Management's discussion and analysis of financial condition and results of operations

The following represents management's analysis of the financial performance and condition of OAO LUKOIL and significant trends that may affect future performance. It should be read in conjunction with our US GAAP consolidated financial statements and notes and supplemental oil and gas disclosure.

References to "LUKOIL", "the Company", "the Group", "we" or "us" are references to OAO LUKOIL and its consolidated subsidiaries and associates. All dollar amounts are in millions of US dollars, unless otherwise indicated. Tonnes of crude oil produced are translated into barrels using conversion rates characterizing the density of oil from each of our oilfields. Tonnes of crude oil purchased as well as other operational indicators expressed in barrels or barrels per day are translated into barrels using an average conversion rate of 7.33 and billions of cubic feet into millions of oil equivalent barrels using a conversion rate of 0.167.

This report includes forward–looking statements – words such as "believes", "anticipates", "expects", "estimates", "intends", "plans", etc. - that reflect management's current estimates and beliefs, but are not guarantees of future results. Please see "Forward-looking statement" on page 33 for a discussion of some of the factors that could cause actual results to differ materially.

Key financial and operational results

	2004	% change to 2003	2003	% change to 2002	2002
Sales (including excise and export tariffs)	**33,845**	53.0%	22,118	44.2%	15,334
Net Income	**4,248**	14.8%	3,701	100.8%	1,843
Net income excluding cumulative effect of change in accounting principle and gain from sale of share in Azeri, Chirag, Guneshli in 2003, and excluding special items relating to tax claims made by the taxing authorities in respect of income and other taxes and pension adjustments made in 2002 and 2003*	**4,248**	78.0%	2,386	20.2%	1,985
EBITDA	**7,203**	27.9%	5,630	62.3%	3,468
Earnings per share of common stock (US dollars)					
Basic earnings	**5.20**	15.0%	4.52	100.0%	2.26
Diluted earnings	**5.13**	15.3%	4.45	96.9%	2.26
Crude oil production by consolidated subsidiaries (thousands of tonnes)	**82,408**	8.3%	76,072	6.7%	71,275
Refined products produced at Group refineries (thousands of tonnes)	**40,825**	4.1%	39,233	0.0%	39,219

*See detailed discussion on page 13.

During 2004 net income was $4,248 million, which was $1,862 million more than in the 2003 (excluding the cumulative effect of change in accounting principle, special items and gain from sale of our share in Azeri, Chirag, Guneshli amounting to $1,315 million).

The increase in net income resulted from favorable price conditions in the year ended December 31, 2004 and improved cost control. However, an increased tax burden, appreciation of the ruble against the US dollar and an increase in transportation costs have restrained growth of our profitability. These restraining factors as well as other drivers impacting the results of our operations are considered below in detail.

Segment information

Our operations are divided into three main business segments:

- **Exploration and Production** – which includes our exploration, development and production operations relating to crude oil and natural gas. These activities are primarily located within Russia, with additional activities in Azerbaijan, Kazakhstan, Uzbekistan, the Middle East, Northern Africa and Colombia
- **Refining, Marketing and Distribution** – which includes marketing and trading of crude oil, natural gas and refined products, and refining and transport operations
- **Chemicals –** which include processing and trading of petrochemical products

Other businesses include banking and finance, construction and other activities. Each of our three main segments is dependent on the other, with a portion of the revenues of one segment being a part of the costs of the other. In particular, our Refining, Marketing and Distribution segment purchases crude oil from our Exploration and Production segment. As a result of certain factors considered in section "Domestic crude oil prices" on page 5, benchmarking crude oil market prices in Russia cannot be determined with certainty. Therefore, the prices set for inter-segment purchases of crude oil reflect a combination of market factors, primarily international crude oil market prices, transportation costs and need for investment resources at oil producing companies within the Group. Accordingly, an analysis of either of these segments on a stand-alone basis could give a misleading impression of that segment's underlying financial position and results of operations. For this reason, we do not analyze either of our main segments separately in the discussion that follows, but we do present the financial data for each in Note 22 to our consolidated financial statements.

Operating developments

Restructuring

In 2004 we continued implementing a restructuring plan designed to improve our operations and maximize shareholder value. The plan included undertaking the following measures in the near term: (i) increase exports of crude oil and refined products; (ii) accelerate the development of our most productive fields; (iii) shut-in low-producing wells; (iv) apply enhanced oil recovery technologies; (v) seek competitive bids for oilfield services; (vi) divest non-core businesses, including certain producing assets where we are not the operator, and reduce headcount; (vii) strengthen performance-related pay; and (viii) streamline our administration.

The following has been achieved to date:

- Our oil and refined products international sales in 2004 increased by 21.9% in terms of volumes while domestic sales volumes decreased by 19.2%, which added $5.6 billion to our revenues

- 7 new oil fields were brought on line in 2004 (2003: 14 fields), which allowed us to increase production while also shutting in low production wells

- 1,161 low production wells were shut in 2004 (2003: 2,191) and partly as a result of this measure and despite the real appreciation of the ruble against the US dollar of 18.5% our cost of oil production decreased on 1.1%, or to $2.58 per barrel, compared to $2.61 in 2003

- In November, 2004, the Company entered into a contract to sell its 100% interest in OOO LUKOIL-Burenie and its subsidiaries ("LUKOIL-Burenie") for $69 million. The terms of the contract require signing a five-year contract for drilling services to be provided to the Group and revising the terms of Group financing previously provided to LUKOIL-Burenie. The transaction was completed in December 2004

- In August 2004, the Company entered into contracts to sell its 99% ownership interest in OAO Bank Petrocommerce (the "Bank") for $214 million to a group of companies of a related party, whose management and directors include members of the Group's management and Board of Directors. The Company used an independent valuation in the determination of the selling price. The transaction was structured to be completed in two phases. The first phase of the transaction representing the sale of 78% of the Group's ownership interest for $169 million was completed on September 22, 2004. The second phase in which the Group will sell its remaining 21% of ownership interest in the Bank for $45 million will be completed by the end of June 2007

- In 2004 we began restructuring our transport division ZAO LUKOIL-TRANS. LUKOIL-TRANS is a diversified transport company, which provides services both to our upstream and downstream subsidiaries. It has significant car and railway fleets. Currently we are negotiating with potential investors who have expressed their interest in buying the transport division

- Other achievements are described in detail in other parts of this report

Strategic Partnership with ConocoPhillips

In September 2004, LUKOIL and ConocoPhillips entered into a Shareholder agreement forming a broad-based strategic alliance with ConocoPhillips. In the framework of the partnership LUKOIL and ConocoPhillips plan to set up in 2005 a joint venture in the Nenetsky Autonomous District to develop LUKOIL's oil reserves in the northern Timan-Pechora area. The joint venture will be governed by LUKOIL and ConocoPhillips in equal parts, but with effective interest of 70% and 30% respectively. It is expected that the joint venture's crude oil production will reach approximately 200 thousand barrels per day by 2008. The joint venture will be formed on the basis of our 100% subsidiary OOO Narianmarneftegaz, which crude oil production in 2004 was approximately 15 thousand barrels per day.

Recent developments

In December 2004, a Group company acquired the remaining 50% interest in LUKAgip N.V. ("LUKAgip") for $143 million from Eni Group (of which $111 million represents repayment of debt to the Eni Group). The acquisition increased the Group's ownership in LUKAgip to 100%. LUKAgip owns a 24% interest in the Meleiha Hydrocarbon License Concession Agreement located onshore in Egypt. It also owns a 10% interest in the Shakh Deniz Exploration, Development and Production Sharing Agreement, 8% of the midstream gas marketing entity, the Azerbaijan Gas Supply Company, and 100% of LUKAgip Midstream B.V., which holds LUKAgip's 10% interest in the South Caucasus Pipeline Company.

In October 2004, we put into operation Petrotel-LUKOIL S.A., our Romanian refinery, after modernization. We invested $121 million in the refinery reconstruction since its closure in 2001. The annual throughput is expected to reach 2.4 million tonnes.

In June 2004, we put into operation the first stage of our reloading and distribution terminal in Vysotsk. The terminal's initial capacity is 4.7 million tonnes of crude oil and refined products a year. Through this terminal we will export light refined products to Western Europe and the United States. It is planned that the full capacity of approximately 12.0 million tonnes will be reached in 2006.

In June 2004, we entered into an agreement for exploration, development and production of non-associated gas in Uzbekistan. In respect of this agreement, the Company has minimum exploration commitments of $16 million over next 3 years. The amount of recoverable reserves agreed upon under the terms of the contract is 283 bcm.

In March 2004, we entered into an agreement for exploration, development and production of non-associated gas and condensate in Saudi Arabia. Minimum exploration commitments in respect of this agreement amount to $215 million over the next 5 years with the Company's share of $172 million.

On January 26, 2004, a Group company entered into an agreement with ConocoPhillips to purchase 308 gas stations and contracts to supply petroleum products to an additional 471 gas stations in the Northeast of the United States of America for $270 million. The transaction was finalized in May 2004.

In October 2003, the Group acquired 79.5% of the share capital of Beopetrol for 117 million EUR. Beopetrol is a marketing and distribution company operating in Serbia. Beopetrol owns and operates over 200 refueling stations and 8 refined product storage facilities. In 2002 Beopetrol's sales reached 390 thousand tonnes, which allows it to control approximately 20% of Serbian retail fuel market. Under the terms of the purchase agreement the Company is required to invest in Beopetrol 85 million EUR over the next three years.

In June 2003, the Group acquired 39.4% of the outstanding shares in OAO Tebukneft and 55.4% of the outstanding shares in OAO Ukhtaneft, thereby increasing the Group's ownership stake in these companies to 85% and 85.5%, respectively. The Group also acquired 77.4% of outstanding shares in ZAO RKM-Oil.

The total cost of the interests acquired in these companies was $134 million. Prior to these acquisitions, OAO Tebukneft and OAO Ukhtaneft were recorded as associated companies using the equity method of accounting. In the second half of 2003, the Group acquired an additional 8.9% of the outstanding shares in OAO Tebukneft, 12.2% of the remaining share capital in OAO Ukhtaneft and 22.6% of outstanding shares in ZAO RKM-Oil, thereby increasing the Group's ownership stake in these companies to 93.9%, 97.7% and 100%, respectively. The total cost of the interests acquired in these companies was $27 million. OAO Tebukneft, OAO Ukhtaneft and ZAO RKM-Oil are exploration and production companies operating in the Komi Republic of the Russian Federation. At the time of acquisition in June 2003 OAO Tebukneft, OAO Ukhtaneft and ZAO RKM-Oil had total proved reserves of approximately 242 million barrels.

In June 2003, the Group acquired 1.25% of ZAO LUKOIL-AIK for approximately $1 million, thereby increasing the Group's share in this company to 51%. Prior to this acquisition ZAO LUKOIL-AIK was recorded as an associated company using the equity method of accounting. ZAO LUKOIL-AIK is an exploration and production company operating in Western Siberia. At the time of acquisition ZAO LUKOIL-AIK had total proved oil reserves of approximately 171 million barrels.

Acquisitions in 2005

In March, 2005 we signed a purchase and sale agreement for 100% shares of Oy Teboil Ab and Suomen Petrooli Oy, incorporated in Finland. Oy Teboil Ab and Suomen Petrooli Oy are mainly engaged in the operation of 289 retail petrol service stations and 132 retail diesel fuel outlets, wholesale of refined oil products as well as production and sale of lubricants. The amount of the transaction was $160 million.

In January 2005 a Group company acquired an additional 22% interest in LUKOIL Neftochim Bourgas AD for $56 million (20.7% interest was acquired from a related party for $52 million). The acquisition increased the Group's ownership stake in LUKOIL Neftochim Bourgas AD to 93.2%.

Consolidation of the Group

In June 2003, the Group acquired the remaining 27% of shares in ZAO LUKOIL-Perm from a related party, which was controlled by certain members of the Group's management, for $398 million, thereby increasing the Group's ownership stake in ZAO LUKOIL-Perm to 100%.

By the end of 2003 we completed the restructuring of the Group's oil producing assets in the Perm region. ZAO LUKOIL-Perm merged with OOO LUKOIL-Permneft, our 100% subsidiary. Furthermore, oil producing assets of ZAO LUKOIL-Perm located in Western Siberia and the Komi Republic were transferred to the Group's companies operating in the respective regions. Thus, we created a single oil extraction company operating in the Perm region, namely OOO LUKOIL-Perm. Within the bounds of this restructuring process we took certain measures, which allowed us to:

- optimize organizational structure
- dispose from the Group certain service companies and non-core businesses
- decrease general and administrative expenses
- introduce standardized organizational structure and management functions

During our optimization of the organizational structure we decreased the number of employees in OOO LUKOIL-Perm by more than 1,000. The consolidation of our oil producing assets will allow us to further increase our labor productivity and production output.

Main macroeconomic factors affecting our results of operations

Change in the price of crude oil and refined products

The price at which we can sell crude oil and refined products is the primary driver of our revenues. During 2004 crude oil prices were steadily high due to growth of the world economy (5.0% in 2004) and increased worldwide crude oil consumption (in 2004 worldwide crude oil consumption was 82.1 million barrels a day, or 3.3% more than in 2003). In 2004, due to the continuing growth in demand in the USA and China, certain geopolitical tensions, refining and distribution bottlenecks in some major consuming regions, crude oil prices rapidly escalated and in October reached their historical records (OPEC Reference basket) in absolute terms. In responding to this and in order to ensure market stability, OPEC decided to increase daily production up to 27.0 million barrels a day from November 2004. However, based on OPEC's data, actual daily production in December reached 29.7 million barrels a day – near to OPEC's full capacity. This situation can be viewed as an indicator that crude oil prices will remain steadily high in a medium-term perspective.

Substantially all of the crude oil that we sell for export is Urals blend. The following table shows the average crude oil export prices for respective periods of 2002, 2003 and 2004 and refined product prices based on Northern Europe averages:

	2004	% change from 2003	2003	% change from 2002	2002
	(in US dollars per bbl, except for figures in percent)				
Brent crude	**38.27**	33.3%	28.71	14.9%	24.98
Urals crude (CIF Mediterranean)*	**34.50**	27.6%	27.03	14.1%	23.68
	(in US dollars per metric tonne, except for figures in percent)				
Fuel oil 3.5% (FOB Rotterdam)	**151.81**	2.3%	148.37	15.0%	128.89
Diesel fuel (FOB Rotterdam)	**349.37**	37.8%	253.53	21.4%	208.84
High-octane gasoline (FOB Rotterdam)	**400.33**	35.2%	296.13	21.6%	243.62

Source: Platts

* The Company sells crude oil on foreign markets on various delivery terms. Thus the average realized sale price of oil on international markets differs from the average price of Urals crude (CIF Mediterranean).

Domestic crude oil prices

Crude oil prices in Russia have remained below world levels primarily due to constraints on the ability of Russian oil companies to export their crude oil, which has led to large regional surpluses in Russia and increased domestic supplies. Because substantially all crude oil is produced in Russia by vertically integrated oil companies such as ours, there is no concept of a benchmark domestic market price for crude oil. Most transactions are between affiliated entities within vertically integrated groups. There is also a market within Russia for residual crude oil that is produced but not refined or exported by one of the vertically integrated oil companies. Prices for this oil are generally determined on a transaction-by-transaction basis against a background of world market prices, but with no direct reference or correlation. At any time there may exist significant price differences between regions for similar quality crude as a result of the regional imbalances referred to above and competitive and economic conditions in those regions.

Domestic refined product prices

Domestic prices for refined products are determined to some extent by world market prices, but they are also directly affected by local demand, competition and prices imposed on government-directed sales. The portion of our domestic refined product sales in 2004 was 18.1% (2003: 20.8%) of total tonnes sold, but represented 13.8% of our total sales revenue (2003: 15.6%). In general, retail prices on refined products in Russia are comparable to those in the USA. For example, during the twelve months ended December 31, 2004 the average retail price on regular gasoline in the USA was about 50 cents per liter, an increase of 18% as compared to the same period of 2003. In central regions of European Russia the average retail price on gasoline of the same quality (95 octane) during the twelve months ended December 31, 2004 was 47 cents per liter, an increase of 19% as compared to 2003.

The U.S. dollar-ruble exchange rate and inflation

A substantial part of our revenues is either denominated in US dollars or is correlated to some extent with US dollar crude oil prices, while most of our costs in the Russian Federation are settled in Russian rubles. Therefore, the movements of ruble inflation and exchange rates can significantly affect the results of our operations. In particular, our operating margins are generally adversely affected by real appreciation of the ruble against the US dollar, because this will generally cause our costs to increase in US dollar terms relative to our revenues. It should be noted that during 2003 and 2004 the exchange rate of the ruble to the US dollar was increasing, rather than declining like in periods prior to 2003.

The following table gives data on inflation in Russia, the nominal change in the ruble–dollar exchange rate, and the level of real appreciation.

	2004	2003	2002
Ruble inflation (CPI)	**11.7%**	12.0%	15.1%
Nominal appreciation/(devaluation) of the exchange rate (ruble to the US dollar)	**5.8%**	7.3%	(5.5)%
Real appreciation of the exchange rate (ruble to the US dollar)	**18.5%**	20.8%	9.2%
Average exchange rate for the period (ruble to the US dollar)	**28.82**	30.69	31.35
Exchange rate at the end of the period (ruble to the US dollar)	**27.75**	29.45	31.78

Tax burden

Given the relative size of our activities in Russia, our tax profile is largely determined by the taxes payable in Russia (based on records maintained under Russian legislation – not US GAAP). For 2004, 2003 and 2002 the tax charge on the Russian part of our operations was more than 80% of our total tax charge.

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. Taxes to which we are subject include:

- mineral extraction tax;
- excise and export tariffs;
- property tax;
- social taxes;
- sales tax and VAT;
- other local and regional taxes

The effective rates of total taxes and tariffs (total taxes, including income taxes, taxes other than on income and excise and export tariffs, divided by income before taxes and tariffs) for 2004, 2003 and 2002, respectively, were 71%, 64% and 72%.

The measures that we use for tax planning and management strategies have been based on our understanding of tax legislation existing at the time of implementation of these measures. We are subject to tax authority audits on an ongoing basis, as is normal in the Russian environment, and, at times, the authorities have attempted to impose significant additional taxes on us. We believe that we have adequately met and provided for tax liabilities based on our interpretation of existing tax legislation. However, the relevant authorities may have differing interpretations and the effects could be significant.

The following table represents average enacted rates for other taxes specific to oil industry in Russia for the respective periods:

		2004 *	% change to 2003	2003 *	% change to 2002	2002 *
Export tariffs on crude oil............	$/tonne	**55.77**	83.5%	30.40	59.3%	19.08
Export tariffs on refined products						
Light distillates (gasoline), middle distillates (jet fuel), diesel fuel and gasoils............................	$/tonne	**37.93**	38.6%	27.36	(3.7)%	28.40
Liquid fuels (fuel oil)...................	$/tonne	**36.64**	33.9%	27.36	91.3%	14.30
Excise on refined products						
High-octane gasoline............	RUR/tonne	**3,360.00**	12.0%	3,000.00	44.8%	2,072.00
Low-octane gasoline.............	RUR/tonne	**2,460.00**	12.3%	2,190.00	44.8%	1,512.00
Diesel fuel	RUR/tonne	**1,000.00**	12.4%	890.00	44.5%	616.00
Motor oils.............................	RUR/tonne	**2,732.00**	12.0%	2,440.00	45.2%	1,680.00
Mineral extraction tax..................	RUR/tonne	**1,052.76**	31.4%	801.44	20.1%	667.12

* Average values.

During 2004 our tax burden rose significantly compared to the previous year. Average crude oil export tariffs increased by 83.5% compared to 2003. Approximately 49% of the increase related to growth of crude oil prices, and the remaining 34% resulted from changes in the duty rate calculations effective June 2004 (see page 8). Export tariffs on gasoline, kerosene, jet fuel, diesel fuel and gasoils increased by 38.6%. Excise on refined products increased by approximately 12%.

The mineral extraction tax rate increased by 31.4% compared to 2003. This resulted from an increase of the Urals crude price and increase of the base rate.

The mineral extraction tax rate is determined as follows. The base rate is set at 347 Rubles per metric tonne extracted (effective from January 1, 2004; prior to this the base rate was 340 rubles) and is adjusted depending on the international market price of the Urals blend and the ruble exchange rate. The tax rate is zero when the average Urals international market price for a tax period is less than or equal to $8.00 per barrel. Each $1.00 per barrel increase in the international Urals price over the stated limit ($8.00 per barrel) effectively results in an increase of the tax rate by $1.38 per tonne extracted (or $0.19 per barrel extracted using a conversion factor of 7.33).

Crude oil export duties also depend on the international market price of the Urals blend. Before June 2004 the duty rates were calculated as follows (for a new method of the duty rate calculations enacted from June 2004 see "Recent amendments to Russian tax legislation" on page 8). The rates are zero when the average Urals international market price is less than or equal to approximately $15.00 per barrel ($109.50 per metric tonne). If the Urals price is in a layer between $15.00 and $25.00 per barrel ($182.50 per metric tonne), each $1.00 per barrel increase in the Urals price over the layer's lower bound results in increase of the crude oil export duty rate by $0.35 per barrel exported. If the Urals price is above $25.00 per barrel, each $1.00 dollar per barrel increase in the Urals price over this limit results in the increase of the crude oil export duty rate by $0.40 per barrel exported.

Export duty rates on export of refined products are set by the Russian government. Effective from January 2004 the upper bound for refined products export duties limited to 90% of the crude oil export duty was abolished. Crude oil and refined products exported to CIS countries, other than Ukraine, are not subject to export duties.

Tax rates set in rubles and translated at the average exchange rates for respective periods are as follows:

	2004 *	% change to 2003 *	2003 *	% change to 2002	2002 *
		(in USD dollars per tonne)			
Excise on refined products					
High-octane gasoline	**116.59**	19.3%	97.76	47.9%	66.10
Low-octane gasoline	**85.36**	19.6%	71.36	48.0%	48.23
Diesel fuel	**34.70**	19.7%	29.00	47.6%	19.65
Motor oils	**94.80**	19.2%	79.51	48.4%	53.59
Mineral extraction tax	**36.51**	39.8%	26.12	22.7%	21.28

* Average values.

Recent amendments to Russian tax legislation

Effective from January 1, 2005 the formula underlying the mineral extraction tax calculation has been adjusted – the base rate is set at 419 Rubles per metric tonne extracted (instead of 400 Rubles as planned before) and the lower non-taxable threshold has been increased up to $9.00 per barrel. As a result each $1.00 per barrel increase in the international Urals price over the threshold ($9.00 per barrel) will effectively result in an increase of the tax rate by $1.61 per tonne extracted (or $0.22 per barrel extracted using a conversion factor of 7.33). If the Urals blend price in 2005 will be between $35 – 45 per barrel the mineral extraction tax will increase by 12.3 – 13.4% as a result of the amendment.

Effective from June 2004 the Russian government reconsidered crude oil export duty rates. A three-layer progressive scale was introduced. If the Urals price is in a layer between $15.00 ($109.50 per metric tonne) and $20.00 per barrel ($146.00 per metric tonne), each $1.00 per barrel increase in the Urals price over the layer's lower bound results in an increase of the crude oil export duty rate by $0.35 per barrel exported. If the Urals price is in a layer between $20.00 and $25.00 per barrel ($182.50 per metric tonne), each $1.00 per barrel increase in the Urals price over the layer's lower bound results in an increase of the crude oil export duty rate by $0.45 per barrel exported. If the Urals price is above $25.00 per barrel, each $1.00 dollar per barrel increase in the Urals price over this limit results in the increase of the crude oil export duty rate by $0.65 per barrel exported. If the Urals blend price is between $35 – 45 per barrel the crude oil export duties will increase by 40.0 – 47.8% as a result of the amendment.

Effective from January 1, 2005, excise tax rates in Russia were increased by approximately 8% and set at the following level:

		Effective from January 1, 2005
Excise on refined products		
High-octane gasoline	RUR/tonne	3,629.00
Low-octane gasoline	RUR/tonne	2,657.00
Diesel fuel	RUR/tonne	1,080.00
Motor oils	RUR/tonne	2,951.00

Operational highlights

In 2002 our Board of directors approved the Company's development strategy where we set out targets for the next 10 years. According to this development strategy we plan to have approximately 3.0 million of oil equivalent barrels of hydrocarbon production per day by 2013. This represents a 42% increase in crude oil production from the 2002 level and almost a 10 times increase in gas production compared to 2002. We continued to use this strategy as a basis for business activities performed by the Group during 2004 as discussed below.

Oil and gas production

In line with our long-term strategy we increased our total daily oil production (including the Company's share in equity associates) by 7.2% and produced 636,048 thousand barrels (86,200 thousand tonnes) during 2004.

	2004	% change from 2003	2003	% change from 2003	2002
Daily production of crude oil, including Company's share in equity associates (thousand barrels per day)....	**1,738**	7.2%	1,622	5.0%	1,545
Daily production of crude oil, including Company's share in equity associates, but excluding our share in Azeri, Chirag, Guneshli (thousand barrels per day)......	**1,738**	7.2%	1,622	5.5%	1,538
Daily production of gas, including Company's share in Equity associates (million of cubic feet per day)	**475**	30.5%	364	5.5%	345
Refinery thourghput (thousand barrels per day)	**869**	2.8%	845	0.4%	842

The main oil production region of the Company remains Western Siberia. In the oil fields of Western Siberia the Company produced 67.5% of its total production of crude oil in 2004 (67.4% in 2003). The increase of production in Western Siberia by 8.6% is a result of both acquisitions in 2003 by the Group of new oil producing companies (primarily additional interest in LUKOIL-AIK), and improvement and optimization of oil production methods. The organic growth of oil production resulting from these improvements was 5.7%. The increase of production in the Komi Republic by 10.8% primarily resulted from the consolidation of our oil production companies – acquisitions of additional interests in OAO Tebukneft, OAO Ukhtaneft and ZAO RKM-Oil in 2003. The organic growth of the oil production in the Komi Republic was 1.8%. Commencement of oil production in new oil fields in the Nenetsky Autonomous District led to an increase of oil production in this region of Russia more than 1.5 times compared to 2003. In the third quarter of 2004 we started commercial production at Kravtsovskoye (D-6), a Baltic offshore field. In 2004 we produced 81 thousand tonnes of crude oil from this field, and yearly crude oil production will reach 700 thousand tonnes by 2007. The total organic growth of the oil production was 5.3% compared to 2003.

The following table represents our production in 2004 and 2003 by major regions excluding our share in equity associates:

(thousands of tonnes)	**2004**	Change from 2003 Total %	Change from 2003 Change in structure	Change from 2003 Organic growth	2003
Western Siberia	**55,630**	8.6 %	1,464	2,922	51,244
Komi Republic	**9,561**	10.8 %	784	151	8,626
Ural region	**10,010**	0.6 %	–	61	9,949
Volga region	**2,969**	(0.3)%	–	(8)	2,977
Timano-Pechora (Nenetsky Autonomous District)	**1,489**	55.8 %	–	533	956
Other in Russia	**1,380**	11.3 %	29	111	1,240
Crude oil production in Russia	**81,039**	8.1 %	2,277	3,770	74,992
Crude oil produced internationally	**1,369**	26.8 %	–	289	1,080
Total crude oil produced	**82,408**	8.3 %	2,277	4,059	76,072

In April, 2005 we started commercial production on the Nakhodkinskoe gas field. This is a first stage of development of the Bolshekhetskaya basin fields in the Yamalo-Nentsky Autonomous District. We estimate production output from the filed will reach 11 bcm in 2005-2006 and the field's planned production capacity of 10 bcm per year will be achieved in 2007. Development of the Bolshekhetskaya basin fields is a core element of our gas business strategy.

In addition to our production, we purchase crude oil from third parties in Russia and on international markets. In Russia we primarily purchase crude oil from associated producing companies and other producers, including vertically integrated companies that lack refining capacity or are unable to export their crude oil. We may either refine or export purchased crude oil. Crude oil purchased on international markets is used mostly for marketing activities and, on certain occasions, for supplying our overseas refineries.

	2004		**2003**		**2002**	
	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)
Crude oil purchases in Russia	20,810	2,839	34,436	4,698	37,060	5,056
Crude oil purchases internationally	64,695	8,826	59,278	8,087	23,676	3,230
Total crude oil purchased	**85,505**	**11,665**	**93,714**	**12,785**	**60,736**	**8,286**

The volume of crude oil purchased in Russia in 2004 was 2,839 thousand tonnes, a 1,859 thousand tonnes decrease compared to 2003. The decrease occurred because in the first half of 2003 most of our purchases of crude oil in Russia were from associate companies, which in the second quarter of 2003 became fully consolidated subsidiaries. The volume of crude oil purchased internationally increased by 739 thousand tonnes, or by 9.1%, as a result of an increase in our marketing activity.

Refining and marketing

We operate four refineries located in European Russia and three refineries located overseas – in Bulgaria, Ukraine and Romania. Our Romanian refinery, Petrotel-LUKOIL S.A., had been undergoing significant upgrades until October 2004. In October 2004, we put Petrotel-LUKOIL back into operation (see page 3).

Production of refined products in 2004 increased by 4.1% as compared to 2003. Russian refineries increased production by 3.1%, while the overseas refineries increased production by 8.8% primarily due to recommencement of production by Petrotel-LUKOIL.

In 2004 we continued to expand our marketing activities in Western Europe, South-East Asia, Northern and Central America. Our marketing activities mainly include wholesale and bunkering operations in Western Europe and South-East Asia. The total volume of refined products, purchased in this activity from third parties was 13,767 thousand tonnes or $3,878 million (9,134 thousand tonnes or $1,929 million in 2003). In addition, the Group purchases refined products to supply our retail networks in the USA, Baltic states and some other regions. The total volume of refined products purchased in this activity from third parties during 2004 was 6,512 thousand tonnes or $2,965 million (4,254 thousand tonnes or $1,620 million in 2003).

In Russia we purchase refined products on occasion, primarily to manage supply chain bottlenecks.

The following table represents volumes of refined products produced and purchased:

	2004 (thousand of tonnes)	**2003** (thousand of tonnes)	**2002** (thousand of tonnes)
Refined products produced at the Group refineries in Russia................	33,438	32,444	32,325
Refined products produced at the Group refineries outside of Russia...	7,387	6,789	6,894
Total refined products produced...	**40,825**	**39,233**	**39,219**
Refined products purchased in Russia..	2,020	1,399	1,125
Refined products purchased internationally	20,507	14,396	6,274
Total refined products purchased..	**22,527**	**15,795**	**7,399**

Export of crude oil and refined products from Russia

We transport a significant portion of our crude oil through Transneft's trunk oil pipeline system. Access to the Transneft crude oil export pipeline network is allocated quarterly, based on recent volumes produced and delivered through the pipeline and proposed export destinations. The Russian Government places restrictions on access to the Transneft export network, which limits our ability to export via this method because of a need to ensure that sufficient oil remains in Russia to meet domestic requirements and capacity constraints of the crude oil pipeline network.

At the same time additional access to international markets bypassing Transneft export routes is obtained through rail transport or by tankers. Moreover, in the second quarter of 2004 we put into operation the first stage of our Vysotsk terminal and loaded the first tankers with crude oil. In 2004 the Company exported 9.0% of crude oil produced (7,389 thousand tonnes) by means other than Transneft, including through our own export infrastructure. By these methods we were able to export crude oil produced in the Nenetsky Autonomous District and the Kaliningrad Region.

	2004		**2003**		**2002***	
	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)
Export of crude oil using Transneft export routs...	285,204	38,909	240,150	32,763	225,405	30,751
Export of crude oil bypassing Transneft....	54,161	7,389	39,342	5,367	25,479	3,476
Total crude oil export..............................	**339,365**	**46,298**	**279,492**	**38,130**	**250,884**	**34,227**

* Including own export of affiliates.

In March 2004 capacity of the Baltic Pipeline System was increased up to 42 million tonnes of crude oil a year. This allowed us to increase the volume of crude oil exported via Primorsk terminal in 2004 by 3 times as compared to the previous year. In 2004 we exported via Primorsk 8,397 million tonnes of crude oil.

An increase in production of refined products in 2004 coupled with flat domestic sales and increased purchases of refined products in Russia allowed us to increase our export of refined products by 4.0% as compared to the previous year, or up to 14 million tonnes.

Results of operations

The table below details certain income and expense items from our consolidated statements of income for the periods indicated. All items are presented in millions of US dollars, except for earnings per share data and the items expressed as a percentage of revenues.

	2004		2003		2002	
Revenues						
Sales (including excise and export tariffs)	33,845	99.4%	22,118	99.2%	15,334	99.3%
Equity share in income of affiliates	213	0.6%	181	0.8%	115	0.7%
Total revenues	**34,058**	**100.0%**	**22,299**	**100.0%**	**15,449**	**100.0%**
Costs and other deductions						
Operating expenses	(2,880)	(8.5)%	(2,546)	(11.4)%	(2,403)	(15.6)%
Cost of purchased crude oil, petroleum and chemical products	(10,124)	(29.7)%	(5,909)	(26.5)%	(2,693)	(17.4)%
Transportation expenses	(2,784)	(8.2)%	(2,052)	(9.2)%	(1,414)	(9.2)%
Selling, general and administrative expenses	(2,024)	(5.9)%	(1,800)	(8.1)%	(1,313)	(8.5)%
Depreciation, depletion and amortization	(1,075)	(3.2)%	(920)	(4.1)%	(824)	(5.3)%
Taxes other than income taxes	(3,505)	(10.3)%	(2,456)	(11.0)%	(1,972)	(12.8)%
Excise and export tariffs	(5,248)	(15.4)%	(2,954)	(13.3)%	(1,996)	(12.9)%
Exploration expense	(171)	(0.5)%	(136)	(0.6)%	(89)	(0.6)%
Gain from sale of interest in Azeri, Chirag, Guneshli	–	–	1,130	5.1 %	–	–
Loss on disposal and impairment of assets	(213)	(0.6)%	(69)	(0.3)%	(83)	(0.5)%
Income from operating activities	**6,034**	**17.7%**	**4,587**	**20.6%**	**2,662**	**17.2%**
Interest expense	(300)	(0.9)%	(273)	(1.2)%	(222)	(1.4)%
Interest and dividend income	180	0.5 %	139	0.6 %	160	1.0 %
Currency translation gain	135	0.4 %	148	0.7 %	40	0.3 %
Other non-operating income	21	0.1 %	11	0.0 %	11	0.1 %
Minority interest	(62)	(0.2)%	(36)	(0.2)%	(69)	(0.5)%
Income before income taxes	**6,008**	**17.6%**	**4,576**	**20.5%**	**2,582**	**16.7%**
Current income taxes	(1,614)	(4.7)%	(939)	(4.2)%	(834)	(5.4)%
Deferred income taxes	(146)	(0.4)%	(68)	(0.3)%	95	0.6 %
Total income tax expense	**(1,760)**	**(5.1)%**	**(1,007)**	**(4.5)%**	**(739)**	**(4.8)%**
Income before cumulative effect of change in accounting principle	**4,248**	**12.5%**	**3,569**	**16.0%**	**1,843**	**11.9%**
Cumulative effect of change in accounting principle, net of tax	–	–	132	0.6%	–	–
Net income	**4,248**	**12.5%**	**3,701**	**16.6%**	**1,843**	**11.9%**
Earnings per share of common stock (in US dollars):						
Basic	5.20		4.52		2.26	
Diluted	5.13		4.45		2.26	
Exclusion of special items:						
Cumulative effect of change in accounting principle, net of tax	–	–	(132)	(0.6)%	–	–
Gain from sale of interest in Azeri, Chirag, Guneshli	–	–	(1,130)	(5.1)%	–	–
Charges for settlement of tax claims	–	–	–	–	103	0.7%
Pension curtailment	–	–	(53)	(0.2)%	39	0.3%
Net income excluding special items	**4,248**	**12.5%**	**2,386**	**10.7%**	**1,985**	**12.9%**

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

Special items. Our effective income tax rate in 2002 increased as a result of settlement of claims with tax authorities in respect to income tax and other tax relief received in 2001. The Company agreed to settle these claims without prejudice and recorded a provision of $103 million in 2002.

During 2002 we recorded a total pension expense of $82 million, including $39 million related to adjustments of pension liabilities as a result of revision of some underlying actuarial assumptions.

In December 2003 we took the decision to replace the Group's existing defined benefit pension plan with a new plan. The new plan is principally a defined contribution plan. This resulted in the recognition of a curtailment gain of $53 million.

Net income for 2003 includes a non-taxable gain from the sale of our interest in the Azeri, Chirag, Guneshli project of $1,130 million.

Year ended December 31, 2004 compared to the year ended December 31, 2003

Sales revenues

Sales breakdown	**2004**		**2003**	
	(millions of US dollars)			
Crude oil				
Export and sales on international markets other than CIS	10,338	30.5%	6,411	29.0%
Export and sales to CIS	602	1.8%	433	2.0%
Domestic sales	181	0.5%	374	1.7%
	11,121	**32.8%**	**7,218**	**32.7%**
Refined products				
Export and sales on international markets				
Wholesale	11,403	33.7%	7,214	32.6%
Retail	3,914	11.6%	2,266	10.3%
Domestic sales				
Wholesale	3,429	10.1%	2,608	11.8%
Retail	1,236	3.7%	842	3.8%
	19,982	**59.1%**	**12,930**	**58.5%**
Petrochemicals				
Export and sales on international markets	1,021	3.0%	671	3.0%
Domestic sales	332	1.0%	251	1.1%
	1,353	**4.0%**	**922**	**4.1%**
Other	**1,389**	**4.1%**	**1,048**	**4.7%**
Total sales	**33,845**	**100.0%**	**22,118**	**100.0%**

Sales volumes

	2004		**2003**	
	(thousands of barrels)			
Crude oil				
Export and sales on international markets other than CIS	307,523		246,889	
Export and sales to CIS	29,877		29,826	
Domestic sales	11,999		43,826	
Crude oil	(thousands of tonnes)			
Export and sales on international markets other than CIS	41,954	38.6%	33,682	34.3%
Export and sales to CIS	4,076	3.7%	4,069	4.1%
Domestic sales	1,637	1.5%	5,979	6.1%
	47,667	**43.8%**	**43,730**	**44.5%**
Refined products	(thousands of tonnes)			
Export and sales on international markets				
Wholesale	35,946	33.1%	30,193	30.8%
Retail	5,480	5.0%	3,802	3.9%
Domestic sales				
Wholesale	16,981	15.6%	17,967	18.3%
Retail	2,743	2.5%	2,506	2.5%
	61,150	**56.2%**	**54,468**	**55.5%**
Total sales volume of crude oil and refined products	**108,817**	**100.0%**	**98,198**	**100.0%**

Realized average sales prices

	2004		2003	
	($/barrel)	($/tonne)	($/barrel)	($/tonne)
Average realized price international				
Oil (excluding CIS)	33.62	246.42	25.97	190.35
Oil (CIS)	20.13	147.57	14.50	106.25
Refined products				
Wholesale		317.24		238.94
Retail		714.19		596.02
Average realized price within Russia				
Oil	15.09	110.58	8.53	62.54
Refined products				
Wholesale		201.94		145.15
Retail		450.64		335.90

During 2004 sales revenues increased by $11,727 million, or 53.0%, compared to the same period of 2003.

The total volume of crude oil and refined products sold amounted 108.8 million tonnes, which is 10.8% more than that sold in 2003. Our revenues from crude oil sales increased by $3,903 million, or 54.1%. Our sales of refined products increased by $7,052 million, or 54.5%.

Sales of crude oil and refined products on the international market, including the CIS, accounted for 80.4% of total sales volume in 2004 compared to 73.1% in 2003.

The increase in sales was principally due to the following:

- favorable price conditions: international crude oil market prices were at a ten-year high (see “Change in the price of crude oil and refined products” on page 5)
- increase in total volume of crude oil production (see “Oil and gas production” on page 9)
- increase in marketing activities (see page 10)
- decrease of crude oil sales in Russia and increase in volumes exported on international markets (see “Export of crude oil and refined products from Russia” on page 11)

Sales of crude oil

During 2004 the Company decreased its sales of crude oil on the domestic market compared to the previous year by 4,342 thousand tonnes, or 72.6%. This change was caused by an increase in volumes exported by the Company’s domestic producers and an increase in the Group’s refineries throughput.

During 2004 we increased exports of crude oil on international markets by the Company’s domestic producers by 8,168 thousand tonnes. The increase in export sales, along with an increase in the average realized export price of crude oil on international markets (other than CIS) from $25.97 to $33.62 per barrel, allowed us to obtain an additional $2,012 million in revenues.

Sales of refined products

Sales of refined products made up 59.1% of our total sales revenues (56.2% in terms of volumes sold) compared to 58.5% (55.5% – in terms of volumes) in 2003.

The average realized wholesale price on refined products outside of Russia increased by $78.30 per tonne, or 32.8%. Volumes of refined products sold outside of Russia increased by 5,753 thousand tonnes, or 19.1% (see also “Refining and marketing” on page 10). As a result, our revenues from wholesale of refined products outside of Russia increased by $4,189 million, or 58.1%.

In 2004 we increased retail sales of refined products outside of Russia by 1,678 thousand tonnes, or by 44.1% as compared to the same period of 2003. The increase was a result of continuing development of the existing retail chains in other regions and structural changes in the retail network we operate. In particular, we acquired Beopetrol in Serbia in 2003 and the additional retail network in the USA in May 2004. As of December 31, 2004 we operated 3,108 refueling stations outside of Russia compared to 2,560 as of December 31, 2003. Retail sales primarily include sales of gasoline, diesel oil and other refined products (heating oil, lubricants, etc.). Average retail prices increased up to $714.19 per tonne, or by

19.8%. As a result, our revenues from retail sales increased by $1,648 million, or 72.7%. Revenue from retail sales was 25.6% of total sales of refined products outside of Russia in 2004.

Wholesale of refined products within Russia in 2004 decreased by 986 thousand tonnes, or 5.5%, as compared to the same period in 2003. The decrease was caused by an increase in retail sales and increase in export of refined products. It was compensated by an increase of the average domestic realized price on refined products of $56.79 per tonne, or 39.1%. As a result, our revenues from wholesale of refined products on the domestic market increased by $821 million, or 31.5%.

Retail sales within Russia in 2004 increased by 237 thousand tonnes, or 9.5%, as compared to 2003. Average retail prices increased up to $450.64 per tonne, or by 34.2%. As a result, our revenues from retail sales increased by $394 million, or 46.8%. Revenue from retail sales was 26.5% of total sales of refined products in Russia in 2004. As of December 31, 2004 we operated 1,248 refueling stations in Russia as compared to 1,246 as of December 31, 2003.

Sales of petrochemical products

Revenues from sales of petrochemical products increased by $431 million, or 46.7%, during 2004. This was mainly due to an increase of production volume up to 2,240 thousand tonnes, or by 7.8%, compared to 2003, and an increase in average realized prices.

Sales of other products

Other sales increased by $341 million, or 32.5%, as a result of sales of other products produced by the Company, and also increased activity in providing other services to third parties.

Equity share in income of affiliates

Our share in the income of affiliates in 2004 increased by $32 million, or 17.7%, compared to 2003, primarily due to an increase in the net income of ZAO Turgay-Petroleum. ZAO Turgay-Petroleum, our 50% interest affiliate company, is a partner in the Turgay Petroleum joint venture developing the Kumkol field in Kazakhstan. The Group's share in the net income of ZAO Turgay-Petroleum in 2004 amounted $45 million that represents an increase of $17 million as compared to 2003.

Operating expenses

Operating expenses include the following types of costs:

	2004	2003
	(millions of US dollars)	
Extraction expenses	1,556	1,458
Refining expenses	551	479
Petrochemical expenses	188	149
Other operating expenses	585	460
Total operating expenses	**2,880**	**2,546**
Cost of purchased crude oil, petroleum and chemical products	**10,124**	**5,909**

Compared to 2003, operating expenses increased by $334 million, or 13.1%.

Extraction expenses. Our extraction expenses include expenditures related to repairs of extraction equipment, labor costs, expenses of artificial stimulation of reservoirs, fuel and electricity costs and other similar costs.

Expenses of the Company's production enterprises related to the sale of services and goods (such as electricity, heat, etc.) that do not relate to core activities have been excluded from extraction expenses and are included in other operating costs.

Extraction expenses rose by $98 million, or 6.7%, compared to the respective period of 2003. The increase in total extraction expenses resulted from an increase in volumes of oil produced by our subsidiaries from 76.1 million tonnes in 2003 to 82.4 million tonnes in 2004 as well as an 18.5% real ruble appreciation during the 2004. Despite these facts our average extraction cost per barrel slightly decreased from $2.61 to

$2.58 per barrel, or 1.1% (average extraction cost calculated using an average tonnes to barrels conversion rate of 7.33). The decrease was caused by an increase in an average daily oil flow per well from 9.7 tonnes a day in the 2003 to 10.7 tonnes a day in the 2004, or 10.3%, and restructuring of our oil producing assets in the Perm region.

Refining expenses at our refineries increased by $72 million, or 15.0%, in 2004 compared to 2003.

Refining expenses of our domestic refineries increased by 18.7%, or $63 million. This was primarily caused by an appreciation in the exchange rate of the ruble to the US dollar and an increase in volumes produced.

Refining expenses of our international refineries increased by 6.3%, or $9 million, primarily due to the recommencement of operations of our Romanian refinery Petrotel-LUKOIL after modernization.

Operating expenses of petrochemical companies increased by $39 million, or 25.9%, compared to 2003, as result of an appreciation in the exchange rate of the ruble to the US dollar and an increase in volumes produced.

Other operating expenses include the costs of other services provided and goods not related to primary activities (such as electricity, heat, etc.) sold by our production companies, and operating expenses of other non-core businesses of the Group. Other operating expenses also include costs associated with the delivery of crude oil from the Group's exploration and production entities to the Group's refineries, as well as the amount of the change in crude oil and refined products inventory at the Group's marketing entities. Other operating expenses increased by $125 million, or 27.3%, as compared to 2003 primarily as a result of change in crude oil and refined products inventory in 2004.

Cost of purchased crude oil, petroleum and chemical products increased by $4,215 million in 2004, or 71.3%, compared to the prior period due to a significant increase in volumes of refined products purchased for resale in 2004 by 6,394 thousand tonnes and growth of market prices on crude oil and petroleum products.

Transportation expenses

The increase in the total volume of sales led to an increase in transportation expenses. However, the main factor in the increase of $732 million, or 35.7%, in these expenses compared to 2003 was the increase in the transportation tariffs.

During the year ended December 31, 2004, transportation tariffs increased as follows: pipeline transport – 10.9%, including increase of Transneft's tariff – 13.3%, sea shipping – 46.7% (weighted average by volumes transported to different locations), railway transport – 21.6%.

Selling, general and administrative expenses

Our selling, general and administrative expenses increased by $224 million, or 12.4%, compared to 2003. The above-mentioned expenses include general business expenses, payroll costs (excluding extraction entities' and refineries' production staff cost), insurance costs, costs of maintenance of social infrastructure, movement in bad debt provision and other expenses.

The increase in selling, general and administrative expenses was primarily caused by 18.5% real appreciation of the ruble during 2004. It was partly compensated by movements in the bad debt provision. During the year ended December 31, 2004 the bad debt provision increased by $48 million, thus increasing general expenses, while for the same period of 2003 the bad debt provision increased by $79 million. Also, in 2004 the Company accrued $65 million of compensation to management in relation to the share-based compensation program, compared to $26 million in 2003.

Depreciation, depletion and amortization

Depreciation, depletion and amortization expenses include depletion of assets fundamental to production, depreciation of other productive and non-productive assets and certain intangible assets. Our depreciation, depletion and amortization expenses increased by $155 million, or 16.8%, in comparison to 2003. The increase was a result of the Company's capital expenditure program and corresponding growth of depreciable assets. This increase was partly compensated by upward revisions of the Company's proved reserves and, consequently, an increase in estimated useful economic life of fixed assets.

Taxes other than income taxes

Taxes other than income taxes include mineral extraction tax, property tax and social taxes.

	2004		2003	
	in Russia	**International**	**in Russia**	**International**
	(millions of US dollars)			
Mineral extraction tax	2,971	–	1,966	–
Social security taxes and contributions	302	28	235	21
Property tax	91	20	123	16
Other taxes	60	33	59	36
	3,424	**81**	**2,383**	**73**
Total		**3,505**		**2,456**

The increase in taxes other than income taxes resulted primarily from a $1,005 million increase in mineral extraction tax, which is linked to international crude oil prices (see "Tax burden" on page 6). Social taxes and contributions in Russia increased by $67 million, or 28.5%, as compared to 2003. As allowed by the current legislation we recalculated domestic property tax for 2002 and 2003 that resulted in $36 million decrease in property tax charge for 2004.

Excise and export tariffs

Our excise and export tariffs include duties on sales of refined products and export tariffs on export of crude oil and refined products. Excise and export tariffs increased by $2,294 million, or 77.7%, compared to 2003. The increase in export tariff expenses resulted from an increase in export tariff rates (see "Tax burden" on page 6) and also an increase in volumes exported. The increase in international excise taxes on refined products resulted from an increase in excise taxes and fuel sales taxes and from an increase in volumes of products sold across our international group, primarily in the USA.

	2004		2003	
	in Russia	**International**	**in Russia**	**International**
	(millions of US dollars)			
Excise tax and sales taxes on refined products	547	1,774	449	1,106
Export tariffs	2,913	14	1,392	7
	3,460	**1,788**	**1,841**	**1,113**
Total		**5,248**		**2,954**

Exploration expenses

The costs we incur in our exploratory drilling efforts are capitalized to the extent that our exploration efforts are successful and otherwise are charged to expenses of the current period. During 2004 the amount charged to exploration expense increased in comparison with 2003 by $35 million, or by 25.7%.

Loss on disposal and impairment of assets

Loss on disposal and impairment of assets in 2004 was $213 million compared to $69 million in 2003. In the second quarter of 2004 we recognized an impairment loss of $35 million in relation to our decision to sell our ownership interest in OAO Bank Petrocommerce. In the third quarter of 2004 we recognized an impairment loss of $70 million in relation to our decision to sell our ownership interest in OOO LUKOIL-Burenie. For details please refer to Note 10 "Dispositions and assets held for sale" of the consolidated financial statements.

Interest expense

Interest expense in 2004 increased by $27 million compared to the same period of 2003 primarily due to an increase of LIBOR rates in 2004.

Income taxes

Our total income tax expense increased by $753 million, or 74.8%, compared to 2003 while our income before income tax increased by $1,432 million, or 31.3% (excluding gain on sale of interest in Azeri, Chirag, Guneshli, our income before income tax increased by $2,562 million, or 74.3%).

Our effective tax rate in 2004 was 29.3% (in 2003 it was 29.2%, excluding the effect of gain on sale of interest in Azeri, Chirag, Guneshli), which is higher than the maximum statutory rate for the Russian Federation (24%). This is attributable to the fact that some costs incurred during the period are not tax deductible or only deductible to a certain limit. Moreover, despite the impairment losses recorded in the consolidated financial statements, the disposals of OAO Bank Petrocommerce and OOO LUKOIL-Burenie resulted in a taxable gain under Russian tax legislation. In 2004 income tax expense included $28 million related to these disposals, thus increasing our effective tax rate.

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

	2004	2003
	(millions of US dollars)	
Income before income taxes	**6,008**	**4,576**
Add back:		
Depreciation and amortization	1,075	920
Interest expense	300	273
Interest and dividend income	(180)	(139)
EBITDA	**7,203**	**5,630**

Year ended December 31, 2003 compared to the year ended December 31, 2002

Sales revenues

Sales breakdown	**2003**		**2002**	
	(millions of US dollars)			
Crude oil				
Export and sales on international markets other than CIS	6,411	29.0%	4,171	27.2%
Export and sales to CIS	433	2.0%	165	1.1%
Domestic sales	374	1.7%	469	3.1%
	7,218	**32.7%**	**4,805**	**31.4%**
Oil products				
Export and sales on international markets	9,480	42.9%	6,225	40.6%
Domestic sales	3,450	15.6%	2,883	18.8%
	12,930	**58.5%**	**9,108**	**59.4%**
Petrochemicals				
Export and sales on international markets	671	3.0%	392	2.6%
Domestic sales	251	1.1%	134	0.9%
	922	**4.1%**	**526**	**3.4%**
Other	**1,048**	**4.7%**	**895**	**5.8%**
Total sales	**22,118**	**100.0%**	**15,334**	**100.0%**

Sales volumes	**2003**		**2002**	
	(thousands of barrels)			
Crude oil				
Export and sales on international markets other than CIS	246,889		183,826	
Export and sales to CIS	29,826		13,722	
Domestic sales	43,826		56,618	
Crude oil	(thousands of tonnes)			
Export and sales on international markets other than CIS	33,682	34.3%	25,079	31.1%
Export and sales to CIS	4,069	4.1%	1,872	2.3%
Domestic sales	5,979	6.1%	7,724	9.6%
	43,730	**44.5%**	**34,675**	**43.0%**
Oil products	(thousands of tonnes)			
Export and sales on international markets	33,995	34.7%	26,284	32.6%
Domestic sales	20,473	20.8%	19,727	24.4%
	54,468	**55.5%**	**46,011**	**57.0%**
Total sales volume of crude oil and refined products	**98,198**	**100.0%**	**80,686**	**100.0%**

Realized average sales prices

	2003		**2002**	
	($/barrel)	($/tonne)	($/barrel)	($/tonne)
Average realized price international				
Oil (excluding CIS)	25.97	190.35	22.69	166.33
Oil (CIS)	14.50	106.25	12.00	87.97
Refined products		278.87		236.85
Average realized price within Russia				
Oil	8.53	62.54	8.28	60.72
Refined products		168.50		146.14

In 2003 sales revenue increased by $6,784 million, or 44.2%, compared to 2002.

The total volume of crude oil and refined products sold amounted to 98.2 million tonnes, which is 21.7% more than in 2002. Our revenues from crude oil sales increased by $2,413 million, or 50.2%. Our sales of refined products increased by $3,822 million, or 42.0%.

Sales of crude oil and refined products on the international market, including the CIS, accounted for 73.1% of total sales in 2003, compared to 66.0% in 2002.

The increase in sales was principally due to the following:

- increase in crude oil prices and refined products prices compared to 2002 (e.g. price increase on Urals crude (CIF Med) on international markets was 14.1%, light distillates – more than 20.0%, fuel oil – 15.0%)
- increase in volumes exported from Russia (export of crude oil increased by 24.5%; export of refined products decreased by 1.1% due to growth of own consumption)
- increase in total volume of oil production to 76.1 million tonnes
- increase in marketing activities

Reduction in sales of crude oil on the domestic market due to increase in export and refining

In 2003 the Company increased volumes exported by domestic producers by 53.7 million barrels as compared to 2002. In particular this change was caused by a decrease of sales of crude oil on the domestic market compared to the previous year by 12.8 million barrels, or 22.6%.

The increase in export sales, along with an increase in the average realized export price of crude oil on international markets (other than CIS) from $22.69 per barrel in 2002 to $25.97 per barrel in 2003 as well as an increase in the average realized price on CIS markets from $12.00 per barrel to $14.50 per barrel, allowed us to obtain an additional $1.2 billion in revenues.

Change in share of refined products in total sales volumes

Sales of refined products made up 55.5% of our total sales compared to 57.0% in 2002.

The average realized price on refined products outside Russia increased by $42.02 per tonne, or 17.7%. Volumes of refined products sold outside Russia increased by 7,711 thousand tonnes, or 29.3%. As a result our revenues from sales of refined products outside Russia increased by $3,255 million, or 52.3%.

The Company's revenues from refined product sales outside Russia in 2003 include revenues from retail sales of $2,323 million. Refined products sold at retail amounted to 3,926 thousand tonnes; the average realized price was $591.78 per tonne.

The average realized price on refined products sold within Russia increased by $22.36 per tonne, or 15.3%. Domestic refined products sales increased by 746 thousand tonnes, or 3.8%. As a result our revenues from sales of refined products on the domestic market increased by $567 million, or 19.7%.

The Company's revenues from refined product sales on the domestic market in 2003 include revenues from retail sales of $787 million. Refined products sold at retail amounted to 2,315 thousand tonnes; the average realized price was $340.08 per tonne.

Increase in sales of petrochemical products

Revenues from sales of petrochemical products increased by $396 million, or 75.3%, mainly as a result of an increase in sales volumes due to the acquisition of the LUKOR petrochemical plant in the third quarter of 2002 and an increase in average realized prices in 2003 compared to 2002. The increase in the output of petrochemical products at LUKOR in 2003 led to a revenue increase from sales of petrochemical products of $70 million.

Increase in sales of other products

Other sales increased by $153 million, or 17.2%, as a result of sales of other products produced by the Company, and also increased activity in providing services to third parties such as transportation and construction.

Increase in marketing activities

In line with our strategy, during 2003 the Group continued penetration into new international markets and development of the LUKOIL brand name around the world. We significantly expanded our marketing activities in developed markets. In particular, the Group commenced marketing and trading on different markets in Western Europe, South-East Asia, Northern and Central America. The total volume of refined products, which were purchased from third parties for resale, was 9,134 million tonnes or $1,929 million.

In addition, the Group purchased refined products in the USA in order to supply its retail sales chain. Total volume of refined products purchased in this activity from third parties during 2003 was 3.1 million tonnes or $1,068 million.

Increase in the equity share in income of affiliates

Our share in the income of affiliates was $181 million. This is $66 million higher than in the previous year. This increase mainly resulted from significant profits generated by our exploration and production affiliates in 2003 as result of the growth of international market prices for crude oil.

Operating expenses

Operating expenses include the following types of costs:

	2003	**2002**
	(millions of US dollars)	
Extraction expenses	1,458	1,355
Refining expenses	479	417
Processing costs at associated refineries	–	131
Petrochemical expenses	149	115
Other operating expenses	460	385
Total operating expenses	**2,546**	**2,403**
Costs of purchased crude oil and petroleum products	**5,909**	**2,693**

Compared to 2002, operating expenses increased by $143 million, or 6.0%. Costs of purchased crude oil and petroleum products increased by $3,216 million, or 119.4%, compared to 2002 primarily as a result of increase in volumes of crude oil and petroleum products purchased for resale.

During the preparation of the annual financial statements for the year ended December 31, 2003, the Company enhanced its accounting information gathering and processing procedures. It allowed us to classify certain revenues and expenses arising out of transactions with third parties more punctually than was done in the interim financial statements. The changes in classification we made did not have an effect on net income or income from operating activities of the Company for either the whole period ended December 31, 2003, or for any interim period. These changes have an effect on presentation of other revenues and other operating expenses in the financial statements.

Our **extraction expenses** include expenditures related to current and overhaul repairs of extraction equipment, labor costs, expenses of artificial stimulation of reservoirs, fuel and electricity costs and other similar costs.

Expenses of the Company’s production enterprises related to the sale of services and goods (such as electricity, heat, etc.) that do not relate to core activities have been excluded from extraction expenses and are included in other operating costs.

Despite a 20.8% real ruble appreciation during the 2003, our average extraction cost per barrel increased slightly from $2.60 to $2.61 per barrel (average extraction cost calculated using an average tonnes to barrels conversion rate of 7.33). The increase in total extraction expenses resulted from an increase in volumes of oil produced by our subsidiaries from 71.3 million tonnes 2002 to 76.1 million tonnes in 2003. Total extraction expenses rose by $103 million, or 7.6%, as compared to the previous year.

Refining expenses at our refineries increased by $62 million, or 14.9%, compared to 2003. This was primarily a result of refining expenses at the LUKOIL-Nizhegorodnefteorgsintez refinery being included in the Company’s total refining expenses starting from August 2002, when it became a consolidated subsidiary. Prior to this period processing fees at LUKOIL-Nizhegorodnefteorgsintez were accounted for as processing costs at an associated refinery. Expenses of LUKOIL-Nizhegorodnefteorgsintez in 2003 were $66 million, while in the same period of the previous year these expenses amounted to $18 million.

In addition, refining expenses of our international refineries increased by 9.2%, or $12 million. This was primarily caused by an appreciation in the exchange rate of Bulgarian lev to the US dollar. The exchange rate of Bulgarian lev is pegged to the Euro and as such appreciates in line with the Euro-US dollar movement in 2003 (20.3%).

Operating expenses of petrochemical companies increased by $34 million, or 29.6%, compared to 2002. The increase resulted from the acquisition of the LUKOR petrochemical plant in the third quarter of 2002. The operating expenses of the LUKOR refinery for the first half of 2003 were $30 million.

Other operating expenses include the costs of other services provided and goods not related to primary activities (such as electricity, heat, etc.) sold by our production companies, and operating expenses of other non-core businesses of the Group. Other operating expenses also include costs associated with the delivery of crude oil from the Group's exploration and production entities to the Group's refineries, as well as the amount of the change in crude oil and refined products inventory at the Group's marketing entities. Other operating expenses increased by $75 million, or 19.5%, as compared to 2002 in particular as a result of increase in other sales, increase in delivery costs and change in crude oil and refined products inventory during 2003.

Other operating expenses also include pension expense (income). During 2002 we recorded a pension expense of $82 million as a part of other operating expenses. As a result of revisions of underlying actuarial assumptions regarding our pension liabilities and curtailment gains in 2003, we recorded income of $6 million against other operating expense from reduction of such liabilities.

Costs of purchased crude oil and petroleum products increased by $3,216 million, or 119.4%, in comparison with the prior year primarily due to a significant increase in volumes purchased (crude oil by 33.0 million barrels, refined products by 8.4 million tonnes) and an increase in purchase prices.

Transportation expenses

The increase in the total volume of sales and the change in their structure led to an increase in transportation expenses. However, the main factor in the increase of $638 million, or 45.1%, in these expenses compared to 2002 was the increase in the transportation tariffs and increase of transportation of crude oil and oil products by sea, railway and river transport.

During 2003, transportation tariffs increased as follows: pipeline transport – 19.0%, sea shipping – 50.5% (weighted average by volumes transported to different locations), railway transport – 20.2%. At the same time the volume of goods transported by sea tankers decreased by 3%.

Selling, general and administrative expenses

Our other selling, general and administrative expenses increased by $487 million, or 37.1%, in comparison with 2002. The above-mentioned expenses include general business expenses, payroll costs (excluding extraction entities' and refineries' production staff cost), insurance costs, costs of maintenance of social infrastructure, movement in bad debt provision and other expenses.

The increase in other selling, general and administrative expenses was primarily a result of 20.8% real appreciation of the ruble during 2003. Also, the Company accrued $26 million of compensation to management in relation to a stock appreciation rights compensation program. In addition, the movement in bad debt provision had an effect on selling, general and administrative expenses for the periods under consideration. During 2002 our bad debt provision decreased by $12 million thus decreasing general expenses, while for 2003 our bad debt provision increased by $79 million.

Depreciation, depletion and amortization

Depreciation, depletion and amortization expenses include depletion of assets fundamental to production, depreciation of other productive and non-productive assets and certain intangible assets and provision for abandonment and site restoration costs during 2002. Our depreciation, depletion and amortization expenses increased by $96 million, or 11.7%, in comparison to 2002. This increase resulted from implementation by the Company of the capital expenditure program and corresponding growth of depreciable assets, but this increase is partly compensated by upward revisions of the Company's proved reserves and, consequently, an increase in estimated useful economic life of fixed assets.

Taxes other than income taxes

Taxes other than income taxes include extraction tax, road user's tax, property tax and social taxes.

	2003		2002	
	in Russia	International	in Russia	International
	(millions of US dollars)			
Extraction tax	1,966	–	1,472	–
Social security taxes and contributions	235	21	191	7
Road taxes	–	–	126	–
Property tax	123	16	89	12
Other taxes	59	36	48	27
	2,383	**73**	**1,926**	**46**
Total		**2,456**		**1,972**

The increase in taxes other than income taxes resulted primarily from a $494 million increase in mineral extraction tax, which is linked to international crude oil prices. The $58 million increase in social taxes and contributions was compensated by the abolition of road taxes from January 1, 2003.

Excise and export tariffs

Our excise and export tariffs include duties on sales of refined products and export tariffs on export of crude oil and refined products. Excise and export tariffs increased by $958 million, or 48.0%, compared to the previous reporting period. The increase in export tariff expenses resulted from the increase in export tariff rates and also an increase in volumes exported. The increase in international excise taxes on refined products resulted from an increase in excise taxes and fuel sales taxes and from an increase in volumes of products sold across our international group as well as the increase in our refining.

Effective January 1, 2003, domestic tax legislation was amended in terms of payment of excises on refined products. Starting January 1, 2003, excises are paid by our marketing companies if they sell refined products to the end customer. If refined products are sold to another retailer or a wholesaler, the seller is not subject to excise if certain conditions set by legislation are met. During 2003 domestic excise rates rose by more than 44.8% as compared to 2002.

	2003		2002	
	in Russia	International	in Russia	International
	(millions of US dollars)			
Excise tax and sales taxes on refined products	449	1,106	387	811
Export tariffs	1,392	7	796	2
	1,841	**1,113**	**1,183**	**813**
Total		**2,954**		**1,996**

Exploration expenses

The costs we incur in our exploratory drilling efforts are capitalized to the extent that our exploration efforts are successful and otherwise are charged to expenses of the current period. During 2003, the amount charged to exploration expense increased in comparison to 2002 by $47 million.

Loss on disposal and impairment of assets

Loss on disposal and impairment of assets in 2003 was $69 million (excluding gain on sale of interest in Azeri, Chirag, Guneshli) compared to $83 million in 2002.

Interest expense

Interest expense in 2003 increased by $51 million, or 23.0%, compared to 2002 primarily due to an increase in the Group's level of debt, including balances of customers' deposits at the Group's banks. As of December 31, 2002, the Group's total debt was $4,193 million, including customers' deposits of $755 million. By December 31, 2003, the Group's total debt increased to $4,811 million, including customers' deposits of $1,007 million. Also, in 2003 1% convertible US Dollar bonds with a carrying value of $455 million as of December 31, 2002 matured.

Income taxes

Our total income tax expense increased by $268 million, or 36.3%, compared to 2002 while our income before income tax increased by $1,994 million, or 77.2% (excluding gain on sale of interest in Azeri, Chirag, Guneshli, by $864 million, or 33.5%).

Our effective tax rate in 2003, excluding the effect of gain on sale of interest in Azeri, Chirag, Guneshli, was 29.2% (in 2002 it was 28.6%), which is higher than the maximum statutory rate for the Russian Federation (24%). This is attributable to the fact that some costs incurred during the year were not tax deductible or only deductible to a certain limit.

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

	2003	2002
	(millions of US dollars)	
Income before income taxes	**4,576**	**2,582**
Add back:		
Depreciation and amortization	920	824
Interest expense	273	222
Interest and dividend income	(139)	(160)
EBITDA	**5,630**	**3,468**

Liquidity and capital resources

	2004	2003	2002
	(million US dollars)		
Net cash provided by operating activities	4,180	2,936	2,396
Net cash used in investing activities	(3,741)	(2,792)	(2,390)
Net cash (used in) provided by financing activities	(650)	(4)	96
Net debt	2,620	3,376	2,941
Current ratio	1.89	1.50	1.35
Total debt to equity	19%	28%	30%
Long term debt to long term debt and equity	11%	12%	11%
Total net debt to cash flow from operations	0.63	1.15	1.23

Our primary source of cash flow is funds generated from our operations. During 2004 cash generated by operating activities was $4,180 million, an increase of $1,244 million compared to 2003. In 2004 cash inflow from operating activity was impacted by the following factors:

- increase in revenue
- increase in amount of income tax paid
- increase in volume of export sales and, consequently, prepayment of custom fees, export duties and transportation tariffs.

During 2004 the Company spent $3,725 million on capital investments and acquisitions of interests in other companies, which was $381 million less than in 2003 due to a number of acquisitions of subsidiaries taking place in 2003 (see “Recent developments” on pages 3-4). Capital expenditures during 2004 amounted to $3,248 million, which was $367 million more than in 2003. It should be noted that in 2003 net cash provided by investing activities included proceeds of $1,337 million from the sale of our share in Azeri, Chirag, Guneshli. Therefore, our net cash used in investing activities in 2004 decreased on $388 million compared to 2003 (excluding these proceeds).

In 2004 cash outflows related to financing activities was $650 million, an increase of $646 million compared to 2003. This resulted from a decrease of inflow from borrowings on $298 million, an increase of cash used for purchases of treasury stock on $134 million, and growth of dividends payments.

The Company made payments of $661 million, $467 million and $423 million for dividends in 2004, 2003 and 2002, respectively.

As of December 31, 2004 our outstanding long-term debt amounted to $2,981 million, including amounts due within one year, compared to $2,803 as of December 31, 2003. The annual maturities of our total long-term debt are $372 million in 2005, $471 million in 2006, $774 million in 2007, $390 million in 2008, $393 million in 2009 and $581 million thereafter.

As of December 31, 2004, the Company also had obligations under short-term borrowings, excluding current portion of long-term debt, and customer deposits and other borrowings of banking subsidiaries of $893 million and $3 million, respectively, compared with $1,001 million and $1,007 million as of December 31, 2003. Customer deposits and other borrowings of banking subsidiaries now does not include customer deposits placed in OAO Bank Petrocommerce as a result of the Group’s sale of its ownership in the bank in the third quarter of 2004.

As of December 31, 2004 the Company had available unutilized credit facilities with a number of banks in the amount of $502 million.

The Company has sufficient borrowing capacity to meet unanticipated cash requirements, and even during periods of low commodity prices and narrow margins for refined products, it would have the flexibility to increase borrowings and/or modify capital spending plans to continue paying common stock dividend and to maintain the Company’s high-quality debt ratings.

Credit rating

The Company has a credit rating of BB by Standard and Poor’s, which is two grades below the Russian country credit rating of BBB–. Our bonds issued in 2002 are also rated BB.

In April, 2005 Moody's rated the Company at Ba1, which is one grade below the Russian country rating of Baa3.

Analysis of capital expenditures

	2004	2003	2002
	(millions of US dollars)		
Exploration and production			
Russia	2,100	1,537	1,078
International	189	247	333
Total exploration and production	2,289	1,784	1,411
Refining, marketing and distribution			
Russia	749	960	683
International	409	274	110
Total refining, marketing and distribution	1,158	1,234	793
Total capital expenditures*	**3,447**	**3,018**	**2,204**
Acquisitions of subsidiaries **			
Exploration and production			
Russia	23	989	67
International	143	–	–
Total exploration and production	166	989	67
Refining, marketing and distribution			
Russia	6	23	53
International	305	257	57
Total refining, marketing and distribution	311	280	110
Less cash acquired	**–**	**(44)**	**(4)**
Total	**477**	**1,225**	**173**

* Including non-cash transactions.
** Including prepayments related to acquisitions of subsidiaries and minority shareholding interest.

According to our strategy to increase crude oil production by 42% and gas production by 10 times up to 2013, which will be achieved from new provinces, we have started exploring and developing these areas during the last three years. The table below shows our historical capital expenditures included into exploration and production expenditures above on new promising oil regions.

Exploration and production	**2004**	**2003**	**2002**
	(millions of US dollars)		
Northern Timano-Pechora	379	363	338
Yamal	325	116	–
Caspian region	77	118	46

2005 Capital Expenditures Program

The Company estimates 2005 capital expenditures will be $3,542 million (using the exchange rate of 28.00 ruble to the US dollar), which is about 21.3% higher than capital expenditures in 2004. About $2,391 million, or 67.5% of the total, is budgeted for exploration and production activities, with $278 million of that outside of Russia. Exploration and production expenditures will target the most promising exploratory prospects in the Caspian region and major development projects in Timano-Pechora region as well on the maintenance and increase of production on existing fields in the other regions. Refining, marketing and distribution capital spending is estimated to be $614 million, with $171 million of that outside of Russia. Refining, marketing and distribution expenditures in Russia will be allocated to upgrading our refineries and selling facilities. International refining, marketing and distribution capital spending will target our distribution infrastructure in the USA, Hungary, Romania and the others countries, as well as our refineries in Bulgaria, Ukraine and Romania. The capital expenditures in our chemical segment are estimated to be $76 million. The Company may amend the capital expenditures program during the year depending on economic conditions and financial performance of the Group.

Guarantees, off-balance-sheet agreements and contractual obligations, and other contingencies

Financial Guarantees

	Commitment Expiration by Period						
Millions of dollars	**Total**	**2005**	**2006**	**2007**	**2008**	**2009**	**After**
Guarantees of equity affiliate's debt................	629	38	120	124	163	105	79
Guarantees of third party's debt	13	10	1	–	–	1	1

As of December 31, 2004 the Company provided guarantees of $629 million for loans of equity investees and $13 million for third parties. Guarantees issued in regard to equity investees primarily relate to borrowings for capital projects or general corporate purposes. These guarantees were undertaken to enhance the credit standing of the affiliated operations and to achieve lower interest rates. Under the terms of guarantees, the Company would be required to perform should an affiliate be in default of its loans, generally for the full amount disclosed. There are no assets held as collateral for the obligations of affiliates. One of the guarantees is secured by the shares of an affiliated company held by the Group, the carrying amount of which was approximately $31 million as of December 31, 2004. No collateral secures other guarantees. There are no amounts being carried as liabilities for the Company's obligations under these guarantees. For other details see Note 18, "Financial guarantees", in the consolidated financial statements.

Capital commitments and contractual obligations

The Company and its subsidiaries have significant capital commitments in respect to development of oil and gas fields in Russia. These commitments are regulated by law and described in the individual license agreements. We also have long-term lease obligations for retail outlets in the USA.

The Group owns and operates a refinery in Bulgaria through its subsidiary LUKOIL Neftochim Bourgas AD. Because Bulgaria will join the European Union in 2007, LUKOIL Neftochim Bourgas AD is required to upgrade its refining plant to comply with the requirements of European Union legislation in relation to the quality of produced petroleum products and environmental protection. These requirements are stricter than existing Bulgarian legislation. Management is currently assessing the amount of future capital commitment required to upgrade the refinery.

In connection with the sale of LUKOIL-Burenie the Group signed a five year contract for drilling services totaling $2,637 million.

The following table displays our total on and off balance sheet contractual obligations:

Millions of dollars	**Total**	**2005**	**2006**	**2007**	**2008**	**2009**	**After**
On balance sheet							
Short term debt	893	893	–	–	–	–	–
Long-term bank loans and borrowings	1,878	324	411	342	331	130	340
Long-term non-bank loans and borrowings	412	31	43	35	43	35	225
3.5% Convertible US dollar bonds	380	–	–	380	–	–	–
Other bonds	216	–	–	–	–	216	–
Capital lease obligations	95	17	17	17	16	12	16
TOTAL	**3,874**	**1,265**	**471**	**774**	**390**	**393**	**581**
Off balance sheet							
Operating lease obligations	887	109	86	84	83	83	442
Obligation under contract with LUKOIL-Burenie	2,637	361	378	571	661	666	–
Capital commitment in Beopetrol (Serbia)	63	62	1	–	–	–	–
Capital commitments in PSAs	525	176	158	81	65	3	42
Capital commitments under oil and gas license agreements in Russia	1,539	535	381	217	194	95	117
TOTAL	**5,651**	**1,243**	**1,004**	**953**	**1,003**	**847**	**601**

Litigation and claims

On November 27, 2001, Archangel Diamond Corporation ("ADC"), a Canadian diamond development company, filed a lawsuit in the District Court of Denver, Colorado, against OAO "Arkhangelskgeoldobycha" ("AGD"), a Group company, and the Company (together the "Defendants"). ADC claims, among other things, that the Defendants interfered with the transfer of a diamond exploration license to Almazny Bereg, a joint venture between ADC and AGD. The total damages claimed by ADC are approximately $4.8 billion, including compensatory damages of $1.2 billion and punitive damages of $3.6 billion. On October 15, 2002, the District Court of Denver, Colorado dismissed ADC's action against the Defendants based on lack of personal jurisdiction. On November 22, 2002, the Denver District Court denied ADC's request for reconsideration of the Court's October 15th order dismissing the case. ADC subsequently filed an appeal on November 27, 2002 with the Court of Appeals in the State of Colorado. On March 25, 2004, the Court of Appeals upheld the October 15, 2002 decision of the District Court. On April 17, 2004, ADC filed a motion for rehearing that was denied on June 17, 2004. ADC then filed a petition for writ of certiorari with the Colorado Supreme Court on July 16, 2004. On January 10, 2005 the Colorado Supreme Court granted certiorari on a narrow issue: whether the Court of Appeals erred by concluding that a trial court may decide a motion to dismiss for lack of personal jurisdiction by weighing and resolving factual issues without an evidentiary hearing. The Colorado Supreme Court declined to review ADC's other requested issue concerning jurisdiction. Written briefs are being submitted to the Colorado Supreme Court by the parties and, at present, no date has been set for oral arguments of this case. Management does not believe that the ultimate resolution of this matter will have a material adverse effect on the Group's financial condition.

On February 20, 2004 the Stockholm District Court overturned the decision of the Arbitral Tribunal of the Arbitration Institute of the Stockholm Chamber of Commerce made on June 25, 2001 dismissing ADC's action against AGD based on lack of jurisdiction. ADC's lawsuit against AGD was initially filed with the Arbitral Tribunal of the Arbitration Institute of the Stockholm Chamber of Commerce claiming alleged non-performance under an agreement between the parties and its obligation to transfer the diamond exploration license to Almazny Bereg. This lawsuit claimed compensation of damages amounting to $492 million. In March 2004 AGD filed an appeal against the Stockholm District Court decision with the Swedish Court of Appeals. The decision of the Swedish Court of Appeals is expected to be issued during 2005. Management does not believe that the ultimate resolution of this matter will have a material adverse effect on the Group's financial condition.

The Group is involved in various other claims and legal proceedings arising in the normal course of business. While these claims may seek substantial damages against the Group and are subject to uncertainty inherent in any litigation, management does not believe that the ultimate resolution of such matters will have a material adverse impact on the Group's operating results or financial condition.

Quantitative and qualitative disclosures about market risks

Interest rate risk

We are exposed to changes in interest rates, primarily associated with our variable rate short-term and long-term borrowings. We do not utilize any interest rate swaps or other derivatives to hedge against the risk of changes in interest rates on our variable rate debt. Utilizing the actual interest rates in effect and the balance of our variable rate debt as of December 31, 2004 and assuming a 10% change in interest rates and no change in the balance of debt outstanding, the potential effect on annual interest expense would not be material to our results of operations.

Foreign currency risk

The countries in which our principal operations are located have been subject to hyperinflation and during the last 10 years the local currency has been subject to large devaluations. As a result we are subject to the risk that the local currency may suffer future devaluation that may subject us to losses, depending on our net monetary asset position. We currently do not use any formal hedging arrangements to minimize the effect of these potential losses. Additionally, because we have operations in a number of other countries we are required to conduct business in a variety of foreign currencies and, as a result, we are subject to foreign exchange rate risk on cash flows related to sales, expenses, financing and investment transactions. The impacts of fluctuations in foreign currency exchange rates on our geographically diverse operations are varied. We recognized net foreign currency translation gains of $135 million, $148 million and $40 million for the years ended December 31, 2004, 2003 and 2002, respectively

Appreciation of ruble against the US dollar in 2004 had a negative impact on our operating profit and cash flows since it lead to an increase of our costs in dollar terms and a decrease of amount of the export cash revenue in the ruble terms. As mentioned above, a substantial part of our revenue is denominated in US dollars or, to some extent, bound to the oil prices quoted in US dollars, while a significant part of our costs is ruble denominated. We estimate that should the ruble appreciation against US dollars in 2005 be at a level of 12% (on the base of 8.5% inflation forecast of the Ministry of Economic Development and assumption that average nominal exchange rate will be 28.00 of ruble to the US dollar) our operating profit as well as net operating cash flows will decrease by $240 million (assuming that other macroeconomic factors will remain constant).

Commodity instruments

We make limited use of commodity instruments in our operations. The use of such instruments relates to limited marketing and trading of petroleum products outside of our physical crude oil and products businesses and hedging of commodity price risks. This includes the use of futures and swap contracts together with purchase and sale contracts that qualify as derivative instruments. The Company maintains a system of controls over these marketing and trading activities that includes policies covering the authorization, reporting and monitoring of derivative activity. We do not believe our derivative activities pose material credit or market risks to our operations, financial condition or liquidity. We recognized a net loss of $55 million during 2004 ($37 million in 2003) associated with such activities. The fair value of derivative contracts outstanding and recorded on the consolidated balance sheet as of December 31, 2004 was a net asset of $28 million (a net liability of $1 million and $6 million in 2003 and 2002 respectively).

Critical accounting policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to select appropriate accounting policies and to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. See Note 2, "Summary of significant accounting policies," for descriptions of the Company's major accounting policies. Certain of these accounting policies involve judgments and uncertainties to such an extent that there is a reasonable likelihood that materially different amounts would have been reported under different conditions, or if different assumptions had been used.

Successful Efforts Accounting for Oil and Gas Activities

Accounting for oil and gas activities is subject to special accounting rules that are unique to the oil and gas industry. Property acquisitions, successful exploratory wells, all development costs and support equipment and facilities are capitalized. Artificial stimulation and well work-over costs are included in operating expenses as incurred.

Property Acquisition Costs

For individually significant undeveloped properties, management periodically performs impairment test based on exploration and drilling efforts to date. For undeveloped properties acquisition costs that individually are relatively small, management exercises judgment and determines a periodic property impairment charge as required that is reported in exploration expense.

Exploratory Costs

For exploratory wells, drilling costs are temporarily capitalized, or "suspended", on the balance sheet, pending a judgmental determination of whether potentially economic oil and gas reserves have been discovered by the drilling effort. If a judgment is made that the well did not encounter potentially economic oil and gas quantities, the well costs are expensed as a dry hole and are reported in exploration expense. Exploratory wells that are judged to have discovered potentially economic quantities of oil and gas and that are in areas where a major capital expenditure would be required before production could begin, remain capitalized on the balance sheet as long as additional exploratory appraisal work is under way or firmly planned. Unlike license acquisition costs, there is no periodic impairment assessment of suspended exploratory well costs. Management continuously monitors the results of the additional appraisal drilling and seismic work and expenses the suspended well costs as dry holes when it judges that the potential field does not warrant further exploratory efforts in the near term.

Other exploratory expenditures, including geological and geophysical costs are expensed as incurred.

Proved Oil and Gas Reserves

Proved oil and gas reserves are the estimated quantities of crude oil, natural gas liquids including condensate and natural gas that geological and engineering data demonstrate with reasonable certainty can be recovered in future years from known reservoirs under existing economic and operating conditions. Reserves are considered proved if they can be produced economically as demonstrated by either actual production or conclusive formation tests. Reserves which must be produced through the application of enhanced recovery techniques are included in the proved category only after successful testing by a pilot project or operation of an installed program in the same reservoir that provides support for the engineering analysis on which the project was based. Proved developed reserves are expected to be produced through existing wells and with existing facilities and operating methods.

The estimates are made using all available geological and reservoir data as well as historical production data. Estimates are reviewed and revised as appropriate. Revisions occur as a result of changes in prices, costs, fiscal regimes, reservoir performance or a change in the Company's plans.

The Group has included within proved reserves quantities, which the Group expects to produce after the expiry dates of its current production licenses. These licenses expire between 2011 and 2026, with the most significant expiring between 2011 and 2014. We believe the licenses will be extended to produce subsequent to their current expiry dates. The Group is in the process of extending all of its production licenses in the Russian Federation. The Group has already extended a portion of these licenses and expects to extend the remaining licenses for indefinite periods. To date there have been no unsuccessful license renewal applications.

Impairment Of Long-Lived Assets

Long-lived assets used in operations are assessed for impairment whenever changes in facts and circumstances indicate a possible significant deterioration in the future cash flows expected to be generated by an asset group. If, upon review, the sum of the undiscounted pretax cash flows is less than the carrying value of the asset group, the carrying value is written down to estimated fair value. Individual assets are grouped for impairment purposes based on a judgmental assessment of the lowest level for which there are identifiable cash flows that are largely independent of the cash flows of other groups of assets. Because there usually is a lack of quoted market prices for long-lived assets, the fair value usually is based on the present values of expected future cash flows using discount rates commensurate with the risks involved in the asset group. The expected future cash flows used for impairment reviews and related fair value calculations are based on judgmental assessments of future production volumes, prices and costs, considering all available information at the date of review.

Site Restoration and Abandonment Costs

Under various laws, contracts, permits and regulations, the Company has legal obligations to remove tangible equipment and restore the land or seabed at the end of operations at production sites. The largest site restoration and abandonment obligations of the Company relate to wells and oil and gas production facilities and pipelines. In accordance with SFAS No. 143, "*Accounting for Asset Retirement Obligations*", the Company records the fair value of liabilities associated with such obligations when incurred. See Note 2 of the financial statements which describes the Company's adoption of SFAS No. 143 effective January 1, 2003. Estimating the future site restoration and abandonment costs necessary for this accounting calculation involves significant estimates and judgments by management. Most of these obligations are many years in the future and the contracts and regulations often have vague descriptions of what removal practices and criteria will have to be met when the removal event actually occurs. Asset removal technologies and costs are constantly changing, as well as political, environmental, safety and public relations considerations.

Contingencies

The Company is required to both determine whether a loss is probable based on judgment and interpretation of laws and regulations and determine that the loss can be reasonably estimated. When the loss is determined it is charged to net income. The Company's management must continually monitor known and potential contingent matters and make appropriate provisions by charges to net income when warranted by circumstance.

Pension Benefits

Determination of the projected benefit obligations for the Company's defined benefit pension plan is important to the recorded amounts for such obligations on the balance sheet and to the amount of benefit expense in the income statement. This also impacts the required Company contributions into the plans. The actuarial determination of projected benefit obligations and Company contribution requirements involves judgment about uncertain future events, including estimated retirement dates, salary levels at retirement, mortality rates, lump-sum election rates and rates of return on plan assets. The judgmental assumptions used in the actuarial calculations significantly affect periodic financial statements and funding patterns over time. Benefit expense is particularly sensitive to the discount rate and return on plan assets assumptions. Due to the specialized nature of these calculations, the Company engages outside actuarial firms to assist in the determination of these projected benefit obligations.

New Accounting Pronouncements

In January 2003, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 46 "Consolidation of Variable Interest Entities", which was ammended in December 2003 when FASB Interpretation No. 46 (revised in December 2003) "Consolidation of Variable Interest Entities" ("FIN 46 R") was issued. FIN 46 R addresses when a business enterprise should consolidate another entity in which it has a controlling financial interest through means other than voting interests. The provisions of FIN 46 R must be applied for variable interest entities commonly referred to as "special purpose entities" by December 31, 2003. For all other variable interest entities, implementation is required by March 31, 2004.

The full adoption of FIN 46 R did not have a material impact on the Group's results of operations, financial position or cash flows.

Forward-looking statements

Certain statements in this document are not historical facts and are “forward-looking.” We may from time to time make written or oral forward-looking statements in reports to shareholders and in other communications. Examples of such forward-looking statements include, but are not limited to:

• statements of our plans, objectives or goals, including those related to products or services;
• statements of future economic performance; and
• statements of assumptions underlying such statements.

Forward looking statements that may be made by us from time to time (but that are not included in this document) may also include projections or expectations of revenues, income (or loss), earnings (or loss) per share, dividends, capital structure or other financial items or ratios. Words such as “believes,” “anticipates,” “expects,” “estimates,” “intends” and “plans” and similar expressions are intended to identify forward-looking statements but are not the exclusive means of identifying such statements. By their very nature, forward-looking statements involve inherent risks and uncertainties, both general and specific, and risks exist that the predictions, forecasts, projections and other forward-looking statements will not be achieved. You should be aware that a number of important factors could cause actual results to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward-looking statements.

These factors include:
• inflation, interest rate and exchange rate fluctuations;
• the price of oil;
• the effects of, and changes in, Russian government policy;
• the effects of competition in the geographic and business areas in which we conduct operations;
• the effects of changes in laws, regulations, taxation or accounting standards or practices;
• our ability to increase market share for our products and control expenses;
• acquisitions or divestitures;
• technological changes; and
• our success at managing the risks of the aforementioned factors.

This list of important factors is not exhaustive. When relying on forward-looking statements, you should carefully consider the foregoing factors and other uncertainties and events, especially in light of the political, economic, social and legal environment in which we operate. Such forward-looking statements speak only as of the date on which they are made, and, subject to any continuing obligations under the Listing Rules of the U.K. Listing Authority, we do not undertake any obligation to update or revise any of them, whether as a result of new information, future events or otherwise. We do not make any representation, warranty or prediction that the results anticipated by such forward-looking statements will be achieved, and such forward-looking statements represent, in each case, only one of many possible scenarios and should not be viewed as the most likely or standard scenario.