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 2011 and 2010 together with our unaudited consolidated interim condensed financial information as of and for the three months ended 31 March 2011. The unaudited consolidated interim condensed financial information has been prepared in accordance with International Accounting Standard 34, *Interim Financial Reporting*. This consolidated interim condensed financial information should be read together with the audited consolidated financial statements for the year ended 31 December 2010 prepared in accordance with International Financial Reporting Standards (IFRS).

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 (hereinafter jointly referred to as "we" or the "Group").

OVERVIEW

We are Russia's largest independent natural gas producer and the second-largest producer of natural gas in Russia after Gazprom, in each case according to the Central Dispatch Administration of the Fuel and Energy Complex (the "CDU-TEK") for the respective 2010 and 2011 reporting periods. In terms of proved natural gas reserves, we are the second largest holder of natural gas resources in Russia after Gazprom, under the Petroleum Resources Management System ("PRMS") reserve reporting methodology.

Our exploration, development, production and processing of natural gas, gas condensate and crude oil have been conducted primarily within the Russian Federation, and in accordance with Russian law, we sell our natural gas volumes exclusively in the Russian domestic market. We export our stable gas condensate directly to international markets while our liquefied petroleum gas ("LPG") and crude oil are generally delivered to both international (including CIS) and domestic markets. We generally sell oil products produced from our unstable gas condensate on the domestic market.

RECENT DEVELOPMENTS

In March 2011, NOVATEK and TOTAL S.A. ("TOTAL") signed a Memorandum of Cooperation, which provides for TOTAL to acquire a 20% participation interest in the Yamal LNG project. The memorandum stipulates that both parties have defined the parameters of the project's strategic partnership and shall take steps to close the deal by the end of the first half of 2011.

In February 2011, the Group issued a debut Eurobond in an aggregate amount of USD 1,250 million. The bond was issued at par it two tranches, a five-year USD 600 million bond with a coupon rate of 5.326 percent per annum and a ten-year USD 650 million bond with a coupon rate of 6.604 percent per annum. The proceeds from the Eurobonds were used to repay a bridge facility and a portion of the costs associated with the acquisition of OAO "Sibneftegas" ("Sibneftegas").

In December 2010, the Group acquired 51 percent of the outstanding ordinary shares of Sibneftegas, an oil and gas company, which holds exploration and production licenses for the development of oil and gas condensate at the Beregovoye, Pyreinoye, Zapadno-Zapolyarnoye and Khadyryakhinskoye fields located in the Yamal Nenets Autonomous Region ("YNAO"). Sibneftegas' proved reserves, appraised by "DeGolyer and MacNaughton" ("D&M") under the PRMS and Securities and Exchange Commission (SEC) reserves methodologies, as of 31 December 2010, totaled approximately 282 billion and 200 billion cubic meters of natural gas and 2.0 million and 0.7 million tons of liquid hydrocarbons, respectively.

In December 2010, the Group acquired 100 percent of the outstanding ordinary shares of OOO "Yamalgasresource-Chelyabinsk", a regional gas trader, to expand natural gas sales opportunities in the Chelyabinsk Region. The company was renamed to OOO "NOVATEK-Chelyabinsk" in February 2011.

In July 2010, we created a 50/50 joint venture, OOO "Yamal Development" ("Yamal Development"), with OAO "Gazprom Neft" to jointly develop potential hydrocarbon assets in the YNAO. In November 2010, Yamal Development acquired a 51 percent participation interest in OOO "SeverEnergia" ("SeverEnergia"). SeverEnergia holds 100% of the shares of OAO "Arctic Gas", ZAO "Urengoil Inc." and OAO "Neftegaztechnologia", which hold licenses for the development of oil and gas condensate fields in the

YNAO. SeverEnergia’s proved reserves as appraised by D&M under the PRMS and SEC reserves methodologies, as of 31 December 2010, totaled approximately 245 and 224 billion cubic meters of natural gas and 42 and 39 million tons of liquid hydrocarbons, respectively.

In October 2010, we launched the third stage of the second phase development at our Yurkharovskoye field, which includes two additional processing trains for separating natural gas, thus increasing the field’s annual productive capacity to approximately 33 billion cubic meters of natural gas and approximately three million tons of unstable gas condensate.

In September 2010, the Group disposed of its 100 percent participation interest in OOO “NOVATEK-Polymer”, a non-core subsidiary representing the segment “polymer production and marketing”, to JSC SIBUR Holding.

In September 2010, we dispatched a consignment of stable gas condensate to China via the Arctic Ocean’s Northern Sea Route, which significantly reduced the traditional delivery distance from approximately 12,900 nautical miles to approximately 7,700 nautical miles. The cargo was delivered in 22 days, approximately half the time required by the traditional shipping route through the Suez Canal. We plan to continue using the Northern Sea Route for deliveries of our stable gas condensate to the Asian-Pacific region subject to the routes navigability.

In August 2010, we acquired 100 percent of the outstanding ordinary shares of “Intergaz-System Sp.z.o.o.” (“Intergaz-System”), an LPG trader located in the South-East of Poland, and in December 2010 it was merged with our Polish registered wholly-owned subsidiary “Novatek Polska Sp.z.o.o.” (“Novatek Polska”). Intergaz-System owns and operates a discharging and transhipment facility at the wide track (Russian) and narrow track (European) railroad junction. The acquisition enables us to continue developing our commercial activities within Poland and other European countries.

In August 2010, we launched an unstable gas condensate de-ethanization facility at our Yurkharovskoye field and completed the unstable gas condensate pipeline connecting the Yurkharovskoye field to the Purovsky Plant. This launch allows us to process and transport all of the unstable gas condensate produced at the Yurkharovskoye field to the Purovsky Plant without utilizing third party facilities.

In July 2010, the Group acquired 100 percent of the outstanding ordinary shares of OAO “Tambeyneftegas”, an oil and gas company, which holds the license for exploration and development of the Malo-Yamalskoye field (license expiry date 2019) located in the southern part of the Yamal peninsula, in the YNAO, with estimated natural gas and gas condensate reserves according to Russian reserve classification categories C1 + C2 of 161 billion cubic meters and 14.4 million tons, respectively.

In May 2010, we established a wholly-owned subsidiary, OOO “NOVATEK Perm”, to support the Group’s current natural gas deliveries to the Perm region, as well as to expand potential sales opportunities in the region.

Our ongoing exploration work at existing fields in the three months ended 31 March 2011 resulted in the discovery of one new gas condensate deposit at the Novoyurkharovskiy license area. During 2010, we discovered three new gas condensate deposits at the Ukrainsko-Yubileyniy field, four gas condensate deposits and one natural gas deposit at the Severo-Russkiy license area, and one gas condensate deposit at the Yumantylskoye field.

SELECTED DATA

millions of Russian roubles except as stated	Three months ended 31 March: 2011	2010	Change %
Financial results			
Total revenues (net of VAT and export duties)	44,861	27,742	61.7%
Operating expenses	(23,421)	(15,947)	46.9%
Profit attributable to NOVATEK shareholders	18,853	11,182	68.6%
EBITDA [(1)]	23,092	15,160	52.3%
Normalized EBITDA [(2)]	23,092	13,577	70.1%
EBITDAX [(3)]	23,818	15,291	55.8%
Earnings per share (in Russian roubles)	6.22	3.69	68.6%
Operating results			
Natural gas sales volumes (million cubic meters)	13,992	10,106	38.5%
Stable gas condensate sales volumes (thousand tons)	724	412	75.7%
Liquefied petroleum gas sales volumes (thousand tons)	229	225	1.8%
Crude oil sales volumes (thousand tons)	49	44	11.4%
Oil product sales volumes (thousand tons)	1	3	(66.7%)
Total hydrocarbons production (million barrels of oil equivalent)	86.6	71.6	20.9%
Total daily production (thousand barrels of oil equivalent per day)	962	796	20.9%
Cash flow results			
Net cash provided by operating activities	19,205	12,454	54.2%
Capital expenditures	6,342	6,230	1.8%
Free cash flow [(4)]	12,863	6,224	106.7%

(1) EBITDA represents profit (loss) attributable to shareholders of NOVATEK adjusted for the addback of income tax expense and finance income (expense) from the statement of income, and depreciation, depletion and amortization and share-based compensation from the statement of cash flows.

(2) Normalized EBITDA excludes one-time effect from disposal of investments.

(3) EBITDAX represents EBITDA as adjusted for the addback of exploration expenses.

(4) Free cash flow represents the excess of Net cash provided by operating activities over Capital expenditures.

Reconciliation of EBITDA and EBITDAX to profit (loss) attributable to shareholders of OAO NOVATEK is as follows for the three months ended 31 March 2011 and 2010:

millions of Russian roubles	Three months ended 31 March: 2011	2010
Profit (loss) attributable to shareholders of OAO NOVATEK	**18,853**	**11,182**
Depreciation, depletion and amortization	2,061	1,638
Total finance income (expense)	(2,738)	(612)
Total income tax expense	4,916	2,908
Share-based compensation	-	44
EBITDA	**23,092**	**15,160**
Exploration expenses	726	131
EBITDAX	**23,818**	**15,291**

SELECTED MACRO-ECONOMIC DATA

Exchange rate of Russian rouble to US dollar	**Three months ended 31 March: 2011**	**2010**	**Change %**
At the beginning of the period	30.48	30.24	0.8%
At the end of the period	28.43	29.36	(3.2%)
Average for the period	29.27	29.89	(2.1%)

Crude oil prices, USD / bbl	**Three months ended 31 March: 2011**	**2010**	**Change %**
WTI [(1)]			
At the end of the period	106.7	83.8	27.3%
Average for the period	94.6	78.9	19.9%
Brent [(2)]			
At the end of the period	116.9	80.3	45.6%
Average for the period	105.4	76.4	38.0%
Urals [(2)]			
At the end of the period	113.1	78.2	44.6%
Average for the period	102.6	75.4	36.1%

[(1)] Based on prices quoted by New York Mercantile Exchange (NYMEX).

[(2)] Based on prices quoted by Intercontinental Exchange (ICE).

Export duties, USD / ton [(1)]	**Three months ended 31 March: 2011**	**2010**	**Change %**
Crude oil, stable gas condensate			
At the end of the period	365.0	253.6	43.9%
Average for the period	343.0	263.8	30.0%
LPG			
At the end of the period	150.2	80.0	87.8%
Average for the period	166.1	63.7	160.8%

[(1)] Export duties are determined by the government of the Russian Federation in US dollars and are paid in Russian roubles.

CERTAIN FACTORS AFFECTING OUR RESULTS OF OPERATIONS

Current financial market conditions

The economic events that have negatively impacted the domestic and global capital markets over the past couple of years have somewhat receded despite isolated economic uncertainties in several European countries. As a result, this uncertainty may continue to negatively affect all borrowers by limiting access to capital markets, despite the financial markets willingness to price recent transactions.

We have continued to monitor the credit situation very closely and have taken various measures, we deem necessary, to ensure the integrity of our financial condition and mitigate counter-party credit exposure from our natural gas and liquid hydrocarbon sales. In addition, we continue to take proactive steps to ensure the safety of our excess funds deposited with both domestic and international banks as well as limit our risk exposure from prepayments to various service providers. Presently, our cash and deposits are diversified and maintained in banks that we believe are well capitalized in accordance with international capital adequacy rules.

We have reviewed our capital expenditure program for the upcoming year and have concluded that we have sufficient liquidity, through current internal cash flows and short-term borrowing facilities, to adequately fund our core natural gas business operations and planned capital expenditure program.

Management will continue to closely monitor the economic environment in Russia as well as the domestic and international capital markets to determine if any further corrective and/or preventive measures are required to sustain and grow our business. In addition, we will continue to assess the trends in the capital markets for opportunities to access long-term funding at a reasonable cost to the Company commensurate with our investment grade credit ratings and our capital requirements.

Natural gas prices

As an independent natural gas producer, we are not subject to the Russian 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 on the domestic market are strongly influenced by the prices regulated by the Federal Tariffs Service (FTS), a governmental agency, and present market conditions. In the three months ended 31 March 2011, the weighted average FTS price for the primary regions where we delivered our natural gas increased by RR 336 per mcm, or 14.7%, to RR 2,628 per mcm compared to RR 2,292 per mcm in the 2010 period.

The specific 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. Sales to wholesale gas traders allow us to diversify our natural gas sales without incurring additional commercial expenses. Historically, we have realized higher prices and net margins for natural gas volumes sold directly to end-customers, as the gas transportation tariff is included in the contract price and no retail margin is lost to wholesale gas traders. However, the recent shift in our sales mix has demonstrated that the historical norm may or may not prevail in the present or future market situations.

In November 2006, the FTS approved and published a plan to liberalize the price of natural gas sold on the Russian domestic market by the year 2011. As part of the liberalization plan, the FTS approved the increases in the regulated price for natural gas by 15% effective from 1 January 2010 and 2011 for each upcoming year.

In February 2011, the Government of the Russian Federation announced certain revisions to the domestic natural gas market liberalization plan. According to the revised plan, the target date for full liberalization of the domestic natural gas market is 1 January 2015. The regulation of the domestic natural gas price prior to 2015 will be based on the net-back parity of natural gas prices on the domestic and export markets while taking into account the cost of alternative fuels. We expect further increases in the regulated price for natural gas as part of the Russian Federation government’s efforts to liberalize the price of natural gas on the Russian domestic market. We expect that the FTS will continue to approve the effective increase on an annual basis and reserves the right to modify the percentages published as well as potentially prolong the timetable toward market price liberalization based on market conditions and other factors.

In the three months ended 31 March 2011, our average natural gas price to end-customers and ex-field price increased by 14.3% and 15.4%, respectively, whereas our average transportation expense for the delivery of natural gas to end-customers increased by 9.9% primarily due to a 9.3% increase in the average transportation tariff set by the FTS (see “Transportation tariffs” below). As a result, our average netback price on end-customers sales increased by 18.3%, while our total average natural gas price excluding transportation expense increased by 17.0%, compared to respective prices in the corresponding period in 2010.

Our pricing strategy for natural gas is consistent with our commercial marketing strategy to enter new regions and markets to maintain and grow our share of natural gas deliveries to the domestic market, as well as to maintain our production growth.

The following table shows our average realized natural gas sales prices (net of VAT) for the three months ended 31 March 2011 and 2010:

Russian roubles per mcm	**Three months ended 31 March:** 2011	2010	**Change** %
Average natural gas price to end-customers [1]	2,634	2,304	14.3%
Average natural gas transportation expense for sales to end-customers	(1,208)	(1,099)	9.9%
Average natural gas netback price on end-customer sales	1,426	1,205	18.3%
Average natural gas price ex-field (wholesale traders)	1,398	1,211	15.4%
Total average natural gas price excluding transportation expense	1,412	1,207	17.0%

[1] Includes cost of transportation.

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

Crude oil, stable gas condensate, 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 and willingness of oil producing countries to sustain or change production levels to meet changes in global demand and potential disruptions in global crude oil supplies due to war, geopolitical developments, terrorist activities or natural disasters.

The actual prices we receive for our liquid hydrocarbons on both the domestic and international markets are dependent on many external factors beyond the control of management, such as movements in international benchmark crude oil prices. 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 (or historically) trades at a discount to the international benchmark Brent crude oil.

Volatile movements in benchmark crude oil prices can have a positive and/or negative impact on the ultimate prices we receive for our liquid volumes sold on both the domestic and international markets, among many other factors. In the three months ended 31 March 2011, the average benchmark crude oil prices were more than 20% higher than in the corresponding period in 2010.

Our stable gas condensate, LPG (excluding obligatory domestic deliveries at regulated prices), crude oil and oil products prices on both international and domestic markets include transportation expense in accordance with the specific terms of delivery.

In the three months ended 31 March 2011, our stable gas condensate export delivery terms were delivery to the port of destination ex-ship (DES) or priced at cost, insurance and freight (CIF), or priced at cost and freight (CFR), or delivery at point of destination (DAP), or delivery at terminal (DAT), while in the corresponding period in 2010 our delivery terms were either DES or CFR. Our average export stable gas condensate contract price, including export duties, in the three months ended 31 March 2011 was approximately USD 911 per ton compared to approximately USD 667 per ton in the corresponding period in 2010.

In the three months ended 31 March 2011, our crude oil export delivery terms were DAP Feneshlitke, Hungary, while in the corresponding period in 2010 our delivery terms were delivery at frontier (DAF, Feneshlitke, Hungary). Our average crude oil export contract price, including export duties, was approximately USD 733 per ton compared to USD 535 per ton in the 2010 period.

The following table shows our average realized stable gas condensate and crude oil sales prices (net of VAT and export duties, where applicable) for the three months ended 31 March 2011 and 2010 (prices in US dollars were translated from Russian roubles using the average exchange rate for the period):

Russian roubles (RR) or US dollars (USD) per ton	**Three months ended 31 March: 2011**	**2010**	**Change %**
Stable gas condensate			
Net export price, RR per ton	16,846	11,973	40.7%
Net export price, USD per ton	575.5	400.6	43.7%
Domestic price, RR per ton	-	8,475	n/a
Crude oil			
Net export price, RR per ton	11,285	8,016	40.8%
Net export price, USD per ton	385.6	268.2	43.8%
Domestic price, RR per ton	10,107	6,843	47.7%

Our LPG export delivery terms during the three months ended 31 March 2011, were DAP at the border of the customer's country, or carriage paid to (CPT) the Port of Temryuk (southern Russia), or priced free carrier (FCA) at the terminal points in Poland, compared to DAF (at the border of the customer's country), CPT (the Port of Temryuk) and FCA (the terminal points in Poland) in the corresponding period in 2010. In the three months ended 31 March 2011, our average export contract price for LPG produced at the Purovsky Plant, including export duties, was approximately USD 850 per ton compared to USD 637 per ton the corresponding period in 2010. In the three months ended 31 March 2011, our LPG CIS delivery terms were DAP (at the border of the customer's country).

In the three months ended 31 March 2011, as well as in the corresponding period in 2010, we were obliged to sell a portion of our LPG sales volumes on the domestic market at regulated prices while the remaining portion of our sales was sold under commercial terms. In the three months ended 31 March 2011, we sold a total of 12 thousand tons at the regulated price of RR 7,605 per ton. In the three months ended 31 March 2010, we sold 11 thousand tons of LPG on the domestic market at the regulated price of RR 5,750 per ton in January and RR 6,613 per ton in February and March. In the three months ended 31 March 2011, we sold 100 thousand tons at an average commercial price of RR 12,488 per ton, including volumes sold through our wholly-owned subsidiary OOO "NOVATEK-Refueling Complexes", compared to 110 thousand tons at an average commercial price of RR 10,788 per ton in the corresponding period in 2010.

The following table shows our average realized LPG and oil products sales prices excluding trading activities (net of VAT and export duties, where applicable) for the three months ended 31 March 2011 and 2010 (prices in US dollars were translated from Russian roubles using the average exchange rate for the period):

Russian roubles (RR) or US dollars (USD) per ton	**Three months ended 31 March: 2011**	**2010**	**Change %**
LPG			
Net export price, RR per ton	20,383	17,128	19.0%
Net export price, USD per ton	696.4	573.0	21.5%
CIS price, RR per ton	13,355	-	n/a
Domestic commercial price, RR per ton	12,488	10,788	15.8%
Domestic regulated price, RR per ton	7,605	6,346	19.8%
Oil products			
Domestic price, RR per ton	-	7,522	n/a

Transportation tariffs

Natural gas

We transport our natural gas through our pipelines into the Unified Gas Supply System ("UGSS"), which is owned and operated by OAO "Gazprom", a State monopoly. The transportation of all natural gas volumes produced in Russia is performed through the UGSS. Transportation tariffs for the use of the UGSS by independent producers are set by the FTS.

In accordance with the methodology of calculating transportation tariffs for natural gas produced in the Russian Federation 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), the transportation tariff consists of two parts: a rate for the utilization of the trunk pipeline and a transportation rate per mcm per 100 kilometers (km). The rate for utilization of the trunk pipeline is based on an "input/output" function, which is determined by where natural gas enters and exits the trunk pipeline and includes a constant rate for end-customers using Gazprom's gas distribution systems. The constant rate is deducted from the utilization rate for end-customers using non-Gazprom gas distribution systems.

In December 2009, the FTS approved a 12.3% average increase for the 2010 transportation tariff for natural gas effective 1 January 2010. Effective from 1 January 2010, the rate for utilization of the trunk pipeline had a range of RR 32.92 to RR 1,818.37 (excluding VAT) per mcm and the transportation rate was RR 10.27 (excluding VAT) per mcm per 100 km.

In December 2010, the FTS approved a 9.3% average increase for the 2011 transportation tariff for natural gas effective 1 January 2011, which is 0.5% higher than the official inflation rate for 2010 in the Russian Federation. Effective from 1 January 2011, the rate for utilization of the trunk pipeline had a range of RR 44.97 to RR 1,964.13 (excluding VAT) per mcm and the transportation rate was RR 11.23 (excluding VAT) per mcm per 100 km.

The increases in regulated transportation tariffs are passed on to our end-customers pursuant to delivery terms in the majority of our contracts.

Crude oil

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 for the transport of crude oil depends on the length of the transport route from the producing field to the ultimate destination.

Stable gas condensate, LPG and oil products

Our stable gas condensate (to the Port of Vitino on the White Sea), LPG and oil products are transported by rail which is owned and operated by Russian Railways, Russia's state-owned monopoly railway operator. Our transportation tariffs for transport by rail are also set by the FTS and vary depending on product and length of transport route.

In January 2010, the FTS approved the discount co-efficients to existing rail road transportation tariffs related to export deliveries of LPG and stable gas condensate shipped from the Limbey rail station, located in close proximity to our Purovsky Plant. The discount co-efficient for stable gas condensate was set at 0.89 for annual volumes shipped to export markets of more than 2,235 thousand tons and the discount co-efficient for LPG was set at 0.35 for export volumes in excess of 105 thousand tons which we reached in the middle of April 2010. The discount co-efficients remained in effect throughout 2010.

In December 2010, the FTS revised the discount co-efficients to existing rail road transportation tariffs related to export deliveries of LPG and stable gas condensate shipped from the Limbey rail station in 2011. The discount co-efficient for stable gas condensate is set at 0.89 for companies with annual shipped volumes of 2,600 thousand tons and more, and the discount co-efficient for LPG is set at 0.68 for delivered annual volumes of 415 thousand tons and more. The revised discount co-efficients are expected to remain in effect throughout 2011.

We deliver our stable gas condensate to international markets using the loading and storage facilities at the Port of Vitino on the White Sea and tankers for transportation to US, European, South American and countries of the Asian-Pacific region. The costs associated with tanker transportation are determined by the distance to the final destination as well as tanker availability, seasonality of deliveries and standard shipping terms.

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, payments to non-budget funds (formerly known as social taxes) and other contributions.

According to amendments to the Russian Tax Code the UPT rate for natural gas was increased from RR 147 to RR 237 per mcm, or by 61.2%, effective from 1 January 2011. In addition, effective from 1 January 2012 and 1 January 2013 the UPT rate for natural gas is expected to be increased by 5.9% and by 5.6% respectively, as of the reporting date.

In practice, Russian tax authorities often have their own interpretation of tax laws that rarely favours taxpayers, who 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 immediately preceding the year in which the audit is conducted. Previous audits do not completely exclude subsequent claims relating to the audited period. In addition, in some instances, new tax regulations have been given retroactive effect.

We have not employed any tax minimization schemes using offshore or domestic tax zones in the Russian Federation.

OPERATIONAL HIGHLIGHTS

Hydrocarbon sales volumes

Our natural gas sales volumes increased primarily due to an increase in production at the Yurkharovskoye field and the initiation of purchases from our associated company, Sibneftegas, as well as a decrease in inventory balances. Liquids sales volumes increased primarily due to an increase in unstable gas condensate production at the Yurkharovskoye field and a buildup in liquids inventory balances in the 2010 period.

Natural gas sales volumes

millions of cubic meters	Three months ended 31 March: 2011	2010	Change %
Production from:			
Yurkharovskoye field	7,802	5,586	39.7%
East-Tarkosalinskoye field	3,310	3,394	(2.5%)
Khancheyskoye field	809	855	(5.4%)
Other fields	18	20	(10.0%)
Total natural gas production	**11,939**	**9,855**	**21.1%**
Purchases from:			
Sibneftegas	1,371	-	n/a
Total production and purchases	**13,310**	**9,855**	**35.1%**
Purovsky Plant and own usage	(31)	(21)	47.6%
Decrease (increase) in UGSF, UGSS and own pipeline infrastructure	713	272	162.1%
Total natural gas sales volumes	**13,992**	**10,106**	**38.5%**
Sold to end-customers	*7,095*	*6,110*	*16.1%*
Sold ex-field	*6,897*	*3,996*	*72.6%*

In the three months ended 31 March 2011, our total consolidated natural gas production increased by 2,084 mmcm, or 21.1%, compared to the 2010 period primarily due to an increase in production at our Yurkharovskoye field resulting from the launch of the third stage of the field's second phase development in October 2010.

In the three months ended 31 March 2011, we used 18 mmcm of natural gas for methanol production compared to eight mmcm in the corresponding period in 2010. A significant portion of the methanol we produce is used for our own internal purposes.

Liquids sales volumes

thousands of tons	Three months ended 31 March: 2011	2010	Change %
Production from:			
Yurkharovskoye field	679	470	44.5%
East-Tarkosalinskoye field	201	217	(7.4%)
Khancheyskoye field	137	167	(18.0%)
Other fields	7	8	(12.5%)
Total liquids production	**1,024**	**862**	**18.8%**
Purchases from:			
Third parties	1	5	(80.0%)
Total production and purchases	**1,025**	**867**	**18.2%**
Losses and own usage [(1)]	(7)	(12)	(41.7%)
Decreases (increases) in liquids inventory balances	(15)	(171)	(91.2%)
Total liquids sales volumes	**1,003**	**684**	**46.6%**
Stable gas condensate export	*724*	*412*	*75.7%*
Stable gas condensate domestic	-	*0*	*n/a*
Subtotal stable gas condensate	***724***	***412***	***75.7%***
LPG export	*116*	*104*	*11.5%*
LPG CIS	*1*	-	*n/a*
LPG domestic	*99*	*112*	*(11.6%)*
LPG sold through domestic retail and small wholesale stations	*13*	*9*	*44.4%*
Subtotal LPG	***229***	***225***	***1.8%***
Crude oil export	*21*	*21*	*0.0%*
Crude oil domestic	*28*	*23*	*21.7%*
Subtotal crude oil	***49***	***44***	***11.4%***
Oil products domestic	*1*	*3*	*(66.7%)*
Subtotal oil products	***1***	***3***	***(66.7%)***

[(1)] Losses associated with processing at the Purovsky Plant and Surgutsky refinery as well as during rail road, trunk pipeline and tanker transportation.

In the three months ended 31 March 2011, our liquids production increased by 162 thousand tons, or 18.8%, to 1,024 thousand tons compared to 862 thousand tons in the 2010 period, due primarily to the expansion of unstable gas condensate production capacity at our Yurkharovskoye field resulting from the launch of the third stage of the field’s second phase development in October 2010. The decrease in liquids production at the East-Tarkosalinskoye and Khancheyskoye fields was primarily the result of natural declines in the concentration of gas condensate in the extracted gas due to decreasing reservoir pressure at the current gas condensate producing horizons.

RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED 31 MARCH 2011 COMPARED TO THE CORRESPONDING PERIOD IN 2010

The following table and discussion is a summary of our consolidated results of operations for the three months ended 31 March 2011 and 2010. Each line item is also shown as a percentage of our total revenues.

	Three months ended 31 March:			
Millions of Russian roubles	**2011**	**% of total revenues**	**2010**	**% of total revenues**
Total revenues **(net of VAT and export duties)**	**44,861**	***100.0%***	**27,742**	***100.0%***
including:				
natural gas sales	28,330	*63.2%*	18,914	*68.2%*
liquids sales	16,463	*36.7%*	8,323	*30.0%*
Operating expenses	(23,421)	*(52.2%)*	(15,947)	*(57.5%)*
Net gain on disposal of interest in subsidiaries	-	*n/a*	1,583	*5.7%*
Other operating income (loss)	64	*0.1%*	(5)	*0.0%*
Profit from operations	**21,504**	***47.9%***	**13,373**	***48.2%***
Finance income (expense)	2,738	*6.1%*	612	*2.2%*
Share of income (loss) of associated companies	(526)	*(1.1%)*	(1)	*0.0%*
Profit before income tax	**23,716**	***52.9%***	**13,984**	***50.4%***
Total income tax expense	(4,916)	*(11.0%)*	(2,908)	*(10.5%)*
Profit (loss)	**18,800**	***41.9 %***	**11,076**	***39.9%***
Non-controlling interest	53	*0.1%*	106	*0.4%*
Profit attributable to shareholders of OAO NOVATEK	**18,853**	***42.0%***	**11,182**	***40.3%***

Total revenues

The following table sets forth our sales (net of VAT and export duties, where applicable) for the three months ended 31 March 2011 and 2010:

Millions of Russian roubles	Three months ended 31 March: 2011	2010	Change %
Natural gas sales	**28,330**	**18,914**	**49.8%**
End-customers	*18,688*	*14,075*	*32.8%*
Ex-field sales	*9,642*	*4,839*	*99.3%*
Stable gas condensate sales	**12,192**	**4,933**	**147.2%**
Export	*12,192*	*4,932*	*147.2%*
Domestic	-	*1*	*n/a*
Liquefied petroleum gas sales	**3,714**	**3,032**	**22.5%**
Export	*2,359*	*1,779*	*32.6%*
CIS	*10*	-	*n/a*
Domestic	*1,345*	*1,253*	*7.3%*
Crude oil sales	**515**	**325**	**58.5%**
Export	*231*	*167*	*38.3%*
Domestic	*284*	*158*	*79.7%*
Oil and gas products sales	**42**	**33**	**27.3%**
Domestic	*42*	33	*27.3%*
Total oil and gas sales	**44,793**	**27,237**	**64.5%**
Sales of polymer and insulation tape	-	469	n/a
Other revenues	68	36	88.9%
Total revenues	**44,861**	**27,742**	**61.7%**

Natural gas sales

In the three months ended 31 March 2011, our revenues from sales of natural gas increased by RR 9,416 million, or 49.8%, compared to the corresponding period in 2010 largely due to an increase in sales volumes and, to a lesser extent, an increase in natural gas prices.

In the three months ended 31 March 2011, our average realized natural gas price per mcm increased by RR 154 per mcm, or 8.2%, to RR 2,025 per mcm from RR 1,871 per mcm in the corresponding period in 2010. Our proportion of natural gas sold to end-customers to total natural gas sales volumes decreased from 60.5% in the 2010 reporting period to 50.7% in the three months ended 31 March 2011. The decrease was due primarily to the commencement of natural gas deliveries to one of our gas traders - Russian oil and gas company “ITERA” - under the long-term contract signed in April 2010 with annual volumes of approximately four billion cubic meters. There were no corresponding sales of natural gas to “ITERA” in the prior reporting period.

The average realized prices of our natural gas sold directly to end-customers (including transportation expense) and sold ex-field were higher by 14.3% and 15.4%, respectively, in the three months ended 31 March 2011 compared to the same period in 2010. In the three months ended 31 March 2011, as well as in the corresponding period in 2010, our sales of natural gas to end-customers were primarily to energy utility companies and large industrial companies.

Stable gas condensate sales

In the three months ended 31 March 2011, our revenues from sales of stable gas condensate increased by RR 7,259 million, or 147.2%, compared to the corresponding period in 2010 due to both an increase in volumes sold and an increase in our average realized prices resulting from an increase in the underlying benchmark crude oil prices used in the price formulation.

In the three months ended 31 March 2011, our total stable gas condensate sales volumes increased by 312 thousand tons, or 75.7%, due to an increase in our unstable gas condensate production and an increase in the realization of stable gas condensate volumes which were recognized as goods in transit or storage at the beginning of the reporting period, compared to the corresponding period in 2010 (see “Change in natural gas, liquid hydrocarbons, and polymer products and work-in-progress” below). In the three months ended 31 March 2011, we exported 724 thousand tons of stable gas condensate, or 100.0% of our total sales volumes, to the Asian-Pacific region, Europe and the United States. In the three months ended 31 March 2010, we sold 412 thousand tons of stable gas condensate, of which approximately 99.9% of our total sales volumes were exported to the United States and Europe.

In the three months ended 31 March 2011, our average realized price, excluding export duties, for stable gas condensate sold on the export market increased by USD 174.9 per ton, or 43.7%, to USD 575.5 per ton (DES, CIF, DAT, DAP and CFR) from USD 400.6 per ton (DES and CFR) in the 2010 period due to a 36.6% increase in our average export contract price that was partially offset by a 23.3% increase in our average export duty per ton. The increase in our average realized contract price was due to an overall increase in crude oil and related commodity prices on international markets in the 2011 period compared to the corresponding period in 2010.

Liquefied petroleum gas sales

In the three months ended 31 March 2011, our revenues from the sales of LPG increased by RR 682 million, or 22.5%, compared to the corresponding period in 2010, primarily due to an increase in our average realized prices.

In the three months ended 31 March 2011, we sold 116 thousand tons of LPG, or 50.7% of our total LPG sales volumes to the export markets for an average price of USD 696.4 per ton (DAP, CPT and FCA excluding export duties), representing an increase of USD 123.4 per ton, or 21.5%, compared to the corresponding period in 2010. The increase in our average realized export prices (excluding export duties) was primarily due to a 33.4% increase in our average contract price that was partially offset by an increase in our average export duty per ton by 138.6%.

In the three months ended 31 March 2011, we sold 112 thousand tons of LPG, or 48.9% of our total LPG sales volumes on the domestic market at an average price of RR 11,972 per ton (FCA, excluding VAT) representing an increase of RR 1,593 per ton, or 15.3%, compared to the 2010 period.

In the three months ended 31 March 2010, we sold 46.2% of our LPG volumes to the export markets and 53.8% to the domestic markets.

Crude oil sales

In the three months ended 31 March 2011, our revenues from the sales of crude oil increased by RR 190 million, or 58.5%, compared to the 2010 period, due to an increase in our average realized prices and, to a lesser extent, an increase in sales volumes.

In the three months ended 31 March 2011, our crude oil sales volumes increased by five thousand tons, or 11.4%, to 49 thousand tons from 44 thousand tons in the corresponding period in 2010 due primarily to an increase in crude oil production. In the three months ended 31 March 2011, 57.1% of our crude oil volumes were sold domestically at an average price of RR 10,107 per ton (excluding VAT) representing an increase of RR 3,264 per ton, or 47.7%, compared to the corresponding period in 2010. The remaining 42.9% of our crude oil volumes were sold to the export markets at an average price of USD 385.6 per ton (DAP, excluding export duties) representing an increase of USD 117.4 per ton, or 43.8%, compared to the corresponding period in 2010. The increase in the average realized export price (excluding export duties) was the result of a 37.0% increase in our average export contract price that was partially offset by a 31.6% increase in our average export duty per ton. The increase in our average realized contract price was due to an overall increase in crude oil and related commodity prices on international markets in the 2011 period compared to the corresponding period in 2010.

Oil and gas products sales

In the three months ended 31 March 2011, our revenue from the sales of oil and gas products increased by RR nine million to the RR 42 million from RR 33 million in corresponding period in 2010.

Our revenues from oil products trading operations through our retail stations on the domestic market increased by RR 14 million to RR 32 million in the three months ended 31 March 2011, compared to RR 18 million in 2010 period primarily due to the expansion of operations of our subsidiary OOO “NOVATEK-Refueling Complexes”, as well as an increase in sales prices. In the three months ended 31 March 2011 and 2010, we sold approximately 1.29 thousand tons and 0.79 thousand tons of oil products (diesel fuel and petrol) for an average price of RR 24,695 per ton and RR 22,414 per ton, respectively.

In the three months ended 31 March 2011, our revenues from oil products produced at the Surgutsky refinery and sold on the domestic market decreased by RR 16 million, or 100.0% due to the cessation of deliveries of our unstable gas condensate to the refinery starting in September 2010 as a result of the launch of our own gas condensate pipeline from the Yurkharovskoye field to the Purovsky Plant in August 2010.

In the three months ended 31 March 2011, we sold approximately one thousand tons of methanol to our associated company, Sibneftegas, and recorded revenues of RR 10 million from such sale.

Sales of polymer and insulation tape

In the three months ended 31 March 2011, our revenues from the sales of polymer and insulation tape decreased by RR 469 million, or 100.0%, due to the disposal of our polymer and insulation tape production subsidiary OOO “NOVATEK–Polymer” in September 2010.

Other revenues

Other revenues include geological and geophysical research services, rent, transportation, handling, storage and other services. In the three months ended 31 March 2011, other revenues increased by RR 32 million, or 88.9%, to RR 68 million from RR 36 million in the corresponding period in 2010. The increase in other revenues was primarily related to a RR 15 million increase in revenues from transportation, handling and storage services. The remaining increase of RR 17 million in other revenues was composed of various immaterial items.

Operating expenses

In the three months ended 31 March 2011, our total operating expenses increased by RR 7,474 million, or 46.9%, to RR 23,421 million compared to RR 15,947 million in the 2010 period, primarily due to an increase in transportation expenses and taxes other than income tax. As a percentage of total operating expenses, our non-controllable expenses, such as transportation and taxes other than income tax, decreased to 69.2% in the three months ended 31 March 2011 compared to 72.0% in the corresponding period in 2010. Total operating expenses decreased as a percentage of total revenues to 52.2% in the three months ended 31 March 2011 compared to 57.5% in the corresponding period in 2010, as shown in the table below. The decrease in our operating expenses as a percentage of total revenues was primarily due to an increase in our natural gas and stable gas condensate sales volumes and prices as well as cost savings from the launching of our own transport and processing infrastructure in August 2010.

	Three months ended 31 March:			
millions of Russian roubles	**2011**	**% of total revenues**	**2010**	**% of total revenues**
Transportation expenses	11,883	*26.5%*	9,063	*32.7%*
Taxes other than income tax	4,320	*9.6 %*	2,424	*8.7%*
Subtotal non-controllable expenses	**16,203**	***36.1%***	**11,487**	***41.4%***
Depreciation, depletion and amortization	2,029	*4.5%*	1,602	*5.8%*
General and administrative expenses	1,995	*4.4%*	1,463	*5.3%*
Materials, services and other	1,282	*2.9%*	1,548	*5.6%*
Purchases of natural gas and liquid hydrocarbons	963	*2.1%*	38	*0.1%*
Exploration expenses	726	*1.6%*	131	*0.5%*
Net impairment expense	12	*n/m*	26	*n/m*
Change in natural gas, liquid hydrocarbons, and polymer products and work-in-progress	211	*n/m*	(348)	*n/m*
Total operating expenses	**23,421**	***52.2%***	**15,947**	***57.5%***

Non-controllable expenses

A significant proportion of our operating expenses are characterized as non-controllable expenses since we are unable to influence the increase in regulated tariffs for transportation of our hydrocarbons or the rates imposed by federal, regional or local tax authorities. In the three months ended 31 March 2011, non-controllable expenses of transportation and taxes other than income tax increased by RR 4,716 million, or 41.1%, to RR 16,203 million from RR 11,487 million in the corresponding period in 2010. The change in transportation expenses was primarily due to an increase in natural gas and liquids sales volumes, as well as the natural gas transportation tariff. Taxes other than income tax increased primarily due to an increase in the natural gas production tax rate by 61.2% effective from 1 January 2011, as well as higher natural gas and liquids production volumes. As a percentage of total revenues, our non-controllable expenses decreased to 36.1% in the three months ended 31 March 2011 from 41.4% in the corresponding period in 2010.

Transportation expenses

In the three months ended 31 March 2011, our total transportation expenses increased by RR 2,820 million, or 31.1%, compared to the corresponding period in 2010.

millions of Russian roubles	**Three months ended 31 March: 2011**	**2010**	**Change %**
Natural gas transportation to customers	8,568	6,712	27.7%
Liquids transportation by rail	2,323	1,628	42.7%
Liquids transportation by tankers	932	551	69.1%
Unstable gas condensate transportation from the fields to the processing facilities through third party pipelines	-	119	n/m
Crude oil transportation to customers	57	48	18.8%
Other transportation costs	3	5	(40.0%)
Total transportation expenses	**11,883**	**9,063**	**31.1%**

In the three months ended 31 March 2011, our transportation expenses for natural gas increased by RR 1,856 million, or 27.7%, to RR 8,568 million from RR 6,712 million in the corresponding period in 2010. The change was due to a 16.1% increase in our sales volumes of natural gas delivered directly to end-customers, where the cost of transportation is included in the sales price, as well as an increase in the natural gas transportation tariff (see “Transportation tariffs” above). Our average transportation distance for natural gas sold to end-customers fluctuates period-to-period and depends on the location of end-customers and the specific routes of transportation.

In the three months ended 31 March 2011, total expenses for liquids transportation by rail increased by RR 695 million, or 42.7%, from RR 1,628 million in the corresponding period in 2010 to RR 2,323 due primarily to an increase in stable gas condensate volumes sold. In the three months ended 31 March 2011, our combined liquids volumes sold and transported via rail increased by 316 thousand tons, or 50.5%, to 942 thousand tons from 626 thousand tons in the corresponding period in 2010.

In the three months ended 31 March 2011, our weighted average transportation tariff for liquids delivered by rail decreased by 5.1% to RR 2,466 per ton from RR 2,600 per ton in the corresponding period in 2010 primarily due to an increase in the share of stable gas condensate volumes in our combined liquids volumes sold and transported via rail. The change in the share of stable gas condensate volumes in our total liquids volumes delivered by rail will affect our weighted average rail tariff due to the relatively low transportation expense for stable gas condensate compared to other liquids.

The rail tariffs set by the FTS increased by 8.0%, compared to the 2010 period, effective from 1 January 2011. In the three months ended 31 March 2011, we applied a co-efficient of 0.89 to the existing rail tariff for stable gas condensate deliveries to export markets beginning in January 2011 compared to the application of the same co-efficient beginning in February in the corresponding period in 2010. In addition, in the three months ended 31 March 2011, we applied a co-efficient of 0.68 to the existing rail tariff for LPG export deliveries at the cross-border points of the Russian Federation (see “Transportation tariffs” above).

Total transportation expense for liquids delivered by tankers to international markets increased by RR 381 million, or 69.1%, to RR 932 million in the three months ended 31 March 2011 from RR 551 million in the 2010 period. The change was due to a 75.7% increase in volumes sold that was partially offset by a slight decrease in average freight rates. In the three months ended 31 March 2011, we delivered 25.0% of our stable gas condensate export volumes to United States markets compared to 85.4% in the 2010 period.

Starting from the middle of August 2010, we no longer incur expenses related to unstable gas condensate transportation from the fields to the processing facilities through third party pipelines as we commenced operation of our own unstable gas condensate pipeline from the Yurkharovskoye field to the Purovsky Plant (see "Recent developments" above).

Taxes other than income tax

millions of Russian roubles	Three months ended 31 March: 2011	2010	Change %
Unified natural resources production tax (UPT)	3,557	2,018	76.3%
Property tax	434	336	29.2%
Excise and fuel taxes	243	31	n/m
Other taxes	86	39	120.5%
Total taxes other than income tax	**4,320**	**2,424**	**78.2%**

In the three months ended 31 March 2011, taxes other than income tax increased by RR 1,896 million, or 78.2%, primarily due to an increase in the unified natural resources production tax expense.

In the three months ended 31 March 2011, our UPT for natural gas increased by RR 1,398 million, or 96.5%, due to a 61.2% increase in the natural gas production tax rate effective 1 January 2011 (from RR 147 to RR 237 per mcm), and an increase in our natural gas production volumes. The remaining increase in UPT expenses of RR 141 million related to the UPT for gas condensate and crude oil and was primarily due to an increase in gas condensate production volumes. Our average UPT rate for crude oil is linked to the Urals benchmark crude oil price and increased from RR 2,878 per ton in the three months ended 31 March 2010 to RR 4,096 per ton in the 2011 period.

In the three months ended 31 March 2011, our property tax expense increased by RR 98 million, or 29.2%, to RR 434 million from RR 336 million in the corresponding period in 2010, primarily due to additions of property, plant and equipment (PPE) at our production subsidiaries.

In the three months ended 31 March 2011, our excise and fuel taxes expense in respect of LPG export sales through our subsidiary Novatek Polska increased by RR 212 million due to the expansion of its trading activities. The excise and fuel taxes are payable when LPG enters Polish territory.

Depreciation, depletion and amortization

In the three months ended 31 March 2011, our depreciation, depletion and amortization ("DDA") expense increased by RR 427 million, or 26.7%, compared to the corresponding period in 2010 as a result of an increase in our depletable cost base, as well as a 20.9% increase in our total hydrocarbon production in barrels of oil equivalent (boe). The Company accrues depreciation and depletion using the "units of production" method for producing assets and straight-line method for other facilities.

In the three months ended 31 March 2011, our DDA per boe was RR 20.1 compared to RR 19.6 in the corresponding period in 2010. The increase in our DDA charge calculated on a boe basis was primarily due to an increase in our depletable cost base as a result of completing the capital expansion program related to the third stage of the second phase development at the Yurkharovskoye field in October 2010, as well as costs capitalized during the reporting period in 2011.

Our reserve base used as the denominator in the calculation of the DDA charge under the "units of production" method is only appraised on an annual basis as of 31 December and does not fluctuate during the year, whereas our depletable cost base does change each quarter due to the ongoing capitalization of our costs throughout the year.

General and administrative expenses

In the three months ended 31 March 2011, our general and administrative expenses increased by RR 532 million, or 36.4%, to RR 1,995 million compared to RR 1,463 million in the 2010 period. The main components of these expenses were employee compensation and charitable contributions, which, on aggregate, comprised 73.4% and 70.7% of total general and administrative expenses in the three months ended 31 March 2011 and 2010, respectively.

millions of Russian roubles	**Three months ended 31 March: 2011**	**2010**	**Change %**
Employee compensation	1,311	838	56.4%
Charitable contributions	153	196	(21.9%)
Legal, audit, and consulting services	112	86	30.2%
Rent expense	74	63	17.5%
Business trip expenses	45	45	0.0%
Security services	45	38	18.4%
Depreciation – administrative buildings	32	36	(11.1%)
Concession management services	24	35	(31.4%)
Insurance expense	10	19	(47.4%)
Other	189	107	76.6%
Total general and administrative expenses	**1,995**	**1,463**	**36.4 %**

Employee compensation increased by RR 473 million, or 56.4%, to RR 1,311 million in the three months ended 31 March 2011 as compared to RR 838 million in the corresponding period in 2010 primarily due to a RR 257 million increase in bonus accruals related to employee performance and the results we achieved. In addition, we performed an indexation of basic salaries by 10% effective 1 July 2010 resulting in an additional RR 73 million in payroll expenses. Moreover, in the three months ended 31 March 2011, we recognized RR 88 million in employee compensation due to the initiation in March 2010 of NOVATEK's share-based compensation program for a limited number of the Group's senior and key management.

In the three months ended 31 March 2011, our charitable contributions decreased by RR 43 million, or 21.9%, to RR 153 million compared to RR 196 million in the corresponding period in 2010, and were primarily related to our donations to sport clubs and activities as well as continued support for charities and social programs in the regions where we operate. Charitable contributions will continue to fluctuate period-on-period depending on the funding needs and the implementation schedules of specific programs we support.

Legal, audit, and consulting services expenses increased by RR 26 million, or 30.2%, to RR 112 million compared to RR 86 million in the 2010 period largely due to an increase in consulting and legal services related to the Group's recent acquisitions as well as services connected with the development of the Yamal LNG project.

In the three months ended 31 March 2011, our rent expense increased by RR 11 million, or 17.5%, to RR 74 million from RR 63 million in the 2010 period largely due to the rent of additional office space in Moscow starting from November 2010.

Security services expense increased by RR seven million, or 18.4%, to RR 45 million in the three months ended 31 March 2011 from RR 38 million in the corresponding period in 2010 largely due to security services provided to our new Moscow head office.

Concession management services represent administrative expenses incurred by Tharwa Petroleum Company S.A.E (the operator of the El Arish concession area located in Egypt). In the three months ended 31 March 2011, our expenses related to concession management services decreased by RR 11 million, or 31.4%, compared the corresponding period in 2010. The decrease in costs in the 2011 period is consistent with our approved business plan for this project.

In the three months ended 31 March 2011, other general and administrative expenses increased by RR 82 million, or 76.6%, compared to the 2010 period, of which RR 77 million related to the statutory requirement to maintain a bank guarantee in respect of minority shareholders due to the Sibneftegas acquisition. The remaining increase of RR five million was allocated amongst different expense categories within other general and administrative expenses which, taken individually, changed immaterially.

Materials, services and other

In the three months ended 31 March 2011, our materials, services and other expenses decreased by RR 266 million, or 17.2%, to RR 1,282 million compared to RR 1,548 million in the 2010 period. The main components of this expense category were employee compensation and repair and maintenance services, which comprised 58.4% and 19.0%, respectively, of total materials, services and other expenses in the 2011 period.

millions of Russian roubles	**Three months ended 31 March: 2011**	**2010**	**Change %**
Employee compensation	749	642	16.7%
Repair and maintenance services	243	124	96.0%
Electricity and fuel	94	98	(4.1%)
Security services	60	40	50.0%
Materials and supplies	35	361	(90.3%)
Tolling and processing fees	25	204	(87.7%)
Other	76	79	(3.8%)
Total materials, services and other	**1,282**	**1,548**	**(17.2%)**

Our employee compensation increased by RR 107 million, or 16.7%, to RR 749 million compared to RR 642 million in the 2010 period due primarily due to a 10% indexation of base salaries effective 1 July 2010.

Repair and maintenance services increased by RR 119 million, or 96.0%, to RR 243 million in the three months ended 31 March 2011 compared to RR 124 million in the 2010 period. The increase was primarily related to the current repair works at our production assets and was consistent with our on-going maintenance schedules.

In the three months ended 31 March 2011, electricity and fuel expenses decreased by RR four million, or 4.1%, to RR 94 million from RR 98 million in the corresponding period in 2010 primarily due to a disposal of our subsidiary OOO “NOVATEK-Polymer” in September 2010. The decrease was partially offset by an increase in energy consumption at the Yurkharovskoye field resulting from the commencement of operations of new production assets.

Security services expense increased by RR 20 million, or 50.0%, to RR 60 million in the three months ended 31 March 2011 from RR 40 million in the corresponding period in 2010 largely due to additional security related to recently completed infrastructure projects.

Materials and supplies expense decreased by RR 326 million, or 90.3%, mainly due to a decrease in purchases of raw materials required for the production of polymer and insulation tape products as a result of the disposal of OOO “NOVATEK-Polymer” in September 2010, which accounted for RR 294 million, or 90.1%, of the total decrease in materials and supplies expense.

Tolling and processing fees decreased by RR 179 million, or 87.7%, to RR 25 million in the three months ended 31 March 2011, from RR 204 million in the 2010 period due primarily to the launch of our own unstable gas condensate de-ethanization facility at the Yurkharovskoye field in August 2010, which resulted in a savings of RR 173 million on third-party processing fees.

Purchases of natural gas and liquid hydrocarbons

Purchases of natural gas and liquid hydrocarbons increased by RR 925 million to RR 963 million in the three months ended 31 March 2011, from RR 38 million in the corresponding period in 2010, of which RR 933 million related to the purchases of natural gas from our associated company Sibneftegas. The increase was offset by a decrease of RR eight million related to purchases of crude oil and oil products.

Exploration expenses

In the three months ended 31 March 2011, our exploration expenses increased by RR 595 million to RR 726 million from RR 131 million in the corresponding period in 2010. In the 2011 period, we expensed the capitalized cost of two exploratory wells in accordance with our accounting policy in the total amount of RR 407 million at the El Arish (Egypt) and Raduzhny licence areas.

Change in natural gas, liquid hydrocarbons, and polymer products and work-in-progress

In the three months ended 31 March 2011, we recorded a charge of RR 211 million to change in inventory expense as compared to a reversal of RR 348 million in the corresponding period in 2010:

millions of Russian roubles	Three months ended 31 March: 2011	2010
Natural gas	227	110
Stable gas condensate	(6)	(395)
Other	(10)	(63)
Increase (decrease) in operating expenses due to change in inventory balances and work-in-progress	**211**	**(348)**

In the three months ended 31 March 2011, we recorded a charge to our operating expenses of RR 227 million due to a decrease in our natural gas inventory balance by 713 mmcm. Our volumes of natural gas injected into Gazprom's underground gas storage facilities (UGSF) fluctuate period-to-period depending on market conditions, storage capacity constraints and our development plans to sustain and/or grow production during periods of seasonality.

In addition, in the three months ended 31 March 2011, we recorded a reversal of RR six million to our operating expenses due to an increase in our inventory balance of stable gas condensate in transit and storage by 18 thousand tons.

The following table highlights movements in our inventory balances:

Inventory balances in transit or in storage	2011 At 31 March	At 1 January	Increase / (decrease)	2010 At 31 March	At 1 January	Increase / (decrease)
Natural gas (millions of cubic meters)	**77**	**790**	**(713)**	**472**	**744**	**(272)**
including Gazprom's UGSF	*48*	*761*	*(713)*	*405*	*584*	*(179)*
Liquid hydrocarbons (thousand tons)	**371**	**356**	**15**	**322**	**151**	**171**
including stable gas condensate	*282*	*264*	*18*	*277*	*111*	*166*

Net gain on disposal of interest in subsidiaries

In the three months ended 31 March 2010, we realized a net gain of RR 1,583 million on the disposal of a 49 percent participation interest in our subsidiary ZAO "Terneftegas" to TOTAL Termokarstovoye B.V., which is represented by a net income on disposal of RR 776 million and a gain of RR 807 million due to revaluation to fair value of the remaining 51 percent participation interest.

Other operating income (loss)

In the three months ended 31 March 2011, we recognized other operating income of RR 64 million compared to other operating loss of RR five million in the corresponding period in 2010. Total other operating income or loss were primarily related to different immaterial items, including profit (loss) on disposal of materials, fixed assets, equipment and other similar transactions.

Profit from operations

As a result of the factors discussed above, our profit from operations increased by RR 8,131 million, or 60.8%, to RR 21,504 million in the three months ended 31 March 2011, compared to RR 13,373 million in the corresponding period in 2010. In the three months ended 31 March 2011, our profit from operations as a percentage of total revenues decreased to 47.9% compared to 48.2% in the 2010 period primarily due to significant net gain on disposal of interest in subsidiaries recognized in the 2010 period.

Finance income (expense)

In the three months ended 31 March 2011, we recorded net finance income of RR 2,738 million compared to net finance income of RR 612 million in the corresponding period in 2010 due primarily to a foreign exchange gain from the appreciation of the Russian rouble relative to the US dollar in both periods.

In the three months ended 31 March 2011, our total accrued interest expense increased to RR 1,518 million compared to RR 672 million in the corresponding period in 2010 as a result of an increase in our average borrowings. In the three months ended 31 March 2011 and 2010, we capitalized RR 863 and RR 523 million, respectively, of interest expense to the cost of additions in our property, plant and equipment account in accordance with the Group's accounting policy.

Interest income increased to RR 919 million in the three months ended 31 March 2011, from RR 115 million in the 2010 period primarily due to an increase in interest income on loans provided to our associated companies.

In the three months ended 31 March 2011, we recorded a net foreign exchange gain of RR 2,474 million compared to a net foreign exchange gain of RR 646 million in 2010 period due primarily to the revaluation of our foreign currency denominated borrowings. The US dollar had depreciated by 6.7% and 2.9% during the three months ended 31 March 2011 and 2010, respectively. We will continue to record foreign exchange gains and losses each period based on the movements between exchange rates and the currency denomination of our debt portfolio.

Share of income (loss) of associated companies

In the three months ended 31 March 2011, our proportionate share in loss of associated companies increased to RR 526 million compared to RR one million in the 2010 period, of which the significant portion related to Sibneftegas and Yamal Development. The losses we recognized in our associates were primarily due to the revaluation of oil and gas properties acquired to fair value and the subsequent amortization of those costs under IFRS.

Income tax expense

Our overall consolidated effective income tax rates (total income tax expense calculated as a percentage of our reported IFRS profit before income tax) were 20.3% and 20.8% for the three months ended 31 March 2011 and 2010, respectively. Our effective income tax rate, after excluding the effect of foreign subsidiaries, was 20.6% and 21.4% in the 2011 and 2010 periods, respectively. The Russian statutory income tax rate for both periods was 20%. The difference between our effective and statutory income tax rates is primarily due to certain non-deductible expenses.

Profit attributable to shareholders and earnings per share

As a result of the factors discussed above, profit for the period increased by RR 7,724 million, or 69.7%, to RR 18,800 million in the three months ended 31 March 2011 from RR 11,076 million in the corresponding period in 2010. The profit attributable to NOVATEK shareholders increased by RR 7,671 million, or 68.6%, to RR 18,853 million in the three months ended 31 March 2011 from RR 11,182 million in the corresponding period in 2010.

Our weighted average basic and diluted earnings per share, calculated from the profit attributable to NOVATEK shareholders, increased by approximately RR 2.53 per share, or 68.6%, to RR 6.22 per share in the 2011 period from RR 3.69 per share in corresponding period in 2010.

LIQUIDITY AND CAPITAL RESOURCES

The following table shows our net cash flows from operating, investing and financing activities for the three months ended 31 March 2011 and 2010:

millions of Russian roubles	Three months ended 31 March: 2011	2010	Change %
Net cash provided by operating activities	19,205	12,454	54.2%
Net cash used in investing activities	(29,065)	(6,467)	349.4%
Net cash provided by (used in) financing activities	15,453	(4,895)	n/a

Liquidity ratios	31 March 2011	31 December 2010	Change, %
Current ratio	1.93	0.51	278.4%
Total debt to equity	0.51	0.49	4.1%
Long-term debt to long-term debt and equity	0.32	0.24	33.3%
Net debt to total capitalization (1)	0.25	0.25	0.0%

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

Net cash provided by operating activities

In the three months ended 31 March 2011, our net cash provided by operating activities increased by RR 6,751 million, or 54.2%, to RR 19,205 million compared to RR 12,454 million in the corresponding period in 2010. The increase in our net cash provided by operating activities was due primarily to an increase in natural gas and liquids sales volumes and prices, which was partially offset by an increase in accounts receivables, prepayments and income tax paid.

Net cash used in investing activities

In the three months ended 31 March 2011, our net cash used in investing activities increased by RR 22,598 million, or 349.4%, to RR 29,065 million as compared to RR 6,467 million in the corresponding period 2010 primarily due to the payment for shares of our associated company Sibneftegas, which was acquired in 2010.

Net cash provided by (used in) financing activities

In the three months ended 31 March 2011, our net cash provided by financing activities amounted to RR 15,453 million, of which the most significant portion was related to a Eurobond issuance in an aggregate amount of USD 1,250 million. The proceeds from the Eurobonds were used to repay a bridge facility in February 2011 and to finance the acquisition of our associate company, Sibneftegas. In the three months ended 31 March 2010, the net cash used in financing activities was related to repayments of our long-term and short-term borrowings.

Working capital

Our net working capital position (current assets less current liabilities) at 31 March 2011 was a positive RR 18,745 million compared to a negative RR 27,876 million at 31 December 2010. The change in our net working capital position during the first quarter 2011 was mainly due to a significant decrease in our short-term debt and accounts payable due to the acquisition of certain oil and gas companies in the fourth quarter 2010.

At 31 December 2010, the Group had an outstanding bridge loan facility for the financing of the acquisition by its joint venture, Yamal Development, of a 51 percent participation interest in SeverEnergia of RR 18,200 million (USD 597 million). In February 2011, the bridge facility was fully repaid ahead of its maturity schedule. In addition, at 31 December 2010, the Group had a balance of accounts payable to OAO "Gazprombank" of RR 21,176 million due to the acquisition of a 51 percent stake in Sibneftegas, which was fully repaid in the three months ended 31 March 2011. We improved our net working capital position by the successful refinancing of our payables through the issuance of long-term Eurobonds in February 2011 (see "Recent developments" above).

The Group's management believes that it presently has and will continue to have the ability to generate sufficient cash flows (from operating and financing activities) to repay all current liabilities and finance the Company's capital construction programs.

Capital expenditures

Total capital expenditures on property, plant and equipment for the three months ended 31 March 2011 and 2010 were as follows:

millions of Russian roubles	**Three months ended 31 March: 2011**	**2010**	**Change %**
Exploration, production and marketing	6,342	6,141	3.3%
Polymer production and marketing	-	89	n/a
Total	**6,342**	**6,230**	**1.8%**

Exploration, production and marketing expenditures represent our investments in exploring for and developing our oil and gas properties. The majority of our capital expenditures related to ongoing development and exploration activities at our three core fields and at the Purovsky Plant. The following table shows the expenditures at our main fields and processing facilities for the three months ended 31 March 2011 and 2010:

millions of Russian roubles	**Three months ended 31 March: 2011**	**2010**
Yurkharovskoye field	2,601	4,822
South-Tambeyskoye field	736	80
Gas Condensate Fractionation Complex and Transshipment facilities (Ust-Luga)	551	4
East-Tarkosalinskoye field	304	204
Purovsky Plant	291	234
West-Urengoisky license area	241	9
Khancheyskoye field	167	5
Olimpiyskiy licence area	103	116
Yarudeyskiy license area	81	17
Other	1,267	650
Exploration, production and marketing	**6,342**	**6,141**

Debt obligations

We utilize a variety of financial instruments to ensure the flexibility of our financing strategy. This includes maintaining a debt portfolio with a balance of short-term and long-term financing, a mix of fixed interest rate and floating interest rate instruments and debt portfolio denominated in either Russian roubles or US dollars.

Our total debt increased from RR 72,226 million at 31 December 2010 to RR 84,780 million at 31 March 2011, or by RR 12,554 million, to supplement our internally generated cash flows for the financing of capital expenditures related to the development of our three core fields and investments in related assets such as the Purovsky Plant, as well as the acquisition of new oil and gas assets.

Our total debt position (net of unamortized transaction costs) at 31 March 2011 and 31 December 2010 was as follows:

Facility	Amount	Maturity	Interest rate	At 31 March 2011	At 31 December 2010
Eurobonds Ten-Year	USD 650 million	February 2021	6.604%	18,331	-
Eurobonds Five-Year	USD 600 million	February 2016	5.326%	16,938	-
Sberbank	RR 15 billion	December 2013	7.5%	14,952	14,948
Gazprombank	RR 10 billion	November 2012	8% [1]	10,000	10,000
Russian rouble Bonds	RR 10 billion	June 2013	7.5%	9,954	9,949
Syndicated term loan facility	USD 800 million	April 2011	LIBOR+1.5%	3,244	6,952
Nordea Bank	USD 200 million	November 2013	LIBOR+1.9%	5,686	6,095
UniCredit Bank	USD 200 million	October 2012	LIBOR+3.25% [1]	5,675	6,082
Bridge loan facility [2]	USD 600 million	November 2011	LIBOR+1%	-	18,200
Total				**84,780**	**72,226**

[1] – interest rates were changed during the periods
[2] – bridge loan repaid in February 2011 ahead of maturity schedule

Scheduled maturities of our long-term debt outstanding (net of unamortized transaction costs) at 31 March 2011were as follows:

Maturity period:	**RR million**
1 April 2012 to 31 March 2013	12,891
1 April 2013 to 31 March 2014	29,171
1 April 2014 to 31 March 2015	-
1 April 2015 to 31 March 2016	16,938
After 31 March 2016	18,331
Total long-term debt	**77,331**

At 31 March 2011, the Group had available funds under short-term credit lines in the form of bank overdrafts with various international banks in the aggregate amount of RR 5,544 million (USD 195 million) at either fixed or variable interest rates subject to the specific type of credit facility.

The Group also has funds available under credit facilities with Credit Agricole Corporate and Investment Bank in the amount of USD 100 million until June 2011 and ZAO “UniCredit Bank” in the amount of USD 100 million until August 2012, with the interest rates applicable under the aforementioned credit facilities to be negotiated at the time of each withdrawal, as well as funds available under credit facility with ZAO “BNP PARIBAS Bank” in the amount of USD 100 million until May 2012 with predetermined interest rates depending on the period of debt.

In addition, at 31 March 2011, we had funds available under a credit facility with Sumitomo Mitsui Banking Corporation Europe Limited in the amount of USD 300 million until December 2013 with an annual interest rate of LIBOR plus 1.45 percent. The facility was used in April 2011.

Management believes it has sufficient internally generated cash flows as well as access to available external borrowings (both short- and long-term) to fund its capital expenditure program, service its existing debt and meet its current obligations as they become due.

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 prices for crude oil and stable gas condensate destined for export sales are linked to international crude oil prices. We are exposed to foreign exchange risk to the extent that a portion of 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. As of 31 March 2011, RR 44,924 million, or 53.0%, of our long-term debt was denominated in US dollars (out of RR 84,780 million of our total borrowings at that date). Changes in the value of the Russian rouble relative to the US dollar will impact 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 mitigated by the fact that a portion of our total revenues, approximately 30.4% in the three months ended 31 March 2011, is denominated in US dollars. As of 31 March 2011, the Russian rouble had appreciated by approximately 6.7% against the US dollar since 31 December 2010.

A hypothetical and instantaneous 10% strengthening in the Russian rouble in relation to the US dollar as of 31 March 2011 would have resulted in an estimated foreign exchange gain of approximately RR 4,987 million on foreign currency denominated borrowings held at that date.

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 international 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 consolidated financial statements all derivative instruments are recorded at their fair values. Unrealized gains or losses on derivative instruments are recognized within other operating income (loss), unless the underlying arrangement qualifies as a hedge.

Pipeline access

We transport substantially all of our natural gas through the Gazprom owned 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 reduced demand for our hydrocarbons available for sale and the corresponding revenues generated from these sales would limit our ability to maintain an adequate level of capital expenditures, which in turn could limit our ability to increase or maintain current levels of production and deliveries of natural gas, gas condensate, crude oil and other associated products; thereby, adversely affecting our financial and operating results.

Off balance sheet activities

As of 31 March 2011, 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.