# 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 June 30, 2008, and for the six and three months ended June 30, 2008 and 2007, and significant trends that may affect its future performance. It should be read in conjunction with our interim US GAAP consolidated financial statements and notes thereto.

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.*

## Key financial and operational results

| | 1st half of | | Change, | 2nd quarter of | | Change, |
|---|---|---|---|---|---|---|
| | **2008** | **2007** | **%** | **2008** | **2007** | **%** |
| Sales (millions of US dollars) | 56,890 | 35,781 | 59.0 | 31,935 | 20,129 | 58.7 |
| Net income (millions of US dollars) | 7,293 | 3,816 | 91.1 | 4,130 | 2,517 | 64.1 |
| EBITDA (millions of US dollars) | 11,082 | 6,349 | 74.5 | 6,236 | 3,917 | 59.2 |
| Basic earnings per share of common stock (US dollars) | 8.70 | 4.59 | 89.5 | 4.92 | 3.03 | 62.4 |
| Hydrocarbon production by the Group including our share in equity affiliates (thousands of BOE) | 396,117 | 399,864 | (0.9) | 196,623 | 198,327 | (0.9) |
| Crude oil production by the Group including our share in equity affiliates (thousands of tonnes) | 47,006 | 48,528 | (3.1) | 23,384 | 24,097 | (3.0) |
| Gas available for sale produced by the Group including our share in equity affiliates (millions of cubic meters) | 8,402 | 7,030 | 19.5 | 4,112 | 3,449 | 19.2 |
| Refined products produced by our subsidiaries (thousands of tonnes) | 25,459 | 23,472 | 8.5 | 12,999 | 12,048 | 7.9 |

During the first half of 2008, our net income was $7,293 million, which is $3,477 million, or 91.1%, more than in the same period of 2007.

The main factor for improvement of our performance in the first half of 2008 was an increase in the international crude oil and refined products prices, and increased volumes of crude oil refining in Russia. On the other side we were affected by growing operating expenses, tax expenses and transportation tariffs. 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, South America, 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 a power generation business, 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 9, 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 22 "Segment information" to our interim consolidated financial statements.

## Executive overview

### Changes in the Group structure, acquisition and disposition of assets

In July 2008, a Group company signed an agreement to acquire a 100% interest in Akpet group for $555 million, subject to finalization of working capital and other adjustments. Akpet group operates 693 petrol filling stations on the basis of dealer agreements and owns eight refined product terminals, five LNG storage tanks, three jet fuel terminals and a lubricant production plant in Turkey. The acquisition is expected to be finalized in the third quarter of 2008.

In June 2008, a Group company signed an agreement with ERG S.p.A. to establish a joint venture to operate the ISAB refinery complex in Priolo, Italy. In accordance with the purchase agreement the Group will acquire a 49% stake in the joint venture for approximately $2,100 million, which is subject to finalization of working capital and other adjustments. The seller has a put option, the effect of which would be to increase the Group's stake in the joint venture. The agreement states that each partner will be responsible for procuring crude oil and marketing refined products in line with its equity stake in the joint venture. The ISAB refinery complex has the flexibility to process Urals blend crude oil, and the Company intends to fully integrate its share of the ISAB refinery complex capacity into its crude oil supply and refining products marketing operations. The ISAB refinery complex has an annual refining capacity of 16 million tonnes. The ISAB refinery complex also includes three jetties and storage tanks totaling 3,700 thousand cubic meters. The transaction is subject to antitrust approvals and other customary closing conditions and is expected to be finalized in the fourth quarter of 2008.

In April 2008, the Company entered into an agreement to sell 49.99% of the share capital of OAO Arkhangelskgeoldobycha ("AGD") to De Beers and Archangel Diamond Corporation ("ADC") for $100 million, which is subject to the finalization of a working capital adjustment. The agreement provides for two additional components of contingent purchase consideration.

- The first contingent payment, of $75 million, is payable when both the signing of the mining protocol by the AGD shareholders and the decision to mine have been passed by the AGD board of directors.
- The second contingent payment, of $50 million, is payable at the commencement of commercial production. The amount will only be payable if the first contingent event has occurred.

The agreement contains a put option in favour of ADC whereby ADC can require the Company to repurchase ADC's 49.99% interest in AGD at the original purchase price adjusted for amounts invested in AGD as defined by the agreement. The option is exercisable up to 18 months from the transaction completion date if pre-purchase tax, environmental or restructuring losses individually or in aggregate equal or exceed $50 million.

It is expected that the transaction will be finalized by the end of 2008. In accordance with the agreement, upon completion, the litigation and arbitration proceedings described in Note 19 "Commitments and contingencies" between ADC and the Group will be terminated. AGD is a company which owns a diamond exploration license in the Timan-Pechora region of the Russian Federation.

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 was finalized in April 2008, for a price that approximated their carrying value of $70 million.

In March 2008, a Group company entered into an agreement to acquire 75 petrol stations and storage facilities in Bulgaria for approximately $367 million. The transaction was finalised in the second quarter of 2008.

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.

- The first contingent payment, of $100 million, was based on an agreed level of proved and probable hydrocarbon reserves as verified by an independent petroleum engineer. This condition was met and the amount was paid in June 2008.
- The second contingent payment, of $100 million, is payable both upon approval of the agreed development program by the Uzbekistan authorities and if 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 64.31% interest in OAO UGK TGK-8 ("TGK-8") for approximately $2,117 million. The purchase consideration partly consists of 23.55 million shares of common stock of the Company (at a market value of approximately $1,620 million). The transaction was finalized in May 2008. By the end of June, 2008, a Group company acquired an additional 1.45% interest in TGK-8 for $51 million. The acquisition increased the Group's ownership to 65.76%. TGK-8 is one of the major gas consumers in the Southern Federal District with an annual consumption of 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 with total productive capacity of 3.6 GW. 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%. During the first half of 2008, the Group acquired the remaining 3.09% of the share capital of OAO LUKOIL-Nizhegorodnefteorgsintez from minority shareholders for $64 million, increasing the Group's share in OAO LUKOIL-Nizhegorodnefteorgsintez to 100%. OAO LUKOIL-Nizhegorodnefteorgsintez is a refinery plant located in European Russia.

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 our refined products sales 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 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 $444 million from ConocoPhillips, its related party. 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 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.

## Operational highlights

### Hydrocarbon production

| | 1st half of | |
|---|---|---|
| | 2008 | 2007 |
| Daily production of hydrocarbons, including the Company's share in equity affiliates (thousand BOE per day) | 2,176 | 2,210 |
| - crude oil | 1,905 | 1,981 |
| - natural and petroleum gas* | 271 | 229 |
| Hydrocarbon extraction expenses (US dollar per BOE) | 4.09 | 3.49 |

| | 2nd quarter of | |
|---|---|---|
| | 2008 | 2007 |
| Daily production of hydrocarbons, including the Company's share in equity affiliates (thousand BOE per day) | 2,161 | 2,179 |
| - crude oil | 1,895 | 1,956 |
| - natural and petroleum gas* | 266 | 223 |
| Hydrocarbon extraction expenses (US dollar per BOE) | 4.31 | 3.64 |

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

**Crude oil production.** In the first half of 2008, our total daily crude oil production decreased by 3.8% compared to the same period of 2007. We produced (including the Company's share in equity affiliates) 346.7 million barrels, or 47.0 million tonnes.

The following table represents our production in the first half of 2008 and 2007 by major regions.

| | 1st half of 2008 | Change to 2007 | | | 1st half of 2007 |
|---|---|---|---|---|---|
| (thousands of tonnes) | | Total, % | Change in structure | Organic change | |
| Western Siberia | 28,371 | (5.8) | 105 | (1,865) | 30,131 |
| Komi Republic | 6,436 | 5.1 | – | 312 | 6,124 |
| Ural region | 5,678 | 2.8 | – | 153 | 5,525 |
| Volga region | 1,514 | 1.6 | – | 24 | 1,490 |
| Northern Timan-Pechora | 1,137 | 7.6 | – | 80 | 1,057 |
| Other in Russia | 1,073 | 3.1 | – | 32 | 1,041 |
| Crude oil production in Russia | 44,209 | (2.6) | 105 | (1,264) | 45,368 |
| Crude oil produced internationally | 1,594 | (14.9) | (360) | 81 | 1,873 |
| **Total crude oil produced by consolidated subsidiaries** | **45,803** | **(3.0)** | **(255)** | **(1,183)** | **47,241** |
| **Our share in crude oil production of equity affiliates:** | | | | | |
| in Russia | 147 | (32.3) | (69) | (1) | 217 |
| outside Russia | 1,056 | (1.3) | – | (14) | 1,070 |
| **Total crude oil production** | **47,006** | **(3.1)** | **(324)** | **(1,198)** | **48,528** |

The main oil producing region of the Company is Western Siberia. In the oil fields of Western Siberia the Company produced 61.9% of its crude oil in the first half of 2008 (63.8% in the first half of 2007). In the first half of 2008, the Western Siberian producing assets continue to mature resulting in a production decline and increasing water cut. A significant impact on our production in the period was caused by a lack of sufficient power generating capacities to meet the growing demand for extra power from a wide range of oil producers in Western Siberia as they face the need to scale up pumping operations supporting crude oil production operations. In order to compensate for the decrease in crude oil production the Company is opening up oil fields in the Timan-Pechora and Caspian regions. At the end of June 2008, we commenced a comprehensive testing of the first stage of the Yuzhnoye Khylchuyu oil field, located in Timan-Pechora region. Start-up of the second stage is planned for December 2008. In 2009, we expect to reach annual production of 7.5 million tonnes. This oil field is developed within our strategic partnership with ConocoPhillips.

The structural decrease in overseas crude oil production reflects the changes in ownership of Caspian, where the Group reduced its interest from 100% to 50% at 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 either refine or export this purchased crude oil. Crude oil purchased on international markets is used for trading activities, for supplying our overseas refineries or for processing at third party refineries.

| | 1st half of | | | |
|---|---|---|---|---|
| | 2008 | | 2007 | |
| | (thousand of barrels) | (thousand of tonnes) | (thousand of barrels) | (thousand of tonnes) |
| Crude oil purchases in Russia | 462 | 63 | 213 | 29 |
| Crude oil purchases internationally | 27,700 | 3,779 | 18,097 | 2,469 |
| **Total crude oil purchases** | **28,162** | **3,842** | **18,310** | **2,498** |

| | 2nd quarter of | | | |
|---|---|---|---|---|
| | 2008 | | 2007 | |
| | (thousand of barrels) | (thousand of tonnes) | (thousand of barrels) | (thousand of tonnes) |
| Crude oil purchases in Russia | 228 | 31 | 59 | 8 |
| Crude oil purchases internationally | 15,913 | 2,171 | 11,559 | 1,577 |
| **Total crude oil purchases** | **16,141** | **2,202** | **11,618** | **1,585** |

The increase in volumes of crude oil purchased internationally was primarily due to purchases for trading. Also, during the first half of 2008, we purchased 1,467 thousand tonnes in order to process at our and at third party refineries compared to 924 thousand tonnes during the first half of 2007.

**Gas production.** In the first half of 2008, we produced 8,402 million cubic meters of gas available for sale (including our share in equity affiliates), an increase of 19.5% compared to the same period of 2007.

Our major gas production field is the Nakhodkinskoe gas field, where we produced 4,287 million cubic meters of natural gas in the first half of 2008, compared to 4,149 million cubic meters in the first half of 2007. In mid-2007, we began production from the Shakh-Deniz field in Azerbaijan where our share in gas production totaled 246 million cubic meters in the first half of 2008. At the end of 2007, we began production from the Khauzak gas field in Uzbekistan, where we produced 929 million cubic meters of natural gas in the first half of 2008.

## 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. In April 2008, we put it back into operation after the completion of the upgrade. Annual capacity of the Odessa refinery amounts to 2.8 million tonnes per year.

Compared to the first half of 2007, production at our refineries increased by 8.5%. Russian refineries increased production by 6.4%. In the second quarter of 2008, the production of our Ukhta refinery was lower than the average quarterly level by approximately 0.4 million tonnes due to a planned overhaul. In the first half 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. The production of our overseas refineries increased by 18.6% in the first half of 2008, compared to the same period of 2007, primarily due to putting into operation 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 3,461 and 3,425 thousand tonnes of Euro 4 and Euro 5 diesel fuel in the first half of 2008 and 2007, respectively. In the first half of 2008 and 2007, our production of Euro 3 gasoline amounted to 1,806 and 398 thousand tonnes, respectively.

Along with our own production of refined products we refined crude oil at third party refineries. In Russia we refined 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 crude oil at third party refineries in Belarus and Serbia. In early 2007, we decreased processing of our crude oil at Belarussian refineries due to a reduction in profitability resulting from changes in legislation. However, the growth in refining margins at the end of 2007 and beginning of 2008 resulted in increased volumes of refining in Belarus. Refined products processed in Belarus are used for supplying our local retail network and for wholesale export.

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, Central and Eastern Europe, the Baltic States and other regions. As a result of our international expansion, the total volume of refined products purchased from third parties for wholesale and to supply retail networks increased to 20,190 thousand tonnes, or $17,061 million, in the first half of 2008 (compared to 18,814 thousand tonnes, or $10,262 million in the first half of 2007).

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.

| | **1st half of** | | **2nd quarter of** | |
|---|---|---|---|---|
| | **2008** | **2007** | **2008** | **2007** |
| | (thousand barrels per day) | | | |
| Own refinery throughput* | 1,090 | 1,015 | 1,110 | 1,045 |
| Refinery throughput at third party refineries | 110 | 90 | 111 | 95 |
| **Total refinery throughput** | **1,200** | **1,105** | **1,221** | **1,140** |
| | (thousand of tonnes) | | | |
| Refined products produced at the Group refineries in Russia* | 20,747 | 19,500 | 10,202 | 9,896 |
| Refined products produced at the Group refineries outside Russia | 4,712 | 3,972 | 2,797 | 2,152 |
| **Total refined products produced at the Group refineries** | **25,459** | **23,472** | **12,999** | **12,048** |
| Refined products produced at the third party refineries in Russia | 1,508 | 1,634 | 806 | 823 |
| Refined products produced at the third party refineries outside Russia | 1,031 | 404 | 522 | 267 |
| **Total refined products produced at the third party refineries** | **2,539** | **2,038** | **1,328** | **1,090** |
| Refined products purchased in Russia | 823 | 675 | 342 | 375 |
| Refined products purchased internationally | 20,278 | 18,842 | 10,662 | 9,780 |
| **Total refined products purchased** | **21,101** | **19,517** | **11,004** | **10,155** |

* Excluding mini refineries.

### Exports of crude oil and refined products from Russia

In the first half of 2008, our export of crude oil from Russia was 11.9% less than in the same period of 2007. During the first half of 2008, we exported 43.4% of our total domestic crude oil production (48.1% in the first half of 2007). The decrease of export was due to increased crude oil refining in Russia and a decrease in crude oil production.

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

| | 1st half of | | | |
|---|---|---|---|---|
| | 2008 | | 2007 | |
| | (thousand of barrels) | (thousand of tonnes) | (thousand of barrels) | (thousand of tonnes) |
| Exports of crude oil using Transneft export routes ... | 134,535 | 18,354 | 152,259 | 20,772 |
| Exports of crude oil bypassing Transneft.................. | 6,179 | 843 | 7,550 | 1,030 |
| **Total crude oil exports............................................** | **140,714** | **19,197** | **159,809** | **21,802** |

| | 2nd quarter of | | | |
|---|---|---|---|---|
| | 2008 | | 2007 | |
| | (thousand of barrels) | (thousand of tonnes) | (thousand of barrels) | (thousand of tonnes) |
| Exports of crude oil using Transneft export routes ... | 68,961 | 9,408 | 76,474 | 10,433 |
| Exports of crude oil bypassing Transneft.................. | 2,880 | 393 | 4,347 | 593 |
| **Total crude oil exports............................................** | **71,841** | **9,801** | **80,821** | **11,026** |

In the first half of 2008, the crude oil exported through our own export infrastructure was 744 thousand tonnes.

In June 2008, we finalized construction of the offshore ice-resistant terminal in Varandey. This has an annual capacity of 12 million tonnes. The Varandey oil export terminal will be used to export crude oil produced by the Group in Timan-Pechora, including our joint-venture with ConocoPhillips.

In the first half of 2008, we exported from Russia 12.9 million tonnes of refined products, an increase of 6.3% compared to the first half of 2007. We export from Russia primarily diesel fuel, fuel oil and gasoil. These products account for approximately 89% of our refined products export volumes.

## Main macroeconomic factors affecting our results of operations

### Changes 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 the first half of 2008, the Brent crude oil price fluctuated between $87 and $139 per barrel and reached its peak of $139.10 at the end of June.

According to OPEC, despite increased production the OPEC Reference Basket reached a record high of $128.34 per barrel. The price growth was driven by escalation in geopolitical tensions which has been strengthened by financial market speculation. The continued US dollar fluctuations and supply concerns due to a storm threat in the Gulf of Mexico have also boosted prices. However, due to the speculative nature of the crude oil price the probability of a price correction remains high.

Substantially all the crude oil we export is Urals blend. The following table shows the average crude oil and refined product prices for the the respective periods of 2008 and 2007.

| | 1st half of | | Change, | 2nd quarter of | | Change, |
|---|---|---|---|---|---|---|
| | 2008 | 2007 | % | 2008 | 2007 | % |
| | (in US dollars per barrel, except for figures in percent) | | | | | |
| Brent crude | 109.05 | 63.22 | 72.5 | 121.18 | 68.76 | 76.2 |
| Urals crude (CIF Mediterranean)* | 105.22 | 59.74 | 76.1 | 117.24 | 65.30 | 79.5 |
| Urals crude (CIF Rotterdam)* | 105.50 | 59.65 | 76.9 | 117.47 | 65.03 | 80.6 |
| | (in US dollars per metric tonne, except for figures in percent) | | | | | |
| Fuel oil 3.5% (FOB Rotterdam) | 489.71 | 280.36 | 74.7 | 536.46 | 314.97 | 70.3 |
| Diesel fuel (FOB Rotterdam) | 998.62 | 554.73 | 80.0 | 1,134.38 | 596.63 | 90.1 |
| High-octane gasoline (FOB Rotterdam) | 944.74 | 644.97 | 46.5 | 1,050.28 | 740.72 | 41.8 |

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 2007 and in the first half of 2008, 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 for the for the respective periods of 2008 and 2007.

| | 1st half of | | Change, | 2nd quarter of | | Change, |
|---|---|---|---|---|---|---|
| | 2008 | 2007 | % | 2008 | 2007 | % |
| | (in US dollars per metric tonne, except for figures in percent) | | | | | |
| Fuel oil | 284.16 | 138.91 | 104.6 | 310.56 | 174.85 | 77.6 |
| Diesel fuel | 745.49 | 450.17 | 65.6 | 826.86 | 481.07 | 71.9 |
| High-octane gasoline (Regular) | 795.45 | 563.16 | 41.2 | 863.35 | 631.37 | 36.7 |
| High-octane gasoline (Premium) | 858.52 | 646.14 | 32.9 | 908.34 | 678.87 | 33.8 |

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 US dollar terms reduces this adverse effect. The devaluation of the purchasing power of the US dollar in the Russian Federation calculated on the basis of the ruble-dollar exchange rates and the level of inflation in Russia was 24.0% in the first half of 2008, compared to the same period of 2007.

The following table gives data on inflation in Russia and the change in the ruble-dollar exchange rate.

| | 1st half of | | 2nd quarter of | |
|---|---|---|---|---|
| | **2008** | **2007** | **2008** | **2007** |
| Ruble inflation (CPI), % | 8.8 | 5.7 | 3.8 | 2.2 |
| Change of the ruble-dollar exchange rate, % | 4.4 | 2.0 | 0.2 | 0.8 |
| Average exchange rate for the period (ruble to US dollar) | 23.94 | 26.08 | 23.63 | 25.86 |
| Exchange rate at the end of the period (ruble to US dollar) | 23.46 | 25.82 | – | – |

### Tax burden

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

| | | 1st half of | | Change, |
|---|---|---|---|---|
| | | **2008*** | **2007*** | **%** |
| Export tariffs on crude oil | $/tonne | 336.57 | 175.48 | 91.8 |
| Export tariffs on refined products | | | | |
| Light distillates (gasoline), middle distillates (jet fuel), diesel fuel and gasoils | $/tonne | 239.05 | 130.55 | 83.1 |
| Liquid fuels (fuel oil) | $/tonne | 128.81 | 70.30 | 83.2 |
| 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 | – |
| Low-octane gasoline | RUR/tonne | 2,657.00 | 2,657.00 | – |
| Diesel fuel | RUR/tonne | 1,080.00 | 1,080.00 | – |
| Motor oils | RUR/tonne | 2,951.00 | 2,951.00 | – |
| Mineral extraction tax | | | | |
| Crude oil | RUR/tonne | 3,701.90 | 2,121.99 | 74.5 |
| Natural gas | RUR/1,000 $m^3$ | 147.00 | 147.00 | – |

* Average values.

| | | 2nd quarter of | | Change, |
|---|---|---|---|---|
| | | **2008*** | **2007*** | **%** |
| Export tariffs on crude oil | $/tonne | 359.22 | 170.97 | 110.1 |
| Export tariffs on refined products | | | | |
| Light distillates (gasoline), middle distillates (jet fuel), diesel fuel and gasoils | $/tonne | 254.29 | 127.52 | 99.4 |
| Liquid fuels (fuel oil) | $/tonne | 137.02 | 68.67 | 99.5 |
| 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 | – |
| Low-octane gasoline | RUR/tonne | 2,657.00 | 2,657.00 | – |
| Diesel fuel | RUR/tonne | 1,080.00 | 1,080.00 | – |
| Motor oils | RUR/tonne | 2,951.00 | 2,951.00 | – |
| Mineral extraction tax | | | | |
| Crude oil | RUR/tonne | 4,097.39 | 2,338.65 | 75.2 |
| Natural gas | RUR/1,000 $m^3$ | 147.00 | 147.00 | – |

* Average values.

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

| | | 1st half of | | Change, |
|---|---|---|---|---|
| | | **2008*** | **2007*** | **%** |
| Excise on refined products | | | | |
| Straight-run gasoline | $/tonne | 110.97 | 101.88 | 8.9 |
| High-octane gasoline | $/tonne | 151.56 | 139.15 | 8.9 |
| Low-octane gasoline | $/tonne | 110.97 | 101.88 | 8.9 |
| Diesel fuel | $/tonne | 45.11 | 41.41 | 8.9 |
| Motor oils | $/tonne | 123.25 | 113.15 | 8.9 |
| Mineral extraction tax | | | | |
| Crude oil | $/tonne | 154.61 | 81.36 | 90.0 |
| Natural gas | $/1,000 $m^3$ | 6.14 | 5.64 | 8.9 |

* Average values.

| | | 2nd quarter of | | Change, |
|---|---|---|---|---|
| | | **2008*** | **2007*** | **%** |
| Excise on refined products | | | | |
| Straight-run gasoline | $/tonne | 112.45 | 102.75 | 9.4 |
| High-octane gasoline | $/tonne | 153.59 | 140.33 | 9.4 |
| Low-octane gasoline | $/tonne | 112.45 | 102.75 | 9.4 |
| Diesel fuel | $/tonne | 45.71 | 41.76 | 9.4 |
| Motor oils | $/tonne | 124.89 | 114.11 | 9.4 |
| Mineral extraction tax | | | | |
| Crude oil | $/tonne | 173.41 | 90.44 | 91.7 |
| Natural gas | $/1,000 $m^3$ | 6.22 | 5.68 | 9.4 |

* Average values.

These rates of taxes specific to the oil industry in Russia are linked to international crude oil prices and are changed in line with them. The methods to determine the rates for such taxes are presented below.

**Crude oil extraction tax rate.** 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 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.

Effective from January 1, 2009, the tax rate calculation will be changed. The threshold crude oil price up to which the tax rate is zero will be raised from $9.00 to $15.00 per barrel. This will lead to a $1.3 per barrel decrease in crude oil extraction tax expenses in Russia. Also, the list of regions where, depending on the period and volume of production, zero crude oil extraction tax rate applies will be extended. In particular, it now includes Caspian offshore and the Nenetsky Autonomous District, where the Group explores and produces hydrocarbons.

**Natural gas extraction tax rate.** The mineral extraction tax on natural gas production is calculated using a flat rate. The current rate of 147 rubles per thousand 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 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 $15.00 results in an increase of the crude oil export duty rate by $0.35 per barrel exported. If the Urals blend price is 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 $20.00 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. Crude oil exported from Russia to Belarus is subject to export duties with an application of a coefficient 0.335 in 2008 (0.293 in 2007) to the regular export duty rate set by the Government of the Russian Federation for calculation of export duty on crude oil exports from Russia to Belarus.

### 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 that 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 by the 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. We use the Vysotsk terminal to export refined products. In the future we expect to use the terminal to export both crude oil and refined products, depending on market conditions. Currently it has capacity of 12 million tonnes per year and it can be expanded up to 15 million tonnes per year.

Transportation of refined products in Russia is performed by railway transport and the pipeline system of OAO AK Transnefteproduct. Russian railway infrastructure is owned and operated by OAO Russian Railways. Both these 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 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.

## Six months ended June 30, 2008, compared to six months ended June 30, 2007

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

| | 1st half of 2008 | 1st half of 2007 |
|---|---|---|
| | (millions of US dollars) | |
| **Revenues** | | |
| Sales (including excise and export tariffs) | 56,890 | 35,781 |
| Equity share in income of affiliates | 282 | 151 |
| **Total revenues** | **57,172** | **35,932** |
| **Costs and other deductions** | | |
| Operating expenses | (3,678) | (2,914) |
| Cost of purchased crude oil, gas and products | (21,119) | (12,120) |
| Transportation expenses | (2,554) | (2,135) |
| Selling, general and administrative expenses | (1,790) | (1,463) |
| Depreciation, depletion and amortization | (1,327) | (1,105) |
| Taxes other than income taxes | (6,752) | (4,043) |
| Excise and export tariffs | (9,776) | (6,669) |
| Exploration expense | (85) | (125) |
| Loss on disposals and impairments of assets | (191) | (34) |
| **Income from operating activities** | **9,900** | **5,324** |
| Interest expense | (164) | (154) |
| Interest and dividend income | 74 | 53 |
| Currency translation gain | 76 | 71 |
| Other non-operating expense | (118) | (81) |
| Minority interest | (103) | (70) |
| **Income before income taxes** | **9,665** | **5,143** |
| Current income taxes | (2,440) | (1,458) |
| Deferred income taxes | 68 | 131 |
| **Total income tax expense** | **(2,372)** | **(1,327)** |
| **Net income** | **7,293** | **3,816** |
| Basic earnings per share of common stock (in US dollars) | 8.70 | 4.59 |

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

## Sales revenues

| Sales breakdown | 1st half of 2008 | 2007 |
|---|---|---|
| | (millions of US dollars) | |
| Crude oil | | |
| Export and sales on international markets other than CIS | 12,199 | 8,543 |
| Export and sales to CIS | 868 | 486 |
| Domestic sales | 330 | 194 |
| | **13,397** | **9,223** |
| Refined products | | |
| Export and sales on international markets | | |
| Wholesale | 27,256 | 16,193 |
| Retail | 6,136 | 3,802 |
| Domestic sales | | |
| Wholesale | 4,127 | 2,579 |
| Retail | 2,571 | 1,574 |
| | **40,090** | **24,148** |
| Petrochemicals | | |
| Export and sales on international markets | 804 | 730 |
| Domestic sales | 481 | 322 |
| | **1,285** | **1,052** |
| Gas and gas products | | |
| Export and sales on international markets | 422 | 240 |
| Domestic sales | 515 | 372 |
| | **937** | **612** |
| Other products and services | **1,181** | **746** |
| **Total sales** | **56,890** | **35,781** |

| Sales volumes | 1st half of 2008 | 2007 |
|---|---|---|
| Crude oil | (thousands of barrels) | |
| Export and sales on international markets other than CIS | 117,522 | 143,903 |
| Export and sales to CIS | 12,248 | 11,875 |
| Domestic sales | 6,700 | 6,003 |
| Crude oil | (thousands of tonnes) | |
| Export and sales on international markets other than CIS | 16,033 | 19,632 |
| Export and sales to CIS | 1,671 | 1,620 |
| Domestic sales | 914 | 819 |
| | **18,618** | **22,071** |
| Refined products | (thousands of tonnes) | |
| Export and sales on international markets | | |
| Wholesale | 33,197 | 30,843 |
| Retail | 4,055 | 3,584 |
| Domestic sales | | |
| Wholesale | 6,785 | 6,708 |
| Retail | 2,662 | 2,149 |
| | **46,699** | **43,284** |
| **Total sales volume of crude oil and refined products** | **65,317** | **65,355** |

**Realized average sales prices**

| | 1st half of 2008 | | 1st half of 2007 | |
|---|---|---|---|---|
| | ($/barrel) | ($/tonne) | ($/barrel) | ($/tonne) |
| Average realized price international | | | | |
| Oil (excluding CIS) | 103.81 | 760.91 | 59.37 | 435.16 |
| Oil (CIS) | 70.85 | 519.35 | 40.91 | 299.84 |
| Refined products | | | | |
| Wholesale | | 821.05 | | 525.01 |
| Retail | | 1,513.32 | | 1,060.73 |
| Average realized price within Russia | | | | |
| Oil | 49.23 | 360.83 | 32.35 | 237.10 |
| Refined products | | | | |
| Wholesale | | 608.11 | | 384.55 |
| Retail | | 966.08 | | 732.34 |

During the first half of 2008, our revenues increased by $21,109 million, or by 59.0%, compared to the first half of 2007.

The total volume of crude oil and refined products sold was 65.3 million tonnes, which is at the same level as in the respective period of 2007. At the same time our revenues from crude oil sales increased by $4,174 million, or by 45.3%. Our revenue from sales of refined products increased by $15,942 million, or by 66.0%.

Sales of crude oil and refined products on international markets, including the CIS, accounted for 84.1% of the total sales volume in the first half of 2008 (in the first half of 2007 – 85.2%).

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

*Sales of crude oil*

The 45.3% increase in our total crude oil sales revenue was attributable to the increase in crude oil sales prices. The international crude oil prices (excluding CIS) increased by 74.9%, compared to the first half of 2007. The decrease in the total volume of international crude oil sales (other than in CIS) by 18.3% resulted from a decrease in crude oil export from Russia and an increase in our international refining.

*Sales of refined products*

In the first half of 2008, our revenue from the wholesale of refined products outside Russia increased by $11,063 million, or by 68.3%, compared to the same period of 2007, mainly due to an increase in the average realized price. The increase in wholesale volumes outside Russia was primarily due to the increase in trading activities.

In the first half of 2008, our revenue from international retail sales increased by $2,334 million, or by 61.4%, compared to the first half of 2007, mainly due to an increase in average retail prices of 42.7%. The increase of retail sales volumes outside Russia amounted to 471 thousand tonnes, or 13.1%. This increase is attributable to additional sales volumes generated by the petrol stations acquired from ConocoPhillips in the second quarter of 2007. 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 the first half of 2008, our revenue from the wholesale of refined products on the domestic market increased by 60.0%, compared to the same period of the previous year, due to an increase in the average realized price of 58.1%.

In the first half of 2008, our revenue from retail sales in Russia increased by $997 million, or by 63.3%, compared to the same period of 2007, due to both volume and price factors. Revenue from retail sales was 38.4% of total refined products sales in Russia in the first half of 2008 (in the first half of 2007 – 37.9%).

*Sales of petrochemical products*

In spite of slight decrease in sales volumes, our revenue from sales of petrochemical products increased in the first half of 2008 by $233 million, or by 22.1%, compared to the first half of 2007. This increase resulted from an increase in prices of 25.2%.

*Sales of gas and gas products*

In the first half of 2008, sales of gas and gas refined products amounted to $937 million, which is 53.1% more than in the first half of 2007. This increase was due to an increase in gas products sales revenue of $186 million, or by 45.6%, compared to the first half of 2007, as a result of an increase in prices for gas products both in Russia and abroad, and an increase in natural gas sales revenue. This revenue amounted to $328 million (an increase of 69.9% compared to the first half of 2007). This increase was a result of the commencement of natural gas production in Uzbekistan and Azerbaijan, and an increase in average realized prices in Russia.

Our major purchaser of natural gas produced in the Russian Federation is OAO Gazprom. In the first half of 2008, we sold 4,043 million cubic meters of natural gas to OAO Gazprom (3,939 million cubic meters in the same period of the previous year), and the average realized price increased by 8.9% to $44 per 1,000 cubic meters.

*Sales of other products*

Other sales include sales through our retail network, other services provided and goods not related to our primary activities (such as electricity, heat, transportation, etc.) sold by our production and marketing companies and revenue of our electric power generating companies.

In the first half of 2008, other sales increased by $435 million, or by 58.3%, mainly as a result of the growth in other sales and services provided to third parties both in Russia and abroad.

In the first half of 2008, sales of goods and other products from our retail outlets amounted to $300 million, an increase of $127 million above the level of the respective period of 2007. This was mainly attributable to additional sales generated by the petrol stations acquired from ConocoPhillips in the second quarter of 2007 and an overall increase in non-petroleum sales by our international retail outlets.

The Group developed its electric power business. Related sales increased compared to the first half of 2007 by $153 million mainly as a result of the acquisition of TGK-8.

*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 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.

Compared to the first half of 2007, our share in income of affiliates increased by $131 million, or by 86.8%, primarily due to the increase in net income of Turgai-Petroleum, and a general increase in profitability of our affiliates because of an increase in crude oil and refined products prices.

### Operating expenses

Operating expenses include the following:

| | 1st half of 2008 | 1st half of 2007 |
|---|---|---|
| | (millions of US dollars) | |
| Hydrocarbon extraction expenses | 1,571 | 1,350 |
| Own refining expenses | 555 | 410 |
| Refining expenses at third party refineries | 176 | 121 |
| Excise included in the processing fee paid to third party refineries* | 64 | 96 |
| Petrochemical expenses | 141 | 134 |
| Crude oil transportation to refineries | 537 | 411 |
| Other operating expenses | 832 | 516 |
| | **3,876** | **3,038** |
| Change in operating expenses in crude oil and refined products inventory originating within the Group** | (198) | (124) |
| **Total operating expenses** | **3,678** | **2,914** |
| **Cost of purchased crude oil, gas and products** | **21,119** | **12,120** |

*As a result of recent amendments to the Russian tax legislation, effective from January 1, 2007, the responsibility to pay excises on refined products (except for straight-run gasoline) was transferred from traders and retailers to refineries. Therefore excises are included in processing fees.

** The change in operating expenses in crude oil and refined products inventory originating within the Group 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.

Compared to the first half of 2007, operating expenses increased by $764 million, or by 26.2%, which is mainly explained by the growth of other operating expenses, hydrocarbon extraction 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. The devaluation of the purchasing power of the US dollar in the Russian Federation in the first half of 2008 was 24.0%, compared to the same period of 2007.

*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.

In the first half of 2008, our extraction expenses increased by $221 million, or by 16.4%, compared to the first half of 2007. The increase resulted from the effect of the real ruble appreciation against the US dollar, increased expenses for energy supply, overhauls, materials and labor. Our average hydrocarbon extraction cost per barrel of oil equivalent increased from $3.49 to $4.09, or by 17.2%, compared to the first half of 2007.

*Own refining expenses*

In the first half of 2008, refining expenses increased by $145 million, or by 35.4%, compared to the same period of 2007.

Refining expenses at our domestic refineries increased by 28.5%, or by $87 million, mainly as a result of increased expenses for power supply, real ruble appreciation against the US dollar and increased production volumes.

Refining expenses at our international refineries increased by 55.2%, or by $58 million. This resulted mainly from increased expenses for power supply, the effect of appreciation of the exchange rates of the Romanian and Bulgarian currencies to the US dollar, and an increase in production volumes mainly as a result of commencement of operations of Odessa refinery after a wide-scale upgrade.

*Refining expenses at third party refineries*

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

In the first half of 2008, refining expenses at third party refineries increased by 45.5%, compared to the same period of 2007, as a result of increased refining costs in Russia that are linked to crude oil prices. Also, in the first half of 2008, we increased refining volumes in Belarus.

*Petrochemical operating expenses*

In the first half of 2008, operating expenses of our petrochemical companies increased by $7 million, or by 5.2%, compared to the first half of 2007. This was mainly due to increase in expenses at our Stavrolen petrochemical plant as a result of the commencement of operation of our polypropylene production facilities in the fourth quarter of 2007.

*Crude oil transportation to refineries*

Crude oil transportation to refineries increased in the first half of 2008 by $126 million, or by 30.7%, compared to the same period of 2007, due to an increase in transportation tariffs and volumes transported.

*Other operating expenses*

Other operating expenses include expenses of the Group's upstream and downstream enterprises that do not relate to their core activities, namely sales of electricity, heat, transportation services, other goods, etc., operating expenses of our gas processing plants, the costs of other services provided and goods sold by our marketing companies, and operating expenses of our power generating companies and of other non-core businesses of the Group.

In the first half of 2008, our other operating expenses increased by $316 million, or by 61.2%, compared to the same period of 2007. 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. One third of the increase of other operating expenses was attributable to changes in Group structure, mainly the acquisition of TGK-8 in May 2008.

**Cost of purchased crude oil, gas and products**

Cost of purchased crude oil, gas and products increased by $8,999 million in the first half of 2008, or by 74.2%, compared to the same period of 2007, primarily due to an increase in international refined products prices.

Cost of purchased crude oil, gas and products included the result of hedging of international crude oil and refined products sales. In the first half of 2008, we recognized a $719 million expense on hedging, compared to an expense of $198 million in the first half of 2007.

Cost of purchased crude oil, gas and products for the first half of 2008 includes purchases of natural gas and fuel oil to supply TGK-8.

**Transportation expenses**

Our transportation expenses increased in the first half of 2008 by $419 million, or by 19.6%, compared to the same period of 2007. This was due to an increase in transportation tariffs in Russia and an overall increase in refined products sales volumes in Russia and internationally.

Our actual transportation expenses related to crude oil and refined products deliveries to various export destinations, weighted by volumes transported, changed in the first half of 2008, compared to the same period of the previous year, as follows: crude oil freight rates and refined products freight rates remained nearly on the same level; crude oil pipeline tariffs increased by 23.8%; railway tariffs for refined products transportation increased by 14.9%.

### 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.

In the first half of 2008, our selling, general and administrative expenses increased by $327 million, or by 22.4%, compared to the same period of 2007.

The growth was mainly due to real ruble appreciation, expansion of our activities both in Russia and internationally, and an overall increase in selling expenses.

### Depreciation, depletion and amortization

Depreciation, depletion and amortization expenses include depletion of assets fundamental to production, depreciation of other productive and non-productive assets and certain intangible assets.

Our depreciation, depletion and amortization expenses increased by $222 million, or by 20.1%, compared to the first half of 2007. The increase was a result of the Company's capital expenditures and acquisitions and the corresponding increase in depreciable assets.

### Exploration expenses

During the first half of 2008, exploration expense decreased by $40 million, or by 32.0%, compared to the same period of 2007. Dry hole costs decreased by $37 million to $25 million.

Dry hole costs charged to expense in the first half of 2008 were related to our projects in Saudi Arabia and Kazakhstan.

In the first half of 2007, we completed the assessment of two exploratory wells drilled in Saudi Arabia. One of the wells was dry, and its cost of $53 million was charged to expense in the first half of 2007. The second well discovered a natural gas reservoir.

### Loss on disposals and impairments of assets

In the first half of 2008, the loss included $156 million related to impairment of certain oil and gas assets located in the Timan-Pechora region. The impairment resulted from a decrease in crude oil reserves due to revision of geological models.

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

### Taxes other than income taxes

| | 1st half of | |
|---|---|---|
| | **2008** | **2007** |
| | (millions of US dollars) | |
| **In Russia** | | |
| Mineral extraction taxes | 6,162 | 3,543 |
| Social security taxes and contributions | 268 | 227 |
| Property tax | 180 | 133 |
| Other taxes | 65 | 93 |
| **Total in Russia** | **6,675** | **3,996** |
| **International** | | |
| Social security taxes and contributions | 40 | 26 |
| Property tax | 15 | 14 |
| Other taxes | 22 | 7 |
| **Total internationally** | **77** | **47** |
| **Total** | **6,752** | **4,043** |

In the first half of 2008, taxes other than income taxes increased by 67.0%, or by $2,709 million, compared to the first half of 2007, mainly due to an increase in mineral extraction tax resulting from an increase in the crude oil extraction tax rate.

### 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.

| | 1st half of 2008 | 1st half of 2007 |
|---|---|---|
| | (millions of US dollars) | |
| **In Russia** | | |
| Excise tax | 473 | 354 |
| Export tariffs | 7,312 | 4,691 |
| Crude oil | 5,633 | 3,600 |
| Refined products | 1,679 | 1,091 |
| **Total in Russia** | **7,785** | **5,045** |
| **International** | | |
| Excise tax and sales taxes on refined products | 1,878 | 1,609 |
| Export tariffs | 113 | 15 |
| Refined products | 113 | 15 |
| **Total internationally** | **1,991** | **1,624** |
| **Total** | **9,776** | **6,669** |

In spite of a decrease in crude oil export volumes, excise and export tariffs increased by $3,107 million, or by 46.6%, compared to the first half of 2007, due to the increase in tariff rates.

The growth in international excises was mainly due to the effect of the acquisition of the European petrol stations from ConocoPhillips in the second quarter of 2007, increase in volumes sold and the appreciation of the Euro against the US dollar, as the excise rates in most European countries we operate in are either denominated in Euro or tied to it.

### Income taxes

Our total income tax expense increased by $1,045 million, or by 78.7%, compared to the first half of 2007, due to an increase of income before income tax of $4,522 million, or 87.9%.

Our effective income tax rate in the first half of 2008 was 24.5%, compared to 25.8% in the first half of 2007. As a result of recent amendments to Russian tax legislation related to taxation of dividend payments, we recovered the deferred tax liability on undistributed retained earnings of our subsidiaries where our share was less than 100% as of January 1, 2008. This factor led to a decrease in our effective income tax rate.

The Group’s effective income tax rate for the periods presented differs from the statutory income tax rate primarily due to domestic and foreign rate differences and the incurrence of costs that are either not tax deductible or only deductible to a certain limit.

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

| | 1st half of | |
|---|---|---|
| | **2008** | **2007** |
| | (millions of US dollars) | |
| **Net income** | **7,293** | **3,816** |
| Add back: | | |
| Income tax expense | 2,372 | 1,327 |
| Depreciation and amortization | 1,327 | 1,105 |
| Interest expense | 164 | 154 |
| Interest and dividend income | (74) | (53) |
| **EBITDA** | **11,082** | **6,349** |

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. The 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.

## Three months ended June 30, 2008, compared to three months ended June 30, 2007

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

| | 2nd quarter of | |
|---|---|---|
| | **2008** | **2007** |
| | (millions of US dollars) | |
| **Revenues** | | |
| Sales (including excise and export tariffs) | 31,935 | 20,129 |
| Equity share in income of affiliates | 153 | 67 |
| **Total revenues** | **32,088** | **20,196** |
| **Costs and other deductions** | | |
| Operating expenses | (1,770) | (1,471) |
| Cost of purchased crude oil, gas and products | (12,511) | (7,070) |
| Transportation expenses | (1,359) | (1,148) |
| Selling, general and administrative expenses | (994) | (800) |
| Depreciation, depletion and amortization | (703) | (558) |
| Taxes other than income taxes | (3,623) | (2,214) |
| Excise and export tariffs | (5,191) | (3,401) |
| Exploration expense | (51) | (50) |
| Loss on disposals and impairments of assets | (186) | (36) |
| **Income from operating activities** | **5,700** | **3,448** |
| Interest expense | (92) | (77) |
| Interest and dividend income | 49 | 24 |
| Currency translation (loss) gain | (34) | 29 |
| Other non-operating expense | (70) | (62) |
| Minority interest | (63) | (56) |
| **Income before income taxes** | **5,490** | **3,306** |
| Current income taxes | (1,376) | (828) |
| Deferred income taxes | 16 | 39 |
| **Total income tax expense** | **(1,360)** | **(789)** |
| **Net income** | **4,130** | **2,517** |
| Basic earnings per share of common stock (in US dollars) | 4.92 | 3.03 |

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

## Sales revenues

| Sales breakdown | 2nd quarter of 2008 | 2007 |
|---|---|---|
| | (millions of US dollars) | |
| Crude oil | | |
| Export and sales on international markets other than CIS | 6,657 | 4,724 |
| Export and sales to CIS | 543 | 296 |
| Domestic sales | 82 | 112 |
| | **7,282** | **5,132** |
| Refined products | | |
| Export and sales on international markets | | |
| Wholesale | 15,720 | 9,275 |
| Retail | 3,395 | 2,203 |
| Domestic sales | | |
| Wholesale | 2,214 | 1,377 |
| Retail | 1,455 | 854 |
| | **22,784** | **13,709** |
| Petrochemicals | | |
| Export and sales on international markets | 401 | 383 |
| Domestic sales | 256 | 166 |
| | **657** | **549** |
| Gas and gas products | | |
| Export and sales on international markets | 265 | 132 |
| Domestic sales | 257 | 187 |
| | **522** | **319** |
| Other products and services | **690** | **420** |
| **Total sales** | **31,935** | **20,129** |

| Sales volumes | 2nd quarter of 2008 | 2007 |
|---|---|---|
| Crude oil | (thousands of barrels) | |
| Export and sales on international markets other than CIS | 57,482 | 72,538 |
| Export and sales to CIS | 6,809 | 6,451 |
| Domestic sales | 1,320 | 2,888 |
| Crude oil | (thousands of tonnes) | |
| Export and sales on international markets other than CIS | 7,842 | 9,896 |
| Export and sales to CIS | 929 | 880 |
| Domestic sales | 180 | 394 |
| | **8,951** | **11,170** |
| Refined products | (thousands of tonnes) | |
| Export and sales on international markets | | |
| Wholesale | 17,128 | 16,593 |
| Retail | 2,080 | 1,933 |
| Domestic sales | | |
| Wholesale | 3,168 | 3,209 |
| Retail | 1,421 | 1,146 |
| | **23,797** | **22,881** |
| **Total sales volume of crude oil and refined products** | **32,748** | **34,051** |

**Realized average sales prices**

| | 2nd quarter of 2008 | | 2007 | |
|---|---|---|---|---|
| | ($/barrel) | ($/tonne) | ($/barrel) | ($/tonne) |
| Average realized price international | | | | |
| Oil (excluding CIS) | 115.82 | 848.99 | 65.12 | 477.35 |
| Oil (CIS) | 79.69 | 584.16 | 45.79 | 335.61 |
| Refined products | | | | |
| Wholesale | | 917.86 | | 558.97 |
| Retail | | 1,632.26 | | 1,139.29 |
| Average realized price within Russia | | | | |
| Oil | 61.98 | 454.34 | 38.85 | 284.77 |
| Refined products | | | | |
| Wholesale | | 698.35 | | 429.41 |
| Retail | | 1,024.57 | | 744.82 |

During the second quarter of 2008, our revenues increased by $11,806 million, or by 58.7%, compared to the second quarter of 2007.

The total volume of crude oil and refined products sold was 32.7 million tonnes, which represents a decrease of 3.8%, compared to the second quarter of 2007. Our revenues from crude oil sales in the second quarter of 2008 increased by $2,150 million, or by 41.9%, compared to the second quarter of 2007. Our revenue from sales of refined products increased by $9,075 million, or by 66.2%.

Sales of crude oil and refined products on international markets, including the CIS, accounted for 85.4% of the total sales volume in the second quarter of 2008 (in the second quarter of 2007 – 86.1%).

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

*Sales of crude oil*

The 41.9% increase in our total crude oil sales revenue was attributable to the increase in crude oil sales prices. The international crude oil prices (excluding CIS) increased by 77.9%, compared to the second quarter of 2007. At the same time the total volume of international crude oil sales (other than in CIS) decreased by 20.8%, as a result of decreased crude oil export from Russia and an increase in our international refining.

*Sales of refined products*

In the second quarter of 2008, our revenue from the wholesale of refined products outside Russia increased by $6,445 million, or by 69.5%, compared to the same period of 2007, mainly due to an increase in the average realized price.

In the second quarter of 2008, our revenue from international retail sales increased by $1,192 million, or by 54.1%, compared to the second quarter of 2007, mainly due to an increase in average retail prices of 43.3%. The increase of retail sales volumes outside Russia in the second quarter of 2008 amounted to 147 thousand tonnes, or 7.6%, compared to the second quarter of 2007. This increase is attributable to additional sales volumes generated by the petrol stations acquired from ConocoPhillips in the second quarter of 2007. 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 the second quarter of 2008, our revenue from the wholesale of refined products on the domestic market increased by 60.8%, compared to the same period of the previous year, due to an increase in the average realized price by 62.6%.

In the second quarter of 2008, our revenue from retail sales in Russia increased by $601 million, or by 70.4%, compared to the same period of 2007, due to both volume and price factors. Revenue from retail sales was 39.7% of total refined products sales in Russia in the second quarter of 2008 (in the second quarter of 2007 – 38.3%).

*Sales of petrochemical products*

Our revenue from sales of petrochemical products increased in the second quarter of 2008 by $108 million, or by 19.7%, compared to the second quarter of 2007. This increase resulted from an increase in prices of 21.4%.

*Sales of gas and gas products*

In the second quarter of 2008, sales of gas and gas refined products amounted to $522 million, which is 63.6% more than in the second quarter of 2007. This increase was due to an increase in gas products sales revenue of $94 million, or by 43.1%, compared to the second quarter of 2007, as a result of an increase in prices for gas products both in Russia and abroad, and an increase in natural gas sales revenue. This revenue amounted to $201 million (an increase of 114.9% compared to the second quarter of 2007). This increase was as a result of the commencement of natural gas production in Uzbekistan and Azerbaijan, and an increase in average realized prices in Russia.

Our major purchaser of natural gas produced in the Russian Federation is OAO Gazprom. In the second quarter of 2008, we sold 2,024 million cubic meters of natural gas to OAO Gazprom (1,921 million cubic meters in the same period of the previous year), and the average realized price increased by 9.4% to $45 per 1,000 cubic meters.

*Sales of other products*

Other sales include revenues from other sales through our retail network, other services provided and goods not related to our primary activities (such as electricity, heat, transportation, etc.) sold by our production and marketing companies and revenue of our electric power generating companies.

In the second quarter of 2008, other sales increased by $270 million, or by 64.3%, mainly as a result of the growth in other sales and services provided to third parties both in Russia and abroad.

In the second quarter of 2008, sales of goods and other products from our retail outlets amounted to $160 million, an increase of $60 million above the level of the respective period of 2007. This was mainly attributable to an overall increase in non-petroleum sales in our international retail outlets and additional sales generated by the petrol stations acquired from ConocoPhillips in the second quarter of 2007.

The Group developed its electric power business. Related sales increased compared to the second quarter of 2007 by $123 million as a result of the acquisition of TGK-8 and the overall expansion of operations.

*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 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.

Compared to the second quarter of 2007, our share in income of affiliates increased by $86 million, or by 128.4%, primarily due to the increase in net income of Turgai-Petroleum, and a general increase in profitability of our affiliates because of an increase in crude oil and refined products prices.

## Operating expenses

Operating expenses include the following:

| | 2nd quarter of 2008 | 2007 |
|---|---|---|
| | (millions of US dollars) | |
| Hydrocarbon extraction expenses | 823 | 699 |
| Own refining expenses | 287 | 218 |
| Refining expenses at third party refineries | 107 | 55 |
| Excise included in the processing fee paid to third party refineries* | 31 | 48 |
| Petrochemical expenses | 61 | 70 |
| Crude oil transportation to refineries | 275 | 222 |
| Other operating expenses | 448 | 299 |
| | **2,032** | **1,611** |
| Change in operating expenses in crude oil and refined products inventory originating within the Group** | (262) | (140) |
| **Total operating expenses** | **1,770** | **1,471** |
| **Cost of purchased crude oil, gas and products** | **12,511** | **7,070** |

*As a result of recent amendments to the Russian tax legislation, effective from January 1, 2007, the responsibility to pay excises on refined products (except for straight-run gasoline) was transferred from traders and retailers to refineries. Therefore excises are included in processing fees.

** The change in operating expenses in crude oil and refined products inventory originating within the Group included 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.

Compared to the second quarter of 2007, our operating expenses increased by $299 million, or by 20.3%, which is mainly explained by the growth of other operating expenses, hydrocarbon extraction 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. The devaluation of the purchasing power of the US dollar in the Russian Federation in the first half of 2008 was 24.0%, compared to the same period of 2007.

*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.

In the second quarter of 2008, our extraction expenses increased by $124 million, or by 17.7%, compared to the second quarter of 2007. The increase resulted from the effect of the real ruble appreciation against the US dollar, increased expenses for energy supply, overhauls, materials and labor. Our average hydrocarbon extraction cost per barrel of oil equivalent increased from $3.64 to $4.31, or by 18.4%, compared to the second quarter of 2007.

*Own refining expenses*

In the second quarter of 2008, refining expenses increased by $69 million, or by 31.7%, compared to the same period of 2007.

Refining expenses at our domestic refineries increased by 21.3%, or by $35 million, mainly as a result of the increased expenses for power supply, real ruble appreciation against the US dollar and increased production volumes.

Refining expenses at our international refineries increased by 63.0%, or by $34 million. This resulted mainly from increased expenses for power supply, the effect of appreciation of the exchange rates of the Romanian and Bulgarian currencies to the US dollar, and an increase in production volumes mainly as a result of commencement of operations of Odessa refinery after a wide-scale upgrade.

*Refining expenses at third party refineries*

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

In the second quarter of 2008, refining expenses at third party refineries increased by 94.5%, compared to the same period of 2007, primarily as a result of increased refining costs in Russia that are linked to crude oil prices.

*Petrochemical operating expenses*

In the second quarter of 2008, operating expenses of our petrochemical companies decreased by $9 million, or by 12.9%, compared to the second quarter of 2007.

*Crude oil transportation to refineries*

Crude oil transportation to refineries increased in the second quarter of 2008 by $53 million, or by 23.9%, compared to the same period of 2007, due to an increase in transportation tariffs and volumes transported.

*Other operating expenses*

Other operating expenses include expenses of the Group's upstream and downstream enterprises that do not relate to their core activities, namely sales of electricity, heat, transportation services, other goods, etc., operating expenses of our gas processing plants, the costs of other services provided and goods sold by our marketing companies, and operating expenses of our power generating companies and of other non-core businesses of the Group.

In the second quarter of 2008, other operating expenses increased by $149 million, or by 49.8%, compared to the same period of 2007. 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. More than half of the increase of other operating expenses was attributable to changes in Group structure, namely the acquisition of TGK-8 in May 2008.

**Cost of purchased crude oil, gas and products**

Cost of purchased crude oil, gas and products increased by $5,441 million in the second quarter of 2008, or by 77.0%, compared to the same period of 2007, primarily due to an increase in international refined products prices.

Cost of purchased crude oil, gas and products included the result of hedging of international crude oil and refined products sales. In the second quarter of 2008, we recognized a $621 million expense on hedging compared to an expense of $45 million in the second quarter of 2007.

Cost of purchased crude oil, gas and products for second quarter of 2008 includes purchases of gas and fuel oil to supply TGK-8.

**Transportation expenses**

Our transportation expenses increased in the second quarter of 2008 by $211 million, or by 18.4%, compared to the same period of 2007. This was due to an increase in transportation tariffs, and an increase in refined products sales volumes.

**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.

In the second quarter of 2008, our selling, general and administrative expenses increased by $194 million, or by 24.3%, compared to the same period of 2007.

The growth was mainly due to real ruble appreciation, expansion of our activities both in Russia and internationally, and an overall increase in selling expenses.

### Depreciation, depletion and amortization

Depreciation, depletion and amortization expenses include depletion of assets fundamental to production, depreciation of other productive and non-productive assets and certain intangible assets.

Our depreciation, depletion and amortization expenses increased by $145 million, or by 26.0%, compared to the second quarter of 2007. The increase was a result of the Company's capital expenditures and acquisitions and the corresponding increase in depreciable assets.

### Exploration expenses

During the second quarter of 2008, exploration expense remained at the same level, compared to the respective period of 2007. Dry hole costs increased by $3 million to $17 million.

Dry hole costs charged to expense in the second quarter of 2008 were related to our project in Kazakhstan.

In the first half of 2007, we completed the assessment of two exploratory wells drilled in Saudi Arabia. One of the wells was dry and an additional cost of $13 million related to the completion of drilling was charged to expense in the second quarter of 2007 ($40 million was written off in the first quarter of 2007). The second well discovered a natural gas reservoir.

### Loss on disposals and impairments of assets

In the first half of 2008, the loss included $156 million related to impairment of certain oil and gas assets located in the Timan-Pechora region. The impairment resulted from a decrease in crude oil reserves due to revision of geological models.

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

### Taxes other than income taxes

| | 2nd quarter of 2008 | 2nd quarter of 2007 |
|---|---|---|
| | (millions of US dollars) | |
| **In Russia** | | |
| Mineral extraction taxes | 3,322 | 1,939 |
| Social security taxes and contributions | 128 | 111 |
| Property tax | 92 | 67 |
| Other taxes | 41 | 70 |
| **Total in Russia** | **3,583** | **2,187** |
| **International** | | |
| Social security taxes and contributions | 21 | 14 |
| Property tax | 8 | 8 |
| Other taxes | 11 | 5 |
| **Total internationally** | **40** | **27** |
| **Total** | **3,623** | **2,214** |

Taxes other than income taxes increased in the second quarter of 2008 by 63.6%, or by $1,409 million, compared to the second quarter of 2007, mainly due to an increase in mineral extraction tax resulting from an increase in the crude oil extraction tax rate.

### 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.

| | 2nd quarter of | |
|---|---|---|
| | **2008** | **2007** |
| | (millions of US dollars) | |
| **In Russia** | | |
| Excise tax | 271 | 180 |
| Export tariffs | 3,840 | 2,294 |
| Crude oil | 3,028 | 1,799 |
| Refined products | 812 | 495 |
| **Total in Russia** | **4,111** | **2,474** |
| **International** | | |
| Excise tax and sales taxes on refined products | 971 | 917 |
| Export tariffs | 109 | 10 |
| Refined products | 109 | 10 |
| **Total internationally** | **1,080** | **927** |
| **Total** | **5,191** | **3,401** |

In spite of a decrease in crude oil export volumes, excise and export tariffs increased by $1,790 million, or by 52.6%, compared to the second quarter of 2007. This was resulted from the increase in tariff rates.

The growth in international excises was mainly due to the effect of the acquisition of the European petrol stations from ConocoPhillips in the second quarter of 2007, increase in volumes sold and the appreciation of the Euro against the US dollar, as the excise rates in most European countries we operate in are either denominated in Euro or tied to it.

### Income taxes

Our total income tax expense increased by $571 million, or by 72.4%, compared to the second quarter of 2007, due to an increase of income before income tax of $2,184 million, or 66.1%.

Our effective income tax rate in the second quarter of 2008 was 24.8%, compared to 23.9% in the second quarter of 2007.

The Group's effective income tax rate for the periods presented differs from the statutory income tax rate primarily due to domestic and foreign rate differences and the incurrence of costs that are either not tax deductible or only deductible to a certain limit.

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

| | 2nd quarter of | |
|---|---|---|
| | **2008** | **2007** |
| | (millions of US dollars) | |
| **Net income** | **4,130** | **2,517** |
| Add back: | | |
| Income tax expense | 1,360 | 789 |
| Depreciation and amortization | 703 | 558 |
| Interest expense | 92 | 77 |
| Interest and dividend income | (49) | (24) |
| **EBITDA** | **6,236** | **3,917** |

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. The 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

| | 1st half of 2008 | 2007 |
|---|---|---|
| | (millions of US dollars) | |
| Net cash provided by operating activities | 6,991 | 4,474 |
| Net cash used in investing activities | (6,351) | (3,953) |
| Net cash provided by (used in) financing activities | 160 | (305) |

### Operating activities

Our primary source of cash flow is funds generated from our operations. During the first half of 2008, cash generated by operating activities was $6,991 million, an increase of 56.3% compared to the same period of 2007. In the first half of 2008, our operating cash inflows were affected by an increase of working capital by $2,099 million, compared to January 1, 2008. This was mainly caused by:

- an increase in inventory of $2,467 million, resulting from increased volumes of crude oil and refined products in transit and increased hydrocarbons prices
- a $513 million net increase in trade accounts receivable and payable
- a $299 million net increase in other assets and liabilities

At the same time, the negative effect from the above mentioned factors was partly offset by a $1,180 million increase in tax accounts payable.

### Investing activities

An increase in cash used in investing activities resulted from an increase in cash paid for acquisitions of subsidiaries and cash spent on capital expenditures.

In the first half of 2008, we made a final payment of $157 million and a first contingent payment of $100 million for the acquisition of upstream assets in Uzbekistan (SNG Holdings Ltd.), $64 million for the increase in our share of the share capital of our refinery in Nizhny Novgorod. We paid $198 million as the cash part of the consideration of the TGK-8 acquisition. The other payments were primarily advances related to acquisitions of marketing assets in Russia and abroad.

Capital expenditures increased by $1,011 million, or by 25.1%, compared to the first half of 2007 (for a detailed analysis of capital expenditures see a later section).

During the first half of 2007, the Company paid $249 million for the acquisition of licenses for crude oil exploration and production on two oil fields in the Komi Republic. Payments for acquisition of licenses in the first half of 2008 were $12 million.

### Financing activities

In the first half of 2008, net movements of short-term and long-term debt generated an inflow of $34 million, compared to an inflow of $226 million in the same period of 2007.

Inflows of cash in the first half of 2008 included long-term loans of $103 million received from ConocoPhillips as its part of financing our joint venture in the Timan-Pechora region. In the first half of 2007, we received $279 million from ConocoPhillips as its part of financing the joint venture.

Cash inflows in the first half of 2008 included $235 million related to the sale of 7,449 LPG and oil tank-wagons, which were leased back by the Group under a capital lease agreement.

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

### Analysis of capital expenditures

| | 1st half of | | 2nd quarter of | |
|---|---|---|---|---|
| | 2008 | 2007 | 2008 | 2007 |
| | (millions of US dollars) | | | |
| Exploration and production | | | | |
| Russia | 3,679 | 3,040 | 1,900 | 1,475 |
| International | 414 | 345 | 212 | 194 |
| Total exploration and production | 4,093 | 3,385 | 2,112 | 1,669 |
| Refining, marketing and distribution | | | | |
| Russia | 550 | 410 | 321 | 261 |
| International | 339 | 257 | 212 | 129 |
| Total refining, marketing and distribution | 889 | 667 | 533 | 390 |
| Chemicals | | | | |
| Russia | 10 | 55 | 5 | 37 |
| International | 35 | 34 | 13 | 8 |
| Total chemicals | 45 | 89 | 18 | 45 |
| Other | 48 | 34 | – | 9 |
| **Total capital expenditures*** | **5,075** | **4,175** | **2,663** | **2,113** |
| | | | | |
| **Acquisitions of subsidiaries**** | | | | |
| Exploration and production | | | | |
| Russia | – | 5 | – | – |
| International | 257 | 404 | 100 | 404 |
| Total exploration and production | 257 | 409 | 100 | 404 |
| Refining, marketing and distribution | | | | |
| Russia | 500 | 71 | 45 | 59 |
| International | 379 | 442 | 214 | 441 |
| Total refining, marketing and distribution | 879 | 513 | 259 | 500 |
| Other | 2,170*** | 6 | 2,168*** | |
| **Less cash acquired** | (144) | (100) | (136) | (100) |
| **Total acquisitions of subsidiaries** | **3,162** | **828** | **2,391** | **804** |

* Including non-cash transactions and prepayments.

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

*** Including $1,969 million of non-cash part of consideration for acquisition of TGK-8.

During the first half of 2008, our capital expenditures, including non-cash transactions, amounted to $5,075 million, or $900 million more than in the same period of 2007. The growth mainly resulted from expenditures in our exploration and production segment, which increased by $708 million, or by 20.9%, compared to the same period of 2007. The exploration and production capital expenditures in new regions increased by $8 million. The capital expenditures in the traditional exploration and production region of Western Siberia increased by $388 million as a result of an increase in production drilling. The capital expenditures in European Russia increased by $235 million substantially as a result of an increase in investments in pipelines and machinery. An increase in the capital expenditures in our overseas exploration projects (excluding the Caspian region) amounted to $77 million and was primarily related to our projects in Kazakhstan and Saudi Arabia.

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

| | 1st half of | | 2nd quarter of | |
|---|---|---|---|---|
| | 2008 | 2007 | 2008 | 2007 |
| | (millions of US dollars) | | | |
| Northern Timan-Pechora | 894 | 1,009 | 347 | 462 |
| Yamal | 55 | 34 | 41 | 26 |
| Caspian region* | 221 | 119 | 121 | 67 |
| **Total** | **1,170** | **1,162** | **509** | **555** |

* Russian and international projects.