

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 for the three months ended 31 March 2006 and 2005 with our unaudited consolidated interim condensed financial information as of and for the three months ended 31 March 2006. The unaudited consolidated interim condensed financial information has been prepared in accordance with International Accounting Standard 34 “*Interim financial reporting*”. This financial information should be read together with the consolidated financial statements for the year ended 31 December 2005 prepared in accordance with International Financial Reporting Standards (“IFRS”). All Russian rouble amounts have been stated at their nominal value for all periods shown.

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 and its consolidated subsidiaries.

OVERVIEW

We are Russia’s largest independent natural 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 Gas Condensate Processing Plant (Purovsky Plant) in June 2005, we now export the majority of our stable gas condensate directly to international markets, significantly increasing the share of our revenues derived from international sales.

In November and December 2005, we established Novatek Overseas AG and Runitek GmbH, respectively, both registered in Switzerland, to manage the administration, marketing and trading of crude oil, stable gas condensate, liquefied petroleum gas, and other oil products to international markets. Effective January 2006, we commenced export sales through our newly established foreign subsidiaries.

In February 2006, we transferred the assets relating to the Purovsky Plant to our wholly-owned subsidiary Nova ZPK, which is responsible for the operations carried out at the Purovsky Plant.

SELECTED DATA

<i>millions of Russian roubles except as stated</i>	Three months ended 31 March		Change
	2006	2005	%
Financial results			
Revenues (net of VAT and export duties)	11,617	8,793	32%
Operating expenses	(6,723)	(5,541)	21%
Profit attributable to NOVATEK shareholders	3,717	2,315	61%
EBITDA ⁽¹⁾	5,820	4,153	40%
Earnings per share of common stock (in Russian roubles)	1,224	762	61%
Operating results			
Natural gas sales volumes (mmcm)	7,834	7,006	12%
Stable gas condensate sales volumes (thousand tons)	257	-	100%
Liquefied petroleum gas sales volumes (thousand tons)	129	-	100%
Crude oil sales volumes (thousand tons)	66	364	(82%)
Oil product sales (thousand tons)	23	248	(91%)
Cash Flow results			
Net cash provided by operating activities	5,375	4,688	15%
Capital expenditures ⁽²⁾	1,186	1,577	(25%)

⁽¹⁾ EBITDA represents net income before finance income (expense) and income taxes from the Statements of Income, and depreciation, depletion and amortization from the Statements of Cash Flows.

⁽²⁾ Refer to note 4 of notes to the consolidated interim condensed financial information.

CERTAIN FACTORS AFFECTING OUR RESULTS OF OPERATIONS

Transactions with related parties

During 2005, we had significant transactions with our shareholders, companies related to our shareholders and other related parties. Such transactions mainly have included sale of gas condensate and crude oil. Our reported statements of income, balance sheets and statements of cash flows would be different had such transactions been conducted amongst unrelated parties. We estimate that the volume of related party transactions that we will conduct in the future will be significantly reduced.

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 prices regulated by the Federal Tariffs Service (FTS). 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. Sales to wholesale traders allow us to diversify our gas sales without incurring additional commercial expenses. During the three months ended 31 March 2006, the average netback margin differential we received on end-customer sales compared to ex-field sales (average end-customer netback less average ex-field price) increased by RR 11 per mcm, or 23.4%, compared to the corresponding period in 2005 despite the increase in the transportation tariff per mcm in October 2005.

The following table shows our average realized natural gas sales prices (net of VAT) for the three months ended 31 March 2006 and 2005:

<i>Russian roubles per mcm</i>	Three months ended 31 March		Change %
	2006	2005	
Average natural gas price to end-customers ⁽¹⁾	1,220	1,091	12%
Gas transportation expense for sales to end-customers	483	401	20%
Average natural gas netback on end-customer sales	737	690	7%
Average natural gas price ex-field (wholesale traders)	679	643	6%
Average netback margin differential	58	47	23%

⁽¹⁾ Includes cost of transportation.

Crude oil, stable gas condensate, liquefied petroleum gas and oil products prices

Crude oil, stable gas condensate, liquefied petroleum gas (LPG) 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 crude oil supplies due to war, geopolitical developments, terrorist activities or natural disasters. Crude oil 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 and LPG 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 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.

Our crude oil, stable gas condensate, LPG and oil products export and CIS prices include transportation expenses in accordance with the terms of delivery while prices for domestic sales do not. Under these agreements, the buyer takes ownership at the named place and responsibility for further transportation of the product to its final destination. In the three months ended 31 March 2006, our crude oil export price terms were delivery at frontier (DAF) at the border of the Russian Federation, while export price terms in the corresponding period in 2005 were partly free on board (FOB) at the port of Butinge, Lithuania. In the three months ended 31 March 2006, our

average crude oil export contract price, including export duties, was approximately USD 405 per ton compared to approximately USD 291 per ton in the three months ended 31 March 2005.

In the three months ended 31 March 2006, our stable gas condensate was delivered to the port of destination ex-ship (DES) or priced at cost and freight (CFR). Our average export stable gas condensate contract price for that period, including export duties, was approximately USD 527 per ton.

The following table shows our average realized stable gas condensate and crude oil sales prices (net of VAT and export duties) for the three months ended 31 March 2006 and 2005:

<i>Russian roubles (RR) or US dollars (USD) per ton</i>	Three months ended 31 March		Change %
	2006	2005	
Stable gas condensate			
Net export price, RR per ton ⁽¹⁾	9,877	-	100%
Net export price, USD per ton	350.7	-	100%
Crude oil			
Net export price, RR per ton ⁽¹⁾	6,724	5,548	21%
Net export price, USD per ton	238.8	199.3	20%
Domestic price, RR per ton	6,075	3,463	75%

⁽¹⁾ Includes cost of transportation.

Our LPG export and CIS terms of delivery in the three months ended 31 March 2006 were delivery at frontier (DAF) at the Belarusian-Polish and Russian-Latvian borders. In the three months ended 31 March 2006, our average export LPG contract price, including export duties, was approximately USD 531 per ton. Our domestic sales of LPG are delivered free carrier (FCA) at the Purovsk railroad station. Sales of oil products from Surgutsky refinery are priced free carrier (FCA) at the Surgut railroad station.

The following table shows our average realized liquefied petroleum gas and oil products sales prices (net of VAT and export duties) for the three months ended 31 March 2006 and 2005:

<i>Russian roubles (RR) or US dollars (USD) per ton</i>	Three months ended 31 March		Change %
	2006	2005	
LPG			
Net export price, RR per ton ⁽¹⁾	10,629	-	100%
Net export price, USD per ton	377.4	-	100%
CIS price, RR per ton ⁽¹⁾	8,455	-	100%
Domestic price, RR per ton	6,457	-	100%
Oil products			
Domestic price, RR per ton	6,132	4,431	38%

⁽¹⁾ Includes cost of transportation.

Transportation tariffs

Transportation tariffs established by the FTS from 1 October 2005 for the transport of natural gas produced in Russia 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, and Tajikistan) are set at RR 23.84 (excluding VAT) per mcm per 100 km. This represents a 23.1% increase from the tariffs of RR 19.37 (excluding VAT) per mcm per 100 km set on the 1 October 2004. The increases in regulated transportation tariffs may be passed on to end-customers pursuant to contract terms. 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; however, over the past three years the increase in transportation tariff occurred once a year.

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

Our stable gas condensate, LPG and oil products are transported by rail which is owned and operated by Russian Railways (RZD), Russia's state-owned monopoly railway operator. Our transportation tariffs for transport by rail

are set by the FTS and vary depending on product and length of transport route. We deliver our stable gas condensate to international markets using the storage and loading facilities at the Port of Vitino on the White Sea and tankers for transportation to US and European markets. The costs associated with the transportation of stable gas condensate by tanker are determined by the distance to the final destination and standard shipping terms. The majority of our LPG and oil products are sold in Russia and the CIS.

Commencement of Purovsky Plant

Our unstable gas condensate has historically been transported through our own pipeline network and pipelines owned by Gazprom to the Surgutsky refinery for processing into crude oil and oil products (including diesel fuel and light distillate). The crude oil 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 Plant in June 2005, we began transporting our unstable gas condensate production volumes from our East-Tarkosalinskoye and Khancheykoye fields through our own pipeline network directly to the Purovsky 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 Plant. The commissioning of our Purovsky Plant has changed our distribution channel for delivery of stable gas condensate to the market. We now export the majority of our stable gas condensate to international markets via rail and tankers.

We expect our gas condensate revenues and margins to increase since prices for stable gas condensate in international markets have historically exceeded prices for Urals blend crude oil.

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, Unified Natural Resources Production Tax (UPT), export duties, property tax, social taxes and contributions.

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.

OPERATIONAL HIGHLIGHTS

Hydrocarbon sales volumes

In the three months ended 31 March 2006, we increased our natural gas and liquids (crude oil, stable gas condensate, LPG and oil products) sales volumes due to steady increases in our production of these hydrocarbons compared to the corresponding period in 2005. Our growth in production was achieved through the efficient exploitation of our existing producing asset base. 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 sales volumes

<i>millions of cubic meters</i>	Three months ended 31 March		Change
	2006	2005	%
Production from:			
Yurkharovskoye field	2,434	2,228	9%
East-Tarkosalinskoye field	4,046	3,672	10%
Khancheyskoye field	736	660	12%
Other fields	5	15	(67%)
Total natural gas production	7,221	6,575	10%
Purchases from:			
Gazprom	528	554	(5%)
Other	81	50	62%
Total natural gas purchases	609	604	1%
Total production and purchases	7,830	7,179	9%
Purovsky Plant and own usage	(12)	(5)	140%
Changes in pipeline and underground storage	16	(168)	(91%)
Total natural gas sales volumes	7,834	7,006	12%
<i>Sold to end-customers</i>	<i>3,718</i>	<i>3,196</i>	<i>16%</i>
<i>Sold ex-field</i>	<i>4,116</i>	<i>3,810</i>	<i>8%</i>

In the three months ended 31 March 2006, our total consolidated natural gas production increased by 646 mmcm, or 9.8%, compared to the corresponding period in 2005 and accounted for 92.2% of total natural gas sales volumes. The increase in natural gas production was primarily due to the organic growth at the Yurkharovskoye, East-Tarkosalinskoye and Khancheyskoye fields.

In the three months ended 31 March 2006, the Purovsky Plant's and our own usage of natural gas increased by 7 mmcm, or 140.0%, compared to the corresponding period in 2005. The Purovsky Plant started pilot production in April 2005; therefore, there was no usage by the plant in the corresponding 2005 period.

Liquids sales volumes

<i>thousands of tons</i>	Three months ended 31 March		Change %
	2006	2005	
Production from:			
Yurkharovskoye field	169	154	10%
East-Tarkosalinskoye field	218	173	26%
Khancheyskoye field	186	129	44%
Other fields	23	33	(30%)
Total liquids production	596	489	22%
Purchases from:			
Geoilbent	-	109	(100%)
Other	23	37	(38%)
Total liquids purchases	23	146	(84%)
Total production and purchases	619	635	(3%)
Losses and own usage	(5)	(14)	(64%)
Changes in liquids inventory balances	(139)	(9)	nm
Total liquids sales volumes	475	612	(22%)
<i>Stable gas condensate export</i>	257	-	100%
<i>LPG export</i>	13	-	100%
<i>LPG CIS</i>	11	-	100%
<i>LPG domestic</i>	105	-	100%
<i>Crude oil export</i>	6	88	(93%)
<i>Crude oil domestic</i>	60	276	(78%)
<i>Oil products domestic</i>	23	248	(91%)

In the three months ended 31 March 2006, crude oil and gas condensate production increased by 107 thousand tons, or 21.9% to 596 thousand tons, compared to 489 thousand tons in the corresponding period in 2005. The increase was largely attributable to the organic growth of gas condensate production at the Khancheyskoye, East-Tarkosalinskoye and Yurkharovskoye fields. In the 2006 period, total aggregated production from these three core fields increased by 117 thousand tons, or 25.7%.

In the three months ended 31 March 2006, purchases decreased by 123 thousand tons, or 84.2%, compared to the corresponding period in 2005, primarily due to the divestiture of Geoilbent in June 2005. In the 2006 period, other purchases consisted of purchases from Purgazdobycha which decreased by 14 thousand tons, or 37.8% compared to the corresponding period in 2005 due to increased production from our own fields.

In the three months ended 31 March 2006, we delivered 528 thousand tons and 44 thousand tons of unstable gas condensate to the Purovsky Plant and Surgutsky refinery, respectively, compared to nil and 453 thousand tons, respectively, in the corresponding period in 2005. Processed products from the Purovsky Plant are sold separately from the processed products we receive from the Surgutsky refinery. After processing gas condensate at the Surgutsky refinery we receive crude oil and a slate of oil products. The crude oil is sold as Ural's blend and delivered through the Transneft pipeline network. In the 2006 period, oil output comprised 44.4% of the total yield from the Surgutsky refinery compared to 41.8% in the corresponding period in 2005.

Total liquids sales volumes were affected by the commencement of export sales through our newly established foreign subsidiaries and the terms of delivery for these sales. In the three months ended 31 March 2006, we had 140 thousand tons of stable gas condensate in transit and recognized as inventory until such time as it is delivered to the port of destination.

RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED 31 MARCH 2006 COMPARED TO THE CORRESPONDING PERIOD IN 2005

The following table and discussion is a summary of our consolidated results of operations for the three months ended 31 March 2006 and 2005. Each line item is also shown as a percentage of our total revenues.

<i>millions of Russian roubles</i>	Three months ended 31 March			
	2006	% of total revenues	2005	% of total revenues
Total revenues (net of VAT and export duties)	11,617	100%	8,793	100%
Other income (loss)	(113)	(1%)	(4)	(0%)
Total revenues and other income	11,504	99%	8,789	100%
Operating expenses	(6,723)	(58%)	(5,541)	(63%)
Profit from operations	4,781	41%	3,248	37%
Finance income (expense)	93	1%	(241)	(3%)
Share of income from associates	-	-	77	1%
Profit before income tax and minority interest	4,874	42%	3,084	35%
Total income tax expense	(1,172)	(10%)	(776)	(9%)
Profit for the period	3,702	32%	2,308	26%
Minority interest	(15)	(0%)	(7)	(0%)
Profit attributable to NOVATEK shareholders	3,717	32%	2,315	26%

Total revenues and other income

The following table sets forth our net sales (net of VAT and export duties) and other income for the three months ended 31 March 2006 and 2005:

<i>millions of Russian roubles</i>	Three months ended 31 March		Change %
	2006	2005	
Net natural gas sales	7,331	5,938	24%
<i>Net end-customer sales</i>	4,535	3,488	30%
<i>Net ex-field sales</i>	2,796	2,450	14%
Net stable gas condensate sales	2,539	-	100%
<i>Net export sales</i>	2,539	-	100%
Net liquefied petroleum gas sales	909	-	100%
<i>Net export sales</i>	138	-	100%
<i>Net CIS sales</i>	93	-	100%
<i>Net domestic sales</i>	678	-	100%
Net oil products sales	142	1,098	(87%)
<i>Net export sales</i>	-	-	-
<i>Net domestic sales</i>	142	1,098	(87%)
Net crude oil sales	398	1,446	(73%)
<i>Net export sales</i>	40	490	(92%)
<i>Net domestic sales</i>	358	956	(63%)
Total oil and gas sales	11,319	8,482	33%
Sales of polymer and insulation tape	257	212	21%
Other revenues	41	99	(59%)
Total revenues	11,617	8,793	32%
Other income (loss)	(113)	(4)	nm
Total revenues and other income	11,504	8,789	31%

Natural gas sales

In the three months ended 31 March 2006, our revenues from the sale of natural gas increased by RR 1,393 million, or 23.5%, compared to the corresponding period in 2005. The increase in natural gas revenues was primarily attributable to an increase in prices and sales volumes. Revenues from the sale of natural gas accounted for 63.1% and 67.5% of our total revenues in the 2006 and 2005 periods, respectively. The decrease in natural gas sales as a percentage of total revenues was due to the commencement of the Purovsky Plant and corresponding sales of stable gas condensate to international markets. We sell our natural gas volumes exclusively in the Russian domestic market.

In the three months ended 31 March 2006, our average realized natural gas price per mcm increased by RR 88 per mcm, or 10.4%, compared to the corresponding period in 2005, due to an overall increase in prices and an increase in sales volumes to end-customers. The average realized prices of our natural gas sold to end-customers and natural gas sold ex-field were higher by 11.8% and by 5.6%, respectively, in the 2006 period compared to the corresponding period in 2005.

Stable gas condensate sales

In the three months ended 31 March 2006, our revenues from sales of stable gas condensate were RR 2,539 million compared to nil in the corresponding period in 2005, and are directly related to the launch of our Purovsky Plant in June 2005. The volumes of stable gas condensate received from the Purovsky Plant are sold separately from the volumes received from the Surgutsky refinery and, as such, are not included in revenues from crude oil sales.

In the three months ended 31 March 2006, we exported 100% of our stable gas condensate sales volumes, 257 thousand tons, from the Purovsky Plant to markets in the United States and Europe using the loading and storage facilities at the Port of Vitino on the White Sea and tankers. In the 2006 period, our average realized price, excluding export duties, translated into US dollars for stable gas condensate sold on the export market was USD 350.7 per ton.

Liquefied petroleum gas sales

In the three months ended 31 March 2006, our revenues from the sales of LPG were RR 909 million, compared to nil in the corresponding period in 2005, and are also directly related to the launch of our Purovsky Plant in June 2005. In the 2006 period, we sold 129 thousand tons of LPG, of which 81.4% was sold domestically for an average price of RR 6,457 per ton (excluding VAT), 8.5% was sold in CIS for an average price of RR 8,455 per ton (excluding VAT) and the remaining volumes were sold to the export market for an average price of USD 377.4 per ton, excluding export duties.

Oil products sales

In the three months ended 31 March 2006, our revenue from the sales of oil products decreased by RR 956 million, or 87.1%, compared to the corresponding period in 2005. The decrease in oil products revenues was primarily due to a decrease in the volumes of unstable gas condensate delivered to the Surgutsky refinery, which resulted in a decrease in the output of oil products available for sale. The decrease in sales volumes of 225 thousand tons, or 90.7%, was partly offset by an increase in the average domestic price of RR 1,701 per ton, or 38.4%. In the 2006 period, oil products sales volumes from the Surgutsky refinery amounted to 23 thousand tons compared to 248 thousand tons in the corresponding period in 2005. The main oil products sold in both periods were diesel fuel and light distillate. We sold 100% of our oil products' volumes to the domestic market in the 2006 period as we were able to realize better margins for light distillate and diesel fuel. The domestic market for oil products in the corresponding period in 2005 was characterized by generally lower prices across all oil products categories and we received a lower proportion of higher value oil products (diesel and distillate) from the Surgutsky refinery in 2005 compared to 2006.

Crude oil sales

In the three months ended 31 March 2006, our revenues from the sales of crude oil decreased by RR 1,048 million, or 72.5%, compared to the corresponding period in 2005, due to a reduction in the overall volumes of crude oil sold during the 2006 period. The reduction in crude oil sales volumes was offset by higher prices received from both export and domestic markets.

Total sales volumes of crude oil decreased in the three months ended 31 March 2006 by 298 thousand tons, or 81.9%, compared to the corresponding period in 2005. The decrease in sales volumes of crude oil in the 2006 period was due to the migration of processing of our unstable gas condensate from the Surgutsky refinery to the Purovsky Plant (a portion of gas condensate processed at the Surgutsky refinery is sold as crude oil) starting in June 2005, and the divestiture of our participation interest in Geoilbent also in June 2005.

Our average realized sales price, excluding export duties, translated into US dollars for crude oil exported to international markets increased by USD 39.5 per ton, or 19.8%, to USD 238.8 per ton in the three months ended 31 March 2006 compared to USD 199.3 per ton in the corresponding period in 2005, primarily due to the higher pricing environment in the international crude oil markets. Our average realized crude oil domestic sales price (excluding VAT) also increased by RR 2,612 per ton, or 75.4%, to RR 6,075 per ton in the 2006 period, compared to RR 3,463 per ton in the corresponding period in 2005, due to the strengthening of domestic crude oil prices. Due to the high export duties during the period, we sold the majority of our crude oil on the Russian domestic market where we received on average higher netback prices.

Sales of polymer and insulation tape

In the three months ended 31 March 2006, our revenues from the sales of polymer and insulation tape increased by RR 45 million, or 21.2%, to RR 257 million compared to RR 212 million in the corresponding period in 2005, due to higher sales volumes and prices. In June 2005, we commenced production of BOPP film wrap at our subsidiary NOVATEK-Polimer which generated RR 109 million in revenue in the 2006 period compared to nil in the corresponding period in 2005. Other polymers sales contributed an additional RR 148 million in revenues compared to RR 212 million in the corresponding period in 2005.

Other revenues

Other revenues include rent, polymer tolling, telecommunication and other services. In the three months ended 31 March 2006, other revenues decreased by RR 58 million, or 58.6%, to RR 41 million from RR 99 million in the corresponding period in 2005. The decrease was due to the divestiture of certain non-core businesses, including banking and telecommunication, after the period ended 31 March 2005.

Other income (loss)

The increase in other loss was primarily due to the loss on disposal of fixed assets donated to the local administration of Tarko-Sale in the amount of RR 79 million as part of our charitable contributions, and the fair values of open commodity derivative instruments that did not qualify as hedge transactions under IAS 39, *Financial Instruments: Recognition and Measurement* ("IAS 39"), in the amount of RR 37 million.

Operating expenses

In the three months ended 31 March 2006, total operating expenses increased by RR 1,182 million, or 21.3%, to RR 6,723 million compared to RR 5,541 million in the three months ended 31 March 2005. Operating expenses decreased as a percentage of total revenues to 57.9% in the 2006 period compared to 63.0% in the corresponding period in 2005, as shown in the table below.

<i>millions of Russian roubles</i>	Three months ended 31 March			
	2006	% of total revenues	2005	% of total revenues
Transportation expenses	2,594	22%	1,483	17%
Taxes other than income tax	1,553	13%	1,301	15%
Depreciation, depletion and amortization	996	9%	814	9%
Materials, services and other	964	8%	828	9%
General and administrative expenses	665	6%	351	4%
Purchases of oil, gas condensate and natural gas	409	4%	650	7%
Exploration expenses	112	1%	149	2%
Net impairment expense	76	1%	42	0%
Change in inventory	(646)	(6%)	(77)	(1%)
Total operating expenses	6,723	58%	5,541	63%

Transportation expense

Our total transportation expense in the three months ended 31 March 2006 increased by RR 1,111 million, or 74.9%, compared to the corresponding period in 2005.

<i>millions of Russian roubles</i>	Three months ended 31 March		Change %
	2006	2005	
Natural gas transportation to customers	1,796	1,281	40%
Stable gas condensate, liquefied petroleum gas and oil products transported by rail	474	-	100%
Stable gas condensate transported by tankers	294	-	100%
Transportation of unstable gas condensate from the fields to the processing facilities through third party pipelines	20	59	(66%)
Crude oil transportation to customers by pipeline	5	49	(90%)
Insurance expense	-	91	(100%)
Other transportation costs	5	3	67%
Total transportation expenses	2,594	1,483	75%

In the three months ended 31 March 2006, transportation expense for natural gas increased by RR 515 million, or 40.2%, as a result of a 16.3% increase in our sales volumes of natural gas sold to end-customers, for whom the cost of transportation is included in the sales price, and a 20.6% increase in our average natural gas transportation expense per mcm, which is comprised of the tariff per mcm per 100 km, set by the FTS, and the average distance of our gas deliveries. The average tariff for transportation of natural gas in the 2006 period was RR 23.84 per mcm per 100 km compared to RR 19.37 per mcm per 100 km in 2005. The increase in the average natural gas tariff was offset by a 43 km decrease in the average distance of our gas deliveries from 2,069 km in the 2005 period compared to 2,026 km in the corresponding period in 2006.

In the three months ended 31 March 2006, our total expense for transportation of stable gas condensate, LPG and oil products by rail and tanker to export markets increased by RR 768 million compared to nil in the corresponding period in 2005. The increase was primarily due to 281 thousand tons of combined export and CIS volumes of stable gas condensate and LPG in the 2006 period compared to nil in the corresponding period in 2005. We did not sell any oil products to the export market in the 2006 and 2005 periods.

With the commencement of export sales through our foreign subsidiaries, as of 1 January 2006, we now incur tanker expense for delivery of stable gas condensate to US and European markets. Total transportation expense for delivery of stable gas condensate by tanker amounted to RR 294 million in the three months ended 31 March 2006 and included RR 83 million for services provided by ice breakers. We do not expect to incur ice breaker expense during warmer periods.

In the three months ended 31 March 2006, our expense for stable gas condensate transported by rail amounted to RR 353 million, or approximately RR 1,374 per ton. Transportation expense for LPG amounted to RR 101 million, of which RR 73 million was related to export sales and RR 28 million to CIS sales, or approximately RR 5,615 per ton and RR 2,546 per ton, respectively. Transportation expenses for stable gas condensate and LPG were nil in the corresponding period in 2005.

The remaining RR 20 million was related to railway infrastructure maintenance and was not allocated between products.

In the three months ended 31 March 2006, our expense for transportation of crude oil to export markets decreased by RR 44 million, or 89.8%, compared to the corresponding period in 2005. The decrease in crude oil transportation expense was primarily due to a reduction in export volumes delivered which was slightly offset by an increase in the expense per ton due to increases in the transportation tariff in the 2006 period compared to the corresponding period in 2005.

In the three months ended 31 March 2006, our insurance expense relating to transportation of natural gas was nil compared to RR 91 million in the corresponding period in 2005. In the 2006 period, we stopped insuring natural gas deliveries to end-customers due to the fact that we have had no adverse incidents in past periods.

Taxes other than income tax

In the three months ended 31 March 2006, taxes other than income tax increased by RR 252 million, or 19.4%, compared to the corresponding period in 2005. The increase was mainly due to increases in UPT and property tax which were offset by decreases in excise tax and tax penalties and interest.

<i>millions of Russian roubles</i>	Three months ended 31 March		Change %
	2006	2005	
UPT	1,411	1,151	23%
Property tax	103	76	36%
Excise tax	26	51	(49%)
Other taxes	13	23	(44%)
Total tax other than income tax	1,553	1,301	19%

In the three months ended 31 March 2006, the increase in taxes other than income tax resulted primarily from a RR 260 million, or 22.6%, increase in the UPT due to increased hydrocarbon production volumes and an increase in the production tax rate for natural gas compared to the corresponding period in 2005. In the 2006 period, production increases at Tarkosaleneftegas and Yurkharovneftegas accounted for RR 181 million and RR 71 million, respectively, of the increase in this expense. In the 2006 period, the UPT rate for natural gas increased by RR 12 per mcm, or 8.9%, to RR 147 per mcm from RR 135 per mcm in the corresponding period in 2005.

In the three months ended 31 March 2006, property tax expense increased by RR 27 million, or 35.5%, to RR 103 million compared to RR 76 million in the corresponding period in 2005. The increase was due to additions of property, plant and equipment at Nova ZPK, operator of the Purovsky Plant, which accounted for RR 12 million of the increase, and additions at NOVATEK and Yurkharovneftegas, which accounted for RR 6 million and RR 5 million, respectively, of the increase.

Depreciation, depletion and amortization

In the three months ended 31 March 2006, depreciation, depletion and amortization (DDA) expense increased by RR 182 million, or 22.4%, compared to the corresponding period in 2005. The increase was primarily due to our calculation of depreciation and depletion on a unit-of-production basis for our oil and gas properties, which increased by RR 114 million, or 14.3%, due to the growth in our production volumes. In the 2006 period, DDA per barrel of oil equivalent (boe) was RR 19 compared to DDA per boe of RR 17 in the corresponding period in 2005. The remaining balance was due to an increase in straight line depreciation for other assets including RR 36 million relating to Nova ZPK and its Purovsky Plant assets.

Materials, services and other expense

In the three months ended 31 March 2006, our materials, services and other expenses increased by RR 136 million, or 16.4%, to RR 964 million compared to RR 828 million in the corresponding period in 2005. The main components of this expense in the three months ended 31 March 2006 were materials and payroll expenses.

<i>millions of Russian roubles</i>	Three months ended 31 March		Change %
	2006	2005	
Materials expense	356	219	63%
Payroll expense	311	230	35%
Security and fire safety expense	62	21	196%
Processing services expense	61	186	(67%)
Other expenses	174	172	1%
Total materials, services and other expenses	964	828	16%

Materials expense increased by RR 137 million, or 62.6%, to RR 356 million compared to RR 219 million in the corresponding period in 2005. The increase was mainly due to the commencement of BOPP production at NOVATEK-Polimer, and the associated increase in purchases of raw materials. Materials expense at NOVATEK-Polimer in the 2006 period amounted to RR 253 million compared to RR 123 million in the corresponding period in 2005. The increase, of RR 130 million, accounted for 94.9% of the total increase to materials expense.

Payroll expense increased by RR 81 million, or 35.4%, to RR 311 million compared to RR 230 million in the corresponding period in 2005. The increase was primarily due to increased staff at Nova ZPK in the 2006 period, resulting in a payroll expense increase of RR 43 million. Also, additional employees and bonuses at Tarkosalenftegas and Yurkharovneftegas added RR 9 million and RR 4 million, respectively.

Processing services expenses decreased by RR 125 million, or 67.2%, to RR 61 million from RR 186 million in the corresponding period in 2005, due to a decrease in the volumes of unstable gas condensate processed at the Surgutsky refinery. Processing expenses at the Purovsky Plant are allocated among our various expense categories.

In the three months ended 31 March 2006, other materials, services and other expenses increased by RR 43 million, compared to the corresponding period in 2005, due to increases in security and fire safety, which added RR 41 million, and energy, fuel, well services and workovers and other expenses.

General and administrative expenses

In the three months ended 31 March 2006, general and administrative expenses increased by RR 314 million, or 89.5%, to RR 665 million compared to RR 351 million in the corresponding period in 2005. The main components of these expenses, comprising 76.4% of the total expenses, were payroll, insurance, social and charitable, and legal, audit and consulting expenses.

<i>millions of Russian roubles</i>	Three months ended 31 March		Change
	2006	2005	%
Payroll expense	320	139	130%
Insurance expense	79	67	18%
Social and charitable expenses	85	30	182%
Legal, audit and consulting expenses	24	20	20%
Other expenses	157	95	65%
Total general and administrative expenses	665	351	90%

Payroll expense increased by RR 181 million, or 130.2%, to RR 320 million compared to RR 139 million in the corresponding period in 2005. Management bonuses and additional employees' wages at NOVATEK increased by RR 152 million, or 84.5%.

Insurance expenses increased by RR 12 million, or 17.9%, to RR 79 million compared to RR 67 million in the corresponding period in 2005. The increase related to insurance on production assets (primarily the Purovsky Plant machinery and equipment) and Directors' and Officers' management risk insurance resulting from the IPO in July 2005, which were partially offset by a decrease in insurance on processing at the Surgutsky refinery due to lower throughput at the refinery in 2006.

Sponsorship and charitable expenses increased by RR 55 million, or 181.8%, to RR 85 million compared to RR 30 million in the corresponding period in 2005, primarily due to our continued support of students' education and other social programs.

Legal, audit and consulting services expenses increased by RR 4 million, or 20.0%, to RR 24 million compared to RR 20 million in the corresponding period in 2005, due to an increase in consulting services provided to the Group in the 2006 period.

In 2006, other general and administrative expenses increased by RR 62 million, or 65.3%, compared to the corresponding period in 2005 primarily due to the effects of inflation on these expenses. In 2006, other general and administrative expenses included rent and business trip expenses which increased by RR 16 million, or 124.1%, and RR 11 million, or 46.1%, respectively, compared to the 2005 period.

Purchases of oil, gas condensate and natural gas

Our purchases of hydrocarbons decreased by RR 241 million, or 37.1%, to RR 409 million in the three months ended 31 March 2006 from RR 650 million in the corresponding period in 2005 primarily as a result of our divestiture of Geoilbent in June 2005.

Change in inventory

Effective 1 January 2006, we commenced export sales through our newly established subsidiaries which changed the nature of our marketing of liquids to international markets. Based on delivery terms and conditions, export sales in transit will be recorded as inventory until they reach their port of destination. In the three months ended 31 March 2006, changes in inventory decreased by RR 569 million as a result of recording export sales in transit as inventory.

Profit from operations

As a result of the factors discussed above, our profit from operations increased by RR 1,533 million, or 47.2%, to RR 4,781 million in the three months ended 31 March 2006 from RR 3,248 million in the corresponding period in 2005. In the 2006 period, our income from operations as a percentage of total revenues increased to 41.2% compared to 36.9% in the corresponding period in 2005.

Finance income (expense)

Finance expense decreased from a net expense of RR 241 million in the three months ended 31 March 2005 to a net gain of RR 93 million in the corresponding period in 2006. The decrease was the result of foreign exchange gains of RR 167 million in 2006 period, compared to foreign exchange losses of RR 127 million in the corresponding period in 2005. The increase in foreign exchange gain was primarily due to US dollar denominated debt and the general strengthening of the Russian rouble in 2006.

During the three months ended 31 March 2006, the Group entered into two short-term foreign currency forward contracts in February 2006 and March 2006, with both forward contracts expiring on 13 June 2006, to manage our exposure to foreign currency fluctuations on debt repayment in US dollars. Neither of these contracts qualified for hedge treatment under IAS 39. At 31 March 2006, the fair values of the open foreign currency forward contracts resulted in an aggregate loss of RR 14 million recorded within foreign exchange gain (loss).

The increase in foreign exchange gain was partly offset by a decrease in interest income of RR 164 million in the 2006 period, due to the reduction of loans provided to related parties. In the 2006 period, interest expense decreased by RR 204 million, or 59.8%, compared to the corresponding period in 2005 mainly as a result of a reduction in our total debt.

Share of income of associated companies

In the three months ended 31 March 2006, our share of the net income of associated companies was nil compared to RR 77 million in the corresponding period in 2005 as a result of the divestiture of our participation interest in Geoilbent in June 2005.

Income tax expense

Our overall consolidated effective income tax rates (total tax expense calculated as a percentage of our reported IFRS profit before income tax and share of net income from associates) were 24.1% and 25.8% for the three months ended 31 March 2006 and 2005, respectively. Our effective income tax rate excluding foreign subsidiaries in Switzerland would have been 25.7% in the 2006 period. Our effective tax rates in 2006 and 2005 correlate closely with our statutory income tax rate of 24%. The differences are due to an increase in non-deductible expenses and other non-temporary differences.

Profit for the period and earnings per share

As a result of the factors discussed above, profit for the period increased by RR 1,394 million, or 60.4%, to RR 3,702 million in three months ended 31 March 2006 from RR 2,308 million in the corresponding period in 2005. The profit attributable to NOVATEK shareholders increased by RR 1,402 million, or 60.6%, to RR 3,717 million in three months ended 31 March 2006 from RR 2,315 million in the corresponding period in 2005.

Our weighted average basic and diluted earnings per share increased to RR 1,224 per share in the three months ended 31 March 2006 from RR 762 per share in the corresponding period in 2005. The weighted average number of ordinary shares outstanding during both periods was 3,036,306.

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 payments mainly out of operating cash flows supplemented by additional borrowings and equity, if needed. 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 2006 and 2005:

<i>millions of Russian roubles except ratios</i>	Three months ended 31 March		Change
	2006	2005	%
Net cash provided by operating activities	5,375	4,688	15%
Net cash used for investing activities	(1,109)	(1,349)	(18%)
Net cash used for financing activities	(1,279)	(4,610)	(72%)

<i>Liquidity ratios</i>	31 March 2006	31 December 2005	Change
			%
Current ratio	1.47	1.14	29%
Total debt to equity	0.12	0.16	(25%)
Long-term debt to long term debt and equity	0.01	0.02	(50%)
Net debt to total capitalization ⁽¹⁾	0.02	0.08	(75%)

⁽¹⁾ Net debt represents total debt less cash and cash equivalents. Total capitalization represents total debt, total equity and deferred income tax.

Net cash provided by operating activities

Net cash provided by operating activities increased by RR 687 million, or 14.7%, to RR 5,375 million in the three months ended 31 March 2006 compared to RR 4,688 million in the corresponding period in 2005. The increase was mainly attributable to significantly higher operating income from our oil and gas sales as a result of increases in our sales volumes and realized prices in the 2006 period compared to the corresponding period in 2005 which was partially offset by an increase in income tax payments.

Net cash from investing activities

Net cash used in investing activities decreased by RR 240 million, or 17.8%, to RR 1,109 million in the three months ended 31 March 2006 compared to net cash used in investing activities of RR 1,349 million in the corresponding period in 2005. The decrease was primarily due to lower net cash used for investment in purchases of property plant and equipment, primarily associated with the continued development of our oil and gas activities in the 2006 period compared to the corresponding period in 2005 and our provision of short- and long-term loans was significantly lower in the 2006 period compared to the corresponding period in 2005.

Net cash from financing activities

Net cash used in financing activities decreased by RR 3,331 million, or 72.3%, to RR 1,279 million in the three months ended 31 March 2006 compared to net cash used in financing activities of RR 4,610 million in the corresponding period in 2005. The decrease was primarily due to lower repayments of short- and long-term borrowings of RR 2,424 million in the 2006 period compared to RR 6,766 million in the corresponding period in 2005 (See "Debt obligations" below).

Working capital

At 31 March 2006, our working capital surplus (current assets less current liabilities) was RR 4,730 million compared to RR 1,490 million at 31 December 2005. In three months ended 31 March 2006, current assets increased by RR 2,842 million, to RR 14,764 million from RR 11,922 million at 31 December 2005. The increase was primarily due to increases in cash and cash equivalents of RR 2,917 million, prepayments and other current assets, prepaid income tax and short-term loans receivable of RR 1,724 million, which was partially offset by a decrease in trade and other receivables of RR 2,289 million. In three months ended 31 March 2006, current liabilities decreased by RR 398 million compared to the period ended at 31 December 2005, The

decrease was primarily due to a reduction in short-term debt and other taxes payable of RR 1,520 million which was partially offset by an increase in income tax and accounts payable of RR 1,122 million compared to the period ended at 31 December 2005,

Capital expenditures

Total capital expenditures on property, plant and equipment for the three months ended 31 March 2006 and 2005 are as follows:

<i>millions of Russian roubles</i>	Three months ended 31 March		Change
	2006	2005	%
Exploration and production	1,160	1,551	(25%)
Other	26	26	0%
Total	1,186	1,577	(25%)

Exploration and production expenditures represent our investments in developing our oil and gas properties. During the three months ended 31 March 2005, capital expenditures in exploration and production were mainly attributable to the construction of the Purovsky Plant and to a lesser extent the further development at our three core fields. During the 2006 period, capital expenditures were mainly attributable to expenditures in exploration and development. In 2006, we spent RR 95 million, RR 461 million and RR 501 million for field development at the Khancheyskoye, East-Tarkosalinskoye and Yurkharovskoye fields, respectively, and RR 44 million on construction of the Purovsky Plant.

Debt obligations

Our total debt obligations decreased by RR 1,535 million, or 16.9%, to RR 7,559 million at 31 March 2006 from RR 9,094 million at 31 December 2005. 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 Plant and the loading facilities at the Port of Vitino.

Our long-term debt at 31 March 2006 included loans from C.R.R. B.V., in the amount of RR 5,553 million (USD 200 million), repayable in June 2006 and bearing interest of 7.75% per annum and Russian rouble denominated bonds in the amount of RR 1,000 million, repayable in November 2006 and bearing interest of 9.4%.

At 31 March 2006, the Group had unutilized credit facilities in the aggregated amount of USD 69.2 million. In April 2006, the Group obtained an additional credit line in the amount of USD 50 million.

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, and stable gas condensate destined for export sales are linked to crude oil 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. From time to time we may use derivative instruments, such as commodity forward contracts, commodity price swaps, commodity options, foreign exchange forward contracts, foreign currency options, interest rate swaps and forward rate agreements, to manage these market risks and we may hold or issue derivative or other financial instruments for trading purposes.

Foreign currency risk

Our principal exchange rate risk involves changes in the value of the Russian rouble relative to the US dollar and Euro. At 31 March 2006, RR 5,856 million, or 78%, of our long-term debt was denominated in US dollars (out of RR 7,536 million of our total borrowings at that date). Changes in the value of the Russian rouble relative to the US dollar will change our foreign currency denominated costs and expenses and our debt service obligations for foreign currency denominated borrowings in Russian rouble terms as well as receivables at our foreign subsidiaries. We believe that the risks associated with our foreign currency exposure are partially mitigated by the fact that a portion of our total revenues, approximately 35% in the 2006 period, is denominated in US dollars. As of 31 March 2006, the Russian rouble had strengthened against the US dollar by approximately 0.2% since 31 March 2005.

A hypothetical and instantaneous 10% change in currency exchange rates as of 31 March 2006 would have resulted in an estimated foreign exchange gain or loss of approximately RR 146 million on foreign currency denominated borrowings held as of 31 March 2006.

Commodity risk

Substantially all of our crude oil, stable gas condensate and LPG export sales are sold under spot contracts. Our export prices are linked to world crude oil prices. External factors such as geopolitical developments, natural disasters and the actions of the Organization of Petroleum Exporting Countries affect crude oil prices and thus our export prices.

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.

From time to time we may employ derivative instruments to mitigate the price risk of our sales activities. In our interim condensed financial information all derivative instruments are recorded at their fair values. Unrealized gains or losses on derivative instruments are recognized within other income (loss), unless the underlying arrangement qualifies as a hedge.

Pipeline access

We transport substantially all of our natural gas through the Gazprom owned unified gas supply system (UGSS). Gazprom is responsible for gathering, transporting, dispatching and delivering substantially all natural gas supplies in Russia. Under existing legislation, Gazprom must provide access to the UGSS to all independent suppliers on a non-discriminatory basis provided there is capacity not being used by Gazprom. In practice, however, Gazprom exercises considerable discretion over access to the UGSS because it is the sole owner of information relating to capacity. There can be no assurance that Gazprom will continue to provide us with access to the UGSS, however, we have not been denied access in prior periods.

Ability to reinvest

Our business requires significant ongoing capital expenditures in order to 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 increase current levels of production and deliveries of natural gas, gas condensate and crude oil, adversely affecting our results.

Off balance sheet activities

At 31 March 2006, 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.