

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

The following report contains a discussion and analysis of the financial condition of OAO LUKOIL as of June 30, 2012 and the results of its operations for the three and six month periods ended June 30, 2012 and 2011, and significant factors 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 and natural gas liquids produced are translated into barrels using conversion rates characterizing the density of crude oil from each of our oilfields and actual density of liquids produced at our gas processing plants. 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 – 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

	2 nd quarter of		Change,	1 st half of		Change,
	2012	2011	%	2012	2011	%
Sales (millions of US dollars)	32,397	34,912	(7.2)	67,658	64,538	4.8
Net income attributable to OAO LUKOIL (millions of US dollars).....	1,018	3,251	(68.7)	4,807	6,768	(29.0)
EBITDA (millions of US dollars).....	3,462	5,345	(35.2)	8,808	10,688	(17.6)
Taxes other than income taxes, excise and export tariffs (millions of US dollars)	(9,551)	(9,324)	2.4	(18,606)	(16,760)	11.0
Earning per share of common stock attributable to OAO LUKOIL (US dollars):						
Basic	1.34	4.16	(67.8)	6.27	8.66	(27.6)
Diluted	1.32	4.08	(67.5)	6.15	8.48	(27.5)
Hydrocarbon production by the Group including our share in equity affiliates (thousands of BOE).....	195,012	196,518	(0.8)	395,052	395,795	(0.2)
Daily hydrocarbon production by the Group including our share in equity affiliates (thousands of BOE).....	2,143	2,160	(0.8)	2,171	2,187	(0.7)
Crude oil and natural gas liquids produced by the Group including our share in equity affiliates (thousands of barrels)	167,436	170,616	(1.9)	336,450	342,589	(1.8)
Gas available for sale produced by the Group including our share in equity affiliates (millions of cubic meters).....	4,686	4,401	6.5	9,958	9,041	10.1
Refined products produced by the Group including our share in equity affiliates (thousands of tonnes).....	15,652	16,273	(3.8)	30,695	30,845	(0.5)

During the first half of 2012, our net income was \$4,807 million, which is \$1,961 million, or 29.0%, less than in the same period of 2011. Our net income for the second quarter of 2012 amounted to \$1,018 million, which is \$2,233 million, or 68.7%, lower than in the second quarter of 2011.

The decrease in our net income was mainly due to a decrease in hydrocarbon prices in the second quarter of 2012. Moreover, our net income was affected by higher export tariffs and an increase of income tax expenses due to currency translation gains reported by Russian subsidiaries in the second quarter of 2012.

Business overview

The primary activities of OAO LUKOIL and its subsidiaries are oil exploration, production, refining, marketing and distribution. The Company is the ultimate parent entity of a vertically integrated group of companies.

OAO LUKOIL was established in accordance with Presidential Decree 1403, issued on November 17, 1992. Under this decree, on April 5, 1993, the Government of the Russian Federation transferred to the Company 51% of the voting shares of fifteen enterprises. Under Government Resolution 861 issued on September 1, 1995, a further nine enterprises were transferred to the Group during 1995. Since 1995, the Group has carried out a share exchange program to increase its shareholding in each of 24 founding subsidiaries to 100%. From formation, the Group has expanded substantially through consolidation of interests, acquisition of new companies and establishment of new businesses. Now LUKOIL is a global energy company operating through its subsidiaries in 37 countries on four continents.

LUKOIL is one of the world's largest energy companies in terms of hydrocarbon reserves that amounted to 17.3 billion BOE as of January 1, 2012 and comprised of 13.4 billion barrels of crude oil and 23.2 trillion cubic feet of gas.

Our operations are divided into four main business segments:

- **Exploration and Production** – which includes our exploration, development and production operations relating to crude oil and gas. These activities are primarily located within Russia, with additional activities in Azerbaijan, Kazakhstan, Uzbekistan, the Middle East, South America, Northern and Western Africa and South-East Asia.
- **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.
- **Power generation** – which includes generation, transportation and sales of electricity, heat and related services.

Each of our four 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 8, 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 crude oil refining 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 19 “Segment information” to the interim consolidated financial statements.

Changes in the Group structure

On August 22, 2012, the Group acquired ConocoPhillips' investments in OOO “Narianmarneftegas” (“NMNG”) and certain related assets for approximately \$0.6 billion. ConocoPhillips group owned 30% in NMNG. The acquisition brings the Group's total ownership interest in NMNG to 100%.

In January 2012, the Group was offered to acquire a 20% stake in the joint venture operating the ISAB refining complex for €400 million (approximately \$526 million) that would increase Group's ownership in it from 60% to 80%. The transaction was approved by European regulatory authorities and is expected to be completed in September 2012. This is a partial exercise of ERG S.p.A. option to sell in full its stake in the joint venture established in 2008. In April 2011, within this option, the Group acquired an 11% stake in the joint venture for €241 million (approximately \$342 million).

In April 2011, LUKOIL and OAO “ANK Bashneft” (“Bashneft”) signed an agreement to establish a joint venture and to stipulate conditions for the development of two fields named after R. Trebs and A. Titov located in Northern Timan-Pechora region. According to the agreement, in the end of December 2011, the Company purchased a 25.1% interest in OOO “Bashneft-Polus”, a Bashneft subsidiary, in favor of which the license and mineral rights for R.Trebs and A.Titov fields were re-issued, for approximately \$153 million. In its turn, the joint venture purchased from a Group company 29 exploration wells located in the license area for \$60 million. The agreement also envisages the exploitation of the Group’s infrastructure, including the oil export terminal in Varandey and the energy centre of the Yuzhnoye Khyrchuyu field. The total recoverable oil reserves located within the license areas of R.Trebs and A.Titov fields are 140.1 million tonnes. In May 2012, state authorities cancelled the order to transfer the mineral rights for the development of the fields named after R.Trebs and A.Titov to the joint venture and the license was returned to Bashneft. The joint venture contested this decision by the law. Management does not believe that this matter will have a material adverse effect on the Group’s financial condition. The Company and Bashneft continue their cooperation within the project.

Operational highlights

Hydrocarbon production

We undertake exploration for, and production of, crude oil and natural gas in Russia and internationally. In Russia our major oil producing subsidiaries are OOO LUKOIL-Western Siberia, OOO LUKOIL-Komi and OOO LUKOIL-Perm. Exploration and production outside of Russia is performed by our 100% subsidiary LUKOIL-Overseas, that has stakes in PSA's and other projects in Kazakhstan, Azerbaijan, Uzbekistan, Iraq, Saudi Arabia, Egypt, Ghana, Vietnam and Cote d'Ivoire.

The table below summarizes the results of our exploration and production activities.

	2 nd quarter of		1 st half of	
	2012	2011	2012	2011
	(thousand BOE per day)			
Daily production of hydrocarbons, including the Company's share in equity affiliates, including:	2,143	2,160	2,171	2,187
- crude oil and natural gas liquids ⁽¹⁾	1,840	1,875	1,849	1,893
- natural gas ⁽²⁾	303	285	322	294
	(US dollar per BOE)			
Hydrocarbon extraction expenses.....	5.02	5.22	4.86	4.96
- in Russia	5.03	5.26	4.88	4.99
- outside Russia	4.85	4.60	4.58	4.41
	(millions of US dollars)			
Hydrocarbon extraction expenses.....	944	987	1,850	1,887
- in Russia	873	931	1,711	1,777
- outside Russia	71	56	139	110
Exploration expenses.....	104	85	147	113
- in Russia	66	43	92	55
- outside Russia	38	42	55	58
Mineral extraction tax	3,132	3,192	6,272	5,657
- in Russia	3,108	3,171	6,226	5,612
- outside Russia	24	21	46	45

⁽¹⁾ Natural gas liquids produced at the Group gas processing plants.

⁽²⁾ Gas available for sale (excluding gas produced for our own consumption and including petroleum gas sold to third parties).

Crude oil production. In the first half of 2012, we produced 44.6 million tonnes (329.8 million barrels) of crude oil compared to 45.6 million tonnes (336.4 million barrels) in the same period of 2011 (including the Company's share in equity affiliates).

The following table represents our crude oil production in the first half of 2012 and 2011 by major regions.

(thousands of tonnes)	Change to 2011				
	1 st half of 2012	Total, %	Change in structure	Organic change	1 st half of 2011
Western Siberia.....	24,526	0.5	–	129	24,397
Timan-Pechora.....	7,799	(15.3)	–	(1,409)	9,208
Ural region	6,641	5.9	–	368	6,273
Volga region	1,663	8.3	–	127	1,536
Other in Russia.....	941	(3.2)	–	(31)	972
Crude oil produced in Russia	41,570	(1.9)	–	(816)	42,386
Crude oil produced internationally.....	1,699	(1.4)	–	(24)	1,723
Total crude oil produced by consolidated subsidiaries	43,269	(1.9)	–	(840)	44,109
Our share in crude oil produced by equity affiliates:					
in Russia	190	8.6	–	15	175
outside Russia	1,188	(7.7)	–	(99)	1,287
Total crude oil produced	44,647	(2.0)	–	(924)	45,571

The main oil producing region for the Company is Western Siberia where we produced 56.7% of our crude oil in the first half of 2012 (55.3% in the first half of 2011). Since the second half of 2011, the Company managed to stabilize crude oil production in the region that had been declining for several preceding years.

The continuing trend of increasing water cut at our Yuzhnoye Khylochuyu oilfield was the main reason for the production decrease in Russia.

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. Then we either refine or export purchased crude oil. Crude oil purchased on international markets is normally used for trading activities, for supplying our international refineries or for processing at third party refineries.

	2 nd quarter of			
	2012		2011	
	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)
Crude oil purchases in Russia	213	29	176	24
Crude oil purchases internationally	31,028	4,233	35,155	4,796
Total crude oil purchased	31,241	4,262	35,331	4,820

	1 st half of			
	2012		2011	
	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)
Crude oil purchases in Russia	1,305	178	894	122
Crude oil purchases internationally	56,588	7,720	63,573	8,673
Total crude oil purchased	57,893	7,898	64,467	8,795

Significant part of our crude oil purchases is for processing. In the first half of 2012, we purchased 6,066 thousand tonnes of crude oil to process at our and at third party refineries, compared to 6,325 thousand tonnes in the first half of 2011. Our purchases for trading also decreased compared to the first half of 2011.

Production of gas and natural gas liquids. In the first half of 2012, we produced 9,958 million cubic meters (58.6 million BOE) of gas available for sale (including our share in equity affiliates), that is 10.1% more than in the first half of 2011.

Our major gas production field is the Nakhodkinskoe field, where we produced 4,000 million cubic meters of natural gas in the first half of 2012 (4,204 million cubic meters in the first half of 2011). Our international gas production increased by 36.6%, mostly due to growth of our production in Uzbekistan. We produced 497 million cubic meters of gas from the Gissar field (commercial production commenced in December 2011), and increased production from the Khauzak field by 418 million cubic meters, or by 32.0%.

In the first half of 2012, the output of natural gas liquids at the Group gas processing plants in Western Siberia, Ural and Volgograd regions of Russia was 6.7 million BOE, compared to 6.2 million BOE in the first half of 2011.

Refining, marketing and trading

Refining. We own and operate four refineries located in European Russia and three refineries located outside of Russia – in Bulgaria, Ukraine and Romania. Moreover, we have a 60% stake in the ISAB refinery complex in Italy (49% before April 1, 2011) and a 45% interest in the Zeeland Refinery in the Netherlands.

Compared to the first half of 2011, the total volume of refined products produced by the Group (including our share in equity affiliates production) remained on roughly the same level. Our consolidated refineries decreased their production by 3.7%. Due to scheduled overhauls, production volumes of our Russian refineries decreased by 3.6% and production of our international refineries – by 4.0%. At the same time, our share of production of ISAB and Zeeland Refinery increased by 13.9% that resulted from an increase of Group's share in the ISAB refinery and from low level of production at this refinery in February 2011 due to planned overhauls.

We invested, and continue to invest, significant resources in our refineries aiming at taking the leading position in Russia in producing ecological fuel of high quality standards. Starting from July 1, 2012, all the gasoline and most of diesel fuel produced by the Group in Russia comply with Euro-5 standards.

Along with our own production of refined products we can refine crude oil at third party refineries depending on market conditions and other factors. In 2011, we began processing our crude oil at a third party refinery in Kazakhstan. In 2012, we restarted processing operations in Belarus.

The following table summarizes key figures for our refining activities.

	2 nd quarter of		1 st half of	
	2012	2011	2012	2011
	(millions of US dollars)			
Refining expenses at the Group refineries.....	363	337	678	673
- in Russia	288	264	528	514
- outside Russia	75	73	150	159
Refining expenses at ISAB and Zeeland Refinery	239	256	479	422
Refining expenses at third party refineries	24	2	47	5
Capital expenditures.....	266	174	560	299
- in Russia	186	129	302	214
- outside Russia	80	45	258	85
	(thousand barrels per day)			
Refinery throughput at the Group refineries	1,042	1,098	1,027	1,075
- in Russia	854	925	874	912
- outside Russia	188	173	153	163
Refinery throughput at ISAB and Zeeland Refinery ^{(1) (2)}	260	258	253	222
Refinery throughput at third party refineries	56	6	53	7
Total refinery throughput	1,358	1,362	1,333	1,304
	(thousands of tonnes)			
Refined products produced at the Group refineries	12,414	13,032	24,361	25,285
- in Russia	10,130	10,977	20,696	21,467
- outside Russia	2,284	2,055	3,665	3,818
Production of ISAB and Zeeland Refinery ⁽¹⁾	3,238	3,241	6,334	5,560
Refined products produced at third party refineries	646	74	1,235	169
Total refined products produced	16,298	16,347	31,930	31,014

⁽¹⁾ Group's share.

⁽²⁾ Including refined product processed.

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

The Group retails its refined products in 26 countries through nearly 5.6 thousand petrol stations. Most of the stations operate under the LUKOIL brand.

The table below summarizes figures for our trading activities.

	2 nd quarter of		1 st half of	
	2012	2011	2012	2011
	(thousands of tonnes)			
Retail sales	3,764	3,679	7,268	6,948
Wholesale sales	22,976	22,653	46,935	43,325
Total refined products sales	26,740	26,332	54,203	50,273
Refined products purchased in Russia.....	493	477	751	896
Refined products purchased internationally	12,237	11,379	25,426	22,460
Total refined products purchased.....	12,730	11,856	26,177	23,356

Exports of crude oil and refined products from Russia. The volumes of crude oil exported from Russia by our subsidiaries are summarized as follows:

	2 nd quarter of			
	2012	2011		
	(thousands of barrels)	(thousands of tonnes)	(thousands of barrels)	(thousands of tonnes)
Exports of crude oil using Transneft export routes	62,452	8,520	52,168	7,117
Exports of crude oil bypassing Transneft.....	4,999	682	9,947	1,357
Total crude oil exports	67,451	9,202	62,115	8,474

	1 st half of			
	2012	2011		
	(thousands of barrels)	(thousands of tonnes)	(thousands of barrels)	(thousands of tonnes)
Exports of crude oil using Transneft export routes	121,305	16,549	104,497	14,256
Exports of crude oil bypassing Transneft.....	11,376	1,552	21,228	2,896
Total crude oil exports	132,681	18,101	125,725	17,152

In the first half of 2012, our export of crude oil from Russia increased by 5.5%, compared to the same period of 2011, and we exported 43.5% of our total domestic crude oil production (40.5% in the first half of 2011).

Almost all the volume of crude oil exported bypassing Transneft was routed through our own export infrastructure. The reduction of export through our own export infrastructure was mainly caused by a decrease in production from Yuzhnoye Khylychuyu oilfield (713 thousand tonnes in the first half of 2012 compared to 2,088 thousand tonnes in the first half of 2011).

In the first half of 2012, we exported from Russia 11.7 million tonnes of refined products, a decrease of 8.3%, compared to the respective period of 2011. Primarily, we export from Russia diesel fuel, fuel oil and gasoil. These products account for approximately 89% of our refined products export volumes.

The decrease in refined products export and increase in the export of crude oil were both a result of a decrease in throughput at our refinery in Nizhny Novgorod, Russia, due to scheduled overhauls in the second quarter of 2012.

In the first half of 2012, our revenue from export of crude oil and refined products from Russia both to Group companies and third parties amounted to \$13,193 million and \$8,790 million, respectively (\$12,249 million for crude oil and \$9,488 million for refined products in the first half of 2011).

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 the Group's revenues. During the first half of 2012, the Brent crude oil price fluctuated between \$88 and \$128 per barrel and reached its peak of \$128.1 in the beginning of March. During the second quarter of 2012, average crude oil prices decreased by 9.0% compared to the first quarter of 2012, quarter-end Brent price amounted to \$94.5 per barrel.

Substantially all the crude oil the Group exports is Urals blend. The following table shows the average crude oil and refined product prices in the respective periods of 2012 and 2011.

	2 nd quarter of		Change,	1 st half of		Change,
	2012	2011	%	2012	2011	%
	(in US dollars per barrel, except for figures in percent)					
Brent crude.....	108.29	117.04	(7.5)	113.61	111.09	2.3
Urals crude (CIF Mediterranean) ⁽¹⁾	106.84	113.75	(6.1)	112.10	108.08	3.7
Urals crude (CIF Rotterdam) ⁽¹⁾	106.31	113.73	(6.5)	111.76	108.00	3.5
	(in US dollars per metric tonne, except for figures in percent)					
Fuel oil 3.5% (FOB Rotterdam).....	625.79	624.82	0.2	657.12	590.78	11.2
Diesel fuel 10 ppm (FOB Rotterdam)	942.77	983.45	(4.1)	978.04	946.86	3.3
High-octane gasoline (FOB Rotterdam).....	1,030.22	1,058.25	(2.6)	1,046.54	988.59	5.9

Source: Platts.

⁽¹⁾ 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.

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

The table below represents average domestic wholesale prices of refined products in the respective periods of 2012 and 2011.

	2 nd quarter of		Change,	1 st half of		Change,
	2012	2011	%	2012	2011	%
	(in US dollars per metric tonne, except for figures in percent)					
Fuel oil.....	279.63	335.79	(16.7)	293.25	315.92	(7.2)
Diesel fuel.....	746.57	683.73	9.2	791.02	760.76	4.0
High-octane gasoline (Regular)	817.20	870.07	(6.1)	797.61	840.50	(5.1)
High-octane gasoline (Premium)	881.46	898.56	(1.9)	848.31	877.58	(3.3)

Source: InfoTEK (excluding VAT).

Changes in the US dollar-ruble exchange rate and inflation

A substantial part of our revenue 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 appreciation of the ruble against the US dollar generally causes our costs to increase in US dollar terms, and vice versa. The appreciation 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 3.0% in the first half of 2012, compared to the first half of 2011.

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

	2 nd quarter of		1 st half of	
	2012	2011	2012	2011
Ruble inflation (CPI), %	1.7	1.1	3.2	5.0
Change of the ruble-dollar exchange rate, %	(11.9)	1.2	(1.9)	7.9
Average exchange rate for the period (ruble to US dollar)	31.01	27.99	30.64	28.62
Exchange rate at the end of the period (ruble to US dollar)	32.82	28.08	32.82	28.08

Tax burden

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

		2 nd quarter of		Change, %
		2012 ⁽¹⁾	2011 ⁽¹⁾	
Export tariffs on crude oil	\$/tonne	443.09	446.58	(0.8)
Export tariffs on refined products				
Middle distillates (jet fuel), diesel fuel and gasoils	\$/tonne	292.37	299.22	(2.3)
Light distillates				
gasoline	\$/tonne	398.75	369.76	7.8
straight-run gasoline	\$/tonne	398.75	334.23	19.3
Liquid fuels (fuel oil)	\$/tonne	292.37	208.54	40.2
Mineral extraction tax				
Crude oil	RUR/tonne	4,826.60	4,464.47	8.1
Natural gas	RUR/1,000 m ³	251.00	237.00	5.9

⁽¹⁾ Average values.

		1 st half of		Change, %
		2012 ⁽¹⁾	2011 ⁽¹⁾	
Export tariffs on crude oil	\$/tonne	422.03	395.03	6.8
Export tariffs on refined products				
Middle distillates (jet fuel), diesel fuel and gasoils	\$/tonne	278.49	266.99	4.3
Light distillates				
gasoline	\$/tonne	379.80	302.46	25.6
straight-run gasoline	\$/tonne	379.80	284.59	33.5
Liquid fuels (fuel oil)	\$/tonne	278.49	179.94	54.8
Mineral extraction tax				
Crude oil	RUR/tonne	5,054.99	4,278.72	18.1
Natural gas	RUR/1,000 m ³	251.00	237.00	5.9

⁽¹⁾ Average values.

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

		2 nd quarter of		Change, %
		2012 ⁽¹⁾	2011 ⁽¹⁾	
Mineral extraction tax				
Crude oil	\$/tonne	155.63	159.53	(2.4)
Natural gas	\$/1,000 m ³	8.09	8.47	(4.5)

⁽¹⁾ Average values.

		1 st half of		Change, %
		2012 ⁽¹⁾	2011 ⁽¹⁾	
Mineral extraction tax				
Crude oil	\$/tonne	164.99	149.48	10.4
Natural gas	\$/1,000 m ³	8.19	8.28	(1.1)

⁽¹⁾ Average values.

The 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 446 rubles per metric tonne extracted (419 rubles in 2011) 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 \$15.00 per barrel. Each \$1.00 per barrel increase in the international Urals blend price over the threshold (\$15.00 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).

The base rate for 2013 is currently set at 470 rubles per metric tonne extracted. However, the rate may be amended by the authorities later on.

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, the Caspian Sea and the Nenetsky Autonomous District, depending on the period and volume of production.

The Group produces crude oil in the Caspian Sea. In the first half of 2012, the amount of incentive was relatively insignificant, but we expect it to increase as the production volumes grow.

Natural gas extraction tax rate. The mineral extraction tax on natural gas production is calculated using a flat rate. In 2011, the rate was 237 rubles per thousand cubic meters. On January 1, 2012, the rate was raised to 251 rubles per thousand cubic meters.

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 no more than by \$0.65 per barrel exported. Starting from October 1, 2011, the maximum increase of export duty rate is \$0.60 per barrel for each \$1.00 per barrel increase in the Urals blend price.

The crude oil export duty rate is revised monthly on the basis of the immediately preceding one-month period of crude oil price monitoring.

A special export duty regime is in place for certain greenfields. Effective from December 2010, the list of the oilfields where the reduced rate applies also includes our Yu. Korchagin and V. Filanovsky oilfields located in the Caspian Sea.

Export duty rates on refined products prior to 2011 were set by the Russian government. The rate of export duty depended on internal demand for refined products and international crude oil market conditions. Starting from 2011, export duty rates on refined products are calculated by multiplying the current crude oil export duty rate by a coefficient according to the table below.

	Before October 1, 2011	After October 1, 2011
Multiplier for:		
Light distillates (except for gasolines), middle distillates (jet fuel), diesel fuel and gasoils	0.670	0.660
Gasolines ⁽¹⁾	0.467	0.900
Liquid fuels (fuel oil)	0.467	0.660
Motor and other oils	0.467	0.660
Other products.....	0.467	0.660

⁽¹⁾ Starting from May 2011, a coefficient for gasoline export duty rate is set at 0.9.

Crude oil and refined products exported to the member countries of the Custom Union – Belarus and Kazakhstan, are not subject to export duties.

Excise on refined products. The responsibility to pay excises on refined products in Russia is imposed on refined product producers (except for straight-run gasoline). Only domestic sales volumes are subject to excises.

In other countries where the Group operates, excises are paid either by producers or retailers depending on the local legislation.

Starting from 2011, excise rates on refined products in Russia were increased and tied to the ecological class of fuel. Excise tax rates for the respective periods of 2012 and 2011 are listed below:

		2 nd quarter of		Change, %
		2012	2011	
Gasoline				
Below Euro-3.....	RUR/tonne	7,725.00	5,995.00	28.9
Euro-3	RUR/tonne	7,382.00	5,672.00	30.1
Euro-4 and -5	RUR/tonne	6,822.00	5,143.00	32.6
Diesel fuel				
Below Euro-3.....	RUR/tonne	4,098.00	2,753.00	48.9
Euro-3	RUR/tonne	3,814.00	2,485.00	53.5
Euro-4 and -5	RUR/tonne	3,562.00	2,247.00	58.5
Motor oils.....	RUR/tonne	6,072.00	4,681.00	29.7
Straight-run gasoline	RUR/tonne	7,824.00	6,089.00	28.5

		2 nd quarter of		Change, %
		2012	2011	
Gasoline				
Below Euro-3.....	\$/tonne	249.08	214.22	16.3
Euro-3	\$/tonne	238.02	202.67	17.4
Euro-4 and -5	\$/tonne	219.97	183.77	19.7
Diesel fuel				
Below Euro-3.....	\$/tonne	132.13	98.37	34.3
Euro-3	\$/tonne	122.98	88.80	38.5
Euro-4 and -5	\$/tonne	114.85	80.29	43.0
Motor oils.....	\$/tonne	195.78	167.26	17.1
Straight-run gasoline	\$/tonne	252.27	217.58	15.9

		1 st half of		Change, %
		2012	2011	
Gasoline				
Below Euro-3.....	RUR/tonne	7,725.00	5,995.00	28.9
Euro-3	RUR/tonne	7,382.00	5,672.00	30.1
Euro-4 and -5	RUR/tonne	6,822.00	5,143.00	32.6
Diesel fuel				
Below Euro-3.....	RUR/tonne	4,098.00	2,753.00	48.9
Euro-3	RUR/tonne	3,814.00	2,485.00	53.5
Euro-4 and -5	RUR/tonne	3,562.00	2,247.00	58.5
Motor oils.....	RUR/tonne	6,072.00	4,681.00	29.7
Straight-run gasoline	RUR/tonne	7,824.00	6,089.00	28.5

		1 st half of		Change, %
		2012	2011	
Gasoline				
Below Euro-3.....	\$/tonne	252.13	209.44	20.4
Euro-3	\$/tonne	240.93	198.15	21.6
Euro-4 and -5	\$/tonne	222.66	179.67	23.9
Diesel fuel				
Below Euro-3.....	\$/tonne	133.75	96.18	39.1
Euro-3	\$/tonne	124.48	86.81	43.4
Euro-4 and -5	\$/tonne	116.26	78.50	48.1
Motor oils.....	\$/tonne	198.18	163.53	21.2
Straight-run gasoline	\$/tonne	255.36	212.72	20.0

Income tax. Starting from January 1, 2009, the Federal income tax rate is 2.0% and the regional income tax rate varies between 13.5% and 18.0%. The Group's foreign operations are subject to taxes at the tax rates applicable to the jurisdictions in which they operate.

Until January 1, 2012, there were no provisions in the taxation legislation of the Russian Federation to permit the Group to reduce taxable profits of a Group company by offsetting tax losses of another Group company against such profits. Tax losses could be fully or partially used to offset taxable profits in the same company in any of the ten years following the year of loss.

Starting from January 1, 2012, if certain conditions are met, taxpayers are able to pay income tax as a consolidated taxpayers' group ("CTG"). This allows taxpayers to offset taxable losses generated by certain participants of a CTG against taxable profits of other participants of the CTG. Certain Group companies met the legislative requirements and pay income tax as a CTG starting from the first quarter of 2012.

Losses generated by a taxpayer before joining a CTG are not available for offset against taxable profits of other participants of the CTG. However, if a taxpayer leaves a CTG, such losses again become available for offset against future profits generated by the same taxpayer. The expiration period of the losses is extended to take account of any time spent within a CTG when the losses were unavailable for use.

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 by crude oil production companies to the markets is dependent on the extent of diversification of the 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 OAO AK Transneft or by railway transport.

Transportation of refined products in Russia is performed by railway transport and the pipeline system of OAO AK Transnefteproduct. The Russian railway infrastructure is owned and operated by OAO Russian Railways. Both these companies are state-owned. We transport the major part of our refined products by railway transport.

In Russia, the gas is mostly sold at the wellhead and then transported through the Unified Gas Supply System ("UGSS"). The UGSS is responsible for gathering, transporting, dispatching and delivering substantially all natural gas supplies in Russia and is owned and operated by OAO Gazprom ("Gazprom"). The Federal Service for Tariffs of the Russian Federation regulates natural gas transportation tariffs. We are not able to sell our gas other than through UGSS.

Three and six months ended June 30, 2012, compared to three and six months ended June 30, 2011

The table below presents our consolidated statements of income for the periods indicated.

	2 nd quarter of		1 st half of	
	2012	2011	2012	2011
	(millions of US dollars)			
Revenues				
Sales (including excise and export tariffs)	32,397	34,912	67,658	64,538
Costs and other deductions				
Operating expenses	(2,327)	(2,440)	(4,542)	(4,578)
Cost of purchased crude oil, gas and products	(14,416)	(15,162)	(30,784)	(28,007)
Transportation expenses	(1,497)	(1,653)	(3,102)	(3,073)
Selling, general and administrative expenses	(932)	(977)	(1,761)	(1,802)
Depreciation, depletion and amortization	(1,177)	(1,149)	(2,272)	(2,208)
Taxes other than income taxes	(3,461)	(3,547)	(6,939)	(6,369)
Excise and export tariffs	(6,090)	(5,777)	(11,667)	(10,391)
Exploration expense.....	(104)	(85)	(147)	(113)
Gain (loss) on disposals and impairments of assets	175	(157)	166	(160)
Income from operating activities	2,568	3,965	6,610	7,837
Interest expense	(160)	(177)	(321)	(350)
Interest and dividend income	66	46	132	91
Equity share in income of affiliates	163	173	344	342
Currency translation loss	(310)	(93)	(396)	(158)
Other non-operating (expense) income	(45)	113	(67)	335
Income before income taxes	2,282	4,027	6,302	8,097
Current income taxes	(1,105)	(649)	(1,592)	(980)
Deferred income taxes	(68)	(165)	52	(473)
Total income tax expense	(1,173)	(814)	(1,540)	(1,453)
Net income	1,109	3,213	4,762	6,644
Net (income) loss attributable to noncontrolling interests	(91)	38	45	124
Net income attributable to OAO LUKOIL.....	1,018	3,251	4,807	6,768
Earning per share of common stock attributable to OAO LUKOIL (in US dollars):				
Basic	1.34	4.16	6.27	8.66
Diluted	1.32	4.08	6.15	8.48

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

Sales revenues

Sales breakdown	2 nd quarter of		1 st half of	
	2012	2011	2012	2011
(millions of US dollars)				
Crude oil				
Export and sales on international markets other than CIS	5,879	7,184	12,683	13,771
Export and sales to CIS.....	347	695	848	1,231
Domestic sales	264	420	647	843
	6,490	8,299	14,178	15,845
Refined products				
Export and sales on international markets				
Wholesale.....	17,359	17,734	36,882	32,266
Retail.....	2,704	2,973	5,106	5,434
Domestic sales				
Wholesale.....	1,899	1,960	3,551	3,497
Retail.....	2,054	1,879	4,027	3,370
	24,016	24,546	49,566	44,567
Petrochemicals				
Export and sales on international markets	268	295	544	572
Domestic sales	66	264	118	503
	334	559	662	1,075
Gas and gas products				
Export and sales on international markets	615	493	1,216	881
Domestic sales	242	236	513	471
	857	729	1,729	1,352
Sales of energy and related services.....	249	362	687	908
Other				
Sales on international markets	224	216	421	423
Domestic sales	227	201	415	368
	451	417	836	791
Total sales	32,397	34,912	67,658	64,538

Sales volumes	2 nd quarter of		1 st half of	
	2012	2011	2012	2011
(thousands of barrels)				
Crude oil				
Export and sales on international markets other than CIS	55,994	63,119	114,561	127,872
Export and sales to CIS.....	8,033	13,025	16,800	22,899
Domestic sales	6,634	8,723	13,407	17,189
	70,661	84,867	144,768	167,960
(thousands of tonnes)				
Crude oil				
Export and sales on international markets other than CIS	7,639	8,611	15,629	17,445
Export and sales to CIS.....	1,096	1,777	2,292	3,124
Domestic sales	905	1,190	1,829	2,345
	9,640	11,578	19,750	22,914
(thousands of tonnes)				
Refined products				
Export and sales on international markets				
Wholesale.....	20,115	19,819	41,763	38,067
Retail.....	1,667	1,737	3,143	3,341
Domestic sales				
Wholesale.....	2,861	2,834	5,172	5,258
Retail.....	2,097	1,942	4,125	3,607
	26,740	26,332	54,203	50,273
Total sales volume of crude oil and refined products.....	36,380	37,910	73,953	73,187

Realized average sales prices	2 nd quarter of		1 st half of		
	2012	2011	2012	2011	
Average realized price international					
Oil (excluding CIS)	(\$/barrel)	104.98	113.83	110.71	107.70
Oil (CIS)	(\$/barrel)	43.31	53.30	50.50	53.73
Refined products					
Wholesale	(\$/tonne)	862.93	894.81	883.11	847.60
Retail.....	(\$/tonne)	1,622.61	1,711.82	1,624.63	1,626.53
Average realized price within Russia					
Oil.....	(\$/barrel)	39.91	48.13	48.27	49.02
Refined products					
Wholesale	(\$/tonne)	663.59	691.55	686.51	664.98
Retail.....	(\$/tonne)	979.18	967.43	976.15	934.40

During the second quarter of 2012, our revenues decreased by \$2,515 million, or by 7.2%, compared to the same period of 2011, crude oil sales decreased by \$1,809 million, or by 21.8%, refined products sales decreased by \$530 million, or by 2.2%. The decrease in sales revenue was mainly a result of a decrease in hydrocarbon prices.

During the first half of 2012, our revenues increased by \$3,120 million, or by 4.8%, compared to the same period of 2011. Our revenues from crude oil sales decreased by \$1,667 million, or by 10.5%, because of the decrease in sales volumes that offset the increase of average sales price. Our revenues from sales of refined products increased by \$4,999 million, or by 11.2%, as a result of the increase of both sales prices and volumes.

Sales of crude oil

Compared to the respective periods of 2011, our total crude oil sales revenues decreased by \$1,809 million, or by 21.8%, in the second quarter of 2012 as a result of the decrease in sales volumes and prices and by \$1,667 million, or by 10.5%, in the first half of 2012 as a result of decreased sales volumes.

Our sales volumes decreased by 16.7%, or by 1,938 thousand tonnes, in the second quarter of 2012 and by 13.8%, or by 3,164 thousand tonnes, in the first half of 2012, because of a decrease in production and lower scale of trading operations.

In the second quarter and the first half of 2012, our revenue from crude oil export from Russia both to the Group companies and third parties amounted to \$6,327 million and \$13,193 million, respectively.

Sales of refined products

Compared to the same periods of 2011, our revenue from the wholesale of refined products outside of Russia decreased by \$375 million, or by 2.1%, in the second quarter of 2012 as a result of a decrease in prices by 3.6% and increased by \$4,616 million, or by 14.3%, in the first half of 2012 due to increase in sales volumes by 9.7% and prices by 4.2%.

Our revenue from international retail sales decreased by \$269 million, or by 9.0%, in the second quarter of 2012 and by \$328 million, or by 6.0%, in the first half of 2012 due to a decrease in average prices by 5.2% and volumes by 4.0% in the second quarter of 2012 and due to a decrease in sales volumes by 5.9% in the first half of 2012. Retail sales volumes decreased by 70 thousand tonnes in the second quarter of 2012 and by 198 thousand tonnes in the first half of 2012, mainly as a result of restructuring of our retail network in the USA.

Our revenue from the wholesale of refined products on the domestic market decreased by \$61 million, or by 3.1%, in the second quarter of 2012 and increased by \$54 million, or by 1.5%, in the first half of 2012, following the average realized price, that decreased by 4.0% and increase by 3.2%, respectively. Our sales volumes did not change significantly in the considered periods.

Our revenue from retail sales in Russia increased by \$175 million, or by 9.3%, in the second quarter of 2012 and by \$657 million, or by 19.5%, in the first half of 2012. Domestic retail sales volumes increased by 8.0% in the second quarter of 2012 and by 14.4% in the first half of 2012 resulting from the increase in domestic demand for motor fuels. Average retail prices in Russia increased by 1.2%, compared to the second quarter of 2011, and by 4.5%, compared to the first half of 2011.

In the second quarter and the first half of 2012, our revenue from export of refined products from Russia both to Group companies and third parties amounted to \$3,793 million and \$8,790 million, respectively.

Sales of petrochemical products

In the second quarter of 2012, our revenue from sales of petrochemical products decreased by \$225 million, or by 40.3%, and in the first half of 2012, our revenue decreased by \$413 million, or by 38.4%, mainly as a consequence of a fire on our petrochemical plant in Stavropol, Russia. Domestic sales volumes dropped by 76.7% in the second quarter of 2012 and by 75.2% in the first half of 2012. International sales volumes increased by 3% both in the second quarter and in the first half of 2012. Our international realized prices decreased by 7.4% in the second quarter of 2012 and by 6.7% in the first half of 2012.

Sales of gas and gas products

Sales of gas and gas refined products increased by \$128 million, or by 17.6%, in the second quarter of 2012 and by \$377 million, or by 27.9%, in the first half of 2012.

Gas products wholesales revenue increased by \$29 million, or by 9.4% in the second quarter of 2012 and by \$117 million, or by 21.2%, in the first half of 2012, primarily as a result of an increase in sales volumes and prices.

Retail gas products revenue decreased by \$6 million, or by 3.7%, in the second quarter of 2012 and by \$10 million, or by 3.4%, in the first half of 2012.

Natural gas sales revenue increased by \$96 million, or by 46.8%, in the second quarter of 2012 and by \$247 million, or by 60.3%, in the first half of 2012. At the domestic market, this was mainly a result of the increase of sales price to Gazprom by 25.9%. The main reason for the rise of revenue outside of Russia was the increase of both sales volumes and prices in Uzbekistan.

Domestic sales of energy and related services

We sell substantially all our energy and related services domestically. International sales are relatively insignificant.

Our revenue from sales of electricity, heat and related services decreased by \$113 million, or by 31.2%, in the second quarter of 2012 and by \$221 million, or by 24.3%, in the first half of 2012 due to the reduction of resale operations as a result of alteration of scheme of electricity supplies to our subsidiaries in Western Siberia.

Sales of other products

Other sales include non-petroleum sales through our retail network, transportation services, rental revenue, crude oil extraction services, and other revenue of our production and marketing companies from sales of goods and services not related to our primary activities.

In the second quarter of 2012, other sales increased by \$34 million, or by 8.2% and in the first half of 2012, other sales increased by \$45 million, or by 5.7%.

Operating expenses

Operating expenses include the following:

	2nd quarter of		1st half of	
	2012	2011	2012	2011
	<i>(millions of US dollars)</i>			
Hydrocarbon extraction expenses	944	987	1,850	1,887
Own refining expenses	363	337	678	673
Refining expenses at third parties and affiliated refineries.....	263	258	526	427
Expenses for crude oil transportation to refineries	302	308	589	540
Power generation and distribution expenses	139	181	317	369
Petrochemical expenses	84	87	158	161
Other operating expenses	232	282	424	521
Total operating expenses	2,327	2,440	4,542	4,578

The method of allocation of operating expenses above differs from the approach used in preparing the data for Note 19 "Segment information" to our interim consolidated financial statements. Expenditures in the segment reporting are grouped depending on the segment to which a particular company belongs. Operating expenses for the purposes of this analysis are grouped based on the nature of the costs incurred.

Our operating expenses decreased by \$113 million, or by 4.6%, in the second quarter of 2012 and by \$36 million, or by 0.8% in the first half of 2012. One of the main reasons for the decrease in expenses was the effect of devaluation of ruble and euro against the US dollar.

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, cost of extraction of natural gas liquids, property insurance of extraction equipment and other similar costs.

In the second quarter of 2012, our extraction expenses decreased by \$43 million, or by 4.4%, and in the first half of 2012, our extraction expenses decreased by \$37 million, or by 2.0%. This decrease in expenses was a result of ruble devaluation against the US dollar. Our average hydrocarbon extraction cost decreased from \$5.22 per BOE in the second quarter of 2011 to \$5.02 per BOE in the second quarter of 2012, or by 3.8%, and from \$4.96 per BOE in the first half of 2011 to \$4.86 per BOE the first half of 2012, or by 2.0%.

Own refining expense

Our own refining expenses increased by \$26 million, or by 7.7%, in the second quarter of 2012, but remained flat to the first half of 2011.

Refining expenses at our domestic refineries increased by 9.1%, or by \$24 million, in the second quarter of 2012 and by 2.7%, or by \$14 million, in the first half of 2012. The main reason for this was increased consumption and cost of additives in the second quarter of 2012 due to changes in Russian refineries' production mix towards larger share of high quality motor fuels.

Refining expenses at our international refineries increased by 2.7%, or by \$2 million, in the second quarter of 2012, but decreased by 5.7%, or by \$9 million, in the first half of 2012. The decrease in expenses was a result of devaluation of euro against the US dollar, but in the second quarter this factor was offset by significant increase of throughput.

Refining expenses at third party and affiliated refineries

Along with our own production of refined products we have the ability to refine crude oil at third party and affiliated refineries both in Russia and abroad.

In the second quarter and the first half of 2012, refining expenses at third party and affiliated refineries increased by 1.9% and 23.2%, respectively. The increase to the first half of 2011 was due to the increase of our share in ISAB from 49% to 60% since April 2011 and commencement of processing on third-party facilities in Belorussia in the first quarter of 2012. This was partly offset by the devaluation of Euro against the US dollar.

Expenses for crude oil transportation to refineries

Expenses for crude oil transportation to refineries include pipeline, railway, freight and other costs related to delivery of the Group's own crude oil to refineries for further processing.

In the second quarter of 2012, expenses for crude oil transportation to refineries decreased by \$6 million, or by 1.9%, while in the first half of 2012 they increased by \$49 million, or by 9.1%. The increase to the first half of 2011 was largely because of supplies of our crude oil to the refineries in Belorussia, where we commenced crude oil processing in the first quarter of 2012. Nevertheless, in the second quarter of 2012, this factor was offset by a significant decrease in supplies to our refinery in Nizhniy Novgorod, Russia, due to planned overhauls.

Petrochemical expenses

In the second quarter of 2012, operating expenses of our petrochemical plants decreased by \$3 million, or by 3.4%, compared to the second quarter of 2011, and in the first half of 2012, these expenses decreased by \$3 million, or by 1.9%, compared to the first half of 2011. Despite the sharp decrease in production as a result of the fire that destroyed the ethylene production unit at our plant in Stavropol, Russia, operating expenses of the plant didn't decrease significantly due to planned overhauls at other plant units. The effect of the increased production at Group's other petrochemical plants was partially compensated for by the devaluation of local currencies against the US dollar.

Power generation and distribution expenses

Power generation and distribution expenses decreased by \$42 million, or by 23.2%, in the second quarter of 2012 and by \$52 million, or by 14.1%, in the first half of 2012 due to a decrease in volumes of resale operations as a result of alteration of scheme of electricity supplies to our subsidiaries in Western Siberia.

Other operating expenses

Other operating expenses include expenses of the Group's upstream and downstream entities that do not relate to their core activities, namely rendering of transportation and extraction services, costs of other services provided and goods sold by our production and marketing companies, and of non-core businesses of the Group.

In the second quarter of 2012, other operating expenses decreased by \$50 million, or by 17.7%, and in the first half of 2012, other operating expenses decreased by \$97 million, or by 18.6%. Among the factors that contributed to the decrease were movements in assets retirement obligation and decrease in cost of goods sold through our retail network.

Cost of purchased crude oil, gas and products

Cost of purchased crude oil, gas and products includes cost of crude oil and refined products purchased for trading or refining, gas and fuel oil to supply our power generation entities and the result of hedging of international crude oil and refined products sales.

Cost of purchased crude oil, gas and products decreased by \$746 million in the second quarter of 2012, or by 4.9%, compared to the same period of 2011, and increased by \$2,777 million, or by 9.9%, in the first half of 2012, driven by the movements in hydrocarbon prices and changes in trading volumes.

In the second quarter of 2012, we recognized a \$534 million gain from hedging, compared to a \$185 million gain in the second quarter of 2011. At the same time, in the first half of 2012, we recognized an \$82 million gain from hedging, compared to an expense of \$642 million in the first half of 2011.

Transportation expenses

Our transportation expenses decreased by \$156 million, or by 9.4%, compared to the second quarter of 2011, and increased by \$29 million, or 0.9%, compared to the first half of 2011. The decrease to the second quarter of 2011 was due to the change in export mix towards higher share of crude oil and lower share of refined products because of decrease in refined products export. The devaluation of ruble and euro against the US dollar were other factors of the decrease in expenses.

Our actual transportation expenses related to crude oil and refined products deliveries to various export destinations, weighted by volumes transported, changed to the first half of 2011 as follows: crude oil pipeline tariffs increased by 6.4%, railway tariffs for refined products transportation decreased by 4.8%, crude oil freight rates decreased by 15.5%, and refined products freight rates decreased by 2.4%.

Selling, general and administrative expenses

Selling, general and administrative expenses include 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.

Our selling, general and administrative expenses decreased by \$45 million, or by 4.6%, in the second quarter of 2012 and by \$41 million, or by 2.3%, in the first half of 2012. The main reason for this was the effect of the ruble devaluation on our expenses in Russia.

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, crude oil production and marketing in Kazakhstan and refining operations in Europe. Our largest affiliates are Turgai Petroleum and Tengizchevroil, exploration and production companies operating in Kazakhstan, and ISAB and Zeeland Refinery.

Our share in income of affiliates didn't change significantly, compared to the respective periods of 2011.

Taxes other than income taxes

	2 nd quarter of		1 st half of	
	2012	2011	2012	2011
(millions of US dollars)				
In Russia				
Mineral extraction taxes	3,108	3,171	6,226	5,612
Social security taxes and contributions	135	146	283	298
Property tax	125	140	251	269
Other taxes	22	19	39	37
Total in Russia	3,390	3,476	6,799	6,216
International				
Mineral extraction taxes	24	21	46	45
Social security taxes and contributions	26	26	49	51
Property tax	6	5	11	24
Other taxes	15	19	34	33
Total internationally	71	71	140	153
Total	3,461	3,547	6,939	6,369

In the second quarter of 2012, taxes other than income taxes decreased by 2.4%, or by \$86 million, compared to the second quarter of 2011. Compared to the first half of 2011, they increased by 8.9%, or by \$570 million. This was mainly due to changes in mineral extraction taxes in Russia driven by the changes in tax rate following the movements of the international crude oil prices.

Application of decreased rate for depleted oilfields in the second quarter of 2012 led to \$338 million tax reduction (\$304 million in the second quarter of 2011). In the first half of 2012, application of decreased rate for depleted oilfields led to \$714 million tax reduction (\$566 million in the first half of 2011).

Excise and export tariffs

	2 nd quarter of		1 st half of	
	2012	2011	2012	2011
(millions of US dollars)				
In Russia				
Excise tax on refined products	556	451	1,015	824
Crude oil export tariffs	3,325	2,872	6,170	5,328
Refined products export tariffs	1,220	1,456	2,678	2,401
Total in Russia	5,101	4,779	9,863	8,553
International				
Excise tax and sales taxes on refined products	811	910	1,485	1,679
Crude oil export tariffs	73	88	152	159
Refined products export tariffs	105	–	167	–
Total internationally	989	998	1,804	1,838
Total	6,090	5,777	11,667	10,391

Export tariffs increased by \$307 million, or by 7.0%, in the second quarter of 2012 and by \$1,279 million, or by 16.2%, in the first half of 2012.

Export duty rate for crude oil and refined products in Russia depends on the international Urals blend price. As the rate is set monthly based on crude oil price for preceding one-month period, that results in a one-month gap between changes in crude oil price and the rate. Thus, in the second quarter of 2012, the rates increased while crude oil prices had already turned downwards. Compared to the first quarter of 2012, Urals blend price decreased by 9.0%, and crude oil export duty rate increased by 10.5%.

The decrease in excise tax expense outside of Russia to the respective periods of 2011 was a result of lower volume of sales subject to excises as well as of the devaluation of euro and local currencies against the US dollar. In Russia, the increase of excises to the second quarter and the first half of 2011 was driven by the growth of rates and the increase of domestic sales volumes.

Exploration expenses

Our exploration expense increased by \$19 million, or by 22.4%, during the second quarter of 2012 and by \$34 million, or by 30.1%, during the first half of 2012. Dry hole costs amounted to \$77 million in the second quarter of 2012 and \$87 million in the first half of 2012. In the second quarter and in the first half of 2011, dry hole costs amounted to \$47 million and \$50 million, respectively.

In the second quarter of 2012, we charged to expense the cost of an exploratory well in Volga region of Russia totaling \$50 million and in the second quarter of 2011, we charged to expense the cost of exploratory wells in the Komi Republic of Russia in the amount of \$28 million and in Kazakhstan in the amount of \$17 million.

Gain (loss) on disposals and impairments of assets

In the second quarter of 2012, the Group recognized a gain of \$178 million from disposal of 10% of its share in Karachaganak Petroleum Operating consortium (KPO), an upstream project in Kazakhstan. Tax effect of the deal amounted to \$148 million of the income tax expense.

Other non-operating (expense) income

Other non-operating income included the effect of the recalculation of the extraction tax incentive by certain Group companies for prior periods in total amounts of \$189 million in the second quarter of 2011 and \$433 million in the first half of 2011.

Income taxes

In the second quarter of 2012, our total income tax expense increased by \$359 million, or by 44.1%, compared to the second quarter of 2011. At the same time, our income before income tax decreased by \$1,745 million, or by 43.3%.

In the first half of 2012, our total income tax expense increased by \$87 million, or by 6.0%, compared to the first half of 2011, while our income before income tax decreased by \$1,795 million, or by 22.2%.

In the second quarter of 2012, our effective income tax rate was 51.4%, compared to 20.2% in the second quarter of 2011, while in the first half of 2012, our effective income tax rate was 24.4%, compared to 17.9% in the first half of 2011. The maximum statutory rate for the Russian Federation is 20%. The high level of our effective income tax rate in the second quarter of 2012 was a result of taxable currency translation gains reported by Russian subsidiaries and of a tax effect on disposal of 10% of our share in KPO in amount of \$148 million.

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

	2 nd quarter of		1 st half of	
	2012	2011	2012	2011
	(millions of US dollars)			
Net income	1,018	3,251	4,807	6,768
Add back:				
Income tax expense.....	1,173	814	1,540	1,453
Depreciation and amortization	1,177	1,149	2,272	2,208
Interest expense.....	160	177	321	350
Interest and dividend income	(66)	(46)	(132)	(91)
EBITDA	3,462	5,345	8,808	10,688

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

	1 st half of	
	2012	2011
	(millions of US dollars)	
Net cash provided by operating activities.....	7,031	8,290
Net cash used in investing activities.....	(5,198)	(5,660)
Net cash used in financing activities.....	(1,100)	(992)

Operating activities

Our primary source of cash flow is funds generated from our operations. During the first half of 2012, cash generated from operating activities was \$7,031 million, which is 15.2% less than in the first half of 2011. Nevertheless, our cash flow from operating activity was supported by a decrease in working capital by \$114 million, compared to January 1, 2012.

The decrease in working capital was mainly caused by:

- \$284 million net decrease in taxes receivable and payable
- \$269 million net decrease in other assets and liabilities

At the same time, this was partially offset by a \$275 million net increase in trade accounts receivable and payable and a \$117 million net increase in VAT receivable and payable.

Investing activities

The decrease in cash used in investing activities mainly resulted from a decrease in payments for acquisitions.

In the first half of 2012, the Group didn't make any significant acquisitions. While in the first half of 2011, we made an advance payment of \$1,778 million for expected acquisitions of certain upstream assets. In the second quarter of 2012, \$1,760 million from this amount was used for purchase of equity linked notes.

Capital expenditures increased by \$1,757 million, or by 49.2%, compared to the first half of 2011.

Financing activities

In the first half of 2012, net movements of short-term and long-term debt generated an outflow of \$198 million, compared to an outflow of \$888 million in the first half of 2011.

In the first quarter of 2012, we purchased Company's stock worth \$128 million and in the second quarter of 2012, we spent \$740 million for purchase of equity-linked notes.

Analysis of capital expenditures

	2 nd quarter of		1 st half of	
	2012	2011	2012	2011
	(millions of US dollars)			
Capital expenditures⁽¹⁾				
Exploration and production				
Russia.....	1,890	1,274	3,519	2,435
International.....	423	257	796	489
Total exploration and production.....	2,313	1,531	4,315	2,924
Refining, marketing and distribution				
Russia.....	274	203	446	374
International.....	116	68	295	124
Total refining, marketing and distribution.....	390	271	741	498
Chemicals				
Russia.....	17	12	23	19
International.....	7	2	11	9
Total chemicals.....	24	14	34	28
Power generation and distribution.....	167	28	224	78
Other.....	57	48	99	86
Total capital expenditures.....	2,951	1,892	5,413	3,614
Acquisitions of subsidiaries and associates⁽²⁾				
Exploration and production				
Russia.....	–	–	52	18
International.....	12	–	22	1,760
Total exploration and production.....	12	–	74	1,778
Refining, marketing and distribution				
Russia.....	20	10	22	10
International.....	32	342	35	342
Total refining, marketing and distribution.....	52	352	57	352
Power generation and distribution.....	–	–	–	–
Other.....	–	–	–	–
Less cash acquired.....	(15)	–	(16)	–
Total acquisitions.....	49	352	115	2,130

⁽¹⁾ Including non-cash transactions and prepayments.

⁽²⁾ Including prepayments related to acquisitions and non-cash transactions.

Our capital expenditures, including non-cash transactions, amounted to \$5,413 million, which is 49.8% more than in the first half of 2011.

Capital expenditures in exploration and production segment increased by \$1,391 million, or by 47.6%. In Russia, this was due to development of the V. Filanovsky oilfield on the Caspian seashore and increased production drilling in Western Siberia. Internationally, we increased investments in developing our projects in Iraq and Uzbekistan.

The increase in our refining, marketing and distribution capital expenditures was mainly due to construction of a heavy residue processing complex at our Bulgarian refinery.

Capital expenditures in power generation sector increased as a result of fulfilling of our investment program, namely construction of 235 MW combined cycle gas turbine in Astrakhan with a completion scheduled at the third quarter of 2013.

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

	2 nd quarter of		1 st half of	
	2012	2011	2012	2011
	(millions of US dollars)			
Northern Timan-Pechora.....	19	44	39	73
Yamal.....	138	66	317	196
Caspian region ⁽¹⁾	479	135	829	219
Ghana.....	4	39	9	47
Cote d'Ivoire.....	10	8	24	12
Iraq.....	228	44	371	75
Uzbekistan.....	97	78	246	202
Total.....	975	414	1,835	824

⁽¹⁾ Russian and international projects.