change in proceeds from long-term borrowings, which increased by RR257,501 million and by RR130,667 million for the year ended December 31, 2005 and 2004, respectively. These effects were partly offset by higher dividends paid and a change in cash restricted on borrowings, which increased by RR1,179 million and decreased by RR16,882 million for the year ended December 31, 2005 and 2004, respectively.

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, 2005 and 2004 in nominal RR terms, amounted to the following:

	Year ended December 31,	
	2005	2004
(RR million)		
Transportation	185,730	126,098
Production	110,405	109,650
Refining	19,502	13,706
Distribution	20,172	10,965
Other ⁽¹⁾	16,811	13,706
Total	352,620	274,125

Note:

- (1) Primarily includes expenditures for service activities such as drilling, transportation services (other than gas 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 RR78,495 million, or 29%, from RR274,125 million in the year ended December 31, 2004 to RR352,620 million in the year ended December 31, 2005. The increase of our capital expenditures in the transportation segment was primarily due to increased capital expenditure on the construction of major transportation projects, including the pipeline from the northern region of the Tyumen Oblast to Torzhok and Pochinki-Izobilnoye pipeline.

DEBT OBLIGATIONS

Our net debt balance (defined as the sum of short-term borrowings, current portion of long-term borrowings, short-term promissory notes payable, long-term borrowings, long-term promissory notes payable and restructured tax liabilities, net of cash and cash equivalents and balances of cash and cash equivalents restricted as to withdrawal under the terms of certain borrowings and other contractual obligations) increased by RR297,610 million, or 60%, from RR499,855 million as of December 31, 2004 to RR797,465 million as of December 31, 2005.