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

The following report contains a discussion and analysis of the financial condition of OAO LUKOIL as of June 30, 2014 and the results of its operations for the three and six month periods ended June 30, 2014 and 2013, as well as significant factors that may affect its future performance. It should be read in conjunction with our interim US GAAP consolidated financial statements and notes thereto.

References to "LUKOIL," "the Company," "the Group," "we" or "us" are references to OAO LUKOIL and its subsidiaries and equity affiliates. All dollar amounts are in millions of US dollars, unless otherwise indicated. Tonnes of crude oil and natural gas liquids produced are translated into barrels using conversion rates characterizing the density of crude oil from each of our oilfields and actual density of liquids produced at our gas processing plants. Tonnes of crude oil purchased as well as other operational indicators expressed in barrels were translated into barrels using an average conversion rate of 7.33 barrels per tonne. Translations of cubic meters to cubic feet were made at the rate of 35.31 cubic feet per cubic meter. Translations of barrels of crude oil into barrels of oil equivalent ("BOE") were made at the rate of 1 barrel per BOE and of cubic feet – at the rate of 6 thousand cubic feet per BOE.

This report includes forward-looking statements – words such as "believes," "anticipates," "expects," "estimates," "intends," "plans," etc. – that reflect management's current estimates and beliefs, but are not guarantees of future results.

Key financial and operational results

	2nd quarter of 2014	**2nd quarter of 2013**	**Change, %**	**1st half of 2014**	**1st half of 2013**	**Change, %**
	(millions of US dollars)					
Sales	38,205	35,053	9.0	73,886	68,823	7.4
Net income attributable to OAO LUKOIL	2,389	2,104	13.5	4,122	4,685	(12.0)
Adjusted net income attributable to OAO LUKOIL[(1)]	2,389	2,104	13.5	4,642	4,685	(0.9)
EBITDA	5,437	4,359	24.7	9,432	9,134	3.3
Adjusted EBITDA[(1)]	5,437	4,359	24.7	9,952	9,134	9.0
Taxes other than income taxes, excise and export tariffs	(8,747)	(9,183)	(4.7)	(17,680)	(18,067)	(2.1)
Earning per share of common stock attributable to OAO LUKOIL (US dollars):						
Basic	3.16	2.79	13.5	5.46	6.21	(12.0)
Diluted	3.10	2.73	13.4	5.35	6.08	(12.0)
Hydrocarbon production by the Group including our share in equity affiliates (thousands of BOE)	210,444	199,522	5.5	409,740	397,136	3.2
Daily hydrocarbon production by the Group including our share in equity affiliates (thousands of BOE)	2,313	2,193	5.5	2,264	2,194	3.2
Crude oil and natural gas liquids produced by the Group including our share in equity affiliates (thousands of barrels)	182,202	169,998	7.2	351,876	336,613	4.5
Gas available for sale produced by the Group including our share in equity affiliates (millions of cubic meters)	4,799	5,017	(4.3)	9,833	10,284	(4.4)
Refined products produced by the Group including our share in equity affiliates (thousands of tonnes)	15,709	15,968	(1.6)	31,094	30,961	0.4

(1) Adjusted for loss on disposal of assets and dry whole related write-offs.

In the second quarter of 2014, our net income increased by $285 million, or by 13.5%, and our EBITDA increased by $1,078 million, or by 24.7%, compared to the second quarter of 2013. Our net income for the first half of 2014 was affected by a loss on the expected disposal of our share in Caspian Investment Resources Ltd. in the amount of $358 million and write-offs related to our exploration projects in Africa in the amount of $162 million, both booked in the first quarter. Adjusted for these non-recurring losses, our net income remained nearly on the level of the first half of 2013. At the same time, our adjusted EBITDA increased by $818 million, or by 9.0%. Our EBITDA in the second quarter and the first half of 2014 was impacted by commencement of cost compensation at West Qurna-2 project in Iraq.

Business overview

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

OAO LUKOIL was established in accordance with Presidential Decree No. 1403, issued on November 17, 1992. Under this decree, on April 5, 1993, the Government of the Russian Federation transferred to the Company 51% of the voting shares of fifteen enterprises. Under Government Resolution No. 861 issued on September 1, 1995, a further nine enterprises were transferred to the Group during 1995. Since 1995, the Group has carried out a share exchange program to increase its shareholding in each of 24 founding subsidiaries to 100%. From formation, the Group has expanded substantially through consolidation of interests, acquisition of new companies and establishment of new businesses. Now LUKOIL is a global energy company operating through its subsidiaries in 39 countries on four continents.

LUKOIL is one of the world's largest energy companies in terms of hydrocarbon reserves that amounted to 17.4 billion BOE as of January 1, 2014 and comprised of 13.5 billion barrels of crude oil and 23.6 trillion cubic feet of gas.

Our operations are divided into four main business segments:

- **Exploration and Production** – which includes our exploration, development and production operations relating to crude oil and gas. These activities are primarily located within Russia, with additional activities in Azerbaijan, Kazakhstan, Uzbekistan, the Middle East, South America, Northern and Western Africa, Norway and Romania.
- **Refining, Marketing and Distribution** – which includes refining and transport operations, marketing and trading of crude oil, natural gas and refined products.
- **Chemicals** – which includes processing and trading of petrochemical products.
- **Power generation** – which includes generation, transportation and sales of electricity, heat and related services.

Each of our four main segments is dependent on the other, with a portion of the revenues of one segment being a part of the costs of the other. In particular, our Refining, Marketing and Distribution segment purchases crude oil from our Exploration and Production segment. As a result of certain factors considered in the "Domestic crude oil and refined products prices" section on page 9, benchmarking crude oil market prices in Russia cannot be determined with certainty. Therefore, the prices set for inter-segment purchases of crude oil reflect a combination of market factors, primarily international crude oil market prices, transportation costs, regional market conditions, the cost of crude oil refining and other factors. Accordingly, an analysis of either of these segments on a stand-alone basis could give a misleading impression of those segments' underlying financial position and results of operations. For this reason, we do not analyze either of our main segments separately in the discussion that follows. However, we present the financial data for each in Note 20 "Segment information" to our interim consolidated financial statements.

Recent developments

Changes in Group structure

On August 11, 2014, in line with the strategy to optimize downstream portfolio a Group company signed an agreement with AMIC Energy Management GmbH to sell 100% of the Group's interest in LUKOIL Ukraine, a distribution company operating in Ukraine. Closing of the transaction is subject to customary approvals by regulatory authorities.

On August 1, 2014, in line with the strategy to optimize its downstream operations Group companies signed agreements with Slovnaft Česká Republica, Spol. s.r.o. and Norm Benzinkút Kft to sell 100% of shares in LUKOIL Slovakia s.r.o., LUKOIL Hungary Ltd. and LUKOIL Czech Republic s.r.o. These transactions' closing is subject to a number of conditions and is expected before the end of 2014. The selling price consists of two components: fixed component of approximately €100 million and variable component which depends on the amount of the working capital of the abovementioned companies as at the completion date and is subject to certain adjustments.

On April 15, 2014, a Group company entered into a contract with a Sinopec group company, to sell for $1.2 billion the Group's 50% interest in Caspian Investment Resources Ltd., an exploration and production company operating in Kazakhstan. The transaction's closing is subject to a number of conditions, including approval by the Kazakhstan state authorities, and is expected before the end of 2014.

In December 2013, after approval by European regulatory authorities, the Group acquired the remaining 20% interest in the joint venture which operates the ISAB refinery complex (ISAB) for €446 million (approximately $613 million) after final adjustments, increasing its stake in the joint venture from 80% to 100%. This transaction was exercised in line with the initial agreement on the establishment of the joint venture signed in 2008. This agreement gave the second investor, ERG S.p.A., a step-by-step put option to sell its share in the joint venture to the Group. The Group obtained control over ISAB in September 2012, when within this agreement, it acquired a 20% interest in the joint venture for €494 million (approximately $621 million) and increased its stake to 80%.

In April 2013, after approval by the Federal Anti-monopoly Service, in line with the strategy to increase crude oil production in Russia the Company purchased 100% of the shares of ZAO Samara-Nafta for $2.1 billion after final adjustments. ZAO Samara-Nafta is an exploration and production company operating in the Samara and Uljanovsk regions of the Russian Federation.

In April-May 2013, Group companies acquired the remaining 50% of the shares of ZAO Kama-oil, an exploration and production company operating in the Perm region of the Russian Federation, for $400 million increasing the Group’s ownership to 100%. As a result of this acquisition, the Group obtained control over ZAO Kama-oil and consolidated it.

West Qurna-2 project

On December 12, 2009, a consortium of a Group company and Statoil won the tender for development of the West Qurna-2 field in Iraq, one of the largest crude oil fields discovered in the world, with estimated recoverable oil reserves of 12.9 billion barrels (1.8 billion tonnes). The service agreement for West Qurna-2 field development and production was signed on January 31, 2010 and then ratified by the Ministry cabinet of the Iraq Republic. After Statoil withdrew from the West Qurna-2 project in May 2012, the parties of the project are Iraq’s state-owned South Oil Company and a consortium of contractors, consisting of a Group company (75% interest) and state-owned North Oil Company (25% interest).

The Group launched the “Mishrif Early Oil” stage on the West Qurna-2 field and reached the planned production of 120 thousand barrels per day in March 2014. According to the service agreement, costs are compensated after this level of production is achieved and maintained during any 90 days within a 120-day period. In June 2014, we met this term. Therefore, in the second quarter of 2014, the Group accrued revenue from the West Qurna-2 project in total amount of $1,179 million consisting of cost recovery of $1,163 million and remuneration fee of $16 million. Attributable amount of 1,781 thousand tonnes of crude oil (12,218 thousand barrels) was included in Group’s production for the period, that represents approximately 65% of total production from the field of 2,757 thousand tonnes (18,913 thousand barrels). Positive impact of cost compensation on Group’s EBITDA for the second quarter and the first half of 2014 amounted to $1,017 million.

The project’s target production level is 1.2 million barrels per day and the total term of the contract is 25 years.

The Group is exposed to political, economic and legal risks due to its operations in Iraq. Management monitors the risks associated with the projects in Iraq and believes that there is no adverse effect on the Group’s financial condition that can be reasonably estimated at present.

Operational highlights

Hydrocarbon production

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

	2nd quarter of		1st half of	
	2014	2013	2014	2013
Crude oil and natural gas liquids production(1)	(thousand BOE per day)			
Consolidated subsidiaries				
Western Siberia	970	999	976	1,004
Timan-Pechora	306	297	308	301
Ural region	308	293	308	292
Volga region	135	124	135	105
Other in Russia	38	38	37	38
Total in Russia	1,757	1,751	1,764	1,740
Iraq(2)	134	–	67	–
Other outside Russia	61	64	62	65
Total outside Russia	195	64	129	65
Total consolidated subsidiaries	**1,952**	**1,815**	**1,893**	**1,805**
Our share in equity affiliates				
in Russia	10	7	9	7
outside Russia	40	46	42	48
Total share in equity affiliates	**50**	**53**	**51**	**55**
Total crude oil and natural gas liquids	**2,002**	**1,868**	**1,944**	**1,860**
Natural gas production available for sale(3)				
Consolidated subsidiaries				
Western Siberia	185	185	186	190
Timan-Pechora	15	14	14	13
Ural region	16	15	18	17
Volga region	6	6	6	6
Total in Russia	222	220	224	226
Total outside Russia	81	96	87	99
Total consolidated subsidiaries	**303**	**316**	**311**	**325**
Share in equity affiliates				
in Russia	1	1	1	1
outside Russia	7	8	8	8
Total share in production of equity affiliates	**8**	**9**	**9**	**9**
Total natural gas available for sale	**311**	**325**	**320**	**334**
Total daily hydrocarbon production	**2,313**	**2,193**	**2,264**	**2,194**
	(US dollar per BOE)			
Hydrocarbon extraction expenses	6.13	5.59	5.70	5.44
- in Russia	5.65	5.60	5.46	5.47
- outside Russia	9.46	5.51	7.90	5.08
	(millions of US dollars)			
Hydrocarbon extraction expenses	1,259	1,078	2,270	2,087
- in Russia	1,015	999	1,957	1,937
- outside Russia	244	79	313	150
Exploration expenses	64	75	269	138
- in Russia	38	55	123	98
- outside Russia	26	20	146	40
Mineral extraction tax	3,070	3,030	6,169	6,043
- in Russia	3,055	3,010	6,136	6,006
- outside Russia	15	20	33	37

(1) Natural gas liquids produced at the Group gas processing plants.
(2) Compensation oil that represents approximately 65% of production from the West Qurna-2 field.
(3) Including petroleum gas sold to third parties.

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

Crude oil production. In the first half of 2014, we produced (including the Company's share in equity affiliates) 46.9 million tonnes, or 344.7 million barrels, of crude oil.

The following table represents our crude oil production in the first half of 2014 and 2013 by major regions.

		Change to 2013			
(thousands of tonnes)	**1st half of 2014**	**Total, %**	**Change in structure**	**Organic change**	**1st half of 2013**
Western Siberia	23,377	(2.9)	–	(707)	24,084
Timan-Pechora	7,697	2.3	–	175	7,522
Ural region	7,184	4.9	34	299	6,851
Volga region	3,260	33.0	657	152	2,451
Other in Russia	939	(0.1)	–	(1)	940
Crude oil produced in Russia	42,457	1.5	691	(82)	41,848
Iraq(1)	1,781	–	–	1,781	–
Other outside of Russia	1,473	(5.8)	–	(91)	1,564
Crude oil produced internationally	3,254	108.1	–	1,690	1,564
Total crude oil produced by consolidated subsidiaries	**45,711**	**5.3**	**691**	**1,608**	**43,412**
Our share in crude oil produced by equity affiliates:					
in Russia	207	15.6	(17)	45	179
outside Russia	971	(12.8)	–	(143)	1,114
Total crude oil produced	**46,889**	**4.9**	**674**	**1,510**	**44,705**

(1) Compensation oil that represents approximately 65% of production from the West Qurna-2 field.

The main oil producing region for the Company is Western Siberia where we produced 51.1% of our crude oil in the first half of 2014 (55.5% in the first half of 2013).

Crude oil production in Western Siberia continued to decline due to natural depletion of reserves and an increase in water cut. Nevertheless, this was compensated for by the acquisitions of new upstream properties, development of greenfields, successful employment of new technologies and an increase in drilling footage. As a result, our daily domestic crude oil and natural gas liquids production volumes increased by 1.5%, compared to the first half of 2013.

The structural increase in our domestic production was a result of the acquisition of a 100.0% share of ZAO Samara-Nafta and an increase in the Group's ownership in ZAO Kama-oil from 50.0% to 100.0% during the second quarter of 2013. At the same time, the transfer of ZAO Kama-oil from affiliates to subsidiaries led to some structural decrease in the affiliates' production in Russia.

The increase in our international production was a result of commencement of commercial production at the West Qurna-2 oilfield.

In addition to our production, we purchase crude oil in Russia and on international markets. In Russia, we primarily purchase crude oil from affiliated producing companies and other producers. Then we either refine or export purchased crude oil. Crude oil purchased on international markets is normally used for trading activities, for supplying our international refineries or for processing at third party refineries.

	2nd quarter of			
	2014		2013	
	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)
Purchases in Russia	1,129	154	946	129
Purchases for trading internationally	32,809	4,476	10,673	1,456
Purchases for refining internationally	21,719	2,963	17,129	2,337
Total crude oil purchased	**55,657**	**7,593**	**28,748**	**3,922**

	1st half of			
	2014		2013	
	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)
Purchases in Russia	3,262	445	1,151	157
Purchases for trading internationally	56,199	7,667	14,125	1,927
Purchases for refining internationally	38,497	5,252	32,523	4,437
Total crude oil purchased	**97,958**	**13,364**	**47,799**	**6,521**

A significant part of our crude oil purchases is for processing. Compared to the first half of 2013, our purchases for processing at international refineries increased by 18.4% as a result of the increase of crude oil refining at ISAB. Moreover, in the first half of 2014, our purchases for trading were almost four times as much as in the first half of 2013, when the level of such purchases was abnormally low.

Production of gas and natural gas liquids. During the first half of 2014, we produced 9,833 million cubic meters (57.9 million BOE) of gas available for sale (including our share in equity affiliates), that is 4.4% less than in the first half of 2013.

Our major gas production field is the Nakhodkinskoe field, where we produced 4,131 million cubic meters of natural gas in the first half of 2014 (4,116 million cubic meters in the first half of 2013). Our international gas production decreased by 12.3%, compared to the first half of 2013, largely due to lower production volumes in Uzbekistan.

In the first half of 2014, the output of natural gas liquids at the Group gas processing plants in Western Siberia, Ural and Volgograd regions of Russia was 7.2 million BOE, compared to 6.5 million BOE in the first half of 2013.

Refining, marketing and trading

Refining. We own and operate four refineries located in European Russia and three refineries located outside of Russia – in Bulgaria, Romania and Italy. Moreover, we have a 45% interest in the Zeeland refinery in the Netherlands.

In December 2013, the Group increased its stake in ISAB to 100% after acquisition of the remaining 20% share. Initially, in December 2008, the Group acquired a 49% interest in ISAB, then increased its interest to 60% in April 2011 and to 80% in September 2012, when control over the refinery was obtained and ISAB became our consolidated subsidiary, rather than an equity affiliate.

Compared to the first half of 2013, the total volume of refined products produced by the Group (including our share in production at the Zeeland refinery) didn’t change significantly. Production volumes at our Russian refineries increased by 1.6%, largely due to an increase of production volumes at our refinery in Perm region against the background of relatively low production volumes in the first half of 2013. Production at our international refineries decreased by 2.0%. Sharp decrease in production at the Zeeland refinery by 38.3% due to low refining margins and overhaul in the second quarter of 2014 outweighed the increase of production at ISAB.

Along with our own production of refined products we can refine crude oil at third party refineries depending on market conditions and other factors. In the periods considered, we processed our crude oil at third party refineries in Belarus and Kazakhstan. At the same time, the volume of our crude oil processing at the third party refineries in Belarus in the first half of 2014 was lower than in the first half of 2013.

The following table summarizes key figures for our refining activities.

	2nd quarter of		1st half of	
	2014	2013	2014	2013
	(thousand barrels per day)			
Refinery throughput at the Group refineries	1,269	1,223	1,247	1,198
- in Russia	902	888	912	896
- outside Russia[(1)]	367	335	335	302
Refinery throughput at the Zeeland refinery [(1)]	34	101	60	97
Refinery throughput at third party refineries	41	46	29	45
Total refinery throughput	**1,344**	**1,370**	**1,336**	**1,340**
	(thousands of tonnes)			
Production of the Group refineries in Russia	10,743	10,605	21,547	21,217
Production of the Group refineries outside Russia	4,543	4,104	8,059	7,331
Production of the Zeeland refinery	423	1,259	1,488	2,413
Refined products produced by the Group including our share in the Zeeland refinery	**15,709**	**15,968**	**31,094**	**30,961**
Refined products produced at third party refineries	463	535	648	1,029
Total refined products produced	**16,172**	**16,503**	**31,742**	**31,990**
	(millions of US dollars)			
Refining expenses at the Group refineries	518	555	998	1,063
- in Russia	272	291	502	550
- outside Russia	246	264	496	513
Refining expenses at affiliated refineries outside of Russia	33	61	90	118
Refining expenses at third party refineries	19	22	26	42
Capital expenditures	799	395	1,198	974
- in Russia	613	258	814	692
- outside Russia	186	137	384	282

(1) Including refined product processed.

Marketing and trading. Our marketing and trading activities mainly include wholesale and bunkering operations in Western Europe, South-East Asia, Central America and retail operations in the USA, Central and Eastern Europe, the Baltic States and other regions. In Russia, we purchase refined products on occasion, primarily to manage supply chain bottlenecks.

The Group retails its refined products in 27 countries through nearly 5.6 thousand petrol stations (including franchisees). Most of the stations operate under the LUKOIL brand.

The table below summarizes figures for our trading activities.

	2nd quarter of		1st half of	
	2014	2013	2014	2013
	(thousands of tonnes)			
Retail sales	3,990	3,919	7,628	7,465
Wholesale sales	25,070	27,036	49,605	50,908
Total refined products sales	**29,060**	**30,955**	**57,233**	**58,373**
Refined products purchased in Russia	382	469	819	1,099
Refined products purchased internationally	14,532	15,901	29,210	29,441
Total refined products purchased	**14,914**	**16,370**	**30,029**	**30,540**

In August 2014, in line with the strategy to optimize its downstream operations, Group companies signed agreements with third parties to sell 100% of shares in LUKOIL Ukraine, LUKOIL Slovakia s.r.o., LUKOIL Hungary Ltd. and LUKOIL Czech Republic s.r.o. that together operate approximately 380 petrol stations.

During the first half of 2014, political and economic uncertainty in Ukraine has been increasing. As at June 30, 2014, the Group owns downstream assets in Ukraine, consisting of a network of about 240 petrol stations, a petrochemical plant, lubricants distributors, and a jet fuel supplier. Though the Group's assets and operations in Ukraine are not material (in the first half of 2014, revenues that were derived from our operations in Ukraine comprised less than 1% of our total revenues), the Group monitors the situation and assesses the risks associated with its operations in Ukraine. Management believes that there are no potential losses that can be identified and reasonably estimated with respect to situation in Ukraine at present.

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

	2nd quarter of			
	2014		2013	
	(thousands of barrels)	(thousands of tonnes)	(thousands of barrels)	(thousands of tonnes)
Exports of crude oil using Transneft export routes	43,372	5,917	49,228	6,716
Exports of crude oil bypassing Transneft	10,870	1,483	12,669	1,728
Total crude oil exports	**54,242**	**7,400**	**61,897**	**8,444**
Exports of refined products		**6,122**		**6,173**

	1st half of			
	2014		2013	
	(thousands of barrels)	(thousands of tonnes)	(thousands of barrels)	(thousands of tonnes)
Exports of crude oil using Transneft export routes	84,911	11,584	95,906	13,084
Exports of crude oil bypassing Transneft	22,950	3,131	22,482	3,067
Total crude oil exports	**107,861**	**14,715**	**118,388**	**16,151**
Exports of refined products		**12,446**		**12,140**

During the first half of 2014, the volume of our crude oil export from Russia decreased by 8.9%, compared to the first half of 2013, and we exported 34.7% of our total domestic crude oil production (38.6% – during the first half of 2013). The decrease of crude oil export was a result of higher sales in Russia and increased throughput at our domestic refineries.

All the volume of crude oil exported that bypassed Transneft in the periods considered was routed through our own export infrastructure.

During the first half of 2014, the Company exported 600 thousand tonnes of light crude oil through the Eastern Siberia – Pacific Ocean pipeline. This allowed us to preserve the premium quality of crude oil and thus increased the efficiency of export, compared to export to traditional Western markets.

During the first half of 2014, the volume of our exported refined products from Russia increased by 2.5%, compared to the first half of 2013. Primarily, we export from Russia diesel fuel, fuel oil and gasoil. These products accounted for approximately 83% of our exported refined products volumes.

During the first half of 2014, our revenue from export of crude oil and refined products from Russia both to Group companies and third parties amounted to $10,590 million and $9,337 million, respectively ($11,350 million for crude oil and $8,952 million for refined products in the first half of 2013).

Main macroeconomic factors affecting our results of operations

Changes in the price of crude oil and refined products

The price at which we sell crude oil and refined products is the primary driver of the Group's revenues. During the first half of 2014, the Brent crude oil price fluctuated between $103 and $115 per barrel and reached its peak of $115.32 in the middle of June.

Substantially all the crude oil the Group exports is Urals blend. The following table shows the average crude oil and refined product prices in the first half of 2014 and 2013.

	2nd quarter of		Change,	1st half of		Change,
	2014	2013	%	2014	2013	%
	(in US dollars per barrel, except for figures in percent)					
Brent crude	109.67	102.43	7.1	108.93	107.50	1.3
Urals crude (CIF Mediterranean) (1)	108.04	102.34	5.6	107.42	106.70	0.7
Urals crude (CIF Rotterdam) (1)	107.30	101.89	5.3	106.76	106.21	0.5
	(in US dollars per metric tonne, except for figures in percent)					
Fuel oil 3.5% (FOB Rotterdam)	579.13	580.30	(0.2)	575.19	596.69	(3.6)
Diesel fuel 10 ppm (FOB Rotterdam)	922.01	889.35	3.7	923.37	931.71	(0.9)
High-octane gasoline (FOB Rotterdam)	1,021.17	957.59	6.6	989.69	999.06	(0.9)

Source: Platts.

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

Domestic crude oil and refined products prices

Substantially all crude oil produced in Russia is produced by vertically integrated oil companies such as ours. As a result, most transactions are between affiliated entities within vertically integrated groups. Thus, there is no concept of a benchmark domestic market price for crude oil. The price of crude oil that is produced but not refined or exported by one of the vertically integrated oil companies is generally determined on a transaction-by-transaction basis against a background of world market prices, but with no direct reference or correlation. At any time there may exist significant price differences between regions for similar quality crude oil as a result of the competition and economic conditions in those regions.

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

The table below represents average domestic wholesale prices of refined products in the first half of 2014 and 2013.

	2nd quarter of		Change,	1st half of		Change,
	2014	2013	%	2014	2013	%
	(in US dollars per metric tonne, except for figures in percent)					
Fuel oil	285.11	302.48	(5.7)	271.34	332.42	(18.4)
Diesel fuel	800.33	817.59	(2.1)	803.55	861.39	(6.7)
High-octane gasoline (Regular)	866.02	790.42	9.6	837.70	805.95	3.9
High-octane gasoline (Premium)	892.76	847.14	5.4	867.65	856.26	1.3

Source: InfoTEK (excluding VAT).

Changes in the US dollar-ruble exchange rate and inflation

A substantial part of our revenue is either denominated in US dollars or is correlated to some extent with US dollar crude oil prices, while most of our costs in the Russian Federation are settled in Russian rubles. Therefore, ruble inflation and movements of exchange rates can significantly affect the results of our operations. In particular, an appreciation of the ruble against the US dollar generally causes our costs to increase in US dollar terms, and vice versa. The appreciation of the purchasing power of the US dollar in the Russian Federation calculated on the basis of the ruble-dollar exchange rates and the level of inflation in Russia was 5.1% in the first half of 2014, compared to the first half of 2013.

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

	2nd quarter of		1st half of	
	2014	**2013**	**2014**	**2013**
Ruble inflation (CPI), %	2.4	1.6	4.8	3.5
Average exchange rate for the period (ruble to US dollar)	35.00	31.61	34.98	31.02
Exchange rate at the end of the period (ruble to US dollar)	33.63	32.71	33.63	32.71

Tax burden

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

		2nd quarter of		Change,
		2014	**2013**	**%**
Export tariffs on crude oil	$/tonne	382.63	379.72	0.8
Export tariffs on refined products				
Middle distillates (jet fuel), liquid fuels (fuel oil) and gasoils	$/tonne	252.52	250.59	0.8
Light distillates	$/tonne	344.33	341.75	0.8
Diesel fuel	$/tonne	248.65	250.59	(0.8)
Mineral extraction tax				
Crude oil	RUR/tonne	6,135.44	4,954.00	23.8
Natural gas	RUR/1,000 m^3	471.00	265.00	77.7

		1st half of		Change,
		2014	**2013**	**%**
Export tariffs on crude oil	$/tonne	386.65	393.09	(1.6)
Export tariffs on refined products				
Middle distillates (jet fuel), liquid fuels (fuel oil) and gasoils	$/tonne	255.16	259.43	(1.6)
Light distillates	$/tonne	347.94	353.79	(1.7)
Diesel fuel	$/tonne	251.94	259.43	(2.9)
Mineral extraction tax				
Crude oil	RUR/tonne	6,107.12	5,104.08	19.7
Natural gas	RUR/1,000 m^3	471.00	265.00	77.7

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

		2nd quarter of		Change,
		2014	**2013**	**%**
Mineral extraction tax				
Crude oil	$/tonne	175.30	156.71	11.9
Natural gas	$/1,000 m^3	13.46	8.38	60.6

		1st half of		Change,
		2014	**2013**	**%**
Mineral extraction tax				
Crude oil	$/tonne	174.59	164.56	6.1
Natural gas	$/1,000 m^3	13.46	8.54	57.6

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

Crude oil extraction tax rate is determined by adjusting the base rate depending on the international market price of Urals blend and the ruble-dollar exchange rate. The tax rate is zero when the average Urals blend international market price for a tax period is less than or equal to $15.00 per barrel. Each $1.00 per barrel increase in the international Urals blend price over the threshold ($15.00 per barrel) results in an increase of the tax rate by $1.80 per tonne extracted (or $0.25 per barrel extracted using a conversion factor of 7.33) above the base rate.

During the first half of 2014, the base rate was 493 rubles per metric tonne extracted (470 rubles in the first half of 2013).

The crude oil extraction tax rate varies depending on the development and depletion of a particular oilfield. The tax rate is zero for extra-heavy crude oil and for crude oil produced in certain regions of Eastern Siberia, the Caspian Sea, the Nenetsky Autonomous District and some other regions, depending on the period and volume of production.

The Group produces crude oil in the Caspian Sea and benefits from the application of a zero extraction tax rate. We also produce extra-heavy crude oil in Timan-Pechora.

Natural gas extraction tax rate. The mineral extraction tax on natural gas produced by independent producers in Russia is calculated using a flat rate. For the first half of 2014, the rate was set at 471 rubles per thousand cubic meters (265 rubles per thousand cubic meters in the first half of 2013).

Crude oil export duty rate is calculated on a progressive scale. The rate is zero when the average Urals blend international market price is less than or equal to approximately $15.00 per barrel ($109.50 per metric tonne). If the Urals blend price is between $15.00 and $20.00 per barrel ($146.00 per metric tonne), each $1.00 per barrel increase in the Urals blend price over $15.00 results in an increase of the crude oil export duty rate by $0.35 per barrel exported. If the Urals blend price is between $20.00 and $25.00 per barrel ($182.50 per metric tonne), each $1.00 per barrel increase in the Urals blend price over $20.00 results in an increase of the crude oil export duty rate by $0.45 per barrel exported. Each $1.00 per barrel increase in the Urals blend price over $25.00 per barrel results in an increase of the crude oil export duty rate no more than by $0.65 per barrel exported. Starting from October 1, 2011 to December 31, 2013, the maximum increase of export duty rate was $0.60 per barrel for each $1.00 per barrel increase in the Urals blend price. Starting from January 1, 2014 to December 31, 2014, the maximum increase of export duty rate is $0.59 per barrel for each $1.00 per barrel increase in the Urals blend price.

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

A special export duty regime is in place for certain greenfields. The list of the oilfields where the reduced rate is applied includes our Yu. Korchagin and V. Filanovsky oilfields located in the Caspian Sea and extra-heavy crude oil fields in Timan-Pechora.

Export duty rates on refined products are calculated by multiplying the current crude oil export duty rate by a coefficient according to the table below.

	From January 1, 2014 to December 31, 2014	**Prior to January 1, 2014**
Multiplier for:		
Light distillates (except for gasolines), middle distillates (jet fuel), gasoils, liquid fuels (fuel oil), motor and other oils, other products....	0.660	0.660
Diesel fuel...	0.650	0.660
Gasolines...	0.900	0.900

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

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

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

Excise rates on refined products in Russia are tied to the ecological class of fuel. Excise tax rates for the first half of 2014 and 2013 are listed below:

		2nd quarter of		Change,	1st half of		Change,
		2014	2013	%	2014	2013	%
Gasoline							
Below Euro-3	RUR/tonne	11,110.00	10,100.00	10.0	11,110.00	10,100.00	10.0
Euro-3	RUR/tonne	10,725.00	9,750.00	10.0	10,725.00	9,750.00	10.0
Euro-4	RUR/tonne	9,916.00	8,560.00	15.8	9,916.00	8,560.00	15.8
Euro-5	RUR/tonne	6,450.00	5,143.00	25.4	6,450.00	5,143.00	25.4
Diesel fuel							
Below Euro-3	RUR/tonne	6,446.00	5,860.00	10.0	6,446.00	5,860.00	10.0
Euro-3	RUR/tonne	6,446.00	5,860.00	10.0	6,446.00	5,860.00	10.0
Euro-4	RUR/tonne	5,427.00	4,934.00	10.0	5,427.00	4,934.00	10.0
Euro-5	RUR/tonne	4,767.00	4,334.00	10.0	4,767.00	4,334.00	10.0
Motor oils	RUR/tonne	8,260.00	7,509.00	10.0	8,260.00	7,509.00	10.0
Straight-run gasoline	RUR/tonne	11,252.00	10,229.00	10.0	11,252.00	10,229.00	10.0

		2nd quarter of		Change,	1st half of		Change,
		2014	2013	%	2014	2013	%
Gasoline							
Below Euro-3	$/tonne	317.43	325.63	(2.5)	317.61	325.63	(2.5)
Euro-3	$/tonne	306.43	314.34	(2.5)	306.60	314.34	(2.5)
Euro-4	$/tonne	283.32	275.98	2.7	283.48	275.98	2.7
Euro-5	$/tonne	184.29	165.81	11.1	184.39	165.81	11.2
Diesel fuel							
Below Euro-3	$/tonne	184.17	188.93	(2.5)	184.28	188.93	(2.5)
Euro-3	$/tonne	184.17	188.93	(2.5)	184.28	188.93	(2.5)
Euro-4	$/tonne	155.06	159.07	(2.5)	155.15	159.07	(2.5)
Euro-5	$/tonne	136.20	139.73	(2.5)	136.28	139.73	(2.5)
Motor oils	$/tonne	236.00	242.09	(2.5)	236.13	242.09	(2.5)
Straight-run gasoline	$/tonne	321.49	329.79	(2.5)	321.67	329.79	(2.5)

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

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

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

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

Transportation of crude oil and refined products in Russia

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

Transportation of crude oil produced in Russia to refineries and export destinations is performed primarily through the trunk oil pipeline system of the state-owned company, OAO AK Transneft, or by railway transport.

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

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

Three and six months ended June 30, 2014, compared to three and six months ended June 30, 2013

The table below sets forth data from our consolidated statements of comprehensive income for the periods indicated.

	2nd quarter of		1st half of	
	2014	**2013**	**2014**	**2013**
	(millions of US dollars)			
Revenues				
Sales (including excise and export tariffs)	38,205	35,053	73,886	68,823
Costs and other deductions				
Operating expenses	(2,558)	(2,516)	(4,867)	(4,966)
Cost of purchased crude oil, gas and products	(18,871)	(16,462)	(36,114)	(31,565)
Transportation expenses	(1,557)	(1,562)	(3,110)	(3,212)
Selling, general and administrative expenses	(1,015)	(972)	(1,871)	(1,838)
Depreciation, depletion and amortization	(2,485)	(1,444)	(3,997)	(2,813)
Taxes other than income taxes	(3,408)	(3,396)	(6,854)	(6,779)
Excise and export tariffs	(5,339)	(5,787)	(10,826)	(11,288)
Exploration expense	(64)	(75)	(269)	(138)
Gain (loss) on disposals and impairments of assets	1	17	(414)	10
Income from operating activities	**2,909**	**2,856**	**5,564**	**6,234**
Interest expense	(155)	(121)	(295)	(218)
Interest and dividend income	63	58	120	119
Equity share in income of affiliates	91	139	273	297
Currency translation gain (loss)	2	(257)	(268)	(396)
Other non-operating (expense) income	(39)	168	(119)	181
Income before income taxes	**2,871**	**2,843**	**5,275**	**6,217**
Current income taxes	(541)	(658)	(1,346)	(1,304)
Deferred income taxes	70	(90)	208	(233)
Total income tax expense	**(471)**	**(748)**	**(1,138)**	**(1,537)**
Net income	**2,400**	**2,095**	**4,137**	**4,680**
Net (income) loss attributable to non-controlling interests	(11)	9	(15)	5
Net income attributable to OAO LUKOIL	**2,389**	**2,104**	**4,122**	**4,685**
Earning per share of common stock attributable to OAO LUKOIL (in US dollars):				
Basic	3.16	2.79	5.46	6.21
Diluted	3.10	2.73	5.35	6.08

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

Sales revenues

Sales breakdown	2nd quarter of 2014	2nd quarter of 2013	1st half of 2014	1st half of 2013
	(millions of US dollars)			
Crude oil				
Export and sales on international markets other than Customs Union countries	7,230	4,983	14,188	10,082
Export and sales to Customs Union countries	460	380	996	765
Domestic sales	953	658	1,937	1,196
	8,643	**6,021**	**17,121**	**12,043**
Refined products				
Export and sales on international markets				
Wholesale	19,560	20,135	38,413	39,071
Retail	2,758	2,733	5,224	5,176
Domestic sales				
Wholesale	1,861	1,861	3,473	3,782
Retail	2,337	2,267	4,429	4,463
	26,516	**26,996**	**51,539**	**52,492**
Petrochemicals				
Export and sales on international markets	234	249	489	472
Domestic sales	39	214	171	460
	273	**463**	**660**	**932**
Gas and gas products				
Export and sales on international markets	538	527	1,091	1,084
Domestic sales	285	259	583	545
	823	**786**	**1,674**	**1,629**
Sales of energy and related services	**317**	**296**	**818**	**785**
Other				
Sales on international markets	1,426	291	1,662	551
Domestic sales	207	200	412	391
	1,633	**491**	**2,074**	**942**
Total sales	**38,205**	**35,053**	**73,886**	**68,823**

Sales volumes	2nd quarter of 2014	2nd quarter of 2013	1st half of 2014	1st half of 2013
Crude oil	(thousands of barrels)			
Export and sales on international markets other than Customs Union countries	66,644	49,243	131,705	95,437
Export and sales to Customs Union countries	8,686	7,990	19,197	15,518
Domestic sales	19,043	14,484	39,611	25,560
	94,373	**71,717**	**190,513**	**136,515**
Crude oil	(thousands of tonnes)			
Export and sales on international markets other than Customs Union countries	9,092	6,718	17,968	13,020
Export and sales to Customs Union countries	1,185	1,090	2,619	2,117
Domestic sales	2,598	1,976	5,404	3,487
	12,875	**9,784**	**25,991**	**18,624**
Refined products	(thousands of tonnes)			
Export and sales on international markets				
Wholesale	22,228	24,335	44,366	45,578
Retail	1,637	1,694	3,122	3,163
Domestic sales				
Wholesale	2,842	2,701	5,239	5,330
Retail	2,353	2,225	4,506	4,302
	29,060	**30,955**	**57,233**	**58,373**
Total sales volume of crude oil and refined products	**41,935**	**40,739**	**83,224**	**76,997**

Realized average sales prices		2nd quarter of		1st half of	
		2014	2013	2014	2013
Average realized price international					
Oil (excluding Customs Union countries)	($/barrel)	108.49	101.20	107.73	105.64
Oil (Customs Union countries)	($/barrel)	52.96	47.59	51.89	49.34
Refined products					
Wholesale	($/tonne)	879.93	827.45	865.79	857.23
Retail..	($/tonne)	1,685.73	1,612.90	1,673.46	1,636.41
Average realized price within Russia					
Oil..	($/barrel)	50.07	45.41	48.90	46.78
Refined products					
Wholesale	($/tonne)	654.51	689.07	662.85	709.53
Retail..	($/tonne)	993.47	1,018.91	983.10	1,037.56

During the second quarter of 2014, our revenues increased by $3,152 million, or by 9.0%, compared to the second quarter of 2013. Our revenues from crude oil sales increased by $2,622 million, or by 43.5%. Our revenues from sales of refined products decreased by $480 million, or by 1.8%.

During the first half of 2014, our revenues increased by $5,063 million, or by 7.4%, compared to the same period of 2013. Our revenues from crude oil sales increased by $5,078 million, or by 42.2%. Our revenues from sales of refined products decreased by $953 million, or by 1.8%.

The changes in ruble-nominated revenues against the first half of 2013 were significantly affected by the nominal ruble devaluation by 12.8%.

Sales of crude oil

Our international sales volumes increased by 2,469 thousand tonnes, or by 31.6%, compared to the second quarter of 2013, and by 5,450 thousand tonnes, or by 36.0%, compared to the first half of 2013, as a result of increased volumes of trading. Moreover, our international realized crude oil prices increased by 8.9%, compared to the second quarter of 2013, and by 2.9%, compared to the first half of 2013. As a result, our international sales revenue increased by 43.4%, or by $2,327 million, and by 40.0%, or by $4,337 million, in the second quarter and the first half of 2014, respectively.

Our domestic sales volumes increased by 31.5%, compared to the second quarter of 2013, and by 55.0%, compared to the first half of 2013, due to continuing increase in domestic demand and volumes of crude oil production in Russia. As a result, in the second quarter and the first half of 2014, our domestic sales revenue increased by 44.8%, or by $295 million, and by 62.0%, or by $741 million, respectively.

In the second quarter and the first half of 2014, our revenue from crude oil export from Russia both to the Group companies and third parties amounted to $5,337 million and $10,590 million, respectively.

Sales of refined products

Compared to the same periods of 2013, our revenue from the wholesale of refined products outside of Russia decreased by $575 million, or by 2.9%, in the second quarter of 2014 and by $658 million, or by 1.7%, in the first half of 2014. The increase in sales prices by 6.3% in the second quarter of 2014 and by 1.0% in the first half of 2014 was outweighed by the decrease in sales volumes as a result of overhauls at our plants in Bulgaria in the first quarter of 2014 and in the Netherlands in the second quarter of 2014, as well as the decrease in trading volumes compared to the second quarter of 2013.

Compared to the second quarter and the first half of 2013, some decrease of retail volumes outside of Russia was compensated by increase in realized retail prices. As a result, our retail sales revenue didn’t change significantly both to the second quarter and first half of 2013.

In the second quarter of 2014, our revenue from the wholesale of refined products on the domestic market was flat compared to the second quarter of 2013. A decrease in realized prices due to the ruble devaluation was compensated by an increase in sales volumes. In the first half of 2014, a decrease in sales volumes by 91 thousand tonnes, or by 1.7%, was emphasized by a decrease in sales prices by 6.6% caused by ruble devaluation. As a result, our wholesale refined products revenue decreased by $309 million, or 8.2%.

Our revenue from retail sales in Russia increased by $70 million, or by 3.1%, in the second quarter of 2014. Retail sales volumes increased by 5.8% that was partially offset by a decrease in average domestic retail prices by 2.5% as a result of ruble devaluation. In the first half of 2014, an increase in domestic sales volumes nearly offset the decrease in prices, so our domestic retail revenue didn't change significantly, compared to the first half of 2013, despite sizable ruble devaluation.

In the second quarter and the first half of 2014, our revenue from export of refined products from Russia both to Group companies and third parties amounted to $4,617 million and $9,337 million, respectively.

Sales of petrochemical products

Our revenue from sales of petrochemical products decreased by $190 million, or by 41.0%, in the second quarter of 2014 and by $272 million, or by 29.2%, in the first half of 2014. This was largely due to a significant decrease of domestic sales volumes, compared to 2013, as a result of cease of production at our plant in Stavropol region of Russia as a consequence of a fire at the plant in the end of February 2014.

Sales of gas and gas products

Sales of gas and gas refined products increased by $37 million, or by 4.7%, in the second quarter of 2014 and by $45 million, or by 2.8%, in the first half of 2014.

Gas products wholesales revenue increased by $51 million, or by 19.8%, in the second quarter of 2014 and by $60 million, or by 10.9%, in the first half of 2014. Average realized wholesale prices and sales volumes for gas products increased by 11.0% and 7.9% in the second quarter of 2014 and by 6.4% and 4.3%, in the first half of 2014, respectively.

Retail gas products revenue increased by $13 million, or by 8.8%, in the second quarter of 2014 and by $21 million, or by 7.7%, in the first half of 2014.

Natural gas sales revenue decreased by $27 million, or by 7.0%, in the second quarter of 2014 and by $36 million, or by 4.5%, in the first half of 2014. The decrease was mainly due to lower production volumes in Uzbekistan.

Sales of energy and related services

Our revenue from sales of electricity, heat and related services increased by $21 million, or by 7.1%, in the second quarter of 2014 and by $33 million, or by 4.2%, in the first half of 2014. The increase of sales volumes that resulted from commissioning of two combined cycle gas turbines with a combined capacity of 235 MW in Astrakhan, Russia in mid-2013 and consequent increase in volumes of power generation, compared to the second quarter and the first half of 2013, was partially offset by the effect of ruble devaluation.

Sales of other products

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

Revenue from other sales increased by $1,142 million in the second quarter of 2014 and by $1,132 million in the first half of 2014. In the second quarter and the first half of 2014, other revenue included $1,179 million related to cost compensation within the West Qurna-2 project.

Operating expenses

Operating expenses include the following:

	2nd quarter of		**1st half of**	
	2014	**2013**	**2014**	**2013**
	(millions of US dollars)			
Hydrocarbon extraction expenses	1,259	1,078	2,270	2,087
Own refining expenses	518	555	998	1,063
Refining expenses at third parties and affiliated refineries	52	83	116	160
Cost of processing operations at ISAB	–	47	–	91
Expenses for crude oil transportation to refineries	270	335	543	673
Power generation and distribution expenses	171	172	361	364
Petrochemical expenses	45	73	111	152
Other operating expenses	243	173	468	376
Total operating expenses	**2,558**	**2,516**	**4,867**	**4,966**

The method of allocation of operating expenses above differs from the approach used in preparing the data for Note 20 “Segment information” to our interim consolidated financial statements. Expenditures in the segment reporting are grouped depending on the segment to which a particular company belongs. Operating expenses for the purposes of this analysis are grouped based on the nature of the costs incurred.

The changes in ruble-nominated operating expenses against the first half of 2013 were significantly affected by the nominal ruble devaluation by 12.8%.

Compared to the respective periods of 2013, our operating expenses increased by $42 million, or by 1.7%, in the second quarter of 2014, but decreased by $99 million, or by 2.0%, in the first half of 2014.

Hydrocarbon extraction expenses

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

Our extraction expenses increased by $181 million, or by 16.8%, in the second quarter of 2014 and by $183 million, or by 8.8%, in the first half of 2014. In the second quarter of 2014, our extraction expenses included $161 million of start-up costs and production expenses related to West Qurna-2 project. In the first half of 2014, approximately $24 million of the extraction expenses refer to ZAO Samara-Nafta, acquired in April 2013. In Russia, the increase in costs was compensated by the ruble devaluation.

Our average hydrocarbon extraction expenses increased from $5.59 per BOE in the second quarter of 2013 to $6.13 per BOE in the second quarter of 2014, or by 9.7%, and from $5.44 per BOE in the first half of 2013 to $5.70 per BOE in the first half of 2014, or by 4.8%. This was due to write-off of certain start-up costs related to commencement of commercial production at West Qurna-2 oilfield in the second quarter of 2014.

Own refining expense

Our own refining expenses decreased by $37 million, or by 6.7%, in the second quarter of 2014, and by $65 million, or by 6.1%, in the first half of 2014.

Refining expenses at our domestic refineries decreased by 6.5%, or by $19 million, in the second quarter of 2014, and by $48 million, or by 8.7%, in the first half of 2014. The effect of ruble devaluation, lower consumption and cost of additives and lower expenses for overhauls outweighed the effect of increased production volumes.

Refining expenses at our international refineries decreased by 6.8%, or by $18 million, in the second quarter of 2014, and by 3.3%, or by $17 million, in the first half of 2014. Sizeable increase in production volumes at ISAB against the background of low volumes of refining in the first half of 2013 due to overhauls was outweighed by the effect of the drop in electricity tariffs in Sicily and decrease in expenses of our Romanian and Bulgarian refineries due to lower expenses on overhauls.

Refining expenses at third party and affiliated refineries

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

In the second quarter and the first half of 2014, refining expenses at third party and affiliated refineries decreased by 37.3%, or by $31 million, and by 27.5%, or by $44 million, respectively, as a result of significantly lower volumes of crude oil processing at third party refineries in Belarus, and the effect of ruble devaluation.

Expenses for crude oil transportation to refineries

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

Our expenses for crude oil transportation to refineries decreased by $65 million, or by 19.4%, in the second quarter of 2014 and by $130 million, or by 19.3%, in the first half of 2014, due to significantly lower volumes of crude oil processing at third party refineries in Belarus, the decrease in supplies of own crude oil from Russia to ISAB and the effect of ruble devaluation.

Power generation and distribution expenses

During the second quarter and the first half of 2014 power generation and distribution expenses remained nearly flat compared to the respective periods of 2013. The effect of ruble devaluation outweighed the increase of expenses that resulted from the commissioning of new combined cycle gas turbines with a combined capacity of 235 MW in Astrakhan, Russia in the middle of 2013.

Other operating expenses

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

Other operating expenses increased by $70 million, or by 40.5%, in the second quarter of 2014, and by $92 million, or by 24.5%, in the first half of 2014, driven largely by changes in estimates of existing asset retirement obligations.

Cost of purchased crude oil, gas and products

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

Cost of purchased crude oil, gas and products increased by $2,409 million, or by 14.6%, in the second quarter of 2014 and by $4,549 million, or by 14.4%, in the first half of 2014, largely as a result of the increase in crude oil trading volumes.

In the second quarter of 2014, we recognized a $182 million net loss from hedging, compared to a $146 million net gain in the second quarter of 2013. At the same time, in the first half of 2014, we recognized a $109 million net loss from hedging, compared to a net gain of $81 million in the first half of 2013.

Transportation expenses

In the second quarter of 2014, our transportation expenses didn't change significantly, compared to the second quarter of the previous year. In the first half of 2014, transportation expenses decreased by $102 million, or by 3.2%, compared to the first half of 2013, largely due to the ruble devaluation, decrease of tariffs abroad and lower volumes of crude oil export from Russia. At the same time, these factors were partially offset by rerouting of our refined products supplies.

Our actual transportation expenses related to crude oil and refined products deliveries to various export destinations, weighted by volumes transported, changed to the first half of 2013 as follows: crude oil pipeline tariffs decreased by 10.1%, railway tariffs for refined products transportation decreased by 14.5%, crude oil freight rates decreased by 12.5%, and refined products freight rates decreased by 11.3%.

Selling, general and administrative expenses

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

Our selling, general and administrative expenses increased by $43 million, or by 4.4%, in the second quarter of 2014 and by $33 million, or by 1.8%, in the first half of 2014.

Depreciation, depletion and amortization

Our depreciation, depletion and amortization expenses increased by $1,041 million, or by 72.1%, compared to the second quarter of 2013, and by $1,184 million, or by 42.1%, compared to the first half of 2013. Our depreciation, depletion and amortization expenses for the second quarter and the first half of 2014 included $1,005 million related to the West Qurna-2 field, where we commenced commercial production in the second quarter of 2014. The increase in depreciation, depletion and amortization expenses was driven also by our capital expenditures and the corresponding increase in value of depreciable assets and the acquisition of ZAO Samara-Nafta in April 2013.

Equity share in income of affiliates

The Group has investments in equity method affiliates and corporate joint ventures. These companies are primarily engaged in crude oil exploration, production, marketing and distribution operations in the Russian Federation, crude oil production and marketing in Kazakhstan and refining operations in the Netherlands. Our largest affiliates are Turgai Petroleum and Tengizchevroil, exploration and production companies operating in Kazakhstan, and the Zeeland Refinery in the Netherlands.

Our share in income of affiliates decreased by $48 million, or by 34.5%, compared to the second quarter of 2013, and by $24 million, or by 8.1%, compared to the first half of 2013. This was mainly due to the decrease in income of Turgai Petroleum, as a result of lower production volumes, and Zeeland, as a result of lower volumes of refining driven by decreased refining margins and stoppage time for overhauls.

Taxes other than income taxes

	2nd quarter of		1st half of	
	2014	**2013**	**2014**	**2013**
	(millions of US dollars)			
In Russia				
Mineral extraction taxes	3,055	3,010	6,136	6,006
Social security taxes and contributions	133	141	278	307
Property tax	125	141	249	269
Other taxes	23	33	44	52
Total in Russia	**3,336**	**3,325**	**6,707**	**6,634**
International				
Mineral extraction taxes	15	20	33	37
Social security taxes and contributions	32	30	63	60
Property tax	8	8	17	16
Other taxes	17	13	34	32
Total internationally	**72**	**71**	**147**	**145**
Total	**3,408**	**3,396**	**6,854**	**6,779**

In the second quarter and the first half of 2014, taxes other than income taxes didn't change significantly, compared to the respective periods of 2013. The effects of mineral extraction tax rate growth and the increase in domestic crude oil production were partially offset by the increase in the amount of mineral extraction tax incentive. The decrease in social security taxes and contributions, property and other taxes in Russia against the second quarter and the first half of 2013 was mainly due to the ruble devaluation.

In the second quarter and the first half of 2014, application of the reduced rate for crude oil produced from depleted oilfields and the zero rate for crude oil produced from oilfields with extra heavy crude oil and from greenfields led to $607 million and $1,191 million mineral extraction tax reduction, respectively ($436 million and $904 million in the second quarter and the first half of 2013, respectively).

Excise and export tariffs

	2nd quarter of		1st half of	
	2014	**2013**	**2014**	**2013**
	(millions of US dollars)			
In Russia				
Excise tax on refined products	500	489	917	925
Crude oil export tariffs	2,217	2,623	4,765	5,107
Refined products export tariffs	1,527	1,592	3,153	3,207
Total in Russia	**4,244**	**4,704**	**8,835**	**9,239**
International				
Excise tax and sales taxes on refined products	979	929	1,800	1,751
Crude oil export tariffs	51	59	103	121
Refined products export tariffs	65	95	88	177
Total internationally	**1,095**	**1,083**	**1,991**	**2,049**
Total	**5,339**	**5,787**	**10,826**	**11,288**

Export tariffs decreased by $509 million, or by 11.7%, in the second quarter of 2014 and by $503 million, or by 5.8%, in the first half of 2014. Compared to the second quarter and the first half of 2013, the volumes of crude oil export beyond the Customs Union decreased by 11.2% and 5.5%, respectively. Refined products export volumes decreased by 0.8% in the second quarter of 2014 and increased by 2.5% in the first half of 2014. This increase which was outweighed by the decrease of export tariffs rates.

Exploration expenses

In the second quarter of 2014, our exploration expenses decreased by $11 million, while in the first half of 2014, our exploration expenses increased by $131 million as a result of dry whole write-offs in the first quarter of 2014. Thus, dry hole costs in the first half of 2014 amounted to $95 million that represented dry exploratory well in Cote d'Ivoire, compared to $3 million in the first half of 2013. The rest of the increase was due to the growth in volume of seismic in Western Siberia.

Loss on disposals and impairments of assets

In April 2014, the Group entered into an agreement to sell its 50% share in Caspian Investment Resources Ltd. The loss on expected disposal of this share was estimated at $358 million. For more details on this agreement, refer to page 3.

Moreover, in the first quarter of 2014, the Group wrote off signing bonuses related to projects in Sierra Leone and Cote d'Ivoire in the total amount of $67 million.

Income taxes

The maximum statutory rate in Russia is 20%. Nevertheless, the actual effective income tax rate may be higher due to non-deductible expenses or lower due to certain non-taxable gains. Moreover, quarterly deviations of the effective income tax rates from the maximum statutory rate may happen due to currency translation losses and gains reported by Russian subsidiaries, that decrease or increase taxable income in the respective periods.

In the second quarter of 2014, our total income tax expense decreased by $277 million, or by 37.0%, compared to the second quarter of 2013. At the same time, our income before income tax increased by $28 million, or by 1.0%.

In the first half of 2014, our total income tax expense decreased by $399 million, or by 26.0%, compared to the first half of 2013, while our income before income tax decreased by $942 million, or by 15.2%.

In the second quarter of 2014, our effective income tax rate was 16.4%, compared to 26.3% in the second quarter of 2013. In the first half of 2014, effective income tax rate was 21.6%, compared to 24.7% in the first half of 2013.

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

	2nd quarter of		1st half of	
	2014	**2013**	**2014**	**2013**
	(millions of US dollars)			
Net income	**2,389**	**2,104**	**4,122**	**4,685**
Add back:				
Income tax expense	471	748	1,138	1,537
Depreciation and amortization	2,485	1,444	3,997	2,813
Interest expense	155	121	295	218
Interest and dividend income	(63)	(58)	(120)	(119)
EBITDA	**5,437**	**4,359**	**9,432**	**9,134**
Add back loss on disposal of assets and dry whole related write-offs	–	–	520	–
EBITDA adjusted for one-off items	**5,437**	**4,359**	**9,952**	**9,134**
Including impact of West Qurna-2 project	1,017	–	1,017	–

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

Liquidity and capital resources

	1st half of 2014	1st half of 2013
	(millions of US dollars)	
Net cash provided by operating activities	7,562	7,678
Net cash used in investing activities	(6,928)	(10,008)
Net cash provided by financing activities	362	2,642

Operating activities

Our primary source of cash flow is funds generated from our operations. During the first half of 2014, cash generated from operations didn't change significantly, compared to the first half of 2013, and amounted to $7,562 million.

Investing activities

In the first half of 2014, the amount of cash used in investing activities decreased by 30.8% largely against the background of significant spending on the acquisition of licenses and subsidiaries in the first half of 2013.

Our capital expenditures, including non-cash transactions, amounted to $7,722 million, which was 10.7% higher than in the first half of 2013.

	2nd quarter of 2014	2nd quarter of 2013	1st half of 2014	1st half of 2013
	(millions of US dollars)			
Capital expenditures, including non-cash transactions and prepayments				
Exploration and production				
Russia	2,467	2,045	4,440	3,919
International	978	873	1,730	1,536
Total exploration and production	3,445	2,918	6,170	5,455
Refining, marketing and distribution				
Russia	681	323	908	794
International	211	166	431	325
Total refining, marketing and distribution	892	489	1,339	1,119
Chemicals				
Russia	48	31	80	34
International	–	1	–	1
Total chemicals	48	32	80	35
Power generation and distribution	70	94	78	115
Other	35	94	55	249
Total capital expenditures	**4,490**	**3,627**	**7,722**	**6,973**

Capital expenditures in the exploration and production segment increased by $715 million, or by 13.1%, compared to the first half of 2013. In Russia, the increase related to higher volumes and the cost of production drilling in the Ural region, the Komi Republic and Western Siberia was partially outweighed by the effect of ruble devaluation. Internationally, we increased expenditures in Shakh-Deniz project in Azerbaijan and commenced exploration activities at our new projects in Ghana and Romania.

The increase of capital expenditures in domestic refining, marketing and distribution segment was due to continuing construction of a vacuum gasoil refinery complex at the Volgograd refinery and construction of a heavy residue processing complex and a power generation facility at our refinery in Perm.

Other capital expenditures mostly refer to investments of OAO Arkhangelskgeoldobycha, a Group company, involved in diamond deposits development in the Arkhangelsk region of Russia. The decrease of the respective capital expenditures was due to fulfillment of the most stages of the capital investment program at the deposits.

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

	2nd quarter of		1st half of	
	2014	2013	2014	2013
	(millions of US dollars)			
Yamal	218	95	294	208
Caspian region[1]	473	434	708	878
Ghana	149	1	151	8
Cote d'Ivoire	2	29	82	36
Iraq	425	562	801	1,019
Uzbekistan	168	163	301	259
Romania	54	2	56	3
Total	**1,489**	**1,286**	**2,393**	**2,411**

[1] Russian and international projects.

Moreover, in the first half of 2013, a Group company paid $835 million as a second 50% installment for the acquisition of the subsoil rights for the site that includes the Imilorskoye, West Imilorskoye and Istochnoye fields in Western Siberia. The first 50% payment was made in December 2012.

	2nd quarter of		1st half of	
	2014	2013	2014	2013
	(millions of US dollars)			
Acquisitions of subsidiaries and associates[1]				
Exploration and production				
Russia	13	2,387	13	2,390
International	52	–	63	–
Total exploration and production	65	2,387	76	2,390
Refining, marketing and distribution				
Russia	(365)	69	(299)	73
International	10	–	36	–
Total refining, marketing and distribution	(355)	69	(263)	73
Less cash acquired	(34)	(15)	(34)	(15)
Total acquisitions	**(324)**	**2,441**	**(221)**	**2,448**

[1] Including prepayments related to acquisitions and non-cash transactions.

In the first half of 2014, the Group did not make any significant acquisitions. In the first half of 2013, the Company spent $2.1 billion for the acquisition of 100% of the shares of ZAO Samara-nafta and $266 million as the final installment within the acquisition of 50% of the shares of ZAO Kama-oil.

Moreover, in the second quarter of 2014, we received back an advance payment in amount of $367 million, related to planned acquisition in "Refining, marketing and distribution" segment in Russia.

Financing activities

In the first half of 2014, net movements of short-term and long-term debt generated an inflow of $438 million, compared to an inflow of $2,721 million in the first half of 2013.