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

The following report represents management's discussion and analysis of the financial condition and results of operations of OAO LUKOIL as of December 31, 2007, and each of the years ended December 31, 2007, 2006 and 2005, and significant trends that may affect its 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 subsidiaries and equity affiliates. 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 were translated into barrels using an average conversion rate of 7.33 barrels per tonne. Translations of cubic meters to cubic feet were made at the rate of 35.31 cubic feet per cubic meter. Translations of barrels of crude oil into barrels of oil equivalent ("BOE") were made at the rate of 1 barrel per BOE and of cubic feet into BOE at the rate of 6 thousand cubic feet per BOE.

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 41 for a discussion of some of the factors that could cause actual results to differ materially.

Key financial and operational results

	2007	Change to 2006, %	2006	Change to 2005, %	2005
Sales (millions of US dollars)	81,891	21.0	67,684	21.4	55,774
Net income (millions of US dollars)	9,511	27.1	7,484	16.2	6,443
EBITDA (millions of US dollars)	15,388	25.1	12,299	18.2	10,404
Earnings per share of common stock (US dollars)					
Basic earnings (US dollars)	11.48	26.7	9.06	14.5	7.91
Diluted earnings (US dollars)	11.48	27.0	9.04	16.0	7.79
Hydrocarbon production by the Group including our share in equity affiliates (thousands of BOE)	795,099	1.5	783,194	12.3	697,429
Crude oil production by the Group including our share in equity affiliates (thousands of tonnes)	96,645	1.5	95,235	5.6	90,158
Gas available for sale produced by the Group including our share in equity affiliates (millions of cubic meters)	13,955	2.5	13,612	141.6	5,635
Refined products produced by our subsidiaries (thousands of tonnes)	48,819	6.9	45,670	3.4	44,182
Hydrocarbon proved reserves including our share in equity affiliates (millions of BOE)	20,369	–	20,360	0.1	20,330

During 2007, our net income was $9,511 million, which is $2,027 million, or 27.1%, more than in 2006.

The main factor for improvement of our performance in 2007, was an increase in the international crude oil and refined products prices. On the other side we were affected by growing operating expenses and transportation tariffs. However, the negative effect of these factors was partially mitigated by increased volumes of hydrocarbon production and crude oil refining. These and 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, Colombia, and Northern and Western Africa.

- **Refining, Marketing and Distribution** – which includes refining and transport operations, marketing and trading of crude oil, natural gas and refined products.

- **Chemicals** – which includes processing and trading of petrochemical products.

Other businesses include banking, finance 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 the "Domestic crude oil and refined products prices" section on page 11, 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, regional market conditions, the cost of refining crude oil and other factors. Accordingly, an analysis of either of these segments on a stand-alone basis could give a misleading impression of those segments' 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. However we present the financial data for each in Note 23 "Segment information" to our consolidated financial statements.

Executive overview

Recent developments and outlook

The following has been achieved in 2007:

Exploration and production

- 13 new oil and gas fields were brought on line in 2007 (2006: 11 oil and gas fields).
- In 2007, we prepared the Yuzhnoye Khylchuyu oil field in Timan-Pechora region for development and we plan to start production in mid-2008. We estimate that a production volume of 7.5 million tonnes per year will be reached in 2009.
- In November 2007, we started commercial production on Khauzak gas field in Uzbekistan. This is a part of Kandym-Khauzak-Shady gas project, which is jointly implemented with Uzbekneftegaz National Holding Company. Our share of expenses related to the project is 90%, but our share of revenues is based on other factors such as the stage of project development, recovery of exploration and development costs and increases in project profitability. Such factors as increase in project profitability and recovery of previously incurred expenses will result in our share in the project revenues decreasing. The field's maximum annual production capacity of 12 billion cubic meters is expected to be achieved in 2012.

Refining

- As a result of modernization works performed in 2006, the capacity of our refinery in Nizhny Novgorod increased to 17.0 million tonnes per year in 2007, or by 12.6%.
- In 2007, we completed the first stage of our upgrade program in the Odessa refinery, after completion of the second stage of upgrade an annual capacity will amount 2.8 million tonnes. We plan to put the refinery into operation in the second quarter of 2008.

Marketing

- During 2007, the Company acquired a network of 376 petrol stations in 7 European countries from its related party ConocoPhillips.
- In December 2007, we acquired a network of 55 petrol stations and related infrastructure in Southern region of the Russian Federation.
- The Company aims to respond to changing market conditions on a timely basis. In 2007, our refined products exports and international sales increased by 11.7% in terms of volumes, compared to 2006. As a result, in 2007, we earned additional revenue due to increased refining volumes and continued high refining margins. The increase in refined product sales in 2007 led to a decrease of export and international sales of crude oil by 3.9%.

Other achievements in 2007 are described in detail in other parts of this report.

Changes in the Group structure, acquisition and disposition of assets

In March 2008, a Group company acquired 100% of the share capital of the SNG Holdings Ltd. Group for $578 million. The purchase agreement provides for an additional two components of contingent purchase consideration.

- An amount of $100 million payable if an agreed level of proved and probable hydrocarbon reserves are verified by an independent petroleum engineer by June 2008.
- An amount of $100 million payable upon approval of the agreed development program by the Uzbekistan authorities and an agreed minimum production volume of crude oil is achieved by March 2009.

The SNG Holdings Ltd. Group holds a 100% interest in a production sharing agreement in oil and gas condensate fields located in the South-Western Gissar and Ustyurt regions of Uzbekistan. The purpose of the acquisition was to increase the Group's presence in the Uzbekistan oil and gas sector.

In March 2008, a Group company entered into an agreement with a related party, whose management and directors include members of the Group's management and Board of Directors, to acquire a 64.3% interest in OAO "UGK TGK-8" ("TGK-8") for approximately $2,117 million. The agreement purchase consideration consists of 23.55 million shares of common stock of the Company (at a market value of approximately $1,620 million) and a cash payment of approximately $497 million. As of March 31, 2008, a Group company had acquired 29.99% of TGK-8. The transaction is expected to be finalized in the second quarter of 2008. TGK-8 is one of the major gas consumers in the Southern Federal District with the annual consumption reaching 6 billion cubic meters per year. Its power plants are located in Astrakhan, Volgograd and Rostov regions, Krasnodar and Stavropol Districts, and the Republic of Dagestan of the Russian Federation. By purchasing TGK-8 LUKOIL expects significant synergies through natural gas supplies from the Company's gas fields located in the Northern Caspian and in Astrakhan region, which will allow the Company to reach efficient gas price. This acquisition is made in accordance with the Company's plans to develop its electric power business.

During 2007, the Group acquired 7.65% of the share capital of OAO "LUKOIL-Nizhegorodnefteorgsintez" from minority shareholders for $154 million, increasing the Group's ownership to 96.91%. OAO "LUKOIL-Nizhegorodnefteorgsintez" is a refinery plant located in European Russia.

In December 2007, a Group company committed to a plan to sell 162 petrol stations, located in Pennsylvania and the southern New Jersey of USA, previously acquired from ConocoPhillips in 2004. In February 2008, this company entered into an agreement to sell these petrol stations to a third party investor for $138 million, less estimated amounts to extinguish environmental remediation liabilities of approximately $19 million. The Group will continue to supply petroleum products to these petrol stations under a 15 year supply contract with the new owners. The transaction is expected to be finalized in May 2008. As of December 31, 2007, the Group classified these petrol stations with the carrying value of $134 million as assets held for sale in the consolidated balance sheet, additionally the Group had a liability related to assets held for sale with the carrying value of $14 million included in "Other current liabilities" of the consolidated balance sheet.

In December 2007, a Group company acquired a distribution network of 55 petrol stations and storage facilities in the Rostov region, for $56 million. The acquisition of this distribution network will enable the Company to double petroleum products marketing output in the region. We expect refined products output in this region to increase up to 200 thousand tonnes per year, which represents 12% of the local retail market as a result of this acquisition.

In December 2007, OAO LUKOIL and OAO GAZPROM NEFT established a joint venture, OOO Oil and Gas Company "Regional Development". The Group owns a 49% stake in the authorized capital of the joint venture and OAO GAZPROM NEFT has a 51% stake. The joint venture will be managed on a parity basis and will focus on acquiring rights for subsurface use, geological survey of subsurface areas, exploration and production of hydrocarbons, field development, implementation of infrastructure-related projects, transportation and marketing of produced hydrocarbon materials.

In June 2007, the Group finalized the acquisition of a 100% interest in companies owning 376 petrol stations in Europe, including 156 in Belgium and Luxembourg, 49 in Finland, 44 in the Czech Republic, 30 in Hungary, 83 in Poland and 14 in Slovakia, for $442 million from ConocoPhillips, its related party. We intend to re-brand the stations within one year. The stations located in Finland will be re-branded as Teboil stations. The remaining petrol stations in other European countries will be re-branded as LUKOIL stations.

In November 2006, a Group company entered into an agreement with Mittal Investments S.A.R.L. to sell 50% of its interest in Caspian Investment Resources Ltd. ("Caspian", formerly Nelson Resources Limited), which has exploration and production operations in western Kazakhstan, for $980 million. This transaction was completed on April 20, 2007. In addition, Mittal Investments S.A.R.L. paid a liability in the amount of $175 million, which represented 50% of Caspian's outstanding debt to Group companies.

In January 2007, a Group company acquired the remaining 34% of the share capital of OOO Geoilbent for $300 million. The acquisition increased the Group's ownership in OOO Geoilbent to 100%. Prior to this acquisition the Group accounted for its investment using the equity method of accounting due to the fact that the minority shareholder held substantive participating rights. OOO Geoilbent was an exploration and production company operating in the West Siberian region of the Russian Federation.

In December 2006, the Group sold its 100% stakes in LUKOIL Shelf Limited and LUKOIL Overseas Orient Limited, which owned and operated the Astra jack-up rig for $40 million.

In June 2006, the Group acquired 41.81% of the share capital of OAO Udmurtnefteproduct for $25 million. OAO Udmurtnefteproduct is a Russian refined product distribution company, operating more than 100 petrol stations in the Udmurt Republic of the Russian Federation.

In June 2006, a Group company acquired 100% of the share capital of Khanty-Mansiysk Oil Corporation ("KMOC") from Marathon Oil Corporation for $847 million (including $249 million repayment of KMOC debt). At the date of acquisition KMOC owned 95% of the share capital of OAO Khantymansiyskneftegazgeologia and 100% of the share capital of OAO Paitykh Oil and OAO Nazymgeodobycha ("KMOC subsidiaries"). By December 31, 2007, a Group company had acquired the remaining 5% of the share capital of OAO Khantymansiyskneftegazgeologia for $18 million. This acquisition increased the Group's ownership in OAO Khantymansiyskneftegazgeologia to 100%. KMOC's subsidiaries operate oil and gas fields in the West Siberian region of the Russian Federation.

In May 2006, the Group sold its remaining interest in OAO Bank Petrocommerce for $33 million.

In December 2005, the Company made a decision to sell ten tankers. A Group company finalized the sale of eight tankers in May 2006, for a price that approximated their carrying value of $190 million. The sale of the remaining two tankers is expected to be finalized in April 2008, for a price that approximates their carrying value of $70 million. As of December 31, 2007 and 2006, the Group classified these tankers as assets held for sale in the consolidated balance sheets.

During the period from November to December 2005, a Group company acquired 51% of the share capital of OAO Primorieneftegaz for $261 million. Subsequently, in May 2006, a Group company acquired the remaining 49% of the share capital of OAO Primorieneftegaz for 4.165 million shares of common stock of the Company (at a market value of approximately $314 million), thereby increasing the Group's ownership stake in OAO Primorieneftegaz to 100%. OAO Primorieneftegaz is a Russian oil and gas exploration company operating in European Russia.

Resource base

Maintaining a stable oil and gas resource base together with providing a high reserve replacement ratio are key elements of our long-term strategy. Following our strategy we secured stable hydrocarbon reserves level in 2007. The table below summarizes the net oil-equivalent proved reserves of consolidated subsidiaries and our share in equity affiliates:

(millions of BOE)	December 31, 2007	Changes in 2007: Production*	Changes in 2007: Extensions, discoveries and changes in structure	Changes in 2007: Revision of previous estimates	December 31, 2006
Western Siberia	11,387	(509)	499	163	11,234
Komi Republic	2,293	(95)	90	(16)	2,314
Ural region	2,230	(88)	11	92	2,215
Volga region	1,699	(28)	15	10	1,702
Northern Timan-Pechora	1,172	(15)	9	(122)	1,300
Other in Russia	249	(16)	21	(1)	245
Outside Russia	1,339	(58)	(17)	64	1,350
Proved oil and gas reserves	**20,369**	**(809)**	**628**	**190**	**20,360**
Probable oil and gas reserves	**12,187**				**12,340**
Possible oil and gas reserves	**6,301**				**6,022**

* Gas production shown before own consumption.

Increase of proved reserves as a result of the revision of previous estimates mainly relates to increase in hydrocarbon prices. Nevertheless, in the new production regions the increase in costs exceeded the rate of crude oil price increases, which resulted in negative revisions.

Increase of proved hydrocarbon reserves as a result of geological exploration work amounted to 659 million BOE in 2007.

Acquisitions of licenses for production increased our proved reserves by 26 million BOE.

In 2007, we increased our ownership in Geoilbent up to 100%. This increased our proved hydrocarbon reserves by 30 million BOE. The sale of our 50% share in Caspian in 2007 decreased our reserves by 112 million BOE.

Operational highlights

Hydrocarbon production

	2007	2006	2005
Daily production of hydrocarbons, including Company's share in equity affiliates (thousand BOE per day)	2,178	2,145	1,911
- crude oil	1,953	1,926	1,820
- natural and petroleum gas*	225	219	91
Hydrocarbon extraction expenses (US dollar per BOE)	3.58	3.08	2.66

* Gas available for sale (excluding gas produced for our own consumption).

Crude oil production. In 2007, we increased our total daily crude oil production by 1.4%, compared to 2006 (including the Company's share in equity affiliates) and produced 713 million barrels, or 96.6 million tonnes.

The following table represents our production in 2007 and 2006 by major regions.

		Change to 2006			
(thousands of tonnes)	2007	Total, %	Change in structure	Organic change	2006
Western Siberia	59,849	2.5	2,520	(1,085)	58,414
Komi Republic	12,432	6.0	–	701	11,731
Ural region	11,183	3.0	–	328	10,855
Volga region	3,017	0.5	–	16	3,001
Northern Timan-Pechora	2,144	14.7	–	274	1,870
Other in Russia	2,110	2.5	–	51	2,059
Crude oil production in Russia	90,735	3.2	2,520	285	87,930
Crude oil produced internationally	3,412	(5.4)	(687)	492	3,607
Total crude oil produced by consolidated subsidiaries	**94,147**	**2.9**	**1,833**	**777**	**91,537**
Our share in crude oil production of equity affiliates:					
in Russia	365	(77.6)	(1,287)	21	1,631
outside Russia	2,133	3.2	–	66	2,067
Total crude oil production	**96,645**	**1.5**	**546**	**864**	**95,235**

The main oil producing region of the Company is Western Siberia. In the oil fields of Western Siberia the Company produced 63.6% of its crude oil in 2007 (63.8% in 2006).

Delays in putting the Yuzhnoye Khylchuyu oil field in Timan-Pechora region into production resulted in slower growth in crude oil production in 2007. We expect to begin production from this field in mid-2008 with approximate planned annual production of 7.5 million tonnes to be reached from 2009. We are close to finalizing infrastructure construction works related to this field including construction of the offshore ice-resistant terminal in Varandey. This oil field is developed within our strategic partnership with ConocoPhillips.

The organic decline of crude oil production in Western Siberia was compensated by an increase as a result of structural changes. Structural increase in crude oil production in Western Siberia was due to acquisition of the remaining interest in OOO Geoilbent in January 2007, and dismantling by OOO LUKOIL-Western Siberia and Brazos Petroleum Overseas Limited (a Group affiliated company) their joint activity at the end of 2006. Before 2007, the crude oil production of Geoilbent and the joint activity were accounted for using equity method. Beginning from 2007, all crude oil production of the former joint activity was transferred to OOO LUKOIL-Western Siberia. In June 2006, we acquired KMOC and it's subsidiaries, which produced 645 thousand tonnes of crude oil in January-May 2007. Structural changes in overseas crude oil production reflect the changes in ownership of Caspian, where the Group reduced its interest from 100% to 50% in the end of April 2007.

In addition to our production, we purchase crude oil in Russia and on international markets. In Russia we primarily purchase crude oil from affiliated producing companies and other producers, including vertically integrated oil companies that lack refining capacity or are unable to export their crude oil. Then we may either refine or export purchased crude oil. Crude oil purchased on international markets is used for trading activities, for supplying our overseas refineries or for processing at third parties refineries. During 2007, we purchased 1,534 thousand tonnes in order to process at our and at third parties' refineries, compared to 2,293 thousand tonnes during 2006. The decrease in external crude oil purchases was due to increased refining of crude oil produced by the Group to maximize the benefit of high refining margins.

	2007		**2006**		**2005**	
	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)
Crude oil purchases in Russia	345	47	13,561	1,850	10,760	1,468
Crude oil purchases internationally.....	32,802	4,475	37,390	5,101	69,122	9,430
Total crude oil purchased................	**33,147**	**4,522**	**50,951**	**6,951**	**79,882**	**10,898**

In 2007, the volume of crude oil purchased in Russia substantially decreased as a result of changes in the Group structure. The crude oil purchased in 2006 included transactions with our former 66% equity affiliate OOO Geoilbent. In January 2007, we acquired the remaining 34% of OOO Geoilbent, thereby increasing the Group's ownership stake to 100%. The decrease in volume of crude oil purchased internationally was primarily due to decreased purchases for refining.

Gas production. In 2007, we produced 13,955 million cubic meters of gas available for sale (including our share in equity affiliates), an increase by 2.5%, compared to 2006.

We reduced production from the Nakhodkinskoe gas field, where we produced 7,719 million cubic meters of natural gas in 2007, compared to 8,348 million cubic meters in 2006. In June-October 2007, we decreased natural gas supply to OAO Gazprom from the Nakhodkinskoe gas field due to the warm winter. At the same time we increased production of petroleum gas in Western Siberia by 395 million cubic meters, or by 20.2%, compared to 2006 primarily due to a higher level of petroleum gas utilization. Also in 2007, we began production from the Shakh-Deniz field in Azerbaijan where our share in gas production totaled 309 million cubic meters, and from the Khauzak gas field in Uzbekistan, where we produced 136 million cubic meters of natural gas.

In order to ensure continuous supply of natural gas from the Nakhodkinskoe gas field to market, in October 2003, we signed an agreement with OAO Gazprom. In accordance with the agreement OAO Gazprom undertakes to purchase the gas at the Yamburg Compressor Plant and to transport it through the Russian Unified Gas Supply System. In September 2006, we entered into an additional agreement with OAO Gazprom, under which OAO Gazprom undertakes to purchase 8 billion cubic meters of gas annually at a price of 1,059 rubles per 1,000 cubic meters.

Refining, marketing and trading

We operate four refineries located in European Russia and three refineries located overseas – in Bulgaria, Ukraine and Romania. In August 2005, we closed the Odessa refinery to commence a wide-scale upgrade. The test run of the Odessa refinery after the completion of the first stage of the upgrade was held in October 2007. The second stage is planned to be completed by the end of the second quarter of 2008. Annual capacity of the Odessa refinery after completion of the upgrade will be 2.8 million tonnes per year.

Compared to 2006, production at our refineries increased by 6.9%. Russian refineries increased production by 7.8%. In the first quarter of 2007, our refinery throughput in Russia was lower than planned by approximately 0.2 million tonnes due to a fire at the Volgograd refinery in March 2007. We recovered crude oil throughput at the refinery by the end of April 2007, and in the second quarter of 2007, it reached the same production volume as in the respective period of 2006. In the first quarter of 2007, we performed a planned upgrade of our Bulgarian refinery resulting in a slight decrease in output. The above factor resulted in the production of our overseas refineries increasing only by 2.8% in 2007, compared to 2006. A significant increase in production volumes in Russia in 2007, compared to the previous year was primarily due to the increase in capacity of the Nizhny Novgorod refinery from 15.1 to 17.0 million tonnes per year as a result of our modernization program at this refinery.

Production of refined products at our refineries in 2006 increased by 3.4%, compared to 2005. Russian refineries increased production by 6.1%. The production of overseas refineries decreased by 7.7% as a result of the temporary shutdown of the Odessa refinery.

The Group is constantly improving the refined products mix at our refineries in order to produce higher quality and more profitable products. At our Russian refineries we produced 7,218, 6,542 and 4,671 thousand tonnes of Euro 4 and Euro 5 diesel fuel in 2007, 2006 and 2005, respectively. In 2007 and 2006, our production of Euro 3 gasoline amounted to 852 and 548 thousand tonnes, respectively (in 2005 we did not produce Euro 3 gasoline).

Along with our own production of refined products we refined crude oil at third party refineries. In Russia we refined 3,589 thousand tonnes of crude oil at third party refineries primarily to supply our network in the Ural region. To supply our retail networks in Eastern Europe we refined oil at third party refineries in Belorussia and Serbia. In 2007, we decreased processing of our crude oil at Belorussian refineries due to a reduction in profitability resulting from changes in legislation.

Our marketing and trading activities mainly include wholesale and bunkering operations in Western Europe, South-East Asia, Central America and retail operations in the USA, Eastern Europe, the Baltic States and other regions. In 2007, we continued to expand these activities in Central Europe. As a result of this expansion, the total volume of refined products purchased from third parties for wholesale and to supply retail networks increased to 38,694 thousand tonnes or $23,883 million in 2007 (compared to 35,928 thousand tonnes or $19,413 million in 2006, and 32,225 thousand tonnes or $15,021 million in 2005).

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

The following table represents volumes of refinery throughput, refined products produced and purchased.

	2007	2006	2005
	(thousand barrels per day)		
Own refinery throughput	1,044	978	945
Refinery throughput at third parties refineries	93	100	57
Total refinery throughput	**1,137**	**1,078**	**1,002**
	(thousand of tonnes)		
Refined products produced at the Group refineries in Russia*	40,381	37,459	35,290
Refined products produced at the Group refineries outside Russia	8,438	8,211	8,892
Total refined products produced at the Group refineries	**48,819**	**45,670**	**44,182**
Refined products produced at the third party refineries in Russia	3,270	3,002	1,497
Refined products produced at the third party refineries outside Russia	945	1,586	1,159
Total refined products produced at the third party refineries	**4,215**	**4,588**	**2,656**
Refined products purchased in Russia	1,543	919	1,394
Refined products purchased internationally	38,745	36,034	32,238
Total refined products purchased	**40,288**	**36,953**	**33,632**

* Excluding production of mini refineries.

Exports of crude oil and refined products from Russia

In 2007, our export of crude oil from Russia was 4.5% less than in 2006. During 2007, we exported 46.5% of our total domestic crude oil production (50.2% in 2006, and 54.4% in 2005). 2.4% of our crude oil produced in Russia was exported bypassing the trunk oil pipeline system of OAO AK Transneft (“Transneft”) (3.0% in 2006 and 8.7% in 2005). In spite of the overall decrease of our crude oil export from Russia we continue to increase our export by means of Baltic Pipeline System (“BPS”). The volume of crude oil, exported using the BPS (through the Primorsk terminal), increased in 2007 up to 14,022 thousand tonnes (2006 – 13,662 thousand tonnes, 2005 – 9,713 thousand tonnes).

The volumes of crude oil exported from Russia by our subsidiaries are summarized as follows:

	2007		2006		2005	
	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)
Exports of crude oil using Transneft export routes...	293,163	39,995	304,034	41,478	282,418	38,529
Exports of crude oil bypassing Transneft	15,818	2,158	19,461	2,655	53,421	7,288
Total crude oil exports.........................	**308,981**	**42,153**	**323,495**	**44,133**	**335,839**	**45,817**

The crude oil exported through our own export infrastructure was 1,857 thousand tonnes in 2007, 13.6% less than in 2006 due to a decrease in volumes exported through the Svetly terminal. This reduction was mainly due to optimization of export routs and a shift of some crude oil volumes from export to refining.

The Group owns and operates the Vysotsk export terminal. In September 2006, we completed the construction of the Vysotsk terminal and its current capacity can be expanded up to 15 million tonnes per year. Currently we use the terminal to export refined products: in 2007, we exported 10,518 thousand tonnes of refined products through this terminal (in 2006 – 8,423 thousand tonnes, in 2005 – 5,065 thousand tonnes). In the future we expect to use the terminal to export both crude oil and refined products, depending on market conditions.

In 2007, we exported from Russia 25.1 million tonnes of refined products, an increase of 22.0%, compared to 2006. We export from Russia primarily diesel fuel, fuel oil and gasoil. These products account for approximately 85% of our refined products export volumes.

Main macroeconomic factors affecting our results of operation

Change in the price of crude oil and refined products

The price at which we sell crude oil and refined products is the primary driver of our revenues. During 2007, the Brent crude oil price fluctuated between $50 and $96 per barrel and reached its peak of $96.03 at the end of December.

In the beginning of the year lower oil prices were caused by warm weather in the Northern hemisphere and excessive stocks. The oil price has further increased due to restrictions put on production volumes by OPEC, which led to reduction in oil stocks, growing oil demand and decline of oil production in some regions, political instability in the main oil production regions and negative climatic factors, and weakening of the US dollar.

According to the International Energy Agency (IEA), in 2007, the world demand for crude oil and, subsequently, refined products increased by 1.4%, compared to 2006, averaging 86.0 million barrels per day. In 2007, based on OPEC data, its actual daily production amounted to 31.0 million barrels per day, or 1.5% less than in 2006. This situation can be viewed as an indicator that crude oil prices may remain relatively high in the medium-term. However due to the speculative nature of the crude oil price the probability of a price correction remains high. The depth of the correction would depend on OPEC actions.

Substantially all of the crude oil that we export is Urals blend. The following table shows the average crude oil and refined product prices for 2007, 2006 and 2005.

	2007	Change to 2006, %	2006	Change to 2005, %	2005
	(in US dollars per barrel, except for figures in percent)				
Brent crude	72.39	11.1	65.16	20.0	54.31
Urals crude (CIF Mediterranean)*	69.38	13.1	61.37	21.1	50.67
Urals crude (CIF Rotterdam)*	69.16	12.9	61.23	22.2	50.12
	(in US dollars per metric tonne, except for figures in percent)				
Fuel oil 3.5% (FOB Rotterdam)	339.00	18.2	286.91	24.8	229.92
Diesel fuel (FOB Rotterdam)	634.09	9.7	577.92	14.4	505.01
High-octane gasoline (FOB Rotterdam)	695.97	12.4	619.29	15.9	534.11

Source: Platts.

* The Company sells crude oil on foreign markets on various delivery terms. Thus, our average realized sale price of oil on international markets differs from the average prices of Urals blend on Mediterranean and Northern Europe markets.

Domestic crude oil and refined products prices

Substantially all crude oil produced in Russia is produced by vertically integrated oil companies such as ours. As a result, most transactions are between affiliated entities within vertically integrated groups. Thus, there is no concept of a benchmark domestic market price for crude oil. The price of crude oil that is produced but not refined or exported by one of the vertically integrated oil companies is 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 oil as a result of the competition and economic conditions in those regions. At the same time it should be noted that in 2006 and 2007 our domestic crude oil sales prices were nearly at the level of our export net back price.

Domestic prices for refined products are determined to some extent by world market prices, but they are also directly affected by local demand and competition.

The table below represents average domestic wholesale prices of refined products in 2007, 2006 and 2005.

	2007	Change from 2006, %	2006	Change from 2005, %	2005
	(in US dollars per metric tonne, except for figures in percent)				
Fuel oil	194.19	10.9	175.07	42.9	122.54
Diesel fuel	503.84	6.4	473.44	12.8	419.74
High-octane gasoline (Regular)	631.93	13.0	559.11	14.9	486.71
High-octane gasoline (Premium)	712.81	15.5	617.41	15.9	532.52

Source: Kortes (excluding VAT).

Changes in the US 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, ruble inflation and movements of exchange rates can significantly affect the results of our operations. In particular, the real appreciation of the ruble against the US dollar will generally cause our costs to increase in US dollar terms. However, an increase of the ruble denominated revenue in Russia in the US dollar terms reduces this adverse effect.

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

	2007	2006	2005
Ruble inflation (CPI), %	11.9	9.1	10.9
Change of the ruble-dollar exchange rate, %	6.8	8.5	(3.7)
Real appreciation of the ruble against the US dollar*, %	20.0	19.3	6.9
Average exchange rate for the period (ruble to US dollar)	25.58	27.19	28.29
Exchange rate at the end of the period (ruble to US dollar)	24.55	26.33	28.78

* Devaluation of purchasing power of the US dollar in the Russian Federation is calculated on the basis of the ruble-dollar exchange rates and the level of inflation in Russia.

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). In 2007, 2006 and 2005, the tax charge on the operations in Russia was approximately 85% of our total tax charge.

In addition to income taxes, we are subject to a number of other taxes in Russia, many of which are based on revenue or volumetric measures. Other taxes to which we are subject include:

- mineral extraction tax
- excise and export tariffs
- property tax
- social taxes
- 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 2007, 2006 and 2005, respectively, were 74%, 77% and 74%. In 2007, tax expenses in Russia were about 52% of the domestic and export sales revenue of Russian companies of the Group.

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 taxes specific to the oil industry in Russia for the respective periods.

		2007*	Change to 2006, %	2006*	Change to 2005, %	2005*
Export tariffs on crude oil	$/tonne	206.70	4.9	197.01	50.8	130.62
Export tariffs on refined products						
Light distillates (gasoline), middle distillates (jet fuel), diesel fuel and gasoils	$/tonne	151.59	5.7	143.40	55.4	92.26
Liquid fuels (fuel oil)	$/tonne	81.64	5.7	77.27	46.5	52.73
Excise on refined products						
Straight-run gasoline	RUR/tonne	2,657.00	–	2,657.00	–	–
High-octane gasoline	RUR/tonne	3,629.00	–	3,629.00	–	3,629.00
Low-octane gasoline	RUR/tonne	2,657.00	–	2,657.00	–	2,657.00
Diesel fuel	RUR/tonne	1,080.00	–	1,080.00	–	1,080.00
Motor oils	RUR/tonne	2,951.00	–	2,951.00	–	2,951.00
Mineral extraction tax						
Crude oil	RUR/tonne	2,472.67	9.1	2,265.69	20.8	1,876.26
Natural gas	RUR/1,000 m^3	147.00	–	147.00	8.9	135.00

* Average values.

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

		2007*	Change to 2006, %	2006*	Change to 2005, %	2005*
Excise on refined products						
Straight-run gasoline	$/tonne	103.88	6.3	97.74	–	–
High-octane gasoline	$/tonne	141.89	6.3	133.49	4.1	128.29
Low-octane gasoline	$/tonne	103.88	6.3	97.74	4.1	93.93
Diesel fuel	$/tonne	42.23	6.3	39.73	4.1	38.18
Motor oils	$/tonne	115.38	6.3	108.55	4.1	104.33
Mineral extraction tax						
Crude oil	$/tonne	96.68	16.0	83.34	25.7	66.32
Natural gas	$/1,000 m^3	5.75	6.3	5.41	13.4	4.77

* Average values.

Changes in the tax rates specific to the oil industry in Russia in 2007, compared to 2006 were a result of the movements in the Urals crude oil price. These rates are linked to international crude oil price and change in line with them. The methods to determine the rates for such taxes are presented below.

Crude oil extraction tax rate. Before December 31, 2006, the crude oil extraction tax rate was calculated as follows. The base rate is 419 rubles per metric tonne extracted and it is adjusted depending on the international market price of Urals blend and the ruble exchange rate. The tax rate is zero when the average Urals blend international market price for a tax period is less than or equal to $9.00 per barrel. Each $1.00 per barrel increase in the international Urals blend price over the threshold ($9.00 per barrel) results in an increase of the tax rate by $1.61 per tonne extracted (or $0.22 per barrel extracted using a conversion factor of 7.33).

Effective from January 1, 2007, the crude oil extraction tax rate varies depending on the development and depletion of a particular oilfield. The tax rate is zero for extra-heavy crude oil and for crude oil produced in certain regions of Eastern Siberia, depending on the period and volume of production. For crude oil produced in other regions the tax rate calculation described above should be multiplied by a coefficient characterizing the depletion of a particular oilfield. The coefficient is equal to 1.0 for the oilfields with depletion below 80%. Each 1% increase of depletion of a particular oilfield above 80% results in a decrease of the coefficient by 0.035. The minimum value of the coefficient is 0.3. The depletion level assessment is based on crude oil production and reserves information reported to the Russian government.

Natural gas extraction tax rate. Mineral extraction tax on natural gas production is calculated using a flat rate. The current rate of 147 rubles per thousand of cubic meters of natural gas extracted has been effective since January 1, 2006.

Crude oil export duty rate is calculated on a progressive scale. The rate is zero when the average Urals blend international market price is less than or equal to approximately $15.00 per barrel ($109.50 per metric tonne). If the Urals blend price is in a layer between $15.00 and $20.00 per barrel ($146.00 per metric tonne), each $1.00 per barrel increase in the Urals blend 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 blend 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 blend price over the layer's lower bound results in an increase of the crude oil export duty rate by $0.45 per barrel exported. Each $1.00 per barrel increase in the Urals blend price over $25.00 per barrel results in an increase of the crude oil export duty rate by $0.65 per barrel exported.

The Russian government sets export tariff rates for two-month periods. The rates in a specific two-month period are based on Urals blend international market prices in the preceding two months. Thus, the calculation method that the Russian government employs to determine export tariff rates results in a two-month gap between movements in crude oil prices and the revision of the export duty rate based on those crude oil prices.

Export duty rates on refined products are set by the Russian government. The rate of export duty depends on internal demand for refined products and international crude oil market conditions.

Crude oil and refined products exported to CIS countries, other than Ukraine, are not subject to export duties. On January 1, 2007, customs regulations between Russia and Belorussia were changed. Crude oil exported from Russia to Belorussia is now subject to export duties. The latest amendments made by customs authorities set a coefficient of 0.293 to be applied from February 1, 2007 to the regular export duty rate set by the Russian Government for calculation of export duty on crude oil exports from Russia to Belorussia.

Transportation of crude oil and refined products in Russia

The main Russian crude oil production regions are remote from the main crude oil and refined products markets. Therefore, access of crude oil production companies to the markets is dependent on the extent of diversification of transport infrastructure and access to it. As a result, transportation cost is an important macroeconomic factor affecting our net income.

Transportation of crude oil produced in Russia to refineries and export destinations is performed primarily through the trunk oil pipeline system of state-owned Transneft. 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 crude oil transported by Transneft is Urals blend – a mix of crude oils of various qualities, therefore Russian companies, which produce crude oil of a higher quality, can not obtain benefits from selling it using Transneft's pipeline. Alternative access to international markets bypassing Transneft export routes can be obtained through railroad transport, by tankers, and own export infrastructure of oil producing companies. Our own export infrastructure includes the Vysotsk terminal in the Leningrad region, the Varandey terminal in the Nenetsky Autonomous District and the Svetly terminal in the Kaliningrad region. We use the Varandey terminal to export crude oil produced by our joint venture with ConocoPhillips located in Northern Timan-Pechora. The Svetly terminal exports crude oil primarily produced by OOO LUKOIL-Kaliningradmorneft, our subsidiary operating in the Kaliningrad region, and refined products.

Transportation of refined products in Russia is performed by railway transport and pipeline system of OAO AK Transnefteproduct. Russian railway infrastructure is owned and operated by OAO Russian Railways. Both companies are state-owned. Besides transportation of refined products OAO Russian Railways provides oil companies with crude oil transportation services. We transport the major part of our refined products by railway transport.

As the activities of the above mentioned companies fall under the scope of natural monopolies, the fundamentals of their tariff policies are defined by the state authorities to ensure the balance of interests of the state and all participants in the transportation process. Transportation tariffs of natural monopolies are set by the Federal Service for Tariffs of the Russian Federation ("FST"). The tariffs are dependent on transport destination, delivery volume, distance of transportation, and several other factors. Changes in the tariffs depend on inflation forecasts by the Ministry of Economic Development and Trade of the Russian Federation, the investment needs of owners of transport infrastructure, other macroeconomic factors, and compensation of economically reasonable expenses, incurred by entities of natural monopolies. Tariffs are to be revised by FST at least annually.

According to the Federal Statistics Service of the Russian Federation, during 2007, transportation tariffs increased as follows: transportation of crude oil by pipeline – 9.9%, transportation of refined products by pipeline – 17.2%, transportation by railway – 7.7%. These amounts differ from actual changes in tariffs for transportation of crude oil and refined products by the Group for the period considered due to the specifics in the routes and geography of our supplies from the Russian transportation averages.

Year ended December 31, 2007, compared to years ended December 31, 2006 and December 31, 2005

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

	2007	2006	2005
	(millions of US dollars)		
Revenues			
Sales (including excise and export tariffs)	81,891	67,684	55,774
Equity share in income of affiliates	347	425	441
Total revenues	**82,238**	**68,109**	**56,215**
Costs and other deductions			
Operating expenses	(6,172)	(4,652)	(3,443)
Cost of purchased crude oil, gas and products	(27,982)	(22,642)	(19,590)
Transportation expenses	(4,457)	(3,600)	(3,371)
Selling, general and administrative expenses	(3,207)	(2,885)	(2,578)
Depreciation, depletion and amortization	(2,172)	(1,851)	(1,315)
Taxes other than income taxes	(9,367)	(8,075)	(6,334)
Excise and export tariffs	(15,033)	(13,570)	(9,931)
Exploration expense	(307)	(209)	(317)
(Loss) gain on disposals and impairments of assets	(123)	(148)	52
Income from operating activities	**13,418**	**10,477**	**9,388**
Interest expense	(333)	(302)	(275)
Interest and dividend income	135	111	96
Currency translation gain (loss)	93	169	(134)
Other non-operating expense	(240)	(118)	(44)
Minority interest	(55)	(80)	(121)
Income before income taxes	**13,018**	**10,257**	**8,910**
Current income taxes	(3,410)	(2,906)	(2,301)
Deferred income taxes	(97)	133	(166)
Total income tax expense	**(3,507)**	**(2,773)**	**(2,467)**
Net income	**9,511**	**7,484**	**6,443**
Basic earnings per share of common stock (in US dollars)	11.48	9.06	7.91
Diluted earnings per share of common stock (in US dollars)	11.48	9.04	7.79

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

Sales revenues

Sales breakdown	2007	2006	2005
	(millions of US dollars)		
Crude oil			
Export and sales on international markets other than CIS	18,346	16,859	15,589
Export and sales to CIS	912	790	778
Domestic sales	440	376	120
	19,698	**18,025**	**16,487**
Refined products			
Export and sales on international markets			
Wholesale	37,971	30,302	22,923
Retail	9,183	7,157	6,293
Domestic sales			
Wholesale	5,862	5,431	4,753
Retail	3,721	2,720	1,972
	56,737	**45,610**	**35,941**
Petrochemicals			
Export and sales on international markets	1,569	1,260	1,134
Domestic sales	733	569	469
	2,302	**1,829**	**1,603**
Other	**3,154**	**2,220**	**1,743**
Total sales	**81,891**	**67,684**	**55,774**

Sales volumes	2007	2006	2005
Crude oil	(thousands of barrels)		
Export and sales on international markets other than CIS	268,974	278,972	312,712
Export and sales to CIS	19,879	21,682	23,852
Domestic sales	11,757	13,363	4,926
Crude oil	(thousands of tonnes)		
Export and sales on international markets other than CIS	36,695	38,059	42,662
Export and sales to CIS	2,712	2,958	3,254
Domestic sales	1,604	1,823	672
	41,011	**42,840**	**46,588**
Refined products	(thousands of tonnes)		
Export and sales on international markets			
Wholesale	64,394	57,558	49,549
Retail	7,910	7,171	7,117
Domestic sales			
Wholesale	13,704	15,155	16,421
Retail	4,853	3,995	3,549
	90,861	**83,879**	**76,636**
Total sales volume of crude oil and refined products	**131,872**	**126,719**	**123,224**

Realized average sales prices

	2007		2006		2005	
	($/barrel)	($/tonne)	($/barrel)	($/tonne)	($/barrel)	($/tonne)
Average realized price international						
Oil (excluding CIS)	68.21	499.96	60.43	442.96	49.85	365.41
Oil (CIS)	45.86	336.15	36.46	267.22	32.63	239.20
Refined products						
Wholesale		589.66		526.46		462.61
Retail		1,160.90		998.05		884.30
Average realized price within Russia						
Oil	37.43	274.37	28.16	206.43	24.44	179.15
Refined products						
Wholesale		427.74		358.38		289.41
Retail		766.67		680.79		555.80

During 2007, our revenues increased by $14,207 million, or by 21.0%, compared to 2006 (in 2006 by $11,910 million, or by 21.4%, compared to 2005).

The total volume of crude oil and refined products sold was 132 million tonnes, which represents an increase of 4.1%, compared to 2006. Our revenues from crude oil sales increased by $1,673 million, or by 9.3%, compared to 2006 (in 2006 by $1,538 million, or by 9.3%, compared to 2005). Our sales of refined products increased in 2007 by $11,127 million, or by 24.4%, compared to 2006 (in 2006 by $9,669 million, or by 26.9%, compared to 2005).

Sales of crude oil and refined products on international markets, including the CIS, accounted for 84.7% of the total sales volume in 2007 (in 2006 – 83.4%, and in 2005 – 83.3%).

The increase in sales was principally due to the following:

- increase in hydrocarbon prices
- increase in crude oil refining, resulting from high refining margins
- increase in trading activities
- increase in total volume of crude oil production

Sales of crude oil

2007 vs. 2006

The 9.3% increase in our total crude oil sales from 2006 to 2007 was attributable primarily to an increase in our international crude oil sales revenues (excluding CIS). This sales revenue, which accounted for approximately 93.1% of our total crude oil sales revenue in 2007 and 93.5% in 2006, increased by 8.8% primarily due to an increase in sales prices by 12.9%. At the same time the total volume of crude oil sales decreased by 3.6%, compared to 2006 as a result of increased crude oil refining in Russia.

2006 vs. 2005

In 2006, we reduced exports of crude oil from Russia by 1,684 thousand tonnes, or by 3.7%. However, revenue from crude oil sales on international markets increased by 7.8%, compared to the previous year. The effect of reduced volumes of exports from Russia and our crude oil trading activities on international markets was offset by the growth of crude oil prices.

During 2006, we increased our sales of crude oil on the domestic market, compared to 2005 by 1,151 thousand tonnes, or by 171.3%, in order to take advantage of the increased profitability of domestic sales.

Sales of refined products

2007 vs. 2006

In 2007, sales of refined products was 69.3% of our total revenues (68.9% in terms of volumes sold), compared to 67.3% (66.3% – in terms of volumes) in 2006. In 2007, the portion of our domestic refined product sales was 14.1% of the total tonnes sold (in 2006 – 15.2%), and represented 11.7% of our total revenues (in 2006 – 12.0%). The decrease in our domestic refined products sales as a percentage of total refined products sales was due to the expansion of our international activities, including the increase of export from Russia.

The average realized wholesale price of refined products outside Russia increased by $63.20 per tonne, or by 12.0%, compared to 2006. Wholesale volumes of refined products sold outside Russia increased by 6,836 thousand tonnes, or by 11.9%, primarily due to increased volumes of export from Russia. As a result, our revenue from the wholesale sales of refined products outside Russia increased by $7,669 million, or by 25.3%.

During 2007, retail sales of refined products outside Russia increased by 739 thousand tonnes, or by 10.3%, compared to 2006. This increase is attributable to additional sales volumes generated by the 376 petrol stations acquired from ConocoPhillips in the second quarter of 2007. Refined products sales at those stations were 769 thousand tonnes in the period June-December 2007. Average retail prices increased to $1,160.90 per tonne, or by 16.3%. As a result, our revenue from retail sales increased by $2,026 million, or by 28.3%, compared to 2006. In 2007, revenue from retail sales was 19.5% (in 2006 – 19.1%) of total refined products sales outside Russia. Our international retail sales include supplies of refined products to third party retail networks under long-term contracts with pricing similar to retail pricing.

In 2007, the average domestic wholesale realized price on refined products increased by $69.36 per tonne, or by 19.4%, compared to 2006. In 2007, the wholesale of refined products within Russia decreased by 1,451 thousand tonnes, or by 9.6%, compared to 2006. As a result, our revenue from the wholesale of refined products on the domestic market increased by 7.9%. Volumes of refined products, which were not utilized in the domestic wholesale market were directed to a retail segment or exported from Russia.

In 2007, retail sales within Russia increased by 858 thousand tonnes, or by 21.5%, compared to 2006. Average retail prices increased to $766.67 per tonne, or by 12.6%. As a result, our revenue from retail sales increased by $1,001 million in 2007, or by 36.8%, compared to 2006. Revenue from retail sales was 38.8% of total refined products sales in Russia in 2007 (in 2006 – 33.4%).

2006 vs. 2005

In 2006, sales of refined products was 67.3% of our total revenues (66.3% in terms of volumes sold), compared to 64.4% (62.2% – in terms of volumes) in 2005. In 2006, the portion of our domestic refined product sales was 15.2% of the total tonnes sold (in 2005 – 16.2%), but represented 12.0% of our total revenues (in 2005 – 12.0%). The decrease in our domestic refined products sales as a percentage of total refined products sales was due to the expansion of our trading activities outside Russia.

In 2006, the average realized wholesale price of refined products outside Russia increased by $63.85 per tonne, or by 13.8%, compared to 2005. Wholesale volumes of refined products sold outside Russia increased by 8,009 thousand tonnes, or by 16.2%, due to increased volumes of refined products trading and exports from Russia. As a result, our revenue from the wholesale of refined products outside Russia increased by $7,379 million, or by 32.2%.

In 2006, retail sales of refined products outside Russia were approximately at the same level as in 2005. Average retail prices increased up to $998.05 per tonne, or by 12.9% from 2005 to 2006. As a result, our revenue from retail sales increased by $864 million, or by 13.7% from 2005 to 2006. In 2006, revenue from retail sales was 19.1% (in 2005 – 21.5%) of total refined products sales outside Russia.

The wholesale of refined products within Russia in 2006 decreased by 1,266 thousand tonnes, or by 7.7%, compared to 2005. The average domestic realized price on refined products increased by $68.97 per tonne, or by 23.8%. As a result, our revenue from the wholesale of refined products on the domestic market increased by $678 million, or by 14.3%. Volumes of refined products, which were not utilized in the domestic wholesale market were directed to a retail segment or exported from Russia.

Retail sales within Russia increased in 2006 by 446 thousand tonnes, or by 12.6%, compared to 2005. Average retail prices increased up to $680.79 per tonne, or by 22.5%. As a result, our revenue from retail sales increased by $748 million in 2006, or by 37.9%, compared to 2005. Revenue from retail sales was 33.4% of total refined products sales in Russia in 2006 (in 2005 – 29.3%).

Sales of petrochemical products

2007 vs. 2006

Revenue from sales of petrochemical products increased in 2007 by $473 million, or by 25.9%, compared to 2006. This increase in revenue resulted from both price and volume factors.

2006 vs. 2005

Revenue from sales of petrochemical products increased in 2006 by $226 million, or by 14.1%, compared to 2005, due to an increase in prices for petrochemical products.

Sales of other products

Other sales include revenues from sales of gas, gas refined products and other services provided and goods not related to our primary activities (such as electricity, heat, transportation, etc.) sold by our production and marketing companies. Our major purchaser of natural gas produced in the Russian Federation is OAO Gazprom.

2007 vs. 2006

Other sales increased by $934 million, or by 42.1%, mainly as a result of the growth in other sales and services provided to third parties, gas and gas refined products sales both in Russia and abroad. In 2007, sales of natural gas amounted to $389 million (an increase by 69.1%, compared to 2006). In 2007, we sold 7.2 billion cubic meters of natural gas to OAO Gazprom at $41.4 per 1,000 cubic meters.

2006 vs. 2005

Other sales increased by $477 million, or by 27.4%, generally as a result of the growth in gas and gas refined products sales. Sales of natural gas amounted to $230 million in 2006. In 2006, we sold 7.5 billion cubic meters of natural gas to OAO Gazprom at $23.6 per 1,000 cubic meters.

Equity share in income of affiliates

The Group has investments in equity method affiliates and corporate joint ventures. These companies are primarily engaged in crude oil exploration, production, marketing, refining and distribution operations in the Russian Federation and crude oil production and marketing in Kazakhstan. Our largest affiliate is ZAO Turgai-Petroleum, a 50% interest affiliate company developing the Kumkol oil field in Kazakhstan. In January 2007, we acquired the remaining interest in OOO Geoilbent, and, at the end of 2006, ceased the joint activity of OOO LUKOIL-Western Siberia and Brazos Petroleum Overseas Limited (a Group affiliated company). Before 2007, OOO Geoilbent and the joint activity were accounted for using equity method.

2007 vs. 2006

Compared to 2006, our share in income of affiliates decreased by $78 million, or by 18.4%, primarily due to the changes in affiliates' structure.

2006 vs. 2005

Compared to 2005, our share in income of affiliates decreased by $16 million, or by 3.6%. The Group's share in the net income of ZAO Turgai-Petroleum in 2006 was $184 million, which represented a decrease of $14 million, compared to 2005. This decrease in the net income of ZAO Turgai-Petroleum, along with the effect of changes in our ownership of equity affiliates reduced the overall growth in the profitability of our Russian oil and gas producing affiliates.

Operating expenses

Operating expenses include the following types of costs:

	2007	2006	2005
		(millions of US dollars)	
Hydrocarbon extraction expenses	2,757	2,312	1,764
Own refining expenses	880	730	644
Refining expenses at third parties refineries	242	230	104
Excise included in processing fee paid to third parties refineries*	158	–	–
Petrochemical expenses	272	247	214
Crude oil transportation to refineries	848	686	448
Other operating expenses	1,271	861	679
	6,428	**5,066**	**3,853**
Change in operating expenses in crude oil and refined products inventory originated within the Group	(256)	(414)	(410)
Total operating expenses	**6,172**	**4,652**	**3,443**
Cost of purchased crude oil, petroleum and chemical products	**27,982**	**22,642**	**19,590**

*As a result of recent amendments to the Russian tax legislation, effective since January 1, 2007, responsibility to pay excises on refined products (except for straight-run gasoline) was transferred from traders and retailers to refineries. Before 2007, substantial part of excises on realization of refined products produced at third parties refineries was paid by the marketing subsidiaries of the Group and included in "Excise and export tariffs" of our results of operations. Currently such excises are included into processing fee.

Compared to 2006, operating expenses increased by $1,520 million, or by 32.7%, which is mainly explained by the growth of hydrocarbon extraction expenses, other operating expenses and processing and refining costs. Real appreciation of the ruble against the US dollar is a significant factor affecting our operating expenses in Russia. In 2007, the real ruble appreciation was 20.0%.

Hydrocarbon extraction expenses

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

Expenses of the Company's oil and gas 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.

2007 vs. 2006

In 2007, our extraction expenses rose by $445 million, or by 19.2%, compared to 2006. The increase resulted from an increase in hydrocarbon production by our subsidiaries to 774.6 million BOE, which is an increase of 2.8%, compared to 2006, the effect of the real ruble appreciation, increased expenses for energy supply, materials and labor. In 2007, extraction expenses included approximately $45 million of expenses related to changes in the Group structure. Our average hydrocarbon extraction cost per barrel of oil equivalent increased from $3.08 to $3.58, or by 16.1%, compared to 2006.

2006 vs. 2005

In 2006, our extraction expenses rose by $548 million, or by 31.1%, compared to 2005. The increase resulted from an increase in hydrocarbon production by our subsidiaries to 753.8 million BOE, or by 13.3%, compared to 2005, the effect of the real ruble appreciation, increased expenses of artificial stimulation of reservoirs and expenses for energy supply and materials. In 2006, extraction expenses included $95 million of expenses related to crude oil producing companies acquired in late 2005 and in 2006. Our average hydrocarbon extraction cost per barrel of oil equivalent increased from $2.66 to $3.08, or by 15.8%, compared to 2005.

Own refining expenses

2007 vs. 2006

In 2007, refining expenses increased by $150 million, or by 20.5%, compared to 2006.

Refining expenses at our domestic refineries increased by 25.4%, or by $132 million, as a result of increased production volume, the effect of the real ruble appreciation, and due to large-scale overhauls at the Perm refinery in the second quarter of 2007.

Refining expenses at our international refineries increased by 8.6%, or by $18 million. This resulted mainly from a general increase in refining costs including an effect of an appreciation of the exchange rates of Romanian and Bulgarian currencies, which are tied to Euro, to the US dollar.

2006 vs. 2005

In 2006, refining expenses increased by $86 million, or by 13.4%, compared to 2005.

Refining expenses at our domestic refineries increased by 14.3%, or by $65 million as a result of the effect of the real ruble appreciation and due to increased production volume.

Refining expenses at our international refineries increased in 2006 by 11.1%, or by $21 million, compared to 2005. The growth of refining expenses was primarily due to the growth of high-quality production output at our plant in Bulgaria, which was partly offset by the reduction of refining expenses at the Odessa refinery, due to its wide-scale upgrade.

Refining expenses at third parties refineries

Along with our own production of refined products we refined crude oil at third parties refineries both in Russia and overseas.

2007 vs. 2006

In 2007, refining expenses increased by 5.2%, compared to 2006 as a result of increased refining costs in Russia, which was partially offset by decreased refining volumes in Belorussia.

2006 vs. 2005

In 2006, refining expenses at third parties refineries amounted to $230 million, which is more than twice the prior year, due to an almost doubling of volumes refined in Russia.

Petrochemical operating expenses

2007 vs. 2006

In 2007, operating expenses of our petrochemical companies increased by $25 million, or by 10.1%, compared to 2006. This was mainly due to increase of expenses at our Stavrolen petrochemical plant as a result of putting in operation of polypropylene production facilities.

2006 vs. 2005

Operating expenses of our petrochemical companies increased by $33 million, or by 15.4%, compared to 2005, mainly as a result of the increased cost of raw materials and power supply and maintenance activities performed at our Russian petrochemical plants in the second quarter of 2006.

Crude oil transportation to refineries

2007 vs. 2006

Crude oil transportation to refineries increased in 2007 by $162 million, or by 23.6%, compared to 2006, due to an increase in transportation tariffs and volumes refined transported.

2006 vs. 2005

Crude oil transportation to refineries increased in 2006 by $238 million, or by 53.1%, compared to 2005, due to an increase in transportation tariffs and volumes refined transported.

Other operating expenses

Other operating expenses include operating expenses of our gas processing plants, the costs of other services provided and goods not related to our core activities (such as electricity, heat, transportation, etc.) sold by our production and marketing companies, and operating expenses of other non-core businesses of the Group.

2007 vs. 2006

Other operating expenses increased by $410 million, or by 47.6%, compared to 2006. This was due to a general increase in other sales including growth of transportation and other services provided by the Group in the international segment.

2006 vs. 2005

Other operating expenses increased by $182 million, or by 26.8%, compared to 2005. This was due to increase in other services provided.

Change in operating expenses in crude oil and refined products inventory originated within the Group

This line includes extraction and refining expenses related to crude oil and refined products produced by the Group during the reporting period, but not sold to third parties.

Before 2006, such amounts included changes in inventory balances related to mineral extraction taxes, export tariffs and transportation expenses. Commencing in the first quarter of 2006, such changes are reflected in the corresponding income statement lines. Since the Group's management assesses the effect of the change in this classification on the presentation of the income statement for the year 2005 as not material, no reclassifications were made to comparatives.

Cost of purchased crude oil, gas and products

2007 vs. 2006

Cost of purchased crude oil, gas and products increased by $5,340 million in 2007, or by 23.6%, compared to 2006, primarily due to an increase in international refined products trading volumes and prices.

Cost of purchased crude oil, gas and products included the result of hedging of international crude oil and refined products sales. In 2007, we recognized a $575 million expense on hedging, compared to an income of $183 million in 2006.

2006 vs. 2005

Cost of purchased crude oil, gas and products increased by $3,052 million in 2006, or by 15.6%, compared to the previous year due to a significant increase in the volume of refined products trading and increase in market prices for crude oil and petroleum products. At the same time we saw a decrease in the cost of purchased crude oil of $1,166 million. The decrease in external crude oil purchases was due to increased refining of crude oil produced by the Group to maximize the benefit of high refining margins.

Cost of purchased crude oil, gas and products included the result of hedging of international crude oil and refined products sales. In 2006, we recognized a $183 million income on hedging, compared to an expense of $171 million in 2005.

Transportation expenses

2007 vs. 2006

Our transportation expenses increased in 2007 by $857 million, or by 23.8%, compared to 2006. This was due to an increase in transportation tariffs, the increased volumes of refined products export from Russia, changes in exports destinations and an overall increase in sales volumes.

Average transportation tariffs weighted by volumes of the Group's crude oil and refined products export deliveries to different locations changed in 2007, compared to the same period of the previous year as follows: crude oil sea shipping tariffs increased by 11.6%; crude oil pipeline tariffs increased by 13.8%; railway tariffs for refined products transportation increased by 35.1%.

2006 vs. 2005

The increase in the total volume of sales together with the increase in transportation tariffs led to the increase in our transportation expenses in 2006 by $229 million, or by 6.8%, compared to 2005.

Average transportation tariffs weighted by volumes of the Group's crude oil and refined products export deliveries to different locations changed in 2006, compared to the previous year as follows: crude oil sea shipping tariffs decreased by 15.2%; crude oil pipeline tariffs increased by 21.5%; railway tariffs for refined products transportation increased by 26.6%.

Selling, general and administrative expenses

Selling, general and administrative expenses include general business expenses, payroll costs (excluding extraction entities' and refineries' production staff costs), insurance costs (except for property insurance related to extraction and refinery equipment), costs of maintenance of social infrastructure, movement in bad debt provision and other expenses.

2007 vs. 2006

In 2007, our selling, general and administrative expenses increased by $322 million, or by 11.2%, compared to 2006.

The growth was mainly due to real ruble appreciation, expansion of our activities both in Russia and internationally, indexation of salaries and increase in information technology expenses.

This was partially offset by the decrease in the cost related to our share-based management compensation plan. In 2007, such expenses amounted to $125 million, compared to $280 million in 2006.

Selling, general and administrative expenses in 2007 also included approximately $69 million of expenses related to the changes in the Group structure.

2006 vs. 2005

In 2006, our selling, general and administrative expenses increased by $307 million, or by 11.9%, compared to 2005.

The increase in selling, general and administrative expenses was a result of the real ruble appreciation and the general expansion of our operations outside Russia. These expenses were also affected by an increase in costs related to our share-based compensation program for management in 2006 ($280 million, compared to $263 million in 2005).

In 2006, selling, general and administrative expenses also included $87 million of expenses related to the subsidiaries, that we acquired in late 2005 and in 2006.

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.

2007 vs. 2006

Our depreciation, depletion and amortization expenses increased by $321 million, or by 17.3%, compared to 2006. The increase was a result of the Company's capital expenditures and the corresponding increase in depreciable assets. This increase included approximately $36 million related to the changes in the Group structure.

2006 vs. 2005

Our depreciation, depletion and amortization expenses increased by $536 million, or by 40.8%, compared to 2005. The increase was a result of the Company's capital expenditures and the corresponding increase in depreciable assets. The increase included $198 million of depreciation, depletion and amortization expenses related to our acquisitions, in late 2005 and in 2006.

Exploration expenses

2007 vs. 2006

During 2007, the amount charged to exploration expense increased by $98 million, or by 46.9%, compared to 2006. Dry hole costs increased by $52 million up to $143 million.

In the first half of 2007, we completed assessment of two exploratory wells drilled in Saudi Arabia. One of the wells was dry, and its cost of $51 million was charged to expense in 2007. The second well discovered a natural gas reservoir. Also, in beginning of 2008, we finalized geological evaluation of another exploratory well drilled in Saudi Arabia, which was found to be dry. Its cost of $21 million was charged to expense in 2007. Other overseas dry hole costs amounted to $20 million.

The dry hole costs in Russia amounted to $51 million and primarily related to Volga, Timan-Pechora and Western Siberia regions.

2006 vs. 2005

During 2006, the amount charged to exploration expense decreased by $108 million, or by 34.1%, compared to 2005. In 2006, dry hole costs amounted to $91 million, primarily related to exploration projects in Egypt ($12 million) and exploration in Komi and Timan-Pechora in Russia ($53 million). Geological and geophysical costs, charged to exploration expense in 2006 were incurred primarily in Russia and Uzbekistan ($78 million and $12 million, respectively).

In 2005, dry hole costs amounted to $170 million. The Group completed drilling the first exploratory wells of the Yalama (D-222) and Tyub-Karagan exploration projects (located in Azerbaijan and Kazakhstan, respectively). Both exploratory wells were dry and the costs of $105 million were charged to expense.

(Loss) gain on disposals and impairments of assets

2007 vs. 2006

Loss on disposals and impairments of assets in 2007 amounted to $123 million, compared to $148 million in 2006.

The losses include the financial result from disposals of a number of non-core assets and individually insignificant impairments of non-performing business units.

2006 vs. 2005

Loss on disposals and impairment of assets in 2006 amounted to $148 million, compared to a $52 million gain in 2005.

The losses included the financial result from disposals of a number of non-core assets and individually insignificant impairments of non-performing business units. In 2006, losses also included the impairment of unproved property in Azerbaijan of $68 million.

In 2005, we recognized a gain of $152 million on the sale of our 30% interest in OOO Narianmarneftegaz to ConocoPhillips, a gain of $4 million on the sale of our 38% interest in ZAO Globalstroy-Engineering and a gain of $25 million on the sale of our interest in ZAO Arktikneft.

Interest expense

2007 vs. 2006

Interest expense increased in 2007 by $31 million, or by 10.3%, compared to 2006 resulting from an overall increase in our indebtedness. At the same time, the weighted-average interest rate on our long-term indebtedness decreased, compared to the level of 2006.

2006 vs. 2005

Interest expense in 2006 increased by $27 million, or by 9.8%, compared to 2005. The growth of interest expense was primarily due to debt service related to a loan of $1,934 million, which the Group obtained to finance the acquisition of Caspian and a general increase of our indebtedness. Moreover, in the second quarter of 2006, the Group and ConocoPhillips reached an agreement to amend the contractual interest rates related to the financing of our joint venture OOO Narianmarneftegaz from 0.1% to 6.8-8.2% per annum, which also impacted interest expense.

Taxes other than income taxes

	2007	2006	2005
		(millions of US dollars)	
In Russia			
Mineral extraction taxes	8,482	7,281	5,590
Social security taxes and contributions	385	309	284
Property tax	284	219	210
Other taxes	105	160	162
Total in Russia	**9,256**	**7,969**	**6,246**
International			
Social security taxes and contributions	57	47	40
Property tax	29	28	23
Other taxes	25	31	25
Total internationally	**111**	**106**	**88**
Total	**9,367**	**8,075**	**6,334**

2007 vs. 2006

Taxes other than income taxes increased in 2007 by 16.0%, or by $1,292 million, compared to 2006, due to an increase in mineral extraction tax resulting from an increase of crude oil extraction tax rate by 16.0%.

2006 vs. 2005

The increase in taxes other than income taxes resulted primarily from a $1,691 million increase in mineral extraction taxes. Other taxes for 2005 included a $150 million provision accrued in relation to the results of tax audits of the Group companies for periods prior to 2004 financial year.

Excise and export tariffs

Our excise and export tariffs include taxes on sales of refined products and export tariffs on the export of crude oil and refined products.

	2007	2006	2005
		(millions of US dollars)	
In Russia			
Excise tax and sales taxes on refined products	734	610	654
Export tariffs	10,814	10,114	6,590
Total in Russia	**11,548**	**10,724**	**7,244**
Internationally			
Excise tax and sales taxes on refined products	3,468	2,835	2,679
Export tariffs	17	11	8
Total internationally	**3,485**	**2,846**	**2,687**
Total	**15,033**	**13,570**	**9,931**

2007 vs. 2006

Excise and export tariffs increased by $1,463 million, or by 10.8%, compared to 2006. The increase in export tariffs resulted mainly from the increase of tariff rates. The volume factor of the tariffs' increase due to expansion of refined products export from Russia was partially offset by reduction of crude oil export.

The growth in international excises was mainly due to the effect of acquisition of the European petrol stations from ConocoPhillips, an increase in 2007 of excise rates in Bulgaria, substantial increase of refined product sales in Romania, and implementation in May, 2006, of a new sales-tax on export of refined products in Romania.

2006 vs. 2005

Excise and export tariffs increased by $3,639 million, or by 36.6%, compared to 2005. The increase in export tariff expenses resulted from a growth in export tariff rates. Because of the two-month lag between the determination of the crude oil export tariff rate and the period of its application in the fourth quarter of 2006 we sold crude oil at lower prices while we paid export tariffs at higher rates. This resulted in approximately $0.4 billion of negative effect on income before income tax.

Income taxes

2007 vs. 2006

Our total income tax expense increased by $734 million, or by 26.5%, compared to 2006, due to an increase of income before income tax by $2,761 million, or by 26.9%.

Our effective income tax rate in 2007 was 26.9% (in 2006 it was 27.0%), 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.

2006 vs. 2005

Our total income tax expense increased by $306 million, or by 12.4%, compared to 2005, due to an increase of income before income tax by $1,347 million, or by 15.1%.

Our effective income tax rate in 2006 was 27.0% (in 2005 it was 27.7%).

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

	2007	2006 (millions of US dollars)	2005
Net income	**9,511**	**7,484**	**6,443**
Add back:			
Income tax expense	3,507	2,773	2,467
Depreciation and amortization	2,172	1,851	1,315
Interest expense	333	302	275
Interest and dividend income	(135)	(111)	(96)
EBITDA	**15,388**	**12,299**	**10,404**

EBITDA is a non-US GAAP financial measure. EBITDA is defined as net income before interest, taxes and depreciation and amortization. The Company believes that EBITDA provides useful information to investors because it is an indicator of the strength and performance of our business operations, including our ability to finance capital expenditures, acquisitions and other investments and our ability to incur and service debt. While depreciation and amortization are considered as operating costs under US GAAP, these expenses primarily represent the non-cash current period allocation of costs associated with long-lived assets acquired or constructed in prior periods. Our EBITDA calculation is commonly used as a basis for some investors, analysts and credit rating agencies to evaluate and compare the periodic and future operating performance and value of companies within the oil and gas industry. EBITDA should not be considered in isolation as an alternative to net income, operating income or any other measure of performance under US GAAP. EBITDA does not include our need to replace our capital equipment over time.

Liquidity and capital resources

	2007	2006	2005
		(millions of US dollars)	
Net cash provided by operating activities	10,881	7,766	6,204
Net cash used in investing activities	(9,715)	(7,515)	(6,225)
Net cash (used in) provided by financing activities	(1,098)	(1,186)	432

Operating activities

Our primary source of cash flow is funds generated from our operations. During 2007, cash generated by operating activities was $10,881 million, an increase of 40.1%, compared to 2006. In 2007, our operating cash inflows were affected by an increase of working capital by $1,828 million, compared to January 1, 2007. This was mainly caused by:

- an increase of $525 million in VAT receivable balances
- a $691 million net increase in trade accounts receivable and payable
- an increase in inventory of $1,148 million, primarily resulting from increased volumes of refined products held.

At the same time, the negative effect from the above mentioned factors was partly offset by a decrease of $521 million in tax accounts receivable and a $15 million net decrease in other assets and liabilities.

In 2006, our cash flows from operating activities were significantly affected by an increase in working capital of $1,621 million, as a result of an increase in inventory, trade and taxes accounts receivable.

Investing activities

An increase in cash used in investing activities resulted from an increase in capital expenditures by $2,652 million, or by 41.3%, compared to 2006 (for detailed analysis of the capital expenditures see the next pages). Also, during 2007, the Company paid $255 million for the acquisition of licenses for crude oil exploration and production for two fields in the Komi Republic.

In 2007, we spent $442 million on acquisition of retail networks in Europe, $154 million on increasing our stake in the Nizhny Novgorod Refinery and $240 million on numerous acquisitions of medium-sized companies and individually insignificant increases of our stake in subsidiaries. Acquisitions in 2007 also included $832 million of advances related to acquisitions of upstream assets in Uzbekistan (SNG Holdings Ltd.) and future acquisitions of downstream assets in Russia and abroad.

Cash flows from investing activities include $1,155 million of cash received from the sale of our 50% interest in Caspian.

In 2006, we spent $1,374 million on acquisitions of interests in other companies, $1,500 million less, compared to 2005. We paid $847 million for the acquisition of KMOC, and $300 million as an advance for the acquisition of the remaining 34% of the share capital of OOO Geoilbent. In 2005, we spent $2,874 million mainly for the acquisitions of Caspian, OAO Primorieneftegaz, Oy Teboil Ab and Suomen Petrooli Oy, the remaining interest in ZAO SeverTEK, an equity interest in OOO Geoilbent and increase of our share in LUKOIL Neftochim Bourgas AD.

Financing activities

In 2007, net movements of short-term and long-term debt generated an inflow of $616 million. These inflows in 2007 included loans of $672 million received from ConocoPhillips as its part of financing our joint venture in the Timan-Pechora region.

In June 2007, a Group company raised $1,000 million by an issue of non-convertible bonds. $500 million were placed with a maturity of 10 years and a coupon yield of 6.356% per annum and the remaining bonds were placed with a maturity of 15 years and a coupon yield of 6.656% per annum. All bonds were placed at the face value and have a half year coupon period. The amount raised was used to refinance a significant part of our debt related to the loan of $1,934 million, which the Group obtained in December 2005 to finance the acquisition of Caspian. As a result, the peak debt burden, which was to fall in December 2008, has halved.

In 2006, net movements of short-term and long-term debt generated an inflow of $715 million, compared to an inflow of $1,132 million in the respective period of 2005. This inflow included:

- 14 million non-convertible rouble bonds with a face value of 1,000 Russian rubles each issued in December 2006 ($532 million)
- $530 million of borrowings related to our KMOC acquisition
- $381 million of loans received from ConocoPhillips as its part of financing our joint venture in the Timan-Pechora region (previously this loan was accounted for as equity contribution).

During 2007, as a result of settlement of a stock-based compensation plan employees purchased approximately 8.8 million shares held by the Group as a treasury stock at the grant price for $129 million and resold approximately 1.5 million shares back to the Group for $134 million.

Also, during 2007, a Group company paid $578 million for the purchase of the Company's common stock under our capital management program. In 2006, we paid $782 million for the purchase of the Company's stock under this program.

In 2007, the Company paid $1,230 million in dividends ($1,015 and $800 million in 2006 and 2005, respectively).

These factors resulted in a net cash outflow from financing activities of $1,098 million in 2007, compared to an outflow of $1,186 million in 2006.

The Group has sufficient borrowing capacity to meet unanticipated cash requirements. As of December 31, 2007, the Company had available unutilized short-term credit facilities with a number of banks of $1,916 million.

The Group systematically works at decreasing the level of secured debt, mainly represented by the pledge of export receivables and fixed assets. As of December 31, 2007, the level of secured debt was approximately 6% of total debt, while as of December 31, 2006, it was 14%, and as of December 31, 2005, it was 35%.

Credit rating

Standard & Poor's Ratings Services raised in 2007 its long-term corporate credit rating and all debt ratings on the Company to BBB- from BB+ following review of the Company's 2006 results, financial policies, and strategic plan.

In 2007, Moody's affirmed the Company's long-term corporate family rating and long-term issuer rating of Baa2.

In 2007, Fitch Ratings affirmed the Company's long-term issuer default rating of BBB- and short-term issuer default rating of F3. In the beginning of 2008, Fitch Ratings changed our outlook from stable to positive.

A rating is not a recommendation to buy, sell or hold securities and may be subject to revision, suspension or withdrawal at any time by the assigning rating organization. Similar ratings on the Company and/or on different types of securities do not necessarily mean the same thing. The ratings do not address the marketability of any of our securities or their market price. Any change in the credit ratings of the Company or our securities could adversely affect the price that a subsequent purchaser will be willing to pay for our securities. We recommend that you analyze the significance of each rating independently from any other rating.

Analysis of capital expenditures

	2007	2006	2005
	(millions of US dollars)		
Exploration and production			
Russia	6,391	4,334	2,487
International	871	786	431
Total exploration and production	7,262	5,120	2,918
Refining, marketing and distribution			
Russia	1,177	916	654
International	645	559	475
Total refining, marketing and distribution	1,822	1,475	1,129
Chemicals			
Russia	73	121	59
International	98	51	18
Total chemicals	171	172	77
Other	117	119	53
Total capital expenditures*	**9,372**	**6,886**	**4,177**
Acquisitions of subsidiaries**			
Exploration and production			
Russia	77	1,469	778
International	357	91	1,959
Total exploration and production	434	1,560	2,737
Refining, marketing and distribution			
Russia	685	122	27
International	511	–	229
Total refining, marketing and distribution	1,196	122	256
Other	38	32	–
Less cash acquired	**(102)**	**(26)**	**(119)**
Total acquisitions of subsidiaries	**1,566**	**1,688**	**2,874**

* Including non-cash transactions.

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

During 2007, capital expenditures, including non-cash transactions, amounted to $9,372 million, $2,486 million more than in the previous year. The growth was mainly resulted from expenditures in our exploration and production segment, which increased by $2,142 million, or by 41.8%, compared to 2006. The growth in exploration and production capital expenditures in new regions amounted to $1,000 million, due to construction of facilities and development of infrastructure on our new oil fields. The capital expenditures in traditional exploration regions of Western Siberia increased by $830 million, substantially, as a result of an increase in exploratory drilling and investment in pipelines and machinery. Capital expenditures in European Russia increased by $209 million. In 2007, an increase in the capital expenditures in our overseas exploration projects (excluding Caspian region) amounted to $103 million and primarily related to our projects in Kazakhstan, Saudi Arabia and Uzbekistan.

The Company estimates its 2008 capital expenditures in our exploration and production segment at approximately $7.1 billion, with $1.0 billion of that outside Russia. Refining, marketing and distribution capital spending is estimated to be $1.9 billion, with $0.6 billion of that outside Russia.

The table below shows our exploration and production capital expenditures in new promising oil regions.

	2007	2006	2005
	(millions of US dollars)		
Northern Timan-Pechora	2,357	1,526	673
Yamal	75	135	216
Caspian region*	441	212	259
Total	**2,873**	**1,873**	**1,148**

* Russian and international projects.

Contractual obligations, other contingencies and off balance sheet arrangements

Capital commitments and contractual obligations

The Group owns and operates refineries in Bulgaria (LUKOIL Neftochim Bourgas AD) and Romania (Petrotel-LUKOIL). As a result of Bulgaria and Romania joined the European Union in 2007, LUKOIL Neftochim Bourgas AD and Petrotel-LUKOIL are required to upgrade their refining plants 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 existed Bulgarian and Romanian legislation. The Group estimates the amount of future capital commitment required to upgrade LUKOIL Neftochim Bourgas AD and Petrotel-LUKOIL to be approximately $878 million and $59 million, respectively.

Group companies have commitments under the terms of existing license agreements in the Russian Federation of $1,561 million over the next 5 years and of $46 million thereafter. Management believes that a significant portion of these commitments will be fulfilled by the services to be provided by Eurasia Drilling Company and ZAO Globalstroy-Engineering as discussed below.

In connection with the sale of LUKOIL-Burenie in 2004 the Group signed a five year contract for drilling services. Under the terms of the contract, drilling services of $1,211 million and $753 million will be provided by LUKOIL-Burenie (now Eurasia Drilling Company) during 2008 and 2009, respectively.

The Company has signed a four-year agreement for the provision of construction, engineering and technical services with ZAO Globalstroy-Engineering. The volume of these services is based on the Group’s capital construction program, which is re-evaluated on an annual basis. The Group estimates the amount of capital commitment under this agreement for 2008 to be approximately $706 million.

A Group company has commitment to purchase equipment for modernization of the petrochemical refinery in Ukraine over the next 2 years. As of December 31, 2007, this commitment was approximately $160 million.

Group companies have commitments for capital expenditure contributions in the amount of $357 million related to various production sharing agreements over the next 30 years.

Group companies have investment commitments relating to oil deposits in Iraq of $495 million to be spent within 3 years from when exploitation becomes possible. Due to significant changes in the political and economic situation in Iraq the future of this contract is not clear, however, the Group is actively pursuing its legal right to this contract in Iraq in alliance with ConocoPhillips.

The following table displays our total contractual obligations and other commitments:

Millions of dollars	Total	2008	2009	2010	2011	2012	After
On balance sheet							
Short term debt	**2,214**	2,214	–	–	–	–	–
Long-term bank loans and borrowings	**2,391**	1,218	204	364	182	138	285
Long-term non-bank loans and borrowings	**48**	11	19	6	7	1	4
Long-term loans and borrowings from related parties	**1,745**	–	–	–	–	–	1,745
6,356% Non-convertible US dollar bonds, maturing 2017	**500**	–	–	–	–	–	500
6,656% Non-convertible US dollar bonds, maturing 2022	**500**	–	–	–	–	–	500
7.25% Russian ruble bonds, maturing 2009	**244**	–	244	–	–	–	–
7.10% Russian ruble bonds, maturing 2011	**326**	–	–	–	326	–	–
7.40% Russian ruble bonds, maturing 2013	**244**	–	–	–	–	–	244
Capital lease obligations	**107**	47	35	14	1	5	5
TOTAL	**8,319**	**3,490**	**502**	**384**	**516**	**144**	**3,283**
Off balance sheet							
Capital commitments under oil and gas license agreements in Russia*	**1,607**	575	473	162	164	187	46
Operating lease obligations	**1,782**	500	426	235	155	133	333
Capital commitment in LUKOIL-Neftochim Bourgas AD	**878**	213	297	143	225	–	–
Capital commitment in LUKOIL-Petrotel	**59**	32	20	7	–	–	–
Commitment for modernization of the petrochemical refinery in Ukraine	**160**	152	8	–	–	–	–
Capital commitments in PSAs	**357**	282	27	7	2	1	38
Obligation under contract with Eurasia Drilling Company	**1,964**	1,211	753	–	–	–	–
Obligation under contract with ZAO Globalstroy-Engineering	**706**	706	–	–	–	–	–

* Management believes that a significant portion of these commitments will be fulfilled by the services to be performed by Eurasia Drilling Company and ZAO Globalstroy-Engineering.

Off balance sheet arrangements

LUKARCO, an investee recorded under the equity method of accounting has a loan facility on which $610 million was drawn as of December 31, 2007. Borrowings under this loan bear interest at LIBOR plus 2.5% per annum, maturing by May 1, 2012. To enhance the credit standing of LUKARCO, the Company guarantees 54% of the interest payment as well as the repayment of 54% of the loan at maturity. As of December 31, 2007, the total amount of the Company's guarantee was $348 million, which includes $19 million related to accrued interest on the outstanding amount. Payments are due if the Company is notified that LUKARCO is not able to fulfill its obligations at maturity date. The Company's guarantee is secured by its 54% interest in LUKARCO with the carrying value of $462 million and $358 million as of December 31, 2007 and 2006, respectively. There are no material amounts being carried as liabilities for the Group's obligations under this guarantee.

		Commitment Expiration by Period					
Millions of dollars	Total	2008	2009	2010	2011	2012	After
Guarantees of equity affiliate's debt	**361**	131	167	63	–	–	–

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 alleged that the Defendants interfered with the transfer of a diamond exploration license to Almazny Bereg, a joint venture between ADC and AGD. ADC claimed total damages of 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 dismissed the lawsuit for lack of personal jurisdiction. This ruling was upheld by the Colorado Court of Appeals on March 25, 2004. On November 21, 2005, the Colorado Supreme Court affirmed the lower courts' ruling that no specific jurisdiction exists over the Defendants. By virtue of this finding, AGD (the holder of the diamond exploration license) was dismissed from the lawsuit. The Supreme Court found, however, that the trial court made a procedural error by not holding an evidentiary hearing before making its ruling concerning general jurisdiction regarding the Company, which is whether the Company had systematic and continuous contacts in the State of Colorado at the time the lawsuit was filed. In a modified opinion dated December 19, 2005, the Colorado Supreme Court remanded the case to the Colorado Court of Appeals (instead of the District Court) to consider whether the lawsuit should have been dismissed on alternative grounds (i.e., forum non conveniens). On June 29, 2006, the Colorado Court of Appeals declined to dismiss the case based on forum non conveniens. The Company filed a petition for certiorari on August 28, 2006, asking the Colorado Supreme Court to review this decision. This petition has been rejected. On March 5, 2007, the Colorado Supreme Court remanded the case to the District Court. On June 11, 2007, the District Court ruled it would conduct an evidentiary hearing on the issue of whether the Company is subject to general personal jurisdiction in the State of Colorado. A status conference with the Court is scheduled for June 13, 2008. 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 ("Arbitration Tribunal"), 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 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. On November 15, 2005, the Swedish Court of Appeals denied AGD's appeal and affirmed the Stockholm District Court decision. On December 13, 2005, AGD filed an appeal against the Swedish Court of Appeals decision with the Swedish Supreme Court. On April 13, 2006, the Swedish Supreme Court denied the application of AGD for appeal against the Swedish Court of Appeal's decision dated November 15, 2005. On May 6, 2006, a Notice of Arbitration was received on behalf of ADC. On December 20, 2006, the first session of the Arbitration Tribunal with participation of both parties took place in order to define procedural issues related to the tribunal. As a result of the hearing the Arbitration Tribunal issued a detailed procedural order setting out the rules and timetable for the conduct of the arbitration. In May 2007, ADC filed a statement of claim that requested the Tribunal to require AGD to transfer the diamond exploration license to Almazny Bereg. On October 22, 2007, AGD submitted a statement of defense. On December 21, 2007, the Arbitration Tribunal issued a procedural order on suspension of the arbitration for four months. 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. As of December 31, 2007, our borrowings that are sensitive to changes in interest rates totaled $3,096 million (for details on long-term borrowings please refer to Note 12 "Long-term debt" of the consolidated financial statement). Utilizing the actual interest rates in effect and the balance of our variable rate debt as of December 31, 2007, and assuming a 10% change in interest rates and no change in the balance of debt outstanding, the potential effect on our annual interest expense would not be material to our results of operations.

The following tables represent principal cash flows and related weighted-average interest rates by expected maturity times.

	Fixed rate borrowings		Floating rate borrowings	
2007	(millions of US dollars)	%	(millions of US dollars)	%
2008	132	5.27	2,035	5.28
2009	297	6.65	169	5.91
2010	41	2.87	329	5.60
2011	373	6.59	142	6.25
2012	2	5.00	137	6.40
After	1,250	6.67	284	6.96
Total*	**2,095**	**6.49**	**3,096**	**5.60**

2006	(millions of US dollars)	%	(millions of US dollars)	%
2007	91	3.07	1,202	5.94
2008	47	3.54	2,224	6.15
2009	283	6.49	79	7.29
2010	35	2.94	242	6.61
2011	341	6.68	56	7.87
After	233	4.70	157	9.40
Total*	**1,030**	**5.59**	**3,960**	**6.29**

* Excluding capital lease obligations and loans and borrowings from related parties.

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 a net foreign currency translation gain of $93 million in 2007, a gain of $169 million in 2006 and a loss of $134 million in 2005.

Appreciation of the ruble against the US dollar in 2005-2007 had a negative impact on our operating profit and cash flows since it lead to an increase of our ruble costs in US-dollar terms and a decrease in the amount of our export cash revenue in ruble terms. As mentioned above, a substantial part of our revenue is denominated in US dollars or, to some extent, linked to oil prices quoted in US dollars, while a significant part of our costs is ruble denominated. Should the ruble appreciation against US dollars in 2008 be at a level of 10% our free cash flows will be significantly affected (taking into account that other macroeconomic factors will remain constant).

Commodity derivative instruments

The Group participates in certain petroleum products marketing and trading activity outside of its physical crude oil and petroleum products businesses. The Group's derivative activity is limited to these marketing and trading activities and hedging of commodity price risks. Currently this activity involves 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. The Group recognized an expense of $575 million in 2007, an income of $183 million in 2006 and an expense of $171 million in 2005 from the use of derivative instruments. The fair value of derivative contracts outstanding and recorded on the consolidated balance sheets was a net liability of $50 million and a net asset of $43 million as of December 31, 2007 and 2006, respectively (a net liability of $26 million in 2005).

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” to our consolidated financial statements 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.

Business combinations

Purchase price allocation
Accounting for the acquisition of a business requires the allocation of the purchase price to the various assets and liabilities of the acquired business. For most assets and liabilities, purchase price allocation is accomplished by recording the asset or liability at its estimated fair value. The most difficult estimations of individual fair values are those involving property, plant and equipment and identifiable intangible assets. We use all available information to make these fair value determinations and, for major business acquisitions, typically engage an outside appraisal firm to assist in the fair value determination of the acquired long-lived assets. We have, if necessary, up to one year after the acquisition closing date to finish these fair value determinations and finalize the purchase price allocation.

Principles of consolidation
Our consolidated financial statements include the financial position and results of the Company, controlled subsidiaries of which the Company directly or indirectly owns more than 50% of the voting interest, unless minority interest shareholders have substantive participating rights, and variable interest entities where the Group is determined to be the primary beneficiary. Other significant investments in companies of which the Company directly or indirectly owns between 20% and 50% of the voting interest and over which it exercises significant influence but not control, are accounted for using the equity method of accounting. Investments in companies of which the Company directly or indirectly owns more than 50% of the voting interest but where minority interest shareholders have substantive participating rights are accounted for using the equity method of accounting. Undivided interests in oil and gas joint ventures are accounted for using the proportionate consolidation method. Investments in other companies are recorded at cost.

Revenue recognition

Revenues from sales of crude oil and petroleum products are recognized when title passes to customers. Revenues include excise on petroleum products sales and duties on export sales of crude oil and petroleum products.

Revenues from non-cash sales are recognized at the fair market value of the crude oil and petroleum products sold.

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 that individually are relatively small, management exercises judgment and determines a periodic property impairment charge as required that is reported in loss on disposals and impairments of assets.

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. 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

Reserves are estimated using the definitions of reserves prescribed by the US Society of Petroleum Engineers and the World Petroleum Congress requirements. Due to the inherent uncertainties and the necessarily limited nature of reservoir data, estimates of reserves are inherently imprecise, require the application of judgment and are subject to change as additional information becomes available. 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.

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. Proved reserves do not include additional quantities of oil and gas reserves that may result from applying secondary or tertiary recovery techniques not yet tested and determined to be economic. The proved reserves include volumes which are recoverable up to and after license expiry dates. Proved developed reserves are the quantities of proved reserves expected to be recovered through existing wells with existing equipment and operating methods.

Management has included within proved reserves significant quantities which the Group expects to produce after the expiry dates of certain of its current production licenses in the Russian Federation. These licenses expire between 2011 and 2026, with the most significant expiring between 2011 and 2014. Management believes 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, such as oil and gas properties, other property, plant, and equipment, and purchased intangibles subject to amortization, are assessed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset group may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset group to the estimated undiscounted future cash flows expected to be generated by that group. If the carrying amount of an asset group exceeds its estimated undiscounted future cash flows, an impairment charge is recognized by writing down the carrying amount to the estimated fair value of the asset group, generally determined as discounted future net cash flows. Assets to be disposed of are separately presented in the balance sheet and reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated. The assets and liabilities of a disposed group classified as held for sale are presented separately in the appropriate asset and liability sections of the balance sheet.

Deferred income taxes

Deferred income tax assets and liabilities are recognized in respect of future tax consequences attributable to temporary differences between the carrying amounts of existing assets and liabilities for the purposes of the consolidated financial statements and their respective tax bases and in respect of operating loss and tax credit carryforwards. Deferred income tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to reverse and the assets be recovered and liabilities settled. The effect on deferred income tax assets and liabilities of a change in tax rates is recognized in the consolidated statement of income in the reporting period which includes the enactment date.

The ultimate realization of deferred income tax assets is dependent upon the generation of future taxable income in the reporting periods in which the originating expenditure becomes deductible. In assessing the realizability of deferred income tax assets, management considers whether it is more likely than not that the deferred income tax assets will be realized. In making this assessment, management considers the scheduled reversal of deferred income tax liabilities, projected future taxable income, and tax planning strategies.

Asset retirement obligations

Under various laws, contracts, permits and regulations, the Group has legal obligations to remove tangible equipment and restore the land or seabed at the end of operations at production sites. The largest asset retirement obligations of the Group relate to wells and oil and gas production facilities and pipelines. In accordance with SFAS No. 143, *"Accounting for Asset Retirement Obligations,"* the Group records the fair value of liabilities associated with such obligations when incurred. Estimating the future asset retirement obligations 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

Certain conditions may exist as of balance sheet dates that may result in losses, but the impact of which will only be resolved when one or more future events occur or fail to occur. The Group is required to both determine whether a loss is probable based on judgment and interpretation of laws and regulations and determine whether the loss can be reasonably estimated. If our assessment of a contingency indicates that it is probable that a material loss will arise, and the amount of the liability can be estimated, then the estimated liability is accrued and charged to the consolidated statement of income. If our assessment indicates that a potentially material loss is not probable, but is only reasonably possible, or is probable but cannot be estimated, then the nature of the contingent liability is disclosed in the notes to our consolidated financial statements. Loss contingencies considered remote are generally not disclosed unless they involve guarantees, in which case the nature of the guarantee is disclosed. The Company's management continually monitor known and potential contingent matters and make appropriate charges to the consolidated statement of income when warranted by circumstance.

Use of derivative instruments

The Group's derivative activity is limited to certain petroleum products marketing and trading outside of its physical crude oil and petroleum products businesses and hedging of commodity price risks. Currently this activity involves the use of futures and swaps contracts together with purchase and sale contracts that qualify as derivative instruments. The Group accounts for these activities under the mark-to-market methodology in which the derivatives are revalued each accounting period. Resulting realized and unrealized gains or losses are presented in the consolidated statement of income on a net basis. Unrealized gains and losses are carried as assets or liabilities on the consolidated balance sheet.

Recent accounting pronouncements

In March 2008, the FASB issued SFAS No. 161, *"Disclosures about Derivative Instruments and Hedging Activities."* This Statement improves financial reporting about derivative instruments and hedging activities by enhanced disclosures of their effects on entity's financial position, financial performance and cash flows. SFAS No. 161 is effective for financial statements for fiscal years and interim periods beginning after November 15, 2008, early application is encouraged. The Group is required to adopt the provisions of SFAS No. 161 in the first quarter 2009 and does not expect any material impact on its results of operations, financial position or cash flows upon adoption.

In December 2007, the FASB issued SFAS No. 141 (Revised), *"Business combinations."* This Statement will apply to all transactions in which an entity obtains control of one or more businesses. SFAS No. 141 (Revised) requires an entity to recognize the fair value of assets acquired and liabilities assumed in a business combination; to recognize and measure the goodwill acquired in the business combination or gain from a bargain purchase and modifies the disclosure requirements. The Group is required to prospectively adopt the provisions of SFAS No. 141 (Revised) for business combinations for which the acquisition date is on or after January 1, 2009. Early adoption of SFAS No. 141 (Revised) is prohibited.

In December 2007, the FASB issued SFAS No. 160, *"Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51."* This Statement will apply to all entities that prepare consolidated financial statements (except not-for-profit organizations) and will affect those which have an outstanding noncontrolling interest (or minority interest) in their subsidiaries or which have to deconsolidate a subsidiary. This Statement changes the classification of a non-controlling interest; establishing a single method of accounting for changes in the parent company's ownership interest that does not result in deconsolidation and requires a parent company to recognize a gain or loss when a subsidiary is deconsolidated. The Group is required to prospectively adopt the provisions of SFAS No. 160 in the first quarter 2009, except for the presentation and disclosure requirements which shall be applied retrospectively. Early adoption of SFAS No. 160 is prohibited.

In February 2007, the FASB issued SFAS No. 159, *"The Fair Value Option for Financial Assets and Financial Liabilities."* This Statement expands the possibility of using fair value measurements and permits enterprises to choose to measure certain financial assets and financial liabilities at fair value. Enterprises shall report unrealized gains and losses on items for which the fair value option has been elected in earnings in each subsequent period. The Group is required to adopt the provisions of SFAS No. 159 in the first quarter 2008 and does not expect any material impact on its financial statements upon adoption.

In September 2006, the FASB issued SFAS No. 158, *"Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans – an amendment of FASB Statements No. 87, 88, 106 and 132(R)."* This Statement requires an employer that sponsors one or more single-employer defined benefit plans to: (a) Recognize the funded status of a benefit plan in its statement of financial position; (b) Recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost; (c) Measure defined benefit plan assets and obligations as of the date of the employer's fiscal year-end statement of financial position (with limited exceptions); (d) Disclose in the notes to financial statements additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation. The provisions of this Statement were effective December 31, 2006, except for the requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end, which is effective December 31, 2008. The adoption of the provisions of SFAS No. 158 did not have a material impact on the Group's results of operations, financial position or cash flows.

In September 2006, the FASB issued SFAS No. 157, *"Fair Value Measurements,"* which establishes a single authoritative definition of fair value, sets out a framework for measuring fair value and requires additional disclosures about fair value measurements. This Statement does not require any new fair value measurements but is expected to increase the consistency of those measurements. The Group is required to adopt the provisions of SFAS No. 157 in the first quarter 2008 and does not expect any material impact on its financial statements upon adoption.

In June 2006, the FASB issued FASB Interpretation No. 48, *"Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109"* (FIN 48). This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *"Accounting for Income Taxes."* The Group adopted the provisions of FIN 48 in the first quarter 2007. The adoption of the provisions of Interpretation No. 48 did not have a material impact on the Group's results of operations, financial position or cash flows.

In June 2006, the FASB ratified the consensus reached by the EITF on Issue No. 06-3, *"How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)."* The consensus requires disclosure of either the gross or net presentation, and any such taxes reported on a gross basis should be disclosed in the interim and annual financial statements. The Group adopted the provisions of EITF Issue No. 06-3 in 2006. The adoption of the Issue did not have a material impact on the Group's financial statements.

In December 2004, the FASB issued SFAS No. 123(R), *"Share-Based Payment,"* which revises SFAS No. 123 and supersedes Accounting Principles Board (APB) Opinion No. 25 regarding stock-based employee compensation plans. SFAS No.123(R) requires liability classified share-based payment awards to employees to be valued at fair value on the date of grant and as of each reporting date and expensed over the vesting period. Equity classified share-based payment awards to employees should be valued at fair value on the date of grant and expensed over the vesting period. The adoption of the provisions of SFAS No. 123(R) during 2006 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.