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

You should read the following discussion and analysis of our financial condition and results of operations as of 31 March 2005 and 2004 and as of 31 December 2004, 2003 and 2002 and the periods then ended in conjunction with our consolidated financial statements as of and for the three months ended 31 March 2005 and 2004, and as of and for the years ended 31 December 2004, 2003 and 2002. The consolidated financial statements and the related notes thereto have been prepared in accordance with International Financial Reporting Standards (IFRS). In accordance with International Accounting Standards (IAS) No. 29, *Financial Reporting in Hyperinflationary Economies*, all rouble amounts related to financial information for periods prior to 1 January 2003 are expressed in constant roubles as of 31 December 2002 purchasing power, unless otherwise noted. As the characteristics of the economic environment of the Russian Federation indicate that hyperinflation has ceased, effective from 1 January 2003, we no longer apply the provisions of IAS 29 and, accordingly, all rouble amounts have been stated at their nominal value for periods beginning on and after that date.

The financial and operating information contained in this "Management's Discussion and Analysis of Financial Condition and Results of Operations" comprises information of OAO NOVATEK, its consolidated subsidiaries and its share of the results of associates. Accordingly, production volumes in the following discussion and analysis exclude volumes of Tarkosaleneftegas and Khancheyneftegas prior to their being consolidated in December 2004. Prior to that date, sales volumes and revenues include the volumes of Tarkosaleneftegas and Khancheyneftegas only to the extent OAO NOVATEK purchased such production from Tarkosaleneftegas and Khancheyneftegas. We have, however, been responsible for managing the development and the operations of these associates for the periods discussed.

In June 2004, we sold to our shareholders our oil and gas construction services business to focus on our core activities of oil and gas exploration and production. Our oil and gas construction services activities primarily consisted of drilling services and construction of oil and gas infrastructure and facilities for related and external parties within the Russian Federation.

Overview

We are Russia's largest independent gas producer and the second-largest producer of natural gas in Russia after Gazprom. In terms of proved natural gas reserves, we are the third largest holder of natural gas resources in Russia after Gazprom and LUKOIL.

Our exploration, development, production, processing and marketing of natural gas, gas condensate, crude oil and related oil products have been conducted primarily within the Russian Federation and, historically, most of our revenues were derived from sales within the Russian Federation. However, with the commissioning of the Purovsky processing plant in June 2005, we plan to export the majority of our gas condensate directly to international markets, significantly increasing the share of our revenues derived from international sales.

Our business has benefited from success in expanding our production volumes, and the production volumes of our associates, as well as from increases in market prices of natural gas, gas condensate, crude oil and related oil products. Our continued efforts in funding exploration and development activities have allowed us to expand our sales volumes annually since our inception. Our sales volumes of natural gas increased from 3,583 mmcm in 2002 to 13,161 mmcm, in 2003, or 267.3%, and to 17,277 mmcm in 2004, or a further 31.3%. Our combined sales volumes of crude oil and gas condensate and oil products increased from 411,000 tonnes in 2002 to 1,235,000 tonnes in 2003, or 200.5%, and to 2,112,000 tonnes in 2004, or a further 71%. We expect to continue to increase our sales volumes, but at a more measured pace, due to continued production growth and the consolidation of production from some of our associates due to the acquisitions described below.

We also benefited from strong international and domestic prices, particularly the continued rise in the domestic natural gas tariffs regulated by the FTS. Unlike Gazprom, we are not required to sell our gas at the regulated tariff. We do, however, sell to customers eligible to purchase natural gas from Gazprom at regulated prices. Thus, the prices we can achieve for our natural gas are strongly influenced by regulated prices. The average realized prices of our natural gas sold to end-customers and natural gas sold at the entry point to the natural gas transportation system (referred to as "ex-field") were higher by 36.6% and 56.2%, respectively, in 2003 than in 2002, and were higher by 10.2% and 16.6%, respectively, in 2004 than in 2003. If regulated prices continue to rise, as forecast in the Russian Federation Energy Strategy 2020, we expect our average realized prices for natural gas to continue to increase.

Recent developments

Significant events occurring between 31 March 2005 and the date of this prospectus are as follows:

- commissioning of the Purovsky processing plant in June 2005;
- commissioning of the Vitino port facilities in June 2005;
- disposal of Geoilbent to LUKOIL and one of its subsidiaries in June 2005;
- sale of Tambeyneftegas to OOO GazpromBank-Invest in July 2005;
- agreement to sell Selkupneftegas to Rosneft executed in June 2005;
- commissioning of the BOPP film wrap plant in June 2005;
- merger of Khancheyneftegas into Tarkosaleneftegas in May 2005; and
- disposal of our stake in NOVA Bank to Levit in May 2005.

Certain Factors Affecting our Results of Operations

Consolidation of our operations

Since 2002, we have pursued a strategy of increasing our holdings in, and focusing on, our core oil and gas assets and made a number of acquisitions and disposals to further this strategy. Our three core fields are held in our subsidiaries Tarkosaleneftegas and Yurkharovneftegas. With the completion of the December 2004 acquisitions discussed below, we acquired 100% of these producing subsidiaries. As a result of these acquisitions and our other consolidation and restructuring initiatives over the past three years, we have simplified our holding structure, allowing us to directly manage our core assets and improving the overall transparency of our financial reporting.

Acquisitions

In December 2004, we undertook a series of transactions whereby we acquired a 67.7% interest in Tarkosaleneftegas and a 57.0% interest in Khancheyneftegas in exchange for the issuance of 789,276 new ordinary shares of NOVATEK, resulting in these companies becoming fully consolidated subsidiaries as at 31 December 2004. In May 2005, Khancheyneftegas was merged into Tarkosaleneftegas. See "Business—Recent Developments—Buyout of the Itera Group; Consolidation and New Share Issuance".

Prior to our acquisitions of additional interests in Tarkosaleneftegas and Khancheyneftegas in December 2004, we purchased approximately 56% of Tarkosaleneftegas' hydrocarbon production and 100% of Khancheyneftegas' hydrocarbon production and then resold the production to third parties. Subsequent to the acquisitions, Tarkosaleneftegas' and Khancheyneftegas' activities were consolidated into our financial position and results of operations. Accordingly, all purchases from, sales to and balances with Tarkosaleneftegas and Khancheyneftegas have been eliminated in our consolidated balance sheets at 31 March 2005 and 31 December 2004 and in our consolidated statement of income for the three months ended 31 March 2005, and each line item within our total operating expenses for the three months ended 31 March 2005 includes the corresponding results of Tarkosaleneftegas and Khancheyneftegas for the period. At all other balance sheet dates and in all other reporting periods, we accounted for Tarkosaleneftegas and Khancheyneftegas under the equity method of accounting as investments in associates, and thus the operating costs of the two acquired entities were effectively included (pro rata to the percentage of volumes purchased) within purchases of oil, gas condensate and natural gas in our consolidated statements of income.

From 31 December 2004 onward, we expect changes in the composition of our consolidated financial statements arising from, among other things, the consolidation of Tarkosaleneftegas and Khancheyneftegas, including a significant increase in operating expenses and a corresponding decrease in purchases of oil, gas condensate and natural gas. See "Pro Forma Information for the Year Ended 31 December 2004."

Divestitures

Historically, our business has included various non-core business activities, including oil and gas construction services, banking and telecommunications. In June 2004, we sold to our shareholders our oil and gas construction services business to focus on our core activities of oil and gas exploration and production. Our oil and gas construction services activities primarily consisted of drilling services and construction of oil and gas infrastructure and facilities for related and external parties within the Russian Federation.

In 2004, we sold to Gazprom a subsidiary of Purneftegasgeologiya, which held the mineral license in the West Tarkosalinskoye field, in return for an 8.34% interest in Purneftegasgeologiya. In connection with this transaction, we retained a right to 10% of the natural gas extracted from the Cenomanian horizon and 100% of the hydrocarbons extracted from the Valanginian horizon at the West Tarkosalinskoye field for the duration of the license (which expires in 2018).

In 2004, other disposals included the sale of our telecommunication business as well as other non-core businesses. In May 2005, we disposed of our equity interest in NOVA Bank to Levit. We plan to continue our efforts to divest our remaining non-core businesses as opportunities arise.

In June 2005, we disposed of our 66% participation interest in Geoilbent to LUKOIL and one of its subsidiaries for approximately RR 5.1 billion. The disposal was in line with our strategy to divest assets that do not fit our core strategy of developing our upstream natural gas and gas condensate assets. We accounted for our interest in Geoilbent under the equity method as all significant operating and financing decisions required the consent of the other shareholder, and thus we were not able to control Geoilbent.

In June 2005, we also agreed to sell our interest in our associated company Selkupneftegas and in July 2005, we disposed of our interest in our associated company Tambeyneftegas.

Growth in production and prices

Growth in production

We have significantly increased our production volumes of natural gas, gas condensate and crude oil during the three years ended 31 December 2004. Our growth in production was achieved through the efficient exploitation of our existing producing asset base, together with increases in our holdings of core assets such that we could consolidate the production from these assets rather than show it as purchases. As discussed in the section on "Acquisitions" above, in December 2004, we began consolidating the production volumes from the fields licensed to Tarkosaleneftegas and Khancheyneftegas into our results.

We expect our total production volumes to continue growing, primarily as a result of the development activities at our existing producing fields and by exploring and developing other oil and gas fields in our asset portfolio.

Natural gas prices

As an independent natural gas producer, we are not subject to the government's regulation of natural gas prices. Historically, we have sold most of our natural gas at prices higher than the regulated prices set by the government for Gazprom's domestic gas sales, although the prices we can achieve are strongly influenced by the regulated prices. The terms for delivery of natural gas affect our average realized prices. Natural gas sold "ex-field" is sold primarily to wholesale gas traders, in which case the buyer is responsible for the payment of gas transportation tariffs. We generally realize higher prices and net margins for natural gas volumes sold directly to the end-customer, as the gas transportation tariff is included in the contract price and no retail margin is lost to wholesale gas traders.

The following table shows our average natural gas sales prices for the three months ended 31 March 2005 and 2004 and for the years ended 31 December 2004, 2003 and 2002:

Natural Gas Prices(1)	Three months ended 31 March		Year ended 31 December		
	2005	2004	2004	2003	2002
Average natural gas price to end-customers(2)	1,055	931	958	869	636
Gas transportation expense for sales to end-customers	379	296	331	337	391
Average natural gas netback on end-customer sales	676	635	627	532	245
Average natural gas price ex-field	654	469	528	453	290

(1) Net of VAT, excise tax and export duties. Average RR realized per mcm.

(2) Includes cost of transportation.

See additional detail on regulated prices in "Russian Gas Industry."

Crude oil and gas condensate and oil products prices

Crude oil and gas condensate and oil products prices on international markets have historically been volatile depending on, among other things, the balance between supply and demand fundamentals, the ability of the OPEC countries to sustain production levels to meet increasing global demand and potential disruptions in global oil supplies due to war or terrorist activities. Crude oil and gas condensate prices in Russia have remained below prices in the international market primarily due to constraints on the ability of Russian oil companies to transport their crude oil, whereas certain oil products prices in Russia have more closely followed prices on international markets. This has occasionally led to crude oil surpluses in key consuming regions in Russia driving down the price in the domestic market. Moreover, there is no independent or uniform benchmark price for crude oil in Russia because the majority of all crude oil destined for sale in Russia is produced and refined by the same vertically integrated Russian oil companies. Crude oil that is not exported from Russia or refined by the producer is offered for sale in the domestic market at prices determined on a transaction-by-transaction basis. Crude oil and gas condensate that we sell bound for international markets is transported through the Transneft pipeline system where it is blended with other crude oil of varying qualities to produce an export blend commonly referred to as "Urals blend," which normally trades at a discount to the international benchmark Brent crude oil.

The following table shows our average crude oil and gas condensate and oil products sales prices for the periods indicated:

Sales Prices(1)(2)	Three months ended 31 March		Year ended 31 December		
	2005	2004	2004	2003	2002
Average oil and gas condensate export price	5,579	4,750	4,743	4,474	5,111
Average oil and gas condensate domestic price	3,930	3,566	3,685	2,362	2,426
Average oil products export price	—	4,900	4,900	3,472	—
Average oil products domestic price	4,918	2,319	4,097	5,186	5,167

(1) Net of VAT, excise tax and export duties. Average RR realized price per tonne.

(2) Includes cost of transportation.

Prior to the commissioning of our Purovsky processing plant in June 2005, all of our gas condensate volumes were sent to a Gazprom controlled gas condensate processing facility in Surgut (Surgutsky refinery) via Gazprom controlled gas condensate trunk pipelines. The stabilized gas condensate we received from the Surgutsky refinery was sold as Urals blend crude oil transported through the Transneft pipeline network and subject to the applicable quotas on export. In addition, our oil products (including diesel fuel, light distillate and naptha) were transported by rail for sale either domestically or on the export market. With the commissioning of our Purovsky processing plant in June 2005, we are migrating the processing of substantially all of our unstable gas condensate to that plant. We expect this migration to be complete at the end of the third quarter of 2005, by which time we expect to be able to export the majority of our stabilized gas condensate to international markets. We expect our gas condensate revenues and margins to increase since prices for stabilized gas condensate in international markets have historically exceeded prices for Urals blend crude oil.

Transportation tariffs

Transportation tariffs established by the FTS from 1 October 2004 for the transport of natural gas produced in Russia are set at RR 19.37 (excluding VAT) per mcm per 100 km for shipments to consumers located within the customs territory of the Russian Federation and the member states of the Customs Union Agreement (Belarus, Kazakhstan, Kyrgyzstan, Russia and Tajikistan). This represents an increase from the tariffs of RR 16.56 (excluding VAT) per mcm per 100 km from 1 August 2003 to 30 September 2004 and RR 13.80 (excluding VAT) per mcm per 100 km prior to 1 August 2003. The increases in regulated transportation tariffs are passed on to end-customers pursuant to our contracts with them. There is no set timetable for reviews or changes in transportation tariffs set by the FTS, and thus changes in transportation tariffs occur on an irregular basis. For a further discussion of transportation tariffs, see "Business—Transportation—Access to the UGSS."

The following table shows our average gas transportation expense per mcm for the three months ended 31 March 2005 and 2004 and for the years ended 31 December 2004, 2003 and 2002:

	Three months ended 31 March		Year ended 31 December		
	2005	**2004**	**2004**	**2003**	**2002**
Gas transportation expense (average realized RR per mcm sold to end-customers)	379	296	331	337	391(1)
Gas transportation expense as a % of end-customer sales	35.9%	31.8%	34.6%	38.8%	61.5%

(1) Prior to 1 January 2003, our financial statements included restatement of balances and transactions for the changes in the general purchasing power of the Russian rouble in accordance with IAS No. 29, *Financial Reporting in Hyperinflationary Economies* (IAS 29).

Our gas transportation expense is a function of the volume of natural gas transported to end-customers, the average distance to end-customers and the transportation tariff per mcm per 100 km. As a percentage of end-customer sales, our gas transportation expense has decreased from 2002 to 2004 due to the price of natural gas increasing at a rate faster than the average transportation tariff and a decrease in the average delivery distance to our end-customers. For the three months ended 31 March 2005, our gas transportation expense increased by 2.8% compared to the corresponding period in 2004 as a result of the tariff increase effective from 1 October 2004.

Our unstable gas condensate has historically been transported through our own pipeline network and pipelines owned by Gazprom to the Surgutsky refinery, where it is processed into stabilized gas condensate and oil products (including diesel fuel, light distillate and naptha). With the commissioning of our Purovsky processing plant in June 2005, we plan to begin transporting substantially all of our unstable gas condensate production volumes from our East Tarkosalinskoye and Khancheyskoye fields through our own pipeline network directly to the Purovsky processing plant. We have an agreement with Gazprom to access its gas condensate pipeline network to deliver the unstable gas condensate produced at our Yurkharovskoye field to the Purovsky processing plant through 2006, after which we will consider constructing our own pipeline if needed. See "Risk Factors—Risks Relating to Our Business—We are dependent on Gazprom, our largest competitor, for the transportation of our natural gas and a part of our unstable condensate." The stabilized gas condensate and oil products mix that we receive from the Surgutsky refinery has historically been transported to market using a combination of the Transneft crude oil pipeline network and the Russian Railways system. With the commissioning of our Purovsky processing plant in June 2005, we plan to change our distribution channel for delivery of stabilized gas condensate to the market and export the majority of our stabilized gas condensate to international markets using our recently commissioned storage and loading facilities at the Port of Vitino.

We transport most of our crude oil through the pipeline network owned and operated by Transneft, Russia's monopoly crude oil pipeline operator. Our transportation tariffs for transportation of crude oil through Transneft's pipeline network are also set by the FTS. The overall expense per tonne for the transport of crude oil depends on the length of the transport route from the producing field to the ultimate destination.

Oil and gas production costs

Our oil and gas production costs are derived from our results of operations for oil and gas producing activities as reported in the unaudited supplemental oil and gas disclosures for the periods ended 31 December 2004 and 2003. Oil and gas production costs do not include general corporate overheads or its associated tax effects. The following tables set forth certain operating information with respect to our oil and gas production costs during the periods presented in roubles and in US dollars per boe:

	Year ended 31 December	
	2004	2003
	(RR million)	
Production costs:		
Operating expenses	711	436
Purchases	5,708	3,310
Taxes other than on income	1,393	641
Transportation costs	3,833	1,829
Total production costs before DD&A	**11,645**	**6,216**
Depreciation, depletion and amortization (DD&A)	584	287
Total production costs	**12,229**	**6,503**

	Year ended 31 December	
	2004	2003
	($/boe)	
Production costs:		
Operating expenses	0.38	0.43
Purchases	3.07	1.72
Taxes other than on income	0.74	0.63
Transportation costs	1.03	0.62
Total production costs before DD&A	**3.12**	**2.11**
Depreciation, depletion and amortization (DD&A)	0.31	0.28
Total production costs	**3.43**	**2.39**

Production costs consist of amounts directly related to the operation and maintenance of our producing oil and gas wells, related equipment and facilities, purchases of natural gas and crude oil and gas condensate from our affiliates and other third parties, and transportation cost to end-customers. The average production costs per boe reflect the crude oil equivalent of natural gas and gas condensate at our respective producing fields converted based on the relative energy content of each field's hydrocarbons. For further information on our conversion factors, see "—Conversion Factors" in the introductory section of this prospectus.

Beginning December 2004, we expect our operating expenses and our operating expenses per boe to significantly increase and our purchases to significantly decrease as a result of the consolidation of Tarkosaleneftegas and Khancheyneftegas.

Transactions with related parties

Historically, we have had significant transactions with our shareholders, companies related to our shareholders, our associated companies and other related parties. Such transactions have included the purchase and sale of natural gas, gas condensate, crude oil, construction and other related services, the holding of equity securities, and the provision of and receipt of loans, guarantees and other non-cash settlements. Our reported statements of income, balance sheets and statements of cash flows would be different had such transactions been conducted amongst unrelated parties. The production volumes of natural gas, gas condensate and crude oil purchased from Tarkosaleneftegas prior to December 2004 represented a combination of our direct equity interest in the field's production volumes and volumes attributable to the equity interest held by our principal shareholders in an aggregate volume of approximately 56% of total Tarkosaleneftegas production. We have purchased 100% of the natural gas production volumes from Khancheyneftegas since it commenced commercial production in 2003. In 2004, we began purchasing volumes attributable to our equity interest in Geoilbent. Prior to that period, Geoilbent marketed its volumes independently.

With the consolidation of our key producing assets, as discussed in the "Acquisitions" section above, and the disposal of Geoilbent, as discussed in the "Divestitures" section above, we estimate that the volume of related party transactions that we will conduct in the future will be significantly reduced. For further discussion, see "Transactions with Affiliates."

Our tax burden

We are subject to a wide range of taxes imposed at the federal, regional, and local levels, many of which are based on revenue or volumetric measures. In addition to income tax, significant taxes to which we are subject include VAT, mineral extraction tax, export duties, property tax, social taxes and contributions, and prior to 1 January 2004, excise tax. See "Regulation—Taxation."

In practice the Russian tax authorities often have their own interpretation of tax laws that rarely favors taxpayers, who often have to resort to court proceedings to defend their position against the tax authorities. Differing interpretations of tax regulations exist both among and within government ministries and organizations at the federal, regional and local levels, creating uncertainties and inconsistent enforcement. Tax declarations, together with related documentation such as customs declarations, are subject to review and investigation by a number of authorities, each of which may impose fines, penalties and interest charges. Generally, taxpayers are subject to an inspection of their activities for a period of three calendar years which immediately precede the year in which the audit is conducted. Previous audits do not exclude subsequent claims relating to the audited period. In addition, in some instances, new tax regulations have been given retroactive effect. While under the Russian Federation tax code only laws benefiting the tax payers may have retroactive effect, tax risks in Russia nevertheless remain more significant than those typically found in countries with more developed tax systems.

We have not employed any tax minimization schemes using offshore or domestic tax zones in the Russian Federation as of and for the periods ended 31 March 2005 and 2004 and 31 December 2004, 2003, and 2002.

Critical accounting policies

Our financial statements reflect the selection and application of accounting policies that require management to make significant estimates and assumptions. We believe that the following are some of the most critical accounting policies that currently affect our financial position and results of operations.

Oil and gas exploration and production activities

We follow the successful efforts method of accounting for oil and gas properties which we believe is the most prudent and conservative accounting treatment for our oil and gas operations. Under the successful efforts method property acquisitions, successful exploratory wells, all development costs and support equipment and facilities are capitalized. Unsuccessful exploratory wells are charged to expense at the time the wells are determined to be non-productive. Production costs, overhead and all exploration costs other than exploratory drilling are charged to expense as incurred. Acquisition costs of unproved properties are evaluated periodically and any impairment assessed is charged to expense.

We calculate our depreciation, depletion and amortization of capitalized costs of oil and gas properties using the unit-of-production method for each field based upon proved developed reserves for exploration and development costs, and total proved reserves for acquisitions of proved properties. For this purpose, the oil and gas reserves of our fields have been determined based on estimates of mineral reserves prepared by us, and for our three core fields reserves have been determined in accordance with internationally recognized definitions and were independently appraised by internationally recognized petroleum engineers. The present value of the estimated costs of dismantling oil and gas production facilities, including abandonment and site restoration costs, are recognized when the obligation is incurred and are included within the carrying value of property, plant and equipment, and therefore are subject to amortization thereon using the unit-of-production method.

Revenue recognition

We recognize revenues from the production and sale of natural gas, crude oil and gas condensate when such products are delivered to customers and title has transferred. Our revenues are stated net of VAT, excise tax and export duties. Revenues from construction contracts are recognized in accordance with contract terms after provision of the contractual goods and services and acceptance by customers. A majority of the payments for the sale of natural gas, crude oil and gas condensate are pre-payments.

Related party transactions

The following are considered to be our related parties:

- our associates are entities we do not control but over which we exercise significant influence and therefore we account for them in accordance with IAS standard No. 28, *Investments in Associates*;
- our major shareholders and their immediate relatives;
- our directors and officers and their immediate relatives;
- enterprises in which principal shareholders, officers and directors and their immediate relatives have control or significant influence; and
- other parties with which we deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests.

In considering each possible related party relationship, attention is directed to the nature and substance of the relationship, and not merely to its legal form. Our reported statements of income, balance sheets and statements of cash flows would be different had such transactions been carried out amongst unrelated parties. Related parties may enter into transactions that unrelated parties might not, and transactions between related parties may not be executed on the same terms, conditions and amounts as transactions between unrelated parties. For more information on our related party transactions, see "Transactions with Affiliates."

Business combinations

On 31 March 2004, the International Accounting Standards Board (IASB) issued IFRS No. 3, *Business Combinations* (IFRS 3), on accounting for business combinations and revised Standard IAS No. 36, *Impairment of Assets* (IAS 36) and IAS No. 38, *Intangible Assets* (IAS 38). The main features of the new and revised standards are that all business combinations within the scope of IFRS 3 must be accounted for using the purchase method. The previously permitted pooling-of-interest method is prohibited. Identifiable assets acquired, liabilities, and contingent liabilities incurred or assumed must be initially measured at fair value. Intangible items acquired in a business combination must be recognized as assets separately from goodwill if they meet the definition of an asset, are either separable or arise from contractual or other legal rights, and their fair value can be measured reliably. Identifiable assets acquired, liabilities, and contingent liabilities incurred or assumed, must be initially measured at fair value. Amortization of goodwill and intangible assets with indefinite useful lives is prohibited. Instead, they must be tested for impairment annually or more frequently if events or changes in circumstances indicate a possible impairment. IFRS 3 allows for the use of provisional values in the initial accounting for a business combination if the fair values of assets and liabilities purchased or the cost of the combination can only be determined provisionally. Adjustments to the provisional values are expected to be finalized within 12 months of the acquisition date. These standards apply to business combinations commencing on or after 31 March 2004. We have accounted for our December 2004 acquisitions of the remaining equity interests in Tarkosaleneftegas and Khancheyneftegas that we did not previously own in accordance with provisions promulgated in IFRS 3, IAS 36 and IAS 38.

We applied the transitional rules of IFRS 3. *Business Combinations*, in respect of goodwill and negative goodwill arising from business combinations for which the agreement date was before 31 March 2004. Consequently, beginning 1 January 2005, previously recognized goodwill was no longer amortized and will be tested for impairment in accordance with IAS 36, *Impairment of Assets*, and on 1 January 2005, previously recognized negative goodwill of RR 762 million was reversed with a corresponding adjustment to the opening balance of retained earnings.

Accounting for the effects of inflation

Prior to 1 January 2003, our financial statements included restatement of balances and transactions for the changes in the general purchasing power of the Russian rouble in accordance with IAS No. 29, *Financial Reporting in Hyperinflationary Economies* (IAS 29). IAS 29 requires that the financial statements prepared in the currency of a hyperinflationary economy be stated in terms of the measuring unit current at the balance sheet date. As the characteristics of the economic environment of the Russian Federation indicate that hyperinflation has ceased, effective from 1 January 2003, we no longer apply the provisions of

IAS 29. Accordingly, no adjustments for the effects of changes in general purchasing power have been made for any periods after 31 December 2002.

New accounting developments

We prepare our financial statements in accordance with IFRS. As discussed within the Business Combinations section above, we were required to adopt the provisions of IFRS 3, *Business Combinations*, for all business combinations within the scope of IFRS 3 from 31 March 2004.

In December 2003, the International Accounting Standards Board issued amendments to 15 existing IFRS standards that became effective 1 January 2005. The application of these 15 revised IFRS standards has not had a material effect on our financial position, statements of income or cash flows.

In 2004, the IASB published five new standards, two revisions and two amendments to existing standards. In addition, the IFRIC issued six new interpretations in 2004. Significant changes relevant to us are discussed below.

The revisions to IAS 1, *Presentation of Financial Statements*, clarify certain presentation requirements. Most significantly, the revised standard requires that minority interest be presented within equity. We have retroactively reflected the revised presentation standard for equity in the consolidated interim condensed financial information.

IAS 24, *Related Party Disclosures*, as revised, requires the disclosure of compensation of key management personnel and clarifies that such personnel include non-executive directors.

Other revised and amended standards effective on 1 January 2005 are as follows: IAS 2, *Inventories*; IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*; IAS 10, *Events after the Balance Sheet Date*; IAS 16, *Property, Plant and Equipment*; IAS 17, *Leases*; IAS 19, *Employee Benefits*; IAS 21, *The Effects of Changes in Foreign Exchange Rates*; IAS 27, *Consolidated and Separate Financial Statements*; IAS 28, *Investments in Associates*; IAS 31, *Investments in Joint Ventures*; *IAS* 32, *Financial Instruments: Disclosure and Presentation*; IAS 33, *Earnings per Share*; IAS 36, *Impairment of Assets*; IAS 38, *Intangible Assets*; and IAS 39, *Financial Instruments: Recognition and Measurement*. The adoption of these revised and amended standards has not had a material effect on our financial position, statements of income or of cash flows.

Other new standards and interpretations that we early adopted on 1 January 2005 are as follows: IAS 19 (amended), *Employee Benefits,* IFRS 4, *Insurance Contracts*; IFRIC 3, *Emission Rights*; IFRIC 4, *Determining whether an Arrangement contains a Lease*; IFRIC 5, *Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds* and IFRIC Amendment to SIC-12. The adoption of these standards did not have a material impact on our financial position, statements of income or of cash flows.

Accounting policies significant to us that were adopted or modified on 1 January 2005 are discussed below.

Share based payments. We account for share-based payments in accordance with IFRS 2, *Share-based Payment* (IFRS 2). The fair value of the employee services received in exchange for the grant of the equity instruments is recognized as an expense. The total amount to be expensed over the vesting period is determined by reference to the fair value of the instruments granted. The proceeds received net of any directly attributable transaction costs are credited to share capital (nominal value) and share premium when the options are exercised. For transactions with parties other than employees, we account for the transaction based upon the fair value of goods or services provided, unless the fair values are not reliably estimable. The adoption of IFRS 2 did not have a material effect on us as we had no outstanding share-based awards at 1 January 2005.

For share-based payments made to employees by shareholders, an increase to additional paid in capital is recorded equal to the associated compensation expense each period.

Business combinations. See **"Critical accounting policies"** above. We account for business combinations in accordance with the provisions of IFRS 3, *Business Combinations* (IFRS 3).

Non-current assets held for sale and discontinued operations. We account for non-current assets held for sale and discontinued operations in accordance with IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations.* IFRS 5 replaced IAS 35, *Discontinuing Operations*. Assets or disposal groups that are classified as held for sale are presented separately on the balance sheet and are carried at the lower of the carrying amount and fair value less costs to sell. Additionally, the results of discontinued operations are shown separately on the face of the income statement. The adoption of IFRS 5 did not have a material effect on us.

On 1 January 2005, we early adopted IFRS 6, *Exploration for and Evaluation of Mineral Resources.* This standard provides guidance on accounting for costs incurred in the exploration for and evaluation of mineral resources. Adoption of the standard did not have a material effect on us and did not result in changes to our accounting policies.

Results of Operations

For the three months ended 31 March 2005 compared to the three months ended 31 March 2004

The following table and discussion is a summary of our consolidated results of operations for the three months ended 31 March 2005 and 2004. Each line item is also shown as a percentage of our total revenues.

	Three months ended 31 March			
	2005		2004	
	(RR million)	(% of total revenues)	(RR million)	(% of total revenues)
Total Revenues[(1)]	**9,004**	**100%**	**6,667**	**100%**
Other income (loss)	(4)	0%	(41)	1%
Total revenues and other income	9,000	100%	6,626	99%
Operating expenses	(5,752)	64%	(5,107)	77%
Income from operations	**3,248**	**36%**	**1,519**	**23%**
Finance income (expense)	(241)	3%	11	0%
Share of income from associates	77	1%	374	6%
Income before income tax and minority interest	3,084	34%	1,904	29%
Total income tax expense	(776)	9%	(479)	7%
Income before minority interest	2,308	26%	1,425	21%
Minority interest	7	0%	9	0%
Net income	**2,315**	**26%**	**1,434**	**22%**

(1) Net of VAT, excise tax and export duties.

Revenues

Our total revenues comprise oil and gas sales, sales from our oil and gas construction services, sales of polymer and insulation tape and other revenues. Total revenues increased by RR 2,337 million, or 35.1%, to RR 9,004 million for the three months ended 31 March 2005 compared to RR 6,667 million for the corresponding period in 2004. Total revenues attributable to our oil and gas construction services business were RR nil and RR 1,067 million for the three month periods ended 31 March 2005 and 2004, respectively. The following table sets forth our net sales, volumes and average realized prices for the three months ended 31 March 2005 and 2004:

	Three months ended 31 March	
	2005	**2004**
Sales of natural gas		
Net sales(1)	5,938	3,476
Volumes in mmcm	7,010	5,055
Average price, $ per mcm(2)	30.4	24
Average price, RR per mcm	847	688
Sales of crude oil and gas condensate		
Net sales(1)	1,560	1,497
Volumes in thousands of tonnes	360	372
Average price, $ per tonne(2)	155.6	140.5
Average price, RR per tonne	4,333	4,024
Sales of oil products		
Net sales(1)	1,195	265
Volumes in thousands of tonnes	243	92
Average price, $ per tonne(2)	176.6	100.6
Average price, RR per tonne	4,918	2,880
Total oil and gas sales	**8,693**	**5,238**
Oil and gas construction services revenues(1)	—	1,067
Sales of polymer and insulation tape(1)	212	159
Other revenues(1)	99	203
Total revenues	9,004	6,667
Net loss on disposals	—	(43)
Other income (expense)	(4)	2
Total revenues and other income	**9,000**	**6,626**

(1) Millions of RR, net of VAT, excise tax and export duties.

(2) Converted from the average realized RR price using average exchange rates for the period—see "Currencies and Exchange Rates."

Excluding revenues from our oil and gas construction services business, which we sold in June 2004, revenues from our core oil and gas business increased by RR 3,455 million, or 66%, for the three months ended 31 March 2005 compared to the corresponding period in 2004, primarily due to the increase in sales volumes of natural gas, crude oil and gas condensate and oil products and higher average realized prices for all three products during the 2005 period. Our natural gas and liquids (crude oil and gas condensate and oil products) sales volumes increased for the three months ended 31 March 2005 by 38.7% and 30%, respectively, compared to the corresponding period in 2004. These increases were the result of an increase in production attributable to our increased interest in Tarkosaleneftegas and to a lesser extent general increases in production at our three core fields (partially offset by decreases in production at our other fields).

Oil and gas sales

The following table shows the sources of our production and purchases of natural gas in the three months ended 31 March 2005 compared to the corresponding period in 2004:

	Three months ended 31 March	
	2005	**2004**
	(mmcm)	
Production from:		
Yurkharovneftegas	2,228	1,303
Tarkosaleneftegas(1)	3,672	—
Khancheyneftegas(1)	660	—
Other	15	1,158
Total natural gas production	**6,575**	**2,461**
Purchases from:		
Khancheyneftegas(1)	—	425
Tarkosaleneftegas(1)	—	1,702
Other	554	361
Total natural gas purchases	**554**	**2,488**
Changes in inventory	(119)	106
Total natural gas sales volumes	**7,010**	**5,055**

(1) These companies were not consolidated in the three months ended 31 March 2004.

In the three months ended 31 March 2005, our three core fields, East Tarkosalinskoye, Yurkharovskoye and Khancheyskoye, produced approximately 6.6 bcm of natural gas, representing over 93.8% of our total natural gas sales volumes. In the three months ended 31 March 2004, we purchased approximately 56% of Tarkosaleneftegas' production and 100% of Khancheyneftegas' production.

Our revenues from the sale of natural gas for the three months ended 31 March 2005 increased by RR 2,462 million, or 70.8%, compared to the corresponding period in 2004. Revenues from the sale of natural gas accounted for 65.9% and 52.1% of our total revenues for the three months ended 31 March 2005 and 2004, respectively. The increase in natural gas revenues was attributable to an increase in sales volumes and an increase in tariffs for the three months ended 31 March 2005 compared to the corresponding period in 2004. We sell our entire natural gas volumes in the Russian domestic market. For the three months ended 31 March 2005, our average realized price per mcm increased by RR 159 per mcm, or 23.1%, compared to the corresponding period in 2004, due to an overall increase in natural gas prices and an increase in sales to end-customers. The decrease in production from "Other" was primarily attributable to the sale of our subsidiary holding the license to the West Tarkosalinskoye field to Gazprom. After the sale, we began purchasing the production from the West Tarkosalinskoye field.

The following table shows the breakdown of natural gas sales volumes between ex-field and end-customer market segments for the three months ended 31 March 2005 and 2004:

	Three months ended 31 March	
	2005	**2004**
	(mmcm)	
Sales ex-field	3,630	2,664
End-customer sales	3,380	2,391
Total gas sales	**7,010**	**5,055**

As part of the December 2004 acquisitions of the remaining interests in Tarkosaleneftegas and Khancheyneftegas, we have committed to sell to the Itera Group ex-field 37.5 bcm of natural gas over a five year period starting in January 2005. As our largest sales contract, this contract will have an effect on the relative proportion of ex-field sales and end-customer sales for that period.

Total sales volumes of crude oil and gas condensate decreased for the three months ended 31 March 2005 by 12,000 tonnes, or 3.2%, compared to the corresponding period in 2004, whereas sales volumes of oil products (diesel fuel, light distillate, naptha and others) increased for the 2005 period by 151,000 tonnes, or 164.1%, compared to the 2004 period, due to a significantly lower yield of stabilized gas condensate from the Surgutsky refinery in the 2005 period.

The following table shows the sources of our production and purchases of crude oil and gas condensate for the three months ended 31 March 2005 and 2004:

	Three months ended 31 March	
	2005	2004
	(mt)	
Production from:		
Yurkharovneftegas	154	122
Tarkosaleneftegas	173	—
Khancheyneftegas	129	—
Other	33	50
Total production	**489**	**172**
Purchases from:		
Tarkosaleneftegas	—	77
Khancheyneftegas	—	107
Geoilbent	109	98
From third parties	37	15
Total purchases	**146**	**297**
Total production and purchases	**635**	**469**
Changes in inventory and other losses	**(32)**	**(5)**
Total liquids sales	**603**	**464**
Oil and gas condensate sales	360	372
Oil products sales	243	92

In the three months ended 31 March 2005, our three core fields, East Tarkosalinskoye, Yurkharovskoye and Khancheyskoye, produced 456,000 tonnes of oil and gas condensate, accounting for 93.3% of our total crude oil and gas condensate production volumes. For the three months ended 31 March 2005, crude oil and gas condensate production increased by 317,000 tonnes, or 184.3%, over production for the corresponding period in 2004. The increase was largely attributable to the continued development of the Yurkharovskoye, Khancheyskoye and East Tarkosalinskoye fields (partially offset by decreases in production at our other fields), and to a lesser extent an increase in production attributable to Tarkosaleneftegas resulting from its consolidation in December 2004. Purchases for the three months ended 31 March 2005 decreased by 151,000 tonnes, or 50.8%, compared to the corresponding period in 2004, primarily due to the consolidation of Tarkosaleneftegas and Khancheyneftegas in December 2004.

The table below shows the net sales, volumes and average realized prices we received for our crude oil and gas condensate in the three months ended 31 March 2005 and 2004.

	Three months ended 31 March	
	2005	**2004**
Sales of crude oil and gas condensate—exported		
Net sales(1)	**491**	**684**
Volumes in thousands of tonnes	88	144
Average price, $ per tonne(2)	200.3	165.8
Average price, RR per tonne	5,579	4,750
Sales of crude oil and gas condensate—domestic		
Net sales(1)	**1,069**	**813**
Volumes in thousands of tonnes	272	228
Average price, $ per tonne(2)	141.1	124.5
Average price, RR per tonne	3,930	3,566

(1) Millions of RR, net of VAT, excise tax and export duties.

(2) Converted from the average realized RR price using average exchange rates for the period—see "Currencies and Exchange Rates."

Our revenues from the sales of crude oil and gas condensate increased marginally by RR 63 million, or 4.2%, for the three months ended 31 March 2005 compared to the corresponding period in 2004, primarily as a result of higher prices for both domestic and export sales volumes (partially offset by a reduction in the overall volumes of crude oil and gas condensate sold during the period.) The negative revenue impact of the reduction in export sales volumes was offset by a higher sales price realized on both the domestic and international markets and an increase in domestic sales volumes. Our revenue from the sales of oil products depends on the product mix we receive from the Surgutsky refinery over which we have limited control. The product mix is a result of the level of refining available whereby more complex refining yields higher margin products like diesel fuel and light distillate while less complex refining yields lower margin products like stabilized condensate and butane fractions. The decrease in sales volumes of crude oil and gas condensate for the three months ended 31 March 2005 compared to the corresponding period in 2004, was primarily the result of a lower yield of stabilized gas condensate from the Surgutsky refinery in the 2005 period. In the three months ended 31 March 2005 stabilized gas condensate output comprised 42.8% of the total yield from the refinery compared with 65.4% for the corresponding period in 2004.

Following our disposal of Geoilbent in June 2005, we ceased purchasing its crude oil volumes which amounted to 109,000 tonnes and 98,000 tonnes in the three months ended 31 March 2005 and 2004, respectively.

Our average realized sales price translated into US dollars for crude oil and gas condensate exported to Europe and the CIS countries increased by USD 34.5 per tonne, or 20.8%, in the three months ended 31 March 2005 compared to the corresponding period in 2004, primarily due to the higher pricing environment in the international crude oil markets during the 2005 period. Our average realized crude oil and gas condensate domestic sales price increased by RR 364 per tonne, or 10.2%, in the three months ended 31 March 2005 compared to the corresponding period in 2004, due to the strengthening of domestic crude oil prices compared to the corresponding period in 2005.

Our crude oil and gas condensate sold for export is generally sold free on board (FOB) or delivery at frontier (DAF) at the border of the Russian Federation. Historically, the majority of our sales volumes sold for export are transported by pipeline to Germany or through the shipping ports at Butinge, Lithuania and Novorossiysk, Russia. Under such agreements, the buyer takes ownership and responsibility for further transportation of the crude oil and gas condensate to its final destination. Our affiliated companies, Kerden Trading Ltd and TNG Energy, act as trading agents for a majority of our export sales of crude oil and gas condensate. See "Transactions with Affiliates."

The following table sets out the net sales, volumes and average realized prices we received for our oil products in the three months ended 31 March 2005 and 2004:

	Three months ended 31 March	
	2005	**2004**
Sales of oil products—export		
Net sales[(1)]	**—**	**98**
Volumes in thousands of tonnes	—	20
Average price, $ per tonne[(2)]	—	171.1
Average price, RR per tonne	—	4,900
Sales of oil products—domestic		
Net sales[(1)]	**1,195**	**167**
Volumes in thousands of tonnes	243	72
Average price, $ per tonne[(2)]	176.6	90.0
Average price, RR per tonne	4,918	2,319

(1) Millions of RR, net of VAT, excise tax and export duties.

(2) Converted from the average realized RR price using average exchange rates for the period—see "Currencies and Exchange Rates."

For the three months ended 31 March 2005, our revenues from the sales of oil products increased by RR 930 million, or 350.9%, compared to the corresponding period in 2004. The increase was attributable roughly equally to increased throughput at the refinery and an increase in the average oil products price in the 2005 period compared to the 2004 period. The main oil products sold were diesel fuel, light distillate and naptha. We did not supply oil products to the export market in the three months ended 31 March 2005, because we were able to realize better margins for light distillate and diesel fuel, the main products sold for export, on the domestic market. For the three months ended 31 March 2005, domestic sales of oil products increased by RR 1,028 million, or 615.6%, compared to the corresponding period in 2004, due to a generally stronger domestic pricing environment and increased volumes in the 2005 period. The domestic market for oil products in the three months ended 31 March 2004 was characterized by generally lower prices across all oil products categories and we received a lower proportion of higher margin processed volumes from the Surgutsky refinery compared to the 2005 period.

Oil and gas construction services

We had no revenues from our oil and gas construction services in the three months ended 31 March 2005 compared to RR 1,067 million for the corresponding period in 2004 due to the divestiture of this business in June 2004. For more information on this divestiture, see "Restructuring activities and discontinued operations" below.

Sales of polymer and insulation tape and other income

Our sales of polymer and insulation tape increased to RR 212 million in the three months ended 31 March 2005 compared to RR 159 million in the corresponding period in 2004 due to higher volumes and prices for the sale of film wrap for the 2005 period.

Other income

Other income includes gains and losses recognized on the disposals of our investments in oil and gas producing subsidiaries and associates.

Operating expenses

Operating expenses for the three months ended 31 March 2005 increased by RR 645 million, or 12.6%, to RR 5,752 million compared to RR 5,107 million for the corresponding period in 2004. Operating expenses decreased as a percentage of revenues from 76.6% for the three months ended 31 March 2004 to 63.9% for the corresponding period in 2005. The decrease was largely attributable to lower materials, services and other expenses due to the divestiture of the oil and gas construction services business in June 2004. Total operating expenses attributable to our oil and gas construction services business were

RR nil and RR 1,153 million for the three month periods ended 31 March 2005 and 2004, respectively. The table below presents a breakdown of operating expenses in each period:

	Three months ended 31 March			
	2005		2004	
	(RR million)	(% of total revenues)	(RR million)	(% of total revenues)
Materials, services and other expense	867	10%	1,710	26%
Purchases of oil, gas condensate and natural gas	611	7%	1,485	22%
Transportation expenses	1,740	19%	1,040	16%
Taxes other than income tax	1,301	14%	392	6%
General and administrative expenses	228	3%	235	4%
Depreciation, depletion and amortization	814	9%	149	2%
Net impairment expense	42	0%	33	0%
Exploration expenses	149	2%	63	1%
Total operating expenses	**5,752**	**64%**	**5,107**	**77%**

Materials, services and other expense

Our materials, services and other expense in the three months ended 31 March 2005 decreased by RR 843 million, or 49.3%, compared to the corresponding period in 2004. The decrease related to the sale of our oil and gas construction services business in June 2004 and was partially offset by increases due to the consolidation of Tarkosaleneftegas and Khancheyneftegas at 31 December 2004. See note on the "Restructuring activities and discontinued operations" below.

Purchases of natural gas, gas condensate and crude oil

For the three months ended 31 March 2005 and 2004, we purchased natural gas, gas condensate and crude oil as shown in the following table:

	Three months ended 31 March			
	2005		2004	
	(Quantity)	(RR million)	(Quantity)	(RR million)
Purchases from related parties				
Purchases of natural gas from (mmcm):				
Tarkosaleneftegas[(1)]	—	—	1,702	509
Khancheyneftegas[(1)]	—	—	425	177
Total purchases of natural gas from related parties	—	—	2,127	686
Purchases of natural gas from third parties	554	231	361	203
Purchases of crude oil and gas condensate from (mt):				
Tarkosaleneftegas	—	—	77	124
Khancheyneftegas	—	—	107	171
Geoilbent	109	288	98	266
Purchases of crude oil and gas condensate from related parties	109	288	282	561
Purchases of crude oil and gas condensate from third parties	37	92	15	35
Total purchases of natural gas and crude oil and gas condensate		**611**		**1,485**
Total purchases from related parties		288		1,247
Total purchases from third parties		323		238

(1) These companies were not consolidated in the three months ended 31 March 2004.

In the three months ended 31 March 2005, our purchases of hydrocarbons decreased significantly due to the consolidation of hydrocarbon production from Tarkosaleneftegas and Khancheyneftegas. In the three months ended 31 March 2005, our purchases of natural gas included production from the West Tarkosalinskoye field in the amount of 219 mmcm of natural gas. This field was previously owned by us (See "Divestures" above) and our net production of natural gas from this field in the three months ended 31 March 2004 was 232 mmcm.

Transportation expense

Our transportation expense for the three months ended 31 March 2005 increased by RR 700 million, or 67.3%, compared to the corresponding period in 2004. Transportation expense for natural gas for the three months ended 31 March 2005, increased by RR 572 million, or 80.7%, to RR 1,281 million compared to the corresponding period in 2004 due to a 41.4% increase in our sales volumes of natural gas sold to end-customers, for whom the cost of transportation is included in the sales prices, and a 16.9% increase in our average natural gas transportation tariff. These two factors contributed roughly equally to the increase in natural gas transportation expense.

Our expenses for transportation of crude oil and gas condensate shipped via the Transneft pipeline network increased by RR 14 million, or 9.4%, for the three months ended 31 March 2005 compared to the corresponding period in 2004, primarily due to an increase in transportation tariffs partially offset by a decrease in volumes shipped.

Our expenses for oil products transported by railroad increased for the three months ended 31 March 2005 due to higher volumes, as compared to the corresponding period in 2004.

Taxes other than income tax

Taxes other than income tax include mineral extraction tax (also referred to as the "unified natural resources production tax"), property tax, excise tax, social taxes and other taxes. For the three months ended 31 March 2005, taxes other than income taxes increased by RR 909 million, or 231.9%, compared to the corresponding period in 2004. This increase in taxes other than income tax resulted primarily from a RR 801 million, or 228.9%, increase in our mineral extraction tax due to increased volumes produced in the three months ended 31 March 2005 compared to the corresponding period in 2004, and the tax impact from the consolidation of Tarkosaleneftegas and Khancheyneftegas. Prior to the consolidation, mineral extraction tax from these companies was not included as part of our expenses due to the fact that, as associates, these companies were accounted for under the equity method.

Effective 1 January 2005, the base rate for unified natural resources production taxes relating to crude oil increased from RR 347 per metric tonne to RR 419 per metric tonne. A new rate will be applicable from 1 January 2007, after which the rate will be 16.5% of our crude oil revenues, net of VAT. Production tax for natural gas in the three months ended 31 March 2004 was RR 107 per mcm and for the corresponding period in 2005 it was increased to RR 135 per mcm.

Other operating expenses

We saw a general increase in other operating expenses for the three months ended 31 March 2005 compared to the corresponding period in 2004, due to the continued development of our oil and gas fields and a corresponding growth in sales volumes resulting from the full consolidation of Tarkosaleneftegas and Khancheyneftegas. However, certain expenses were discontinued following the sale of our oil and gas construction services business in June 2004. See note on the "Restructuring activities and discontinued operations" below.

Notwithstanding the discontinued operations:

- Depreciation, depletion and amortization expense, calculated on a units of production basis for our oil and gas properties, increased by RR 665 million for the three months ended 31 March 2005, or 446.3%, compared to the corresponding period in 2004, largely due to the growth in production volumes and additions of property, plant and equipment at the Yurkharovskoye field and from the consolidation of Tarkosaleneftegas and Khancheyneftegas in December 2004; and
- Employee compensation expense and general and administrative expenses, excluding the effects of the discontinued operations, were generally higher during the three months ended

31 March 2005 compared to the corresponding period in 2004 due to the consolidation of Tarkosaleneftegas and Khancheyneftegas which increased the average number of employees from 2,400 as at 31 March 2004 to 3,800 as at 31 March 2005.

Income from operations

As a result of the factors discussed above, our income from operations increased by RR 1,729 million to RR 3,248 million, or 113.8%, for the three months ended 31 March 2005 from RR 1,519 million for the corresponding period in 2004. Our income from operations as a percentage of our total revenues increased to 36.1% for the three months ended 31 March 2005 compared to 22.8% for the corresponding period in 2004.

Finance income and expense

Finance income and expense decreased from a net gain of RR 11 million in the three months ended 31 March 2004 to a net expense of RR 241 million in the corresponding period in 2005. The decrease was due to higher interest expense resulting from the consolidation of debt and related interest expense of Tarkosaleneftegas and Khancheyneftegas in 2005 (see note on "—Debt obligations"). In addition, the decrease resulted from foreign exchange losses of RR 127 million largely associated with debt, in the three months ended 31 March 2005 compared to a net gain of RR 44 million in the corresponding period in 2004. The increase in finance expense in the three months ended 31 March 2005 was offset by an increase in interest income of RR 134 million for the corresponding period in 2004. Interest income for the three months ended 31 March 2005 increased compared to the corresponding period in 2004 due to the provision of additional loans to our associated companies and other related parties.

Share of income of associated companies

For the three months ended 31 March 2005, our share of the net income of Tarkosaleneftegas and Khancheyneftegas was nil, compared to RR 115 million for the corresponding period in 2004, as we now consolidate these entities and no longer account for them on an equity basis due to the acquisition of the additional interests in these entities in December 2004.

Our share of the net income of other associated companies decreased by RR 297 million to RR 77 million for the three months ended 31 March 2005 compared to RR 374 million for the corresponding period in 2004. The decrease was due to lower income from operations recorded by our associated company, Geoilbent (which was sold in June 2005), and the consolidation of Tarkosaleneftegas and Khancheyneftegas. During the first quarter of 2004, Geoilbent received a beneficial tax ruling reducing its income taxes by RR 341 million, RR 225 million of which was attributable to our 66% participation interest.

Income tax expense

Our overall effective income tax rates (total tax expense calculated as a percentage of our reported IFRS income before income tax, share of net income from associates and minority interest) were 25.8% and 31.3% for the three months ended 31 March 2005 and 2004, respectively. Our share of the taxation expenses of our associated companies is included within our income tax expense.

The table below shows the income tax expense for the three months ended 31 March 2005 and 2004.

	Three months ended 31 March	
	2005	2004
	(RR million)	
Current income tax expense	(866)	(435)
Deferred income tax expense	90	(44)
Total income tax expense	**(776)**	**(479)**

Our effective income tax rate of 25.8% for the three months ended 31 March 2005 correlates closely to our statutory income tax rate of 24%. The difference was primarily due to a reduction in non-deductible expenses for statutory income tax purposes.

Net income and earnings per share

As a result of the factors discussed above, our net income increased by RR 881 million, or 61.4%, to RR 2,315 million for the three months ended 31 March 2005 from RR 1,434 million for the corresponding period in 2004. Net losses attributable to our oil and gas construction services business were RR nil and RR 94 million for the three months ended 31 March 2005 and 2004, respectively.

Our weighted average basic and diluted earnings per share increased to RR 762 per share for the three months ended 31 March 2005 from RR 638 per share for the corresponding period in 2004. The weighted average number of ordinary shares outstanding for the three months ended 31 March 2005 and 2004 were 3,036,306 and 2,247,030, respectively. The weighted average number of shares was higher in the 2005 period due to the issuance of 789,276 new ordinary shares in connection with the acquisitions in December 2004 of the remaining interests in Tarkosaleneftegas and Khancheyneftegas.

The year ended 31 December 2004 compared to the year ended 31 December 2003

The following table and discussion is a summary of our consolidated statements of income for the years ended 31 December 2004 and 2003. The following table includes the activities of our oil and gas construction services business through its sale in June 2004. Total revenues attributable to our oil and gas construction services business were RR 2,053 million and RR 3,258 million for the years ended 31 December 2004 and 2003, respectively. Total operating expenses attributable to our oil and gas construction services business were RR 2,194 million and RR 3,341 million for the years ended 31 December 2004 and 2003, respectively. Net losses, including the loss attributable to the sale of our oil and gas construction services business were RR 335 million and RR 122 million for the years ended 31 December 2004 and 2003, respectively. Each line item is also shown as a percentage of our total revenues.

	Year ended 31 December			
	2004		2003	
	(RR million)	(% of total revenues)	(RR million)	(% of total revenues)
Total revenues(1)	**24,615**	**100%**	**16,058**	**100%**
Other income	583	2%	1,198	7%
Total revenues and other income	25,198	102%	17,256	107%
Operating expenses	(17,584)	(71)%	(13,084)	(81)%
Income from operations	**7,614**	**31%**	**4,172**	**26%**
Finance income (expense)	(292)	(1)%	(156)	(1)%
Share of income from associates	721	3%	524	3%
Income before income tax and minority interest	8,043	33%	4,540	28%
Total income tax expense	(2,075)	(9)%	(1,331)	(8)%
Income before minority interest	5,968	24%	3,209	20%
Minority interest	(274)	(1)%	72	0%
Net income	**5,694**	**23%**	**3,281**	**20%**

(1) Net of VAT, excise tax and export duties.

Revenues

The following table sets forth our sales volumes and our average realized prices for the year ended 31 December 2004 and 2003:

	Year ended 31 December	
	2004	**2003**
Sales of natural gas		
Net sales(1)	12,943	7,612
Volumes in mmcm	17,277	13,161
Average price, $ per mcm(2)	26.1	18.9
Average price, RR per mcm	749	578
Sales of crude oil and gas condensate		
Net sales(1)	6,387	2,268
Volumes in thousands of tonnes	1,589	734
Average price, $ per tonne(2)	139.9	100.7
Average price, RR per tonne	4,020	3,090
Sales of oil products		
Net sales(1)	2,159	2,144
Volumes in thousands of tonnes	523	501
Average price, $ per tonne(2)	143.7	139.5
Average price, RR per tonne	4,128	4,279
Total oil and gas sales	**21,489**	**12,024**
Oil and gas construction services revenues(1)	2,053	3,258
Sales of polymer and insulation tape(1)	617	286
Other revenues(1)	456	490
Total revenues	**24,615**	**16,058**
Net gain (loss) on disposals(1)	198	1,011
Net other income (expense)(1)	385	187
Total revenues and other income	**25,198**	**17,256**

(1) Millions of RR, net of VAT, excise tax and export duties.

(2) Converted from the average realized RR price using average exchange rates for the period—see "Currencies and Exchange Rates."

The increase in total revenues and other income of RR 7,942 million, or 46%, in 2004 compared to 2003 was primarily due to increased sales volumes of natural gas, crude oil and gas condensate and oil products. The increase in sales volumes was due to higher production from our wholly owned subsidiary, Yurkharovneftegas, and an increase in purchases from Tarkosaleneftegas and Khancheyneftegas reflecting the production growth at both the East Tarkosalinskoye and Khancheyskoye fields. The increase in volumes was combined with higher average realized prices for all three products during 2004. In June 2004, we sold our interests in our oil and gas construction services business which resulted in a decrease in revenue from this business for the full year ended 31 December 2004 compared to the corresponding period in 2003 but contributed to higher overall profit margin as a percentage of revenues. Our total revenues include revenues from our oil and gas construction services business up until the point of sale.

Oil and gas sales

Total sales volumes of natural gas increased by 4,116 mmcm, or 31.3%, for 2004 compared to 2003, as shown in the following table of sources of production and purchases of natural gas for 2004 and 2003:

	Year ended 31 December	
	2004	2003
	(mmcm)	
Production from:		
Yurkharovneftegas	6,673	3,019
Other[1]	2,309	1,535
Total natural gas production	**8,982**	**4,554**
Purchases from:		
Khancheyneftegas	2,297	588
Tarkosaleneftegas	5,738	5,223
Pur-Land[2]	—	2,873
Other including third parties	523	30
Total natural gas purchases	**8,558**	**8,714**
Changes in inventory	(263)	(107)
Total natural gas sales volumes	**17,277**	**13,161**

(1) Includes post-sale purchases from Purgasdobycha in 2004—see "Divestitures" above.

(2) In 2004 purchases from Pur-Land ceased due to direct purchases from our associated companies.

For 2004, our revenues from the sale of natural gas increased by RR 5,331 million, or 70%, compared to 2003 as a result of increased production and purchases as well as an increase in prices. Revenues from the sale of natural gas accounted for 52.6% and 47.4% of our total revenues in 2004 and 2003, respectively. During 2004 and 2003, we sold our entire natural gas volumes in the Russian domestic market. For 2004, our average realized price for natural gas increased by RR 171 per mcm, or 29.6%, compared to 2003 due to a larger proportion of our natural gas sales volumes being sold directly to end-customers, mainly to customers in the electricity generation industry. For 2004, end-customer sales volumes increased by 4,916 mmcm, or 123.7%, compared to 2003, more than offsetting a decline in ex-field sales between the same periods. In addition, the regulated natural gas price for 2004, which influenced our contract prices, increased by 21% compared to the regulated natural gas price for 2003. The increase in natural gas revenues in 2004 is attributable in roughly equal amounts to an increase in volumes and natural gas prices for 2004 compared to 2003.

The following table shows the breakdown of natural gas sales volumes between ex-field and end-customer market customer segments for the years ended 31 December 2004 and 2003:

	Year ended 31 December	
	2004	2003
	(mmcm)	
Ex-field sales	8,388	9,188
End-customer sales	8,889	3,973
Total gas sales	**17,277**	**13,161**

The following table shows the sources of our production and purchases of crude oil and gas condensate for 2004 and 2003:

	Year ended 31 December	
	2004	2003
	(mt)	
Production from:		
Yurkharovneftegas	554	275
Other	239	146
Total production	**793**	**421**
Purchases from:		
Tarkosaleneftegas	348	306
Khancheyneftegas	520	336
Geoilbent	358	—
Other including third parties	99	139
Total purchases	**1,325**	**781**
Total production and purchases	**2,118**	**1,202**
Changes in inventory and other losses	(6)	33
Total liquids sales	**2,112**	**1,235**
Oil and gas condensate sales	1,589	734
Oil products sales	523	501

Our production of crude oil and gas condensate increased in 2004 by 372,000 tonnes, or 88.4%, compared to 2003 mainly due to the continued development and extraction of gas condensate at the Yurkharovskoye field. For 2004, our purchases of crude oil and gas condensate increased by 544,000 tonnes, or 69.7%, compared to 2003, due to increased production volumes of gas condensate at Tarkosaleneftegas and Khancheyneftegas and the corresponding increase in our proportion of the production.

The following table sets out the net sales, volumes and average realized prices we received for our crude oil and gas condensate in 2004 and 2003.

	Year ended 31 December	
	2004	2003
Sales of crude oil and gas condensate—exported		
Net sales(1)	**2,381**	**1,132**
Volumes in thousands of tonnes	502	253
Average price, $ per tonne(2)	165.1	145.9
Average price, RR per tonne	4,743	4,474
Sales of crude oil and gas condensate—domestic		
Net sales(1)	**4,006**	**1,136**
Volumes in thousands of tonnes	1,087	481
Average price, $ per tonne(2)	128.3	77.1
Average price, RR per tonne	3,685	2,362

(1) Millions of RR, net of VAT, excise tax and export duties.

(2) Converted from the average realized RR price using average exchange rates for the period—see "Currencies and Exchange Rates."

For 2004, total sales volumes of crude oil and gas condensate increased by 855,000 tonnes, or 116.5%, compared to 2003, while sales of oil products increased by 22,000 tonnes, or 4.4%, compared to 2003.

Our revenues from the sales of crude oil and gas condensate increased in 2004 by RR 4,119 million, or 181.6%, compared to 2003, as a result of increased sales volumes to the export and domestic markets, as well as an increase in the domestic sales price. For 2004, crude oil and gas condensate sold on the export and domestic markets increased by 249,000 tonnes and 606,000 tonnes, or 98.4% and 126%, respectively, compared to 2003. Our average realized sales price translated into US dollars for crude oil and gas condensate exported to Europe and other CIS countries increased by USD 19 per tonne in 2004 from 2003 due to higher sales volumes sold outside the CIS countries, where prices are generally higher relative to prices received from the CIS countries. This figure was also positively affected by the appreciation of the rouble relative to the US dollar. Our average realized crude oil and gas condensate domestic sales price increased by RR 1,323 per tonne, or 56%, in 2004 compared to 2003 due to the strengthening of domestic crude oil prices. The increase in revenues from crude oil and gas condensate sales of 181.6% in 2004 compared to 2003 was attributable to increases in domestic and export sales volumes and price increases, with domestic sales volumes and prices contributing more to the increase than export sales volumes and prices.

For 2004, we increased our liquid volumes processed at the Surgutsky refinery thus slightly increasing our revenues from the sales of oil products by RR 15 million, or less than one percent, compared to 2003. The main oil products sold were diesel fuel, light distillate and butane gas.

The following table sets out the net sales, volumes and average realized prices we received for our oil products in 2004 and 2003:

	Year ended 31 December	
	2004	**2003**
Sales of oil products—exported		
Net sales[1]	**98**	**1,372**
Volumes in thousands of tonnes	20	265
Average price, $ per tonne[2]	170.6	168.7
Average price, RR per tonne	4,900	5,177
Sales of oil products—domestic		
Net sales[1]	**2,061**	**772**
Volumes in thousands of tonnes	503	236
Average price, $ per tonne[2]	142.6	106.7
Average price, RR per tonne	4,097	3,273

(1) Millions of RR, net of VAT, excise tax and export duties.

(2) Converted from the average realized RR price using average exchange rates for the period—see "Currencies and Exchange Rates."

Our oil products export revenue decreased significantly in 2004 to RR 98 million from RR 1,372 in 2003 as we focused on supplying the domestic market due to better margins available domestically from strong diesel fuel prices during 2004. In 2004, domestic sales of oil products increased by RR 1,289 million, or 167%, compared to 2003 due to increased volumes of oil products sold and a generally stronger pricing environment. The increase in domestic revenues from oil products sales in 2004 compared to 2003 was largely attributable to an increase in volumes and to a lesser extent an increase in price for 2004 compared to 2003. Our revenue from the sales of oil products depends on the product mix we receive from the Surgutsky refinery and we have limited control over this product mix. The product mix is a result of the level of refining available whereby more complex refining yields higher margin products like diesel fuel and light distillate while less complex refining yields lower margin products like stable condensate and butane fractions. In 2004, our overall average price decreased by RR 151, or 3.5%, per tonne compared to 2003 because we received a higher proportion of lower margin products from the refinery during 2004.

Oil and gas construction services

For 2004, revenues from our oil and gas construction services decreased by RR 1,205 million, or 37%, compared to 2003 due to the sale of this business segment as of June 2004. For a further discussion, see "Restructuring activities and discontinued operations" below.

Sales of polymer and insulation tape

Our sales of polymer and insulation tape increased to RR 617 million in 2004 compared to RR 286 million in 2003 due to an increase in sales of film wrap for 2004.

Other income

Other income includes gains and losses recognized on the disposals of our investments in oil and gas producing subsidiaries and associates. In November 2003, we sold our 40% interests in both Nakhodkaneftegas and Yamalneftegasdobycha to a subsidiary of LUKOIL and recognized gains of RR 1,015 million. In 2004, we recognized gains on disposal of assets of RR 198 million comprising the net effect of the sale of the oil and gas construction services business and of other subsidiaries to shareholders.

Operating expenses

For 2004, our operating expenses increased by RR 4,500 million, or 34.4%, compared to 2003 due to our substantial growth in operating activities in 2004. Total operating expenses attributable to our oil and gas construction services business sold in June 2004 were RR 2,194 million and RR 3,341 million for the years ended 31 December 2004 and 2003, respectively. As a percentage of total revenues, operating expenses decreased from 81.5% in 2003 to 71.4% in 2004, as shown in the table below:

	Year ended 31 December			
	2004		2003	
	(RR million)	(% of total revenues)	(RR million)	(% of total revenues)
Materials, services and other	4,175	17%	4,982	31%
Purchases of oil, gas condensate and natural gas	5,708	23%	3,310	21%
Transportation expenses	4,234	17%	2,390	15%
Taxes other than income tax	1,569	6%	847	5%
General and administrative expenses	1,152	5%	700	4%
Depreciation, depletion and amortization	681	3%	425	3%
Net impairment expense (benefit)	(118)	0%	308	2%
Exploration expenses	183	0%	122	0%
Total operating expenses	**17,584**	**71%**	**13,084**	**81%**

Materials, services and other expense

The table below presents the main components of our materials, services and other expense.

	Year ended 31 December	
	2004	2003
	(RR million)	
Materials and supplies	1,606	1,932
Employee compensation	756	946
Construction services	415	679
Tolling fees	365	457
Other	1,033	968
Total materials, services and other expenses	**4,175**	**4,982**

For 2004, our materials and supplies, employee compensation and construction services expenses decreased by RR 326 million, or 16.9%, RR 190 million, or 20.1%, and RR 264 million, or 38.9%, respectively, compared to 2003. These decreases were primarily related to the sale of our oil and gas construction services business in June 2004. See note on the "Restructuring activities and discontinued operations" below.

Tolling fees include the fees we pay to the Surgutsky refinery for refining our unstable gas condensate. This expense decreased in 2004 by RR 92 million, or 20.1%, compared to 2003 due to the less complex refining of our unstable gas condensate in 2004 compared to 2003.

Other expenses comprise electricity and fuel, extraction services, rent expense and repair and maintenance services. For 2004, we saw a general increase in other expenses of RR 65 million, compared to 2003 due to increased field development and production at the Yurkharovskoye field. However, certain expenses were discontinued during the period with the disposal of the oil and gas construction services business in June 2004. See note on the "Restructuring activities and discontinued operations" below.

Purchases of natural gas, gas condensate and crude oil

In 2004 and 2003, we purchased natural gas and crude oil and gas condensate volumes as shown in the following table:

	Year ended 31 December			
	2004		2003	
	(Quantity)	(RR million)	(Quantity)	(RR million)
Purchases from related parties				
Purchases of natural gas from (mmcm):				
Tarkosaleneftegas	5,738	1,727	5,223	1,050
Khancheyneftegas	2,297	958	588	245
Pur-Land(1)	—	—	2,873	467
Total purchases of natural gas from related parties	8,035	2,685	8,684	1,762
Purchases of natural gas from third parties	523	288	30	15
Purchases of crude oil and gas condensate from (mt):				
Tarkosaleneftegas	348	557	306	597
Khancheyneftegas	520	832	336	674
Geoilbent	358	920	—	—
Purchases of crude oil and gas condensate from related parties	1,226	2,309	642	1,271
Purchases of crude oil and gas condensate from third parties	99	426	139	262
Total purchases of natural gas and crude oil and gas condensate		**5,708**		**3,310**
Total purchases from related parties		4,994		3,033
Total purchases from third parties		714		277

(1) After 2003 Pur-Land ceased to act as an agent for the sales of natural gas from our associates.

For 2004, our total purchases of natural gas and crude oil and gas condensate increased by RR 2,398, or 72.4%, compared to volumes purchased in 2003.

The growth in volumes purchased from Tarkosaleneftegas and Khancheyneftegas reflect production growth at both the East Tarkosalinskoye and Khancheyskoye fields. Our volumes purchased from Tarkosaleneftegas represented the combined equity interest held directly by us and our principal shareholders in the field. The proportion of production purchased by us from Khancheyneftegas in 2004 and 2003 represented 100% of the production volumes from the commencement of commercial production of natural gas in October 2003, as agreed by the other shareholder in the company. In December 2004, Tarkosaleneftegas and Khancheyneftegas became our wholly owned subsidiaries. See "—Certain Factors Affecting our results of Operations—Consolidation of our operations—Acquisitions."

Transportation expense

Our transportation expense increased by RR 1,844 million, or 77.2%, for 2004 compared to 2003. Transportation expense for natural gas sold to our end-customers increased to RR 2,938 million in 2004 from RR 1,338 million in 2003, or 119.6%, due to the significant increase in our sales volumes of natural gas sold to end-customers for 2004 compared to 2003. For 2004, our volumes sold to end-customers increased by 4,916 mmcm, or 123.7%, compared to 2003. Transportation expenses as a percentage of end-customer sales revenue was lower for 2004 than for 2003.

For 2004, our transportation expense for crude oil and gas condensate shipped via the Transneft pipeline network increased by RR 306 million, or 122.9%, compared to 2003, due to the increase in crude oil and gas condensate volumes sold and an increase in the transportation tariffs.

Our expenses for transportation of oil products by railway increased by RR 49 million for 2004, compared to 2003. The increase was largely attributable to an increase in the volumes sold in the domestic market in 2004 compared to 2003.

Taxes other than on income tax

Taxes other than on income tax include mineral extraction tax, property tax, excise tax and other taxes. For 2004, taxes other than income taxes increased by RR 722 million, or 85.2%, compared to 2003. The increase in taxes other than income tax resulted primarily from a RR 755 million, or 140.3%, increase in our mineral extraction tax due to increased volumes produced in 2004 compared to 2003, plus generally higher average rates for unified natural resources production tax.

Other operating expenses

We saw a general increase in other operating expenses for 2004 compared to 2003 due to the continued development of our oil and gas fields. However, certain expenses were discontinued following the sale of the oil and gas construction services business in June 2004. See note on the "Restructuring activities and discontinued operations" below.

Notwithstanding the discontinued operations noted above:

- Depreciation, depletion and amortization expense, calculated on a units of production basis for our oil and gas properties, increased for 2004 by RR 256 million, or 60.2%, compared to 2003 largely due to the growth in production volumes and the addition of property, plant and equipment at the Yurkharovskoye field in 2004; and
- Employee compensation expense and general and administrative expenses, ignoring the discontinued operations, were generally higher for 2004 compared to 2003 due to a rise in salary levels during 2004. The average number of employees decreased from 6,800 in 2003 to 3,600 in 2004 as a result of the sale of the oil and gas construction services business.

Income from operations

As a result of the factors discussed above, our income from operations increased by RR 3,442 million, or 82.5%, to RR 7,614 million for 2004 from RR 4,172 million for 2003. Our income from operations as a percentage of our total revenues increased from 26% in 2003 to 30.9% in 2004.

Finance income and expense

We recognized net foreign exchange gains of RR 109 million in 2004 compared to RR 192 million in 2003. The change between periods reflects the rouble's appreciation against the US dollar of 5.8% in 2004 and 7.3% in 2003 and its primary impact on foreign currency denominated borrowings during the respective periods.

For 2004, interest income increased by RR 287 million, or 164%, over 2003. The increase was due primarily to an increase in loans provided to our associates and other related parties.

For 2004, interest expense that we incurred increased by RR 340 million, or 65%, compared to 2003. The increase was due primarily to the increase in the amount of our short- and long-term indebtedness, much of which was passed on to our associates and related parties as indicated above.

Share of income of associated companies

Our share of income from associates (before income taxes) for 2004 increased by RR 197 million, or 37.6%, compared to 2003, due primarily to increased income from Geoilbent and Khancheyneftegas in 2004.

The following table provides certain financial information for our main oil and gas producing associates, Tarkosaleneftegas (audited) and Khancheyneftegas (unaudited), for the year ended 31 December 2004:

	Tarkosaleneftegas	Khancheyneftegas
	Year ended 31 December 2004 (audited)	Year ended 31 December 2004 (unaudited)
	(RR million)	
Total revenues and other income[(1)]	**4,680**	**2,664**
Operating expenses	(3,530)	(2,060)
Income from operations	**1,150**	**604**
Finance and other income/(expense)	(1,117)	(103)
Income before income tax	33	501
Total income tax expense	(137)	(80)
Net income (loss)	**(104)**	**421**
Cash and equivalents	505	38
Short-term debt, including	3,940	1,488
Short-term debt to NOVATEK	615	957
Long-term debt, including	935	1,179
Long-term debt to NOVATEK	nil	1,110

(1) Net of VAT, excise tax and customs duties.

In 2004, Tarkosaleneftegas and Khancheyneftegas produced 690,000 tonnes and 576,000 tonnes of crude oil and gas condensate, and 11,409 mmcm and 2,341 mmcm of natural gas, respectively, compared to 584,000 tonnes and 370,000 tonnes of crude oil and gas condensate, and 14,033 mmcm and 687 mmcm of natural gas, respectively, in 2003.

Operating expenses at Tarkosaleneftegas and Khancheyneftegas increased in 2004 compared to 2003 reflecting increased production activities and higher material and supplies costs due to inflation.

Our share of the tax benefits and expenses of our associates is included within our income tax expense.

Income tax expense

Our overall effective income tax rates (total tax expense calculated as a percentage of our reported IFRS income before income tax and minority interest) were 25.8% and 29.3% for the years ended 31 December 2004 and 2003, respectively.

	Year ended 31 December	
	2004	2003
	(RR million)	
Current income tax expense	(1,906)	(1,434)
Deferred income tax benefit (expense)	(212)	191
Share of income tax of associates (benefit)	43	(88)
Total income tax expense	**(2,075)**	**(1,331)**

For 2004, total income tax expense increased by RR 744 million, or 55.9%, compared to 2003. In 2004, our effective income tax rate of 25.8% correlated closely to our statutory income tax rate of 24%. The difference was primarily due to a reduction in non-deductible expenses for statutory income tax purposes.

Net income and earnings per share

As a result of the factors discussed above, our net income for 2004 increased by RR 2,413 million, or 73.5%, to RR 5,694 million compared to RR 3,281 million for 2003. Included in our net income were net losses, including the loss on disposal, attributable to our oil and gas construction services business sold in June 2004 of RR 335 million and RR 122 million for the years ended 31 December 2004 and 2003, respectively.

In 2004, our weighted average basic and diluted earnings per share increased by RR 615 per share, or 32.5%, compared to 2003. In December 2004, we issued an additional 789,276 new ordinary shares to increase our total ordinary shares issued from 2,247,030 to 3,036,306 in connection with our acquisition of the remaining interests in Tarkosaleneftegas and Khancheyneftegas. The weighted average number of ordinary shares outstanding for 2004 and 2003 were 2,268,654 and 1,731,512, respectively.

Restructuring activities and discontinued operations

In June 2004, we sold our 99% investment in the share capital of OOO Novafininvest (NFI) to certain of our principal shareholders to focus our activities in the core areas of oil and gas exploration and production.

For 2004 and 2003, NFI acted as general contractor for construction activities at the Khancheyskoye and Yurkharovskoye fields. NFI was also the holding company for OAO SNP NOVA, which was the primary provider of oil and gas construction services to us. The disposal of NFI represented the discontinuance of our oil and gas construction services operations which represented substantially all of the activities of these operations in our consolidated financial statements. For the years ended 31 December 2004 and 2003, our discontinued operations relating to our oil and gas construction services earned total revenues of RR 2,186 million and RR 3,227 million, respectively, incurred expenses of RR 2,194 million and RR 3,341 million, respectively, incurred pre-tax operating losses of RR 8 million and RR 114 million, respectively, and had related income tax expenses of RR 31 million, and RR 8 million, respectively.

The year ended 31 December 2003 compared to the year ended 31 December 2002

The following table and discussion is a summary of our consolidated statements of income for the years ended 31 December 2003 and 2002. All rouble amounts related to financial information for periods prior to 1 January 2003 are expressed in constant roubles as of 31 December 2002 purchasing power, unless otherwise noted. No adjustments for the effects of changes in general purchasing power have been made for the period commencing from 1 January 2003. The following table includes the activities of our oil and gas construction services business through its disposal in June 2004. Total revenues attributable to our oil and gas construction services business were RR 3,258 million and RR 2,212 million for the years ended 31 December 2003 and 2002, respectively. Total operating expenses attributable to our oil and gas construction services business were RR 3,341 and RR 1,032 million for the years ended 31 December 2003 and 2002, respectively. Net losses attributable to our oil and gas construction services business were RR 122 million and RR 23 million for the years ended 31 December 2003 and 2002, respectively. Each line item is also shown as a percentage of our revenues.

	Year ended 31 December			
	2003		2002	
	(RR million)	(% of total revenues)	(RR million)	(% of total revenues)
Total revenues[1]	**16,058**	**100%**	**5,285**	**100%**
Other income	1,198	7%	394	7%
Total revenues and other income	17,256	107%	5,679	107%
Operating expenses	(13,084)	82%	(5,142)	97%
Income from operations	**4,172**	**26%**	**537**	**10%**
Finance income (expense)	(156)	1%	67	1%
Share of income from associates	524	3%	737	14%
Income before income tax and minority interest	4,540	28%	1,341	25%
Total income tax expense	(1,331)	8%	(749)	14%
Income before minority interest	3,209	20%	592	11%
Minority interest	72	0%	52	1%
Net income	**3,281**	**20%**	**644**	**12%**

(1) Net of VAT, excise tax and export duties.

Revenues

The following table sets forth our volumes and average realized prices for the years ended 31 December 2003 and 2002:

	Year ended 31 December	
	2003	**2002**
Sales of natural gas		
Net sales(1)	7,612	1,094
Volumes in mmcm	13,161	3,583
Average price, $ per mcm(2)	18.9	9.7
Average price, RR per mcm	578	305
Sales of crude oil and gas condensate		
Net sales(1)	2,268	1,084
Volumes in thousands of tonnes	734	387
Average price, $ per tonne(2)	100.7	89.2
Average price, RR per tonne	3,090	2,801
Sales of oil products		—
Net sales(1)	2,144	124
Volumes in thousands of tonnes	501	24
Average price, $ per tonne(2)	139.5	164.6
Average price, RR per tonne	4,279	5,167
Total oil and gas sales	**12,024**	**2,302**
Oil and gas construction services revenues(1)	3,258	2,212
Sales of polymer and insulation tape(1)	286	—
Other revenues(1)	490	771
Total revenues	**16,058**	**5,285**
Net gain on disposals(1)	1,011	79
Net other income(1)	187	315
Total revenues and other income	**17,256**	**5,679**

(1) Millions of RR, net of VAT, excise tax and export duties.

(2) Converted from the average realized RR price using average exchange rates for the period—see "Currencies and Exchange Rates."

The increase in total revenues of RR 10,773 million, or 203.8%, for 2003 compared to 2002 is due to increased sales volumes of natural gas, crude oil and gas condensate, and related oil products, combined with higher average realized sales prices for natural gas and crude oil and gas condensate on the domestic market. Revenues were offset slightly by a decrease in average realized sales prices for crude oil and gas condensate on the export market.

Oil and gas sales

Total sales volumes of natural gas increased by 9,578 mmcm, or 267.3%, for 2003 compared to 2002, as shown in the following table of sources of production and purchases of natural gas for 2003 and 2002:

	Year ended 31 December	
	2003	2002
	(mmcm)	
Production from:		
Yurkharovneftegas	3,019	—
Other	1,535	1,735
Total natural gas production	**4,554**	**1,735**
Purchases from:		
Khancheyneftegas	588	—
Tarkosaleneftegas	5,223	1,978
Pur-Land	2,873	—
Other including third parties	30	—
Total natural gas purchases	**8,714**	**1,978**
Changes in inventory	(107)	(130)
Total natural gas sales volumes	**13,161**	**3,583**

In 2003, we commenced commercial natural gas production at both the Yurkharovskoye and Khancheyskoye fields, which significantly increased production volumes relative to 2002. In addition, we also increased our purchases of natural gas, excluding other adjustments, in 2003 by 6,736 mmcm, or 340.5%, over volumes purchased in 2002. Volumes of natural gas purchased from Tarkosaleneftegas increased by 3,245 mmcm, or 164.1%, to 5,223 mmcm in 2003 from 1,978 mmcm in 2002. We also purchased 2,873 mmcm of natural gas from Pur-Land, a related party owned by our shareholders, in 2003.

For 2003, our revenues from the sale of natural gas increased by RR 6,518 million, or 595.8%, compared to 2002 and accounted for 47.4% and 20.7% of total revenues in 2003 and 2002, respectively. For 2003, our average realized rouble price for natural gas increased by RR 273 per mcm, or 89.5%, compared to 2002 due to an increase in sales to end-customers, mainly from the electricity generation industry, and an increase in the regulated FTS gas price tariff. The average regulated FTS gas price tariff in 2003, which influenced our contract prices, increased by 20% compared to 2002.

Prior to 2003, almost all of our natural gas volumes were sold ex-field to wholesale gas traders who were responsible for securing access to the pipeline transportation network and related transportation expenses. For 2003, the proportion of natural gas sales to end-customers increased to 30.2% from 4.4% in 2002.

The following table shows the breakdown between ex-field and end-customer natural gas sales volumes for the years ended 31 December 2003 and 2002:

	Year ended 31 December	
	2003	2002
	(mmcm)	
Sales ex-field	9,188	3,424
End-customer sales	3,973	159
Total gas sales	**13,161**	**3,583**

The following table shows the sources of our production and purchases of crude oil and gas condensate for the 2003 and 2002:

	Year ended 31 December	
	2003	2002
	(mt)	
Production from:		
Yurkharovneftegas	275	—
Other	146	173
Total production	**421**	**173**
Purchases from:		
Khancheyneftegas	336	
Tarkosaleneftegas	306	117
Other including third parties	139	24
Total purchases	**781**	**141**
Total production and purchases	**1,202**	**314**
Changes in inventory and other losses	**33**	**97**
Total liquids sales	**1,235**	**411**
Oil and gas condensate sales	734	387
Oil products sales	501	24

The following table sets out the net sales, volumes and average realized prices we received for our crude oil and gas condensate in 2003 and 2002:

	Year ended 31 December	
	2003	2002
Sales of crude oil and gas condensate—exported		
Net sales(1)	**1,132**	**276**
Volumes in thousands of tonnes	253	54
Average price, $ per tonne(2)	145.9	162.8
Average price, RR per tonne	4,474	5,111
Sales of crude oil and gas condensate—domestic		
Net sales(1)	**1,136**	**808**
Volumes in thousands of tonnes	481	333
Average price, $ per tonne(2)	77.1	77.3
Average price, RR per tonne	2,362	2,426

(1) Millions of RR, net of VAT, excise tax and export duties.

(2) Converted from the average realized RR price using average exchange rates for the period. See "Currencies and Exchange Rates."

For 2003, total sales volumes of crude oil and gas condensate increased by 347,000 tonnes, or 89.7%, compared to 2002, while sales of oil products increased significantly by 477,000 tonnes, or 21 fold, compared to 2002. Our average realized sales price translated into US dollars for crude oil and gas condensate exported to Europe and the CIS countries decreased by USD 17 per tonne in 2003 from 2002 due to a greater proportion of our export volumes shipped to CIS-based customers, where prices on average are lower relative to other export markets. Our average realized sales price decreased marginally in 2003 from 2002 for crude oil and gas condensate volumes sold on the domestic market.

The following table sets out our net sales, volumes and average realized prices we received for our oil products for 2003 and 2002:

	Year ended 31 December	
	2003	2002
Sales of oil products—export		
Net sales(1)	**920**	**—**
Volumes in thousands of tonnes	265	—
Average price, $ per tonne(1))	113.2	—
Average price, RR per tonne	3,471	—
Sales of oil products—domestic		
Net sales(1)	**1,224**	**124**
Volumes in thousands of tonnes	236	24
Average price, $ per tonne(2)	169.1	164.6
Average price, RR per tonne	5,186	5,167

(1) Millions of RR, net of VAT, excise tax and export duties.

(2) Converted from the average realized RR price using average exchange rates for the period—see "Currencies and Exchange Rates."

In 2002, we did not send any of our unstable gas condensate production to the Surgutsky refinery for processing, because gas condensate produced by our associated company, Tarkosaleneftegas, was sold directly from the field as crude oil. Oil product volumes sold in 2002 were purchased from our subsidiary, Purneftegasgeologiya, which has a limited amount of processing capacity at the field. In 2003, we began transporting our unstable gas condensate volumes to the Surgutsky refinery for processing after the commencement of commercial production at the Yurkharovskoye and Khancheyskoye fields. Our revenues from sales of oil products increased in 2003 by RR 2,020 million, or 17 fold, over 2002. For 2003, the main oil products sold for export were light distillate and diesel fuel to our related party, Kerden Trading Ltd. We had no export sales of oil products in 2002. In 2003, we increased our volumes of oil products sold to the domestic market by 212,000 tonnes, or 883.3%, compared to our volumes sold in 2002.

Oil and gas construction services

Revenues from oil and gas construction services increased by RR 1,046, or 47.3%, for 2003 compared to 2002. Revenues earned from rendering construction services to associated companies increased by RR 530, or 57.8% to RR 1,447 million in 2003 from RR 917 million in 2002. Revenues from construction services rendered to third parties increased to RR 1,811 million in 2003 from RR 1,295 million in 2002. In 2003, our major projects for third parties included oil and gas construction services rendered to Artic Gas and Transneft, as well as services provided to construct the Surgut to Salekhard road.

Other revenues and other income

Other income includes gains and losses recognized on the disposals of our investments in oil and gas producing subsidiaries and associates. In November 2003, we sold our 40% interests in both Nakhodkaneftegas and Yamalneftegasdobycha to a subsidiary of LUKOIL, recognizing a total gain on the sale of RR 1,015 million in 2003.

Operating expenses

Our operating expenses increased by RR 7,942 million, or 154.5%, in 2003 compared to 2002 due to our substantial growth in operating activities, particularly with the commencement of natural gas production from Yurkharovneftegas and Khancheyneftegas. Total operating expenses attributable to our oil and gas construction services business were RR 3,341 and RR 1,032 million for the years ended

31 December 2003 and 2002, respectively. As a percentage of revenues, operating expenses decreased from 97.3% in 2002 to 81.5% in 2003, as shown in the table below:

	Year ended 31 December			
	2003		2002	
	(RR million)	(% of total revenues)	(RR million)	(% of total revenues)
Materials, services and other	4,982	31%	2,844	54%
Purchases of oil, gas condensate and natural gas	3,310	21%	607	11%
Transportation expenses	2,390	15%	321	6%
Taxes other than income tax	847	5%	296	6%
General and administrative expenses	700	4%	584	11%
Depreciation, depletion and amortization	425	3%	151	3%
Net impairment expense	308	2%	283	5%
Exploration expenses	122	0%	56	1%
Total operating expenses	**13,084**	**81%**	**5,142**	**97%**

Materials, services and other expense

The table below presents the main items of the materials, services and other expense.

	Year ended 31 December	
	2003	2002
	(RR million)	
Materials and supplies	1,932	1,040
Employee compensation	946	736
Construction services	679	462
Tolling fees	457	—
Other	968	606
Total materials, services and other expenses	**4,982**	**2,844**

Our materials and supplies, employee compensation and construction services expenses increased in 2003 by RR 892 million, or 85.8%, RR 210 million, or 28.5% and RR 217 million, or 47%, respectively, compared to 2002. These increases were primarily related to an increase in our production activities and higher prices for material purchases due to inflation. In January 2003, Yurkharovneftegas commenced production activities which are reflected in the higher materials and supplies and employee compensation expenses. While commencement of activities in Khancheyneftegas is reflected in higher purchases.

Tolling fees are the fees we pay to the Surgutsky refinery for refining our unstable gas condensate. This expense increased in 2003 by RR 457 million from RR nil in 2002. The increase in 2003 was due to the commencement of production of gas condensate at Yurkharovneftegas and Khancheyneftegas and, due to the increase in volumes, the overall usage of processing services of the Surgutsky refinery.

Other expenses comprised electricity and fuel, extraction services, rent expense and repair and maintenance services. We saw a general increase in other expenses of RR 362 million in 2003 compared to 2002 due to increased development and production at the Yurkharovskoye field.

Purchases of natural gas and crude oil and gas condensate

In 2003 and 2002, we purchased natural gas and crude oil and gas condensate as shown in the following table:

	Year ended 31 December			
	2003		2002	
	(Quantity)	(RR million)	(Quantity)	(RR million)
Purchases from related parties				
Purchases of natural gas from (mmcm):				
Tarkosaleneftegas	5,223	1,050	1,978	222
Khancheyneftegas	588	245	—	—
Pur-Land	2,873	467	—	—
Total purchases of natural gas from related parties	8,684	1,762	1,978	222
Purchases of natural gas from third parties	30	15	—	—
Purchases of crude oil and gas condensate from (mt):				
Tarkosaleneftegas	306	597	117	258
Khancheyneftegas	336	674	—	—
Purchases of crude oil and gas condensate from related parties	642	1,271	117	258
Purchases of crude oil and gas condensate from third parties	139	262	24	127
Total purchases of natural gas and crude oil and gas condensate		**3,310**		**607**
Total purchases from related parties		3,033		480
Total purchases from third parties		277		127

In 2003, our total purchases of natural gas and crude oil and gas condensate increased by RR 2,703 million, or by 445.3%, compared to 2002, due to an increase in volumes purchased in 2003 reflecting our proportion of the growth in production at our associated companies.

The growth in volumes purchased from Tarkosaleneftegas and Khancheyneftegas for 2003 reflects production growth at the East Tarkosalinskoye field and the commencement of production of natural gas at the Khancheyskoye field in October 2003. Our volumes purchased from Tarkosaleneftegas represent our combined equity interest held directly by us and our principal shareholders of approximately 56%. The proportion of production purchased from Khancheyneftegas represents 100% of the production volumes from the commencement of commercial production of natural gas in October 2003, as agreed by the other shareholder.

Transportation expense

Our transportation expense increased by RR 2,069 million, or 644.5%, in 2003 compared to 2002. Transportation expense for natural gas sold to our end-customers increased to RR 1,338 million for 2003 from RR 62 million in 2002, or 21 fold, due to the significant year-on-year increase of natural gas sold to end-customers, for whom the price includes the cost of transportation. For 2003, our volumes sold to end-customers increased by 3,814 mmcm, or approximately 25 fold, compared to volumes sold in 2002.

For 2003, our transportation expense for crude oil and gas condensate shipped via the Transneft pipeline network increased by RR 193 million, or 344.6%, compared to 2002 due to the increase in crude oil and gas condensate volumes sold. In addition, during 2003, we commenced transportation of oil products, mainly light distillate, by rail, which resulted in rail expenses of RR 82 million in 2003 compared with nil in 2002.

Taxes other than income tax

Taxes other than income tax include mineral extraction tax, property tax, excise tax, social taxes and other taxes. For 2003, taxes other than income taxes increased by RR 551 million, or 186.1%, compared to 2002. The increase in taxes other than income tax resulted primarily from a RR 384 million, or 249.4%, increase in our mineral extraction tax due to increased volumes produced in 2003 compared to 2002.

Other operating expenses

We saw a general increase in other operating expenses during the period 2002 through 2003 due to the development of our oil and gas fields, growth in sales volumes and the occupancy of a new head office in Moscow. In particular, depreciation, depletion and amortization expense, calculated on a units-of-production basis for our oil and gas properties, increased in 2003 by RR 274 million, or 181.5%, compared to 2002 due to the commencement of production at the Yurkharovskoye field in 2003.

Income from operations

As a result of the factors discussed above, our income from operations increased by RR 3,635 million, or 676.9%, to RR 4,172 million in 2003 compared to RR 537 million in 2002. Our income from operations as a percentage of our total revenues increased from 10.2% in 2002 to 26% in 2003.

Finance income and expense

We incurred a net foreign exchange gain of RR 192 million in 2003 and a net foreign exchange loss of RR 75 million in 2002. The change between the periods reflects the Russian rouble appreciation against the US dollar of 7.3% in 2003 compared to a depreciation of 5.4% in 2002, and its impact on foreign currency denominated borrowings during the respective periods.

For 2003, interest income that we received increased by RR 154 million, or 733.3%, compared to 2002. The increase was due primarily to an increase in loans provided to our associates and other related companies. during 2003.

For 2003, interest expense that we incurred increased by RR 348 million, or 198.9%, compared to 2002. The increase was due primarily to the increase in the amount of our short- and long-term indebtedness.

In 2002, we recorded a net monetary gain of RR 296 million resulting from the application of the inflationary accounting required under IAS 29.

Share of income of associated companies

Our primary associates accounted for as equity investments in 2003 and 2002 were Tarkosaleneftegas, Khancheyneftegas and Geoilbent.

Our share of income from associates (before income taxes) in 2003 decreased by RR 213 million, or 28.9%, compared to 2002. The decrease was primarily due to lower income from operations recorded by our associate, Geoilbent.

The following table provides key financial information for our main oil and gas producing associated companies, Tarkosaleneftegas (audited) and Khancheyneftegas (unaudited), for the year ended 31 December 2003, is as follows:

	Tarkosaleneftegas	Khancheyneftegas
	Year ended 31 December 2003 (audited)	Year ended 31 December 2003 (unaudited)
	(RR million)	
Total revenues and other income[(1)]	**3,669**	**881**
Operating expenses	(2,610)	(676)
Income from operations	**1,059**	**205**
Finance and other income/(expense)	(288)	17
Income before income tax	771	222
Total income tax expense	(25)	(39)
Net income	**746**	**183**
Cash and equivalents	246	62
Short-term debt, including	1,424	914
Short-term debt to NOVATEK	—	—
Long-term debt, including	2,739	2,305
Long-term debt to NOVATEK	794	1,262

(1) Net of VAT, excise tax and customs duties.

In 2003, Tarkosaleneftegas and Khancheyneftegas produced 584 thousand tonnes and 370 thousand tonnes of crude oil and gas condensate, and 14,033 mmcm and 687 mmcm of natural gas, respectively. Our associate, Khancheyneftegas, commenced commercial production in October 2003 resulting in no corresponding production information for 2002.

Income tax expense

Our overall effective income tax rates (total tax expense calculated as a percentage of our reported IFRS income before income tax and minority interest) were 29.3% and 55.9% for the years ended 31 December 2003 and 2002, respectively. The effective income tax rate of 55.9% in 2002 was primarily due to a larger proportion of non-deductible expenses as a percentage of income before taxes and minority interest and the non-recognition of deductible temporary differences due to the cessation of the application of the provisions of IAS 29 effective 1 January 2003.

The enacted statutory income tax rate in the Russian Federation was 24% for both 2003 and 2002.

Net income and earnings per share

As a result of the factors discussed above, our net income increased by RR 2,637 million, or 409.5%, to RR 3,281 million in 2003 compared to RR 644 million in 2002. Included in our net income were net losses, including losses for both years attributable to our oil and gas construction services business sold in June 2004, of RR 122 million and RR 23 million for the years ended 31 December 2003 and 2002, respectively.

In 2003, our weighted average basic and diluted earnings per share increased by RR 1,330 per share, or 235.4%, compared to 2002. In October 2002, we issued an additional one million new ordinary shares for cash to increase our total issued ordinary shares from 593,682 to 1,593,682. In October 2003, we issued an additional 653,348 new ordinary shares to increase our total issued ordinary shares from 1,593,682 to 2,247,030. The new share issuance was made in connection with an exchange for additional stakes in Tambeyneftegas, Yamalneftegasdobycha and Minlay from the Yamal Fund, and the Group's shareholders contribution of their respective stakes in Minlay.

The weighted average number of ordinary shares outstanding as at 31 December 2003 and 2002 was 1,731,512 and 1,139,636, respectively.

LIQUIDITY AND CAPITAL RESOURCES

Our primary sources of liquidity are the cash provided from operating activities, debt financing, and access to capital markets. Our plan going forward is to finance our budgeted capital expenditures, interest and dividend mainly out of operating cash flows supplemented by additional borrowings and equity. In addition, we intend to improve our debt profile by retiring a portion of our short-term rouble denominated debt and by refinancing our debt portfolio with long-term borrowings in roubles and other currencies.

Cash flows

The following table shows our net cash flows from operating, investing and financing activities for the three months ended 31 March 2005 and 2004 and for each of the years ended 31 December 2004, 2003 and 2002:

	Three months ended 31 March		Year ended 31 December		
	2005	2004	2004	2003	2002
			(RR million)		
Net cash provided by (used in) operating activities	4,681	1,215	4,799	3,812	(787)
Net cash used in investing activities	(1,342)	(1,574)	(12,874)	(5,311)	(2,796)
Net cash provided by (used in) financing activities	(4,610)	173	9,433	2,865	3,083

Net cash provided by (used in) operating activities

Net cash provided by operating activities increased by RR 3,466 million, or 285.3%, to RR 4,681 million for the three months ended 31 March 2005 compared to RR 1,215 million for the corresponding period in 2004, mainly due to the trend noted above of higher operating income from our natural gas, crude oil and gas condensate sales as a result of continued growth in our sales volumes and higher sales prices realized for the three months ended 31 March 2005 compared to the corresponding period in 2004.

Net cash provided by operating activities increased to a cash inflow of RR 4,799 million and RR 3,812 million for 2004 and 2003, respectively, from a cash outflow of RR 787 million in 2002. The cash inflow was mainly attributable to significantly higher operating income from our sales of natural gas and crude oil and gas condensate as a result of increases in our sales volumes and realized prices for 2004 and 2003. The positive impact on our cash flows due to higher sales volumes and realized prices was partially offset by increasing income tax payments in each year.

Net cash used for investing activities

Net cash used in investing activities was RR 1,342 million for the three months ended 31 March 2005 and RR 1,574 million for the corresponding period in 2004, continuing the trend noted below of maintaining capital expenditure levels for development of our key subsidiaries.

Net cash used in investing activities increased to RR 12,874 million and RR 5,311 million in 2004 and 2003, respectively, from RR 2,796 million in 2002. The increase in cash used to finance our activities for 2004 and 2003 is due to significant expenditures we made to continue our oil and gas development activities, particularly funds spent on the Purovsky processing plant and short- and long-term loans provided to our associates, Tarkosaleneftegas and Khancheyneftegas.

In December 2004, we loaned RR 8.1 billion (USD 290 million) to Levit, one of our principal shareholders, for the acquisition of shares in Tarkosaleneftegas and Khancheyneftegas. As Tarkosaleneftegas and Khancheyneftegas are consolidated subsidiaries from 31 December 2004, we expect that short- and long-term loans provided to these entities in the future will be reflected as capital expenditures in our consolidated statements of cash flows. In December 2004, USD 20 million of this loan was repaid.

Net cash provided by financing activities

Net cash used by financing activities increased to RR 4,610 million for the three months ended 31 March 2005 compared to net cash provided by financing activities of RR 173 million for the corresponding period in 2004. The increase in net cash used for financing activities was mainly attributable to the repayment of short- and long-term borrowings during the period, offset slightly by the receipt of additional long-term loans.

Net cash provided by financing activities increased to RR 9,433 million in 2004 compared to RR 2,865 million in 2003, and from RR 3,083 million in 2002. The increase was primarily due to an increase in our net borrowings of RR 8,319 million to finance our investing activities. See "Debt obligations" below. Dividends paid increased to RR 2,010 million in 2004 compared to RR 35 million in 2003.

Working capital

At 31 March 2005, our working capital deficit (current assets less current liabilities) was RR 3,541 million compared to RR 5,105 million at 31 December 2004. The deficit in working capital resulted mainly from the extension of the loan to Levit in December 2004.

Prior to extending the loan to Levit, we had a working capital surplus of RR 937 million as of 31 December 2003 and RR 599 million as of 31 December 2002.

The RR 6,042 million decrease in our net working capital position at the end of 2004 compared to 2003 is primarily due to the extension of the current portion of our long-term debt of RR 5,388 million. Additionally, we expect the loan we extended to Levit (currently classified as a long term loan receivable) to be repaid out of the proceeds of this offering.

We believe that we have sufficient working capital to meet our requirements for at least the next twelve months; however, we are dependent on the continued availability of capital and certain other factors. See "Risk Factors—Risks Relating to Our Business" and "—Risks Relating to the Russian Federation."

Capital expenditures

Total capital expenditures on property, plant and equipment (excluding the effect of the acquisitions of our associates in December 2004) by segment for each of the years ended 31 December 2004, 2003 and 2002 amounted to the following:

	Year ended 31 December					
	2004		2003		2002	
	RR million	% of total	RR million	% of total	RR million	% of total
Exploration and production (includes processing)	7,212	97%	4,376	87%	3,194	93%
Oil and gas construction services	—	—	474	10%	148	4%
Other(1)	200	3%	152	3%	109	3%
Total	**7,412**	**100%**	**5,002**	**100%**	**3,451**	**100%**

(1) Includes expenditures for other activities, including head office services, banking and telecommunications.

Exploration and production expenditures represent our investments in developing our oil and gas properties. During 2002 and 2003, capital expenditures in exploration and production were mainly attributable to the development of the Yurkharovskoye field, including the drilling of wells, the construction of pipelines, and installing gas processing and other support facilities on the property.

In 2004, our capital expenditures program relating to exploration and production activities consisted mainly of the construction of the Purovsky processing plant and the storage and loading facilities at the Port of Vitino as well as further development at our three core fields. During 2004, we spent and capitalized an aggregate of RR 7.9 billion on those activities.

Capitalized interest of RR 446 million, RR 322 million, and RR 265 million was included within capital expenditures for 2004, 2003 and 2002, respectively.

For the three months ended 31 March 2005, our capital expenditures amounted to RR 1,577 million, the majority of which was spent on our exploration and production activities, including the construction of the Purovsky processing plant (which was commissioned in June 2005).

We have budgeted total capital expenditures of approximately RR 5.0 billion for 2005, which included funds for completion of the Purovsky processing plant and the storage and loading facilities at the Port of Vitino, as well as funds targeted for further field development at our Yurkharovskoye and East Tarkosalinskoye fields and other miscellaneous capital projects.

Budgeted total capital expenditures on property, plant and equipment by segment for the year ended 31 December 2005 are as follows:

	2005	
	RR million	% of total
Exploration and production (includes processing)	4,765	97%
Other	142	3%
Total	**4,907**	**100%**

The actual amount and timing of our capital expenditures are subject to adjustment.

Debt obligations

Recent developments

In June 2005, we received a US dollar denominated loan from ZAO International Moscow Bank in the amount of USD 20 million at an interest rate of LIBOR plus 3.5% per annum. The loan is payable in 2006.

In June 2005, we received a Russian rouble denominated credit facility from Sberbank in the amount of up to RR 1,000 million at an interest rate of 8% per annum. The loan is payable in October 2005. Currently, we have borrowed RR 235 million under this loan.

In May 2005, we received a US dollar denominated loan from ZAO Standard Bank in the amount of USD 9 million at an interest rate of LIBOR plus 3.25% per annum. The loan is payable in 2006.

In April 2005, we received a five-year loan from the Yamal Fund, at the time one of our shareholders, in the amount of RR 500 million at an interest rate of 10% per annum. In June 2005, we repaid this loan.

Overview

Our total debt decreased by RR 4,150 million to RR 19,850 million at 31 March 2005 from 24,000 million at 31 December 2004. Our total debt increased by RR 16,179 million to RR 24,000 million at 31 December 2004, from RR 7,821 million at 31 December 2003. Our total debt was RR 4,996 million at 31 December 2002. Our borrowings have been used primarily for the financing of capital expenditures related to development of our three core oil and gas fields and investment in related assets such as the construction of the Purovsky processing plant.

Our debt position at 31 March 2005 and 2004 and at 31 December 2004, 2003 and 2002, was as follows:

	31 March 2005	31 December 2004	2003	2002
		(RR million)		
Short-term debt				
Russian rouble denominated loans	1,230	3,680	1,276	1,420
US dollar denominated loans	705	—	660	159
Loans from related parties(1)	—	425	—	127
Promissory notes issued	991	1,275	133	11
Current portion of long-term debt	4,026	5,388	—	—
Total short-term debt and current portion of long-term debt	**6,952**	**10,768**	**2,069**	**1,717**
Long-term debt				
Russian rouble denominated loans	3,300	4,537	1,628	4
US dollar denominated loans	11,469	11,586	2,946	2,066
Loans from related parties(1)	1,155	1,497	1,178	1,209
Rouble bonds issued	1,000	1,000	—	—
Less current portion of long-term debt	(4,026)	(5,388)	—	—
Total long-term debt	**12,898**	**13,232**	**5,752**	**3,279**
Total debt	**19,850**	**24,000**	**7,821**	**4,996**

(1) Some of the loans from related parties are denominated in US dollars.

Maturities

Scheduled maturities of long-term debt outstanding at 31 December 2004 are as follows:

Year ended 31 December:	Scheduled maturities as at 31 December 2004	2003	2002
		(RR millions)	
2004	—	—	4
2005	—	950	1,209
2006	7,920	2,160	1,271
2007	2,697	982	795
2008	2,093	1,660	—
2009	515	—	—
Thereafter	7	—	—
Total long-term debt	**13,232**	**5,752**	**3,279**

Available credit facilities

In December 2004, we obtained a USD 20 million (RR 559 million) line of credit from BNP Paribas, which was fully drawn in February 2005. The facility bears interest of LIBOR plus 3.5% per annum. In March 2005, we repaid USD 1.7 million (RR 46 million) of this loan.

Short-term debt

Russian rouble denominated loans

At 31 March 2005, our short-term Russian rouble denominated loans had a weighted average interest rate of 11.2% per annum. During the three months ended 31 March 2005, we repaid short-term loans from Sberbank in the aggregated amount of RR 2,450 million.

Our short-term Russian rouble denominated loans had a weighted average interest rate of 10.5% per annum (with interest rates ranging from 8.8% to 12.0% per annum), and 14.4% per annum (with interest rates ranging from 12% to 16% per annum) at 31 December 2004 and 2003, respectively. At 31 December

2002, our short-term Russian rouble denominated loans had a weighted average interest rate of 19% per annum (with interest rates ranging from 18% to 20% per annum).

US dollar denominated loans

At 31 March 2005, our short-term US dollar denominated loans included a loan from International Moscow Bank for USD 7 million at an interest rate of LIBOR plus 4.25% payable in 2006.

At 31 December 2004, we had no outstanding short-term indebtedness denominated in US dollars.

Loans from related parties

At 31 December 2004, our short-term loans from related parties consisted of US dollar denominated loans from the Yamal Fund, at the time one of our shareholders, in the amount of USD 15.3 million (RR 425 million). The loan was obtained by Khancheyneftegas and was consolidated with our debt after the acquisition of Khancheyneftegas in December 2004. The loan bore interest of 10% per annum and was repaid in February 2005.

In March 2003, we obtained a US dollar denominated loan from the Selling Shareholder in the amount of USD 2.2 million with an interest rate of 10% per annum, payable in six months from disbursement. We repaid this loan in 2003.

At 31 December 2002, our short-term loans from related parties consisted of US dollar denominated loans from the Selling Shareholder in the amount of RR 127 million (USD 4 million). The loans were unsecured and bore interest from nil to 10% per annum. During 2003, these loans were repaid.

Promissory notes

At 31 March 2005, short-term promissory notes of RR 991 million consisted of unsecured promissory notes issued by our subsidiary, Tarkosaleneftegas, repayable within one year of issuance. Subsequent to 31 March 2005, we have repaid these promissory notes.

Long-term debt

Russian rouble denominated loans

Sberbank

During the three months ended 31 March 2005, we repaid loans in the amount of RR 1,741 million and obtained additional loans in the amount of RR 547 million from Sberbank. The loans bear interest of 12% per annum and mature in 2009. RR 600 million of the repayments were made ahead of schedule, and as a result, we were released from a pledge of 2.5% of our participation interest in Tarkosaleneftegas.

During 2004, we received loans from Sberbank in the amounts of RR 900 million at an interest rate of 12% per annum repayable between 2008 and 2009, RR 495 million at interest rates between 12% and 13% per annum repayable in 2007, RR 499 million at an interest rate of 10.5% per annum repayable in 2005. The loans are collateralized by a pledge of part of our property, plant and equipment. The loans were obtained for the purpose of financing the construction of the Purovsky processing plant. During 2004, RR 459 million of these loans were repaid.

At 31 December 2004, Tarkosaleneftegas became a consolidated group subsidiary and its Sberbank loans were added to our debt in the amount of RR 1,460 million. The borrowings bear interest at rates ranging from 10.5% to 12% per annum and are repayable between 2005 and 2007.

Finance Department of the Yamal Administration

In August 2003, we received a loan from the Finance Department of the Yamal Administration in the amount of RR 1,130 million with an annual interest rate of 12.75% per annum (effective August 2004 the interest rate was reduced to 11.75% per annum) payable in July 2008. The borrowings were secured by a 4.7% participation interest in Tarkosaleneftegas as at 31 March 2005.

Other

At 31 December 2004, other Russian rouble denominated loans aggregating RR 424 million were free of interest and consisted mainly of a loan from Pur-Land, a related party, in the amount of RR 371 million. These loans were repaid in full during the first quarter of 2005.

US dollar denominated loans

C.R.R. B.V.

In December 2004, we received a loan in the amount of USD 200 million (RR 5,582 million) from C.R.R. B.V. backed by unsecured, 18-month credit-linked notes with an annual coupon of 7.75%, payable semi-annually. The loan is repayable in June 2006 and was guaranteed by Yurkharovneftegas for the full loan amount. Subsequent to 31 December 2004, an additional guarantee was provided by Tarkosaleneftegas. We used the proceeds of this loan to partially fund a USD 290 million loan from us to Levit which we made in December 2004 in connection with the acquisition of the remaining interests in Tarkosaleneftegas and Khancheyneftegas.

In April 2004, we received a loan in the amount of USD 100 million (RR 2,859 million) from ING Bank N.V. backed by unsecured 18-month credit-linked notes with an annual coupon rate of 9.125%, payable semi-annually. The proceeds of the loan were used for developing our oil and gas fields and the construction of the Purovsky processing plant. The loan is repayable in October 2005 and was guaranteed by Yurkharovneftegas and Tarkosaleneftegas for USD 100 million and USD 50 million, respectively. In April 2004, ING Bank N.V. transferred the loan to C.R.R. B.V.

Vneshtorgbank

In 2003, we obtained a USD 100 million (RR 3,157 million) loan from Vneshtorgbank. The loan is collateralized by 26.0% of the participation interest in Tarkosaleneftegas and is guaranteed by Yurkharovneftegas and Khancheyneftegas. Following the merger of Khancheyneftegas with and into Tarkosaleneftegas in May 2005, Tarkosaleneftegas assumed all obligations of Khancheyneftegas under these guarantees. The loan bears interest of 9.75% per annum. The loan is payable between 2005 and 2008.

Other US dollar denominated loans

At 31 March 2005 and 31 December 2004, other loans included US dollar denominated loans totaling USD 20 million (RR 552 million) and USD 17.6 million (RR 487 million), respectively. At 31 March 2005 and 31 December 2004, these US dollar denominated loans had weighted average interest rates of 8.8% and 8.3% per annum, respectively, and were payable between 2005 and 2010.

In 2003, Khancheyneftegas obtained a USD 5 million loan from Raiffeisenbank with an interest rate of 4.43% per annum and payable between 2003 and 2008. Following the merger of Khancheyneftegas into Tarkosaleneftegas in May 2005, Tarkosaleneftegas assumed the obligations of Khancheyneftegas under this loan.

At 31 December 2002, we had an outstanding US dollar denominated loan from LUKOIL Western Siberia totaling RR 795 million (USD 25 million) that was repaid in 2003.

Loans from related parties

In March 2005, we repaid the US dollar denominated loan to the Yamal Fund in the amount of USD 35 million (RR 1,053 million) with an interest rate of 10.0% per annum and obtained the release of the pledge of a 31% participation interest in Yurkharovneftegas.

In February 2005, we received an additional RR 1,000 million loan from the Yamal Fund, at the time one of our shareholders. The loan was unsecured, bore interest of 10% per annum and matured in five years. In June 2005, we repaid this loan.

In December 2001, we entered into a USD 40 million credit agreement with the Yamal Fund, at the time one of our shareholders. The borrowing was secured by a 31% participation interest in Yurkharovneftegas and bore interest of 10% per annum. The total balance repayable at 31 December 2004 was RR 1,126 million, which was repaid subsequent to 31 December 2004, securing the release of the pledge.

In 2003, we repaid in full our loans from the Selling Shareholder, in the amount of RR 1,209 million (USD 38 million). These loans were unsecured and carried interest rates of 12-15% per annum.

Rouble bonds issued

In December 2004, we issued one million non-convertible Russian rouble denominated bonds with a nominal value of RR 1,000 each, payable in 728 days with an annual coupon rate of 9.4%, payable semi-annually.

Contractual obligations and other commitments

We had guaranteed bank debt and interest obligations of related parties totaling RR 999 million and RR 682 million at 31 December 2004 and 2003, respectively.

As of 31 March 2005, we have pledged a part of our property, plant, equipment and inventory under various loan and pledge agreements. We have also pledged a total of 30.7% of our participation interest in Tarkosaleneftegas as a guarantee for long-term bank loans.

In 2003, we entered into a series of five-year lease agreements with Alfa-Leasing to finance purchases of equipment and rolling stock for hydrocarbon liquids in the total amounts of RR 1,716 million (Euros 46.6 million) and RR 627 million (USD 21.3 million). Lease payments are payable during the period beginning 2004 through 2009. As payments on these leases are denominated in US dollars and Euros, our actual expenses, as measured in Russian roubles, will be affected by the changes in the Russian rouble exchange rate against the US dollar and Euro.

As of 31 December 2004, we had entered into commitments to finance construction of the Purovsky processing plant in the amount of RR 2,682 million in 2005.

Our five-year contract with the Itera Group provides for the sale of 37.5 bcm of natural gas over the period from 2005 through 2009 at prices determined annually. The price is calculated as a percentage (which at no time during the term of the contract may be less than 95%) of the price set by the FTS for the Sverdlovsk region. The Itera Group sells this gas in the Sverdlovsk region.

Contingencies

We are subject to various lawsuits, claims and proceedings related to matters incidental to our business activities. Accruals of probable cash outflows are made based on an assessment of a combination of litigation and settlement strategies. It is possible that results of operations in any future period could be materially affected by changes in assumptions or by the effectiveness of these strategies. We record liabilities for potential tax deficiencies. These liabilities are based on management's judgment of the risk of loss. If we were to determine that tax-related items would not be considered deficiencies or that items previously not considered to be potential deficiencies could be considered as potential tax deficiencies (as a result of an audit, tax ruling or other positions or authority) an adjustment to the liability would be recorded through income in the period such determination was made. See "Business—Litigation" for a description of certain tax-related contingencies.

Our oil and gas fields are situated on land belonging to the Russian Federation, Yamal-Nenets and municipalities. We pay unified natural resources production tax to the state budget to explore and produce oil and gas from these fields. We are subject to periodic reviews of our activities by governmental authorities with respect to the requirements of our oil and gas mineral licenses. We correspond with governmental authorities to agree on remedial actions necessary to resolve any findings resulting from these reviews. Failure to comply with the terms of a license could result in fines, penalties or license limitation, suspension or revocation. We expect any issues of non-compliance will be resolved through negotiations or corrective actions without any material adverse effect on our financial position or the operating results, but there can be no assurance that our expectation will prove to be correct.

Russian tax, currency and customs legislation is subject to varying interpretations, and changes, which can occur frequently. Our interpretation of such legislation as applied to our transactions and activities may be challenged by the relevant regional and federal authorities. Recent events within the Russian Federation suggest that the tax authorities may be taking a more assertive position in their interpretation of the legislation and assessments. As a result, significant additional taxes, penalties and interest may be assessed. Fiscal periods remain open to review by the authorities in respect of taxes for three calendar years preceding the year of review. Under certain circumstances reviews may cover longer periods.

Qualitative and quantitative disclosures and market risks

We are exposed to market risk from changes in commodity prices, foreign currency exchange rates, and interest rates. We are exposed to commodity price risk as our crude oil destined for export sales are linked to oil products prices. We are exposed to foreign exchange risk to the extent that our sales revenues, costs, receivables, loans and debt are denominated in currencies other than Russian roubles. We are subject to market risk from changes in interest rates that may affect the cost of our financing.

Foreign currency risk

Our principal exchange rate risk involves changes in the value of the Russian rouble relative to the US dollar. At 31 December 2004, RR 12,547 million, or 67.4%, of our long-term debt, including the current portion of long-term debt, was denominated in US dollars (out of RR 22,725 million of our total borrowings, excluding promissory notes, at that date). Decreases in the value of the Russian rouble relative to the US dollar will increase our foreign currency denominated costs and expenses and our debt service obligations for foreign currency denominated borrowings in Russian rouble terms. A depreciation of the Russian rouble relative to the US dollar will also result in an increase in the value of our foreign currency borrowings in Russian rouble terms. Our foreign currency exposure is partially mitigated by the fact that a portion of our revenues, 13% in 2004, is denominated in US dollars. As of 31 December 2004, the Russian rouble had appreciated against the US dollar by approximately 5.8% since 1 January 2004.

A hypothetical, instantaneous and unfavorable 10% change in currency exchange rates as of 31 December 2004 and 2003 would have resulted in an estimated foreign exchange loss of approximately RR 1,160 million and RR 360 million on foreign currency denominated borrowings held as of 31 December 2004 and 2003, respectively. A hypothetical, instantaneous and unfavorable 10% change on 31 December 2004 and 2003 currency exchange rates would have resulted in additional interest expense of approximately RR 60 million and RR 40 million in 2004 and 2003, respectively, reflecting the hypothetical increased costs in rouble terms of servicing our foreign currency denominated borrowings held as of 31 December 2004 and 2003.

Commodity risk

Substantially all of our crude oil export sales to Europe are sold under spot contracts. Our export prices are linked to world crude oil prices. Worldwide political developments and the actions of the Organization of Petroleum Exporting Countries affect crude oil prices and thus our export prices.

We do not use derivative instruments to hedge our production in order to decrease our price risk exposure.

The weather is another factor affecting demand for and, therefore, the price of natural gas. Changes in weather conditions from year to year can influence demand for natural gas and to some extent gas condensate and oil products. We do not enter into any significant hedging arrangements to mitigate the price risk of our sales activities.

Ability to reinvest

Our business requires significant ongoing capital expenditures in order to maintain and grow our production. An extended period of low natural gas prices or high transportation tariffs would limit our ability to maintain an adequate level of capital expenditures, which in turn could limit our ability to maintain current levels of production and deliveries of natural gas, gas condensate and crude oil, adversely affecting our results.

Off balance sheet activities

As at 31 March 2005, and as at 31 December 2004, 2003 and 2002, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which are typically established for the purpose of facilitating off-balance sheet arrangements.