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

The following represents management's analysis of the financial performance and conditions of OAO LUKOIL and significant trends that may affect its future performance. It should be read in conjunction with our US GAAP consolidated financial statements and notes and supplemental oil and gas disclosure.

References to "LUKOIL", "the Company", "the Group", "we" or "us" are references to OAO LUKOIL and its subsidiaries and associates. All dollar amounts are in millions of US dollars, unless otherwise indicated. Tonnes of crude oil produced are translated into barrels using conversion rates characterizing the density of oil from each of our oilfields. Tonnes of crude oil purchased as well as other operational indicators expressed in barrels are translated into barrels using an average conversion rate of 7.33. Billions of cubic feet are translated into millions of oil equivalent barrels using a conversion rate of 0.167.

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. Please see "Forward-looking statement" on page 36 for a discussion of some of the factors that could cause actual results to differ materially.

Key financial and operational results

	2005	**Change from 2004**	**2004**	**Change from 2003**	**2003**
Sales (including excise and export tariffs)........	**55,774**	64.8%	33,845	53.0%	22,118
Net Income..	**6,443**	51.7%	4,248	14.8%	3,701
Net income excluding cumulative effect of change in accounting principle and gain from sale of share in Azeri, Chirag, Guneshli in 2003	**6,443**	51.7%	4,248	78.0%	2,386
EBITDA	**10,404**	44.4%	7,203	27.9%	5,630
Earnings per share of common stock (US dollars)					
Basic earnings	**7.91**	52.1%	5.20	15.0%	4.52
Diluted earnings	**7.79**	51.9%	5.13	15.3%	4.45
Crude oil production by consolidated subsidiaries (thousands of tonnes)................	**86,193**	4.6%	82,408	8.3%	76,072
Crude oil production by the Group including our share in equity associates (thousands of tonnes)	**90,158**	4.6%	86,200	7.4%	80,226
Refined products produced by consolidated subsidiaries (thousands of tonnes)................	**44,182**	8.2%	40,825	4.1%	39,233

During 2005 net income was $6,443 million, which is $2,195 million more than in the 2004.

The increase in net income resulted from favorable price conditions in 2005 and effective cost control. However, an increased tax burden has restrained growth of our profitability. This restraining factor as well as other drivers impacting the results of our operations are considered below in detail.

Segment information

Our operations are divided into three main business segments:

- **Exploration and Production** – which includes our exploration, development and production operations relating to crude oil and natural gas. These activities are primarily located within Russia, with additional activities in Azerbaijan, Kazakhstan, Uzbekistan, the Middle East, Northern Africa and Colombia

- **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

Other businesses include banking, finance and other activities. Each of our three 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 prices" section on page 5 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, 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, but we do present the financial data for each in Note 23 to our consolidated financial statements.

Operating developments

Restructuring

In 2005 we continued implementing a restructuring plan designed to improve our operations and maximize shareholder value. The plan included undertaking the following measures in the near term: (i) increase exports of crude oil and refined products; (ii) accelerate the development of our most productive fields; (iii) shut-in low-producing wells; (iv) apply enhanced oil recovery technologies; (v) seek competitive bids for oilfield services; (vi) divest non-core businesses, including certain producing assets where we are not the operator, and reduce headcount; (vii) strengthen performance-related pay; and (viii) streamline our administration.

The following has been achieved in 2005 and 2004:

- Our oil and refined products exports and international sales in 2005 increased by 17.3% in terms of volumes while domestic oil sales volumes decreased by 58.9%

- 8 new oil fields and 1 new gas field were brought on line in 2005 (2004: 7 oil fields), which allowed us to increase production while also shutting in low production wells

- 425 low production wells were shut in 2005 (2004: 1,161). Average well debits increased to 11.07 tonnes a day in 2005, or by 3.5%, compared to 2004

- In August 2004 the Company entered into contracts to sell its 99% ownership interest in OAO Bank Petrocommerce (the "Bank") for $214 million to a group of companies of a related party, whose management and directors include members of the Group's management and Board of Directors. The Company used an independent valuation in the determination of the selling price. The transaction was structured to be completed in two phases. The first phase, representing the sale of 78% of the Group's ownership interest for $169 million was completed on September 22, 2004. The second phase in which the Group is to sell its remaining 21% ownership interest in the Bank for $45 million was expected to be completed by the end of June 2007. In December 2005 the Group and the buyer cancelled the contract related to the second phase. Subsequently, in December 2005, the Group made a public auction on the sale of its remaining 21% ownership interest in the Bank and entered into a contract with the bidder, the same related party, at a selling price of $33 million. This transaction is expected to be completed by the end of June 2006

- In November 2004 the Company entered into a contract to sell its 100% interest in OOO LUKOIL-Burenie and its subsidiaries for $69 million. The terms of the contract required signing a five-year contract for drilling services to be provided to the Group and revising the terms of Group financing previously provided to OOO LUKOIL-Burenie. The transaction was completed at the end of December 2004

- Other achievements in 2005 are described in detail in other parts of this report

Strategic Partnership with ConocoPhillips

In September 2004 LUKOIL entered into a Shareholder agreement forming a broad-based strategic alliance with ConocoPhillips. In June 2005 LUKOIL and ConocoPhillips finalized the creation of a joint venture to develop resources in the northern Timan-Pechora area. The joint venture is governed by LUKOIL and ConocoPhillips in equal parts, but with effective ownership interests of 70% and 30%, respectively. The joint venture was formed by selling to ConocoPhillips an effective 30% interest in our wholly owned subsidiary OOO Narianmarneftegaz for $529 million. Crude oil production of OOO Narianmarneftegaz in 2005 was approximately 11 thousand barrels per day.

Recent developments

During the period from November to December 2005 a Group company acquired 51% of the share capital of OAO Primorieneftegaz for $261 million. OAO Primorieneftegaz is a Russian oil and gas exploration company operating in the European Russia.

During the period from October 14 to December 5, 2005 a Group company acquired 100% of the share capital of Nelson Resources Limited ("Nelson") for $1,951 million. Nelson is an exploration and production company operating in western Kazakhstan. Nelson owns an effective 76% interest in the Karakuduk field, 50% interest in Alibekmola, Kozhasai, North Buzachi and Arman fields. In addition, Nelson holds an option to acquire a 25% interest in two exploration blocks in the Kazakhstan sector of the Caspian Sea – South Zhambai and South Zaburunye. The purpose of the acquisition was to increase the Group's presence in the Kazakhstan oil and gas sector and its international oil and gas reserves.

In November 2005 a Group company acquired the remaining 50% of the share capital of ZAO SeverTEK for $318 million from Neste Oil Corporation (including $98 million repayment of ZAO SeverTEK debt). The acquisition increased the Group's ownership stake in ZAO SeverTEK to 100%. ZAO SeverTEK is an exploration and production company operating within the Komi Republic of the Russian Federation.

In July 2005 a Group company acquired 66.0% of the share capital of OOO Geoilbent for $180 million. OOO Geoilbent is an exploration and production company operating in the West Siberian region of the Russian Federation. All decisions over OOO Geoilbent's financing and operating activities require approval by at least a 66.7% majority of the voting rights. Since the minority shareholder of OOO Geoilbent holds substantive participating rights, the Group accounts for its investment in OOO Geoilbent using the equity method of accounting.

In July 2005 LUKOIL sold its 100% stake in ZAO Arktikneft, an oil production company, for approximately $40 million, including about $20 million for settlement of Arktikneft's debt to LUKOIL. ZAO Arktikneft produced 30.3 thousand tonnes of crude oil in the first half of 2005.

In June 2005 the Company sold its 38% interest in its construction affiliate ZAO Globalstroy-Engineering – formerly ZAO LUKOIL-Neftegazstroy for $69 million.

In March 2005 we acquired 100% interest in Oy Teboil Ab and Suomen Petrooli Oy, which are incorporated in Finland, for $160 million. Oy Teboil Ab and Suomen Petrooli Oy are mainly engaged in the operation of 289 retail gas stations and 132 retail diesel fuel outlets, wholesale of refined oil products as well as production and sale of lubricants.

In January 2005 a Group company acquired an additional 22% interest in LUKOIL Neftochim Bourgas AD for $56 million (20.7% interest was acquired from a related party for $52 million). The acquisition increased the Group's ownership stake in LUKOIL Neftochim Bourgas AD to 93.2%. In August 2005 a Group company acquired an additional 4% interest in LUKOIL Neftochim Bourgas AD for $10 million, thereby increasing the Group's ownership stake in LUKOIL Neftochim Bourgas AD to 97.2%.

In December 2004 a Group company acquired the remaining 50% interest in LUKAgip N.V. (“LUKAgip”) for $143 million from Eni Group (of which $111 million represents repayment of debt to the Eni Group). The acquisition increased the Group’s ownership in LUKAgip to 100%. LUKAgip owns a 24% interest in the Meleiha Hydrocarbon License Concession Agreement located onshore in Egypt. It also owns a 10% interest in the Shakh Deniz Exploration, Development and Production Sharing Agreement, 8% of the midstream gas marketing entity, the Azerbaijan Gas Supply Company, and 100% of LUKAgip Midstream B.V., which holds LUKAgip’s 10% interest in the South Caucasus Pipeline Company.

On January 26, 2004 a Group company entered into an agreement with ConocoPhillips to purchase 308 gas stations and contracts to supply petroleum products to an additional 471 gas stations in the Northeast of the United States of America for $270 million. The transaction was finalized in May 2004.

Main macroeconomic factors affecting our results of operations

Change in the price of crude oil and refined products

The price at which we can sell crude oil and refined products is the primary driver of our revenues. During 2005 crude oil prices steadily increased due to growth of the world economy, driven mainly by the USA and China, and increased worldwide crude oil consumption accompanied by refining and distribution bottlenecks in some major consuming regions. In the August 2005 crude oil prices reached their historical records in absolute terms as a result of a crude oil supply interruption in the USA caused by hurricanes Rita and Katrina. According to International Energy Agency (IEA) in 2005 the world demand for crude oil and, subsequently, refined products reached the level of 83.3 million barrels per day, which is 1.3% more than in 2004 and 5.2% more than in 2003. Based on OPEC's data, its actual daily production in 2005 reached 30.0 million barrels a day, or 2.6% more than in 2004, which is near OPEC's full capacity. The current market situation is also influenced by high political and natural risks, which could cause crude oil production to decrease. This situation can be viewed as an indicator that crude oil prices will remain steadily high in a medium-term perspective.

Substantially all of the crude oil that we sell for export is the Urals blend. The following table shows the average crude oil export prices for 2005, 2004 and 2003 and refined product prices based on Northern Europe averages.

	2005	Change from 2004	2004	Change from 2003	2003
	(in US dollars per bbl, except for figures in percent)				
Brent crude	54.31	41.9%	38.27	33.3%	28.71
Urals crude (CIF Mediterranean)*	50.67	46.9%	34.50	27.6%	27.03
Urals crude (CIF Rotterdam)*	50.12	46.9%	34.13	26.6%	26.96
	(in US dollars per metric tonne, except for figures in percent)				
Fuel oil 3.5% (FOB Rotterdam)	229.92	51.4%	151.81	2.3%	148.37
Diesel fuel (FOB Rotterdam)	505.01	44.5%	349.37	37.8%	253.53
High-octane gasoline (FOB Rotterdam)	534.11	33.4%	400.33	35.2%	296.13

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

Domestic crude oil 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. Essentially, crude oil prices on traditional international markets will be higher than those in Russia due to incremental transportation cost incurred to deliver the crude oil from the Russian border to the markets, and export tariffs. However, 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 refined product prices

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. In general, retail prices on refined products in Russia are comparable to those in the USA. For example, during 2005 the average retail price on regular gasoline in the USA was about 60 cents per litre, an increase of 22.0% compared to 2004. In central regions of European Russia the average retail price on gasoline of the same quality (95 octane) during 2005 was about 57 cents per litre, an increase of 22.0% compared to 2004.

The table below represents average domestic wholesale prices on refined products for respective periods of 2005, 2004 and 2003.

($/tonne)	2005	Change from 2004	2004	Change from 2003	2003
Fuel oil	122.54	73.1%	70.78	(3.9)%	73.64
Diesel fuel	419.74	47.4%	284.75	39.1%	204.64
High-octane gasoline (Regular)	486.71	27.3%	382.19	35.1%	282.88
High-octane gasoline (Premium)	532.52	25.7%	423.60	33.6%	317.17

Source: Kortes (excluding VAT).

Changes in the US dollar-ruble exchange rate and inflation

A substantial part of our revenues 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, the movements of ruble inflation and exchange rates can significantly affect the results of our operations. In particular, our operating margins are generally adversely affected by real appreciation of the ruble against the US dollar because this will generally cause our costs to increase in US dollar terms relative to our revenues.

The following table gives data on inflation in Russia, the nominal change in the ruble-dollar exchange rate, and the level of real rouble appreciation.

	2005	2004	2003
Ruble inflation (CPI)	10.9%	11.7%	12.0%
Nominal (devaluation)/appreciation of the exchange rate (ruble to the US dollar)	(3.7)%	5.8%	7.3%
Real appreciation of the exchange rate (ruble to the US dollar)	6.9%	18.5%	20.8%
Average exchange rate for the period (ruble to the US dollar)	28.29	28.82	30.69
Exchange rate at the end of the period (ruble to the US dollar)	28.78	27.75	29.45

Tax burden

Given the relative size of our activities in Russia, our tax profile is largely determined by the taxes payable in Russia (based on records maintained under Russian legislation – not US GAAP). For 2005, 2004 and 2003 the tax charge on the Russian part of our operations was more than 80% of our total tax charge.

In addition to income taxes, we are subject to a number of other taxes in Russia, many of which are based on revenue or volumetric measures. Other taxes to which we are subject include:

- mineral extraction tax
- excise and export tariffs
- property tax
- social taxes
- VAT
- other local and regional taxes

The effective rates of total taxes and tariffs (total taxes, including income taxes, taxes other than on income and excise and export tariffs, divided by income before taxes and tariffs) for 2005, 2004 and 2003, respectively, were 74%, 71% and 64%. In 2005 tax expenses in Russia were 51.8% of the sales revenue in Russia.

The measures that we use for tax planning and management strategies have been based on our understanding of tax legislation existing at the time of implementation of these measures. We are subject to tax authority audits on an ongoing basis, as is normal in the Russian environment, and, at times, the authorities have attempted to impose significant additional taxes on us. We believe that we have adequately met and provided for tax liabilities based on our interpretation of existing tax legislation. However, the relevant authorities may have differing interpretations and the effects could be significant. In 2005 the Group recognized an expense of $163 million in relation to the results of tax audits of the Group companies for periods prior to the 2004 financial year.

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

		2005 *	Change from 2004	2004 *	Change from 2003	2003 *
Export tariffs on crude oil.............	$/tonne	130.62	134.2%	55.77	83.5%	30.40
Export tariffs on refined products						
Light distillates (gasoline), middle distillates (jet fuel), diesel fuel and gasoils	$/tonne	92.26	143.2%	37.93	38.6%	27.36
Liquid fuels (fuel oil)	$/tonne	52.73	43.9%	36.64	33.9%	27.36
Excise on refined products						
High-octane gasoline.............	RUR/tonne	3,629.00	8.0%	3,360.00	12.0%	3,000.00
Low-octane gasoline	RUR/tonne	2,657.00	8.0%	2,460.00	12.3%	2,190.00
Diesel fuel	RUR/tonne	1,080.00	8.0%	1,000.00	12.4%	890.00
Motor oils..............................	RUR/tonne	2,951.00	8.0%	2,732.00	12.0%	2,440.00
Mineral extraction tax..................	RUR/tonne	1,876.26	78.2%	1,052.76	31.4%	801.44

* Average values.

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

	2005 *	Change from 2004	2004 *	Change from 2003	2003 *
			(in USD dollars per tonne)		
Excise on refined products					
High-octane gasoline............................	128.29	10.0%	116.59	19.3%	97.76
Low-octane gasoline	93.93	10.0%	85.36	19.6%	71.36
Diesel fuel	38.18	10.0%	34.70	19.7%	29.00
Motor oils...	104.33	10.0%	94.80	19.2%	79.51
Mineral extraction tax..................................	66.33	81.7%	36.51	39.8%	26.12

* Average values.

During 2005 our tax burden rose significantly compared to the previous year. Average crude oil export tariffs increased by 134.2% compared to 2004. Approximately 89% of the increase related to growth of crude oil prices, and the remaining 45% resulted from changes in the duty rate calculations effective June 2004 (see below). Export tariffs on gasoline, jet fuel, diesel fuel and gasoils increased by 143.2%. Excise on refined products in Russia increased by approximately 10.0%.

The mineral extraction tax rate increased by 78.2% compared to 2004. This resulted from an increase of the Urals crude price and a change in the tax calculation method effective from January 1, 2005.

The mineral extraction tax rate is determined as follows. Effective from January 1, 2005, the base rate is set at 419 Rubles per metric tonne extracted (in 2004 – 347 rubles) and is adjusted depending on the international market price of the Urals blend and the ruble exchange rate. The tax rate is zero when the average Urals blend international market price for a tax period is less than or equal to $9.00 per barrel (before January 1, 2005 the lower non-taxable threshold was $8.00 per barrel). As a result, each $1.00 per barrel increase in the international Urals blend price over the threshold ($9.00 per barrel) will effectively result in an increase of the tax rate by $1.61 per tonne extracted (or $0.22 per barrel extracted using a conversion factor of 7.33). In 2004 each $1.00 per barrel increase in the international Urals blend price over the threshold ($8.00 per barrel) effectively resulted in an increase of the tax rate by $1.38 per tonne extracted (or 0.19 cents per barrel extracted using a conversion factor of 7.33).

In June 2004 the Russian government introduced a new method of crude oil export duty rate calculation with a three-layer 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 in a layer 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 the layer's lower bound results in an increase of the crude oil export duty rate by $0.35 per barrel exported. If the Urals blend price is in a layer 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 the layer's lower bound results in an increase of the crude oil export duty rate by $0.45 per barrel exported. If the Urals blend price is above $25.00 per barrel, each $1.00 dollar per barrel increase in the Urals blend price over this limit results in an increase of the crude oil export duty rate by $0.65 per barrel exported.

Before June 2004 the crude oil export duty rate was calculated as follows. The rate was zero when the average Urals blend international market price was less than or equal to approximately $15.00 per barrel. If the Urals blend price was in a layer between $15.00 and $25.00 per barrel, each $1.00 per barrel increase in the Urals blend price over the layer's lower bound resulted in an increase of the crude oil export duty rate by $0.35 per barrel exported. If the Urals blend price was above $25.00 per barrel, each $1.00 dollar per barrel increase in the Urals blend price over this limit resulted in an increase of the crude oil export duty rate by $0.40 per barrel exported.

Export duty rates on refined products are set by the Russian government. The size of export duty depends on internal demand on refined products and international crude oil market conditions. Crude oil and refined products exported to CIS countries, other than Ukraine, are not subject to export duties.

Operational highlights

In 2004 our Board of Directors approved the Company’s development strategy where we set out targets for the next 10 years. According to this development strategy we plan to have over 3.3 million of oil equivalent barrels of hydrocarbon production per day by 2014. This represents a 41% increase in crude oil production from the 2004 level and an 8 times increase in gas production compared to 2004. In 2005 we continued to use this strategy as a basis for our business activities as discussed below.

Crude oil production

In line with our long-term strategy we increased our total daily crude oil production by 4.7% (including the Company’s share in equity associates) and produced 664.3 million barrels (90.2 million tonnes) during 2005.

	2005	Change from 2004	2004	Change from 2003	2003
Daily production of crude oil, including Company’s share in equity associates (thousand barrels per day)......	1,820	4.7%	1,738	7.2%	1,622
Own refinery throughput (thousand barrels per day)......	945	8.7%	869	2.8%	845

The following table represents our production in 2005 and 2004 by major regions, excluding our share in equity associates.

	2005	Change from 2004			2004
(thousands of tonnes)		Total %	Change in structure	Organic growth	
Western Siberia...	57,345	3.1%	–	1,715	55,630
Komi Republic...	10,046	5.1%	125	360	9,561
Ural region...	10,234	2.2%	–	224	10,010
Volga region..	3,001	1.1%	–	32	2,969
Timan-Pechora (Nenetsky Autonomous District)...	1,739	16.8%	(18)	268	1,489
Other in Russia	1,815	31.5%	(13)	448	1,380
Crude oil production in Russia....................	**84,180**	**3.9%**	**94**	**3,047**	**81,039**
Crude oil produced internationally............	**2,013**	**47.0%**	**361**	**283**	**1,369**
Total crude oil produced.............................	**86,193**	**4.6%**	**455**	**3,330**	**82,408**

The main oil production region of the Company is Western Siberia. In the oil fields of Western Siberia the Company produced 66.5% of its total production of crude oil in 2005 (67.5% in 2004). The increase of production in Western Siberia was 3.1%. The organic growth of oil production in traditional production regions resulted from improvement and optimization of oil production methods. As a result, our average well debits increased from 10.70 tonnes a day in 2004 to 11.07 tonnes a day in 2005, or by 3.5%. In addition to traditional regions we continued exploration and development of new promising production regions. Oil production in new oil fields in the Nenetsky Autonomous District led to an increase of oil production in this region of 1.2 times compared to 2004. In the third quarter of 2004 we started commercial production at Kravtsovskoye (D-6), a Baltic offshore field. In 2005 we produced 562 thousand tonnes of crude oil from this field, and we expect that annual crude oil production will reach 700 thousand tonnes by 2007. The structural growth in international production volumes in 2005 was caused by consolidation of the Company’s share in the Meleiha Hydrocarbon License Agreement as a result of an increase in our share of LUKAgip N.V. at the end of 2004, and by our acquisition of Nelson in October-December of 2005.

In addition to our production, we purchase crude oil in Russia and on international markets. In Russia we primarily purchase crude oil from associated producing companies and other producers, including vertically integrated companies that lack refining capacity or are unable to export their crude oil. Then we may either refine or export purchased crude oil. Crude oil purchased on international markets is used mostly for marketing activities and, on certain occasions, supplying our overseas refineries.

	2005		2004		2003	
	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)
Crude oil purchases in Russia	10,760	1,468	20,810	2,839	34,436	4,698
Crude oil purchases internationally..........................	69,122	9,430	64,695	8,826	59,278	8,087
Total crude oil purchased......	**79,882**	**10,898**	**85,505**	**11,665**	**93,714**	**12,785**

The volume of crude oil purchased in Russia in 2005 was 1,371 thousand tonnes less than in 2004 as a result of decrease in purchases from third parties, however purchases from our associates increased by 587 thousand tonnes mostly as a result of transactions with OOO Geoilbent, a recently acquired associate. The volume of crude oil purchased internationally during 2005 increased by 604 thousand tonnes compared to 2004, because in 2005 we extended our marketing activity on international markets.

Gas production

In 2005 we produced 5,635 million cubic metres of commercial gas (including our share in equity associates), an increase of 14.4% compared to 2004. In April 2005 we started commercial production on the Nakhodkinskoe gas field and produced in this year 472 million cubic metres of natural gas. This is the first stage of development of the Bolshekhetskaya basin fields in the Yamalo-Nenetsky Autonomous District. The field's planned production capacity of 10 billion cubic metres per year is expected to be achieved in 2007. Development of the Bolshekhetskaya basin fields is a core element of our gas business strategy.

	2005	**Change from 2004**	**2004**	**Change from 2003**	**2003**
Daily production of gas, including Company's share in associates (million cubic feet per day)	545	14.8%	475	30.5%	364

Refining and marketing

We operate four refineries located in European Russia and three refineries located overseas – in Bulgaria, Ukraine and Romania. Our Romanian refinery, Petrotel-LUKOIL S.A., was undergoing significant upgrades until October 2004. In October 2004, we put Petrotel-LUKOIL back into operation. In August 2005 we commenced a wide-scale upgrade of the Odessa refinery. The upgrade program is scheduled for three years.

Production of refined products at our refineries in 2005 increased by 8.2% as compared to 2004. Russian refineries increased production by 5.5%. The overseas refineries increased production by 20.4% primarily due to recommencement of production by Petrotel-LUKOIL.

In late 2004 we began changing refined products mix at our refineries in order to produce higher quality and more profitable products. In particular, in 2005 we produced 4,671 thousand tonnes of Euro 4 and Euro 5 diesel fuel at our Russian refineries (2004: 772 thousand tonnes).

Along with own production of refined products we refine our crude oil at third parties' refineries. In Russia we processed 1,634 thousand tonnes of crude oil during 2005 in order to supply our network in the Ural region. In order to supply our retail networks in Eastern Europe in 2005 we processed 1,213 thousand tonnes of crude oil at third parties' refineries in Belorussia and Serbia.

In 2005 we continued to expand our marketing activities in Western Europe, South-East Asia, Northern and Central America. Our marketing activities mainly include wholesale and bunkering operations in Western Europe and South-East Asia as well as retail operations in the USA, Baltic states and some other regions. The total volume of refined products purchased from third parties for wholesale and to supply retail networks was 32,225 thousand tonnes or $15,021 million in 2005 (20,279 thousand tonnes or $6,843 million in 2004). The increase was a result of continuing development of the existing retail chains outside of Russia and structural changes in the retail networks we operate. In particular, in May 2004 we acquired an additional retail network in the USA, and in March 2005 we acquired a retail network in Finland.

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

The following tables represent volumes of refined products produced and purchased.

	2005	2004	2003
		(thousand of tonnes)	
Refined products produced at the Group refineries in Russia	35,290	33,438	32,444
Refined products produced at the Group refineries outside of Russia...	8,892	7,387	6,789
Total refined products produced at the Group refineries...............	**44,182**	**40,825**	**39,233**
Refined products purchased in Russia..	1,394	2,020	1,399
Refined products purchased internationally	32,238	20,507	14,396
Total refined products purchased...	**33,632**	**22,527**	**15,795**

Export of crude oil and refined products from Russia

We transport a significant portion of our crude oil through Transneft's trunk oil pipeline system. Access to the Transneft crude oil export pipeline network is allocated quarterly, based on recent volumes produced and delivered through the pipeline and proposed export destinations. There is a constraint on the ability of Russian companies to export their crude oil due to limited capacity of Russian transportation infrastructure on the most profitable export routes.

In order to overcome such limits Transneft has extended the capacity of the Baltic Pipeline System. During 2005 it rose nearly to 60 million tonnes of crude oil per year. This allowed us to increase the volume of crude oil exported via the Primorsk terminal in 2005 up to 9,713 thousand tonnes, or 1,316 thousand tonnes more than in 2004.

The crude oil transported by Transneft is the Urals blend – a mix of crude oils of various qualities, therefore Russian companies which produce crude oil of a higher quality can not obtain benefits from selling it using Transneft's pipeline.

Additional access to international markets bypassing Transneft export routes can be obtained through rail transport, by tankers or by our own export infrastructure. Our export infrastructure includes the Vysotsk terminal in the Leningrad region, Varandey terminal in the Nenetsky Autonomous District and the Izhevskoye terminal in the Kaliningrad region. In 2005 the Company exported 8.5% of crude oil produced, or 7,288 thousand tonnes, by means other than Transneft (7,389 thousand tonnes in 2004), including 3,755 thousand tonnes through our own export infrastructure (2,319 thousand tonnes in 2004). In the third quarter of 2005 we ceased the export of crude oil through the Vysotsk terminal due to increased capacity of the Baltic Pipeline System. Currently we use the terminal to export refined products. In the future the terminal will be used to export both crude oil and refined products depending on market conditions.

In 2005 we exported 774 thousand tonnes of crude oil to China (in 2004 we did not export crude oil to China).

The volumes of crude oil exported from Russia by our subsidiaries are summarized as follows:

	2005		2004		2003	
	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)
Export of crude oil using Transneft export routs	282,418	38,529	285,204	38,909	240,150	32,763
Export of crude oil bypassing Transneft	53,421	7,288	54,161	7,389	39,342	5,367
Total crude oil export	**335,839**	**45,817**	**339,365**	**46,298**	**279,492**	**38,130**

In 2005 we exported 16.6 million tonnes of refined products, an increase of 17.7% compared to 2004.

Year ended December 31, 2005 compared to the year ended December 31, 2004

Results of operations

The table below details certain income and expense items from our consolidated statements of income for the periods indicated. All items are presented in millions of US dollars, except for earnings per share data and percentage of changes to 2004.

	2005	Change from 2004	2004
Revenues			
Sales (including excise and export tariffs)	55,774	64.8%	33,845
Equity share in income of affiliates	441	107.0%	213
Total revenues	**56,215**	**65.1%**	**34,058**
Costs and other deductions			
Operating expenses	(3,487)	21.1%	(2,880)
Cost of purchased crude oil, petroleum and chemical products	(19,398)	91.6%	(10,124)
Transportation expenses	(3,519)	26.4%	(2,784)
Selling, general and administrative expenses	(2,578)	27.4%	(2,024)
Depreciation, depletion and amortization	(1,315)	22.3%	(1,075)
Taxes other than income taxes	(6,334)	80.7%	(3,505)
Excise and export tariffs	(9,931)	89.2%	(5,248)
Exploration expenses	(317)	85.4%	(171)
Gain (loss) on disposals and impairments of assets	52	–	(213)
Income from operating activities	**9,388**	**55.6%**	**6,034**
Interest expense	(275)	(8.3%)	(300)
Interest and dividend income	96	(46.7%)	180
Currency translation (loss) gain	(134)	–	135
Other non-operating (expense) income	(44)	–	21
Minority interest	(121)	95.2%	(62)
Income before income taxes	**8,910**	**48.3%**	**6,008**
Current income taxes	(2,301)	42.6%	(1,614)
Deferred income taxes	(166)	13.7%	(146)
Total income tax expense	**(2,467)**	**40.2%**	**(1,760)**
Net income	**6,443**	**51.7%**	**4,248**
Earnings per share of common stock (in US dollars):			
Basic	7.91	52.1%	5.20
Diluted	7.79	51.9%	5.13

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

Sales revenues

Sales breakdown	2005		2004	
	(millions of US dollars)			
Crude oil				
Export and sales on international markets other than CIS	15,589	28.0%	10,338	30.5%
Export and sales to CIS	778	1.4%	602	1.8%
Domestic sales	120	0.2%	181	0.5%
	16,487	**29.6%**	**11,121**	**32.8%**
Refined products				
Export and sales on international markets				
Wholesale	22,923	41.1%	11,403	33.7%
Retail	6,293	11.3%	3,914	11.6%
Domestic sales				
Wholesale	4,753	8.5%	3,429	10.1%
Retail	1,972	3.5%	1,236	3.7%
	35,941	**64.4%**	**19,982**	**59.1%**
Petrochemicals				
Export and sales on international markets	1,134	2.0%	1,021	3.0%
Domestic sales	469	0.9%	332	1.0%
	1,603	**2.9%**	**1,353**	**4.0%**
Other	**1,743**	**3.1%**	**1,389**	**4.1%**
Total sales	**55,774**	**100.0%**	**33,845**	**100.0%**

Sales volumes	2005		2004	
	(thousands of barrels)			
Crude oil				
Export and sales on international markets other than CIS	312,712		307,523	
Export and sales to CIS	23,852		29,877	
Domestic sales	4,926		11,999	
Crude oil	(thousands of tonnes)			
Export and sales on international markets other than CIS	42,662	34.7%	41,954	38.6%
Export and sales to CIS	3,254	2.6%	4,076	3.7%
Domestic sales	672	0.5%	1,637	1.5%
	46,588	**37.8%**	**47,667**	**43.8%**
Refined products	(thousands of tonnes)			
Export and sales on international markets				
Wholesale	49,549	40.2%	35,946	33.1%
Retail	7,117	5.8%	5,480	5.0%
Domestic sales				
Wholesale	16,421	13.3%	16,981	15.6%
Retail	3,549	2.9%	2,743	2.5%
	76,636	**62.2%**	**61,150**	**56.2%**
Total sales volume of crude oil and refined products	**123,224**	**100.0%**	**108,817**	**100.0%**

Realized average sales prices	2005		2004	
	($/barrel)	($/tonne)	($/barrel)	($/tonne)
Average realized price international				
Oil (excluding CIS)	49.85	365.41	33.62	246.42
Oil (CIS)	32.63	239.20	20.13	147.57
Refined products				
Wholesale		462.61		317.24
Retail		884.30		714.19
Average realized price within Russia				
Oil	24.44	179.15	15.09	110.58
Refined products				
Wholesale		289.41		201.94
Retail		555.80		450.64

During 2005 our revenues increased by $21,929 million, or 64.8%, compared to 2004.

The total volume of crude oil and refined products sold amounted to 123.2 million tonnes, which is 13.2% more than in 2004. Our revenues from crude oil sales increased by $5,366 million, or 48.3%. Our sales of refined products increased by $15,959 million, or 79.9%.

Sales of crude oil and refined products on the international markets, including the CIS, accounted for 83.3% of total sales volume in 2005 compared to 80.4% in 2004.

The increase in sales was principally due to the following:

- favorable price conditions (see "Change in the price of crude oil and refined products" on page 5)
- increase in total volume of crude oil production (see "Crude oil production" on page 9)
- increase in marketing activities (see page 10)
- increase in crude oil refining

Sales of crude oil

During 2005 the Company decreased its sales of crude oil on the domestic market compared to 2004 by 965 thousand tonnes, or 58.9%, due to increased volume of refining in Russia.

In order to obtain benefits from increased refined products prices in Russia and on international markets and due to a higher level of export tariff on crude oil compared to export tariffs on refined products we slightly decreased the volume of crude oil exported from Russia by 481 thousand tonnes, or 1.0%, compared to 2004.

Sales of refined products

Sales of refined products made up 64.4% of our total revenues (62.2% in terms of volumes sold) compared to 59.1% (56.2% – in terms of volumes) in 2004. The portion of our domestic refined product sales in 2005 was 16.2% of the total tonnes sold (2004: 18.1%), but represented 12.0% of our total revenues (2004: 13.8%). The decrease of this portion is accounted for by more extensive expansion of marketing activities outside of Russia.

The average realized wholesale price on refined products outside of Russia increased by $145.37 per tonne, or 45.8%, compared to 2004. Volumes of refined products sold outside of Russia increased by 13,603 thousand tonnes, or 37.8% (see also "Refining and marketing" on page 10). As a result, our revenue from wholesale of refined products outside of Russia increased by $11,520 million, or 101.0%.

In 2005 retail sales of refined products outside of Russia increased by 1,637 thousand tonnes, or by 29.9%, compared to 2004. The increase was a result of continuing development of the existing retail chains outside of Russia and structural changes in the retail networks we operate. In particular, in May 2004 we acquired an additional retail network in the USA, and in March 2005 we acquired a retail network in Finland. Average retail prices increased up to $884.30 per tonne, or by 23.8%. As a result, our revenue from retail sales increased by $2,379 million, or 60.8%. In 2005 revenue from retail sales was 21.5% (in 2004 – 25.6%) of total refined products sales outside of Russia. Our international retail sales include supplies of refined products to third parties' retail networks within the bounds of long-term contracts with pricing similar to retail pricing.

Wholesale of refined products within Russia in 2005 slightly decreased compared to 2004 because of growth in retail sales and export of refined products from Russia. The average domestic realized price on refined products increased by $87.47 per tonne, or 43.3%. As a result, our revenue from wholesale of refined products on the domestic market increased by $1,324 million, or 38.6%.

Retail sales within Russia in 2005 increased by 806 thousand tonnes, or 29.4%, compared to 2004. Average retail prices increased up to $555.80 per tonne, or by 23.3%. As a result, our revenue from retail sales increased by $736 million, or 59.5%. Revenue from retail sales was 29.3% of total refined products sales in Russia in 2005 (in 2004 – 26.5%).

Sales of petrochemical products

Revenue from sales of petrochemical products increased by $250 million, or 18.5%, during 2005. This was mainly due to an increase in average realized prices.

Sales of other products

Other sales include revenues from sales of gas, gas refined products and other services provided and goods not related to our primary activities (such as electricity, heat, etc.) sold by our production and marketing companies. Other sales increased by $354 million, or 25.5%, as a result of sales of other products produced by the Company, primarily gas and gas refined products, and increased activity in providing other services to third parties.

Equity share in income of affiliates

Our share in the income of affiliates in 2005 increased by $229 million, or 107.5%, compared to 2004 due to a general increase in profitability of our crude oil production affiliates in particular due to an increase in the net income of ZAO Turgai-Petroleum. ZAO Turgai-Petroleum, our 50% interest affiliate company, is a partner in the Turgai-Petroleum joint venture developing the Kumkol oil field in Kazakhstan. The Group's share in the net income of ZAO Turgai-Petroleum in 2005 was $198 million, which represents an increase of $153 million as compared to the previous year.

Operating expenses

Operating expenses include the following types of costs:

	2005	**2004**
	(millions of US dollars)	
Crude oil extraction expenses	1,740	1,556
Refining expenses	644	532
Petrochemical expenses	214	207
Other operating expenses	889	585
Total operating expenses	**3,487**	**2,880**
Cost of purchased crude oil, petroleum and chemical products	**19,398**	**10,124**

Compared to 2004, operating expenses increased by $607 million, or 21.1%. Real appreciation of the ruble against the US dollar is still a significant factor affecting our operating expenses in Russia. In 2005 the real ruble appreciation was 6.9%.

Crude oil extraction expenses. Our extraction expenses include expenditures related to repairs of extraction equipment, labor costs, expenses of artificial stimulation of reservoirs, fuel and electricity costs, property insurance of extraction equipment and other similar costs.

Expenses of the Company's oil production enterprises related to the sale of services and goods (such as electricity, heat, etc.) that do not relate to core activities have been excluded from extraction expenses and are included in other operating costs.

In 2005 our extraction expenses rose by $184 million, or 11.8%, compared to 2004. The increase resulted from growth of crude oil produced by our subsidiaries up to 86.2 million tonnes, or by 4.6%, compared to 2004, and increased expenses on repairs, overhaul and artificial stimulation of reservoirs in our production subsidiaries. Moreover, extraction costs were affected by the real ruble appreciation. However, the impact of these factors was partly mitigated by an increase of average well debits from 10.70 tonnes a day in 2004 to 11.07 tonnes a day in 2005. As a result our average extraction cost per barrel increased from $2.58 to $2.75 per barrel, or by 6.6% (average extraction cost calculated using an average tonnes to barrels conversion rate of 7.33).

Refining expenses at our refineries increased by $112 million, or 21.1%, in 2005 compared to 2004.

Refining expenses of our domestic refineries increased by 13.8%, or $55 million as a result of increased production volume and due to effect of the real ruble appreciation. Moreover, in late 2004 we began changing product mix in order to produce higher quality and more profitable products (in particular, Euro 4 quality standard diesel fuel), which led to an increase of our refinery expenses.

Refining expenses of our international refineries increased by 43.2%, or $57 million, as a result of the recommencement of operations of our Romanian refinery Petrotel-LUKOIL after modernization, and due to growth in heating and power cost at our Bulgarian refinery.

Operating expenses of petrochemical companies increased by $7 million, or 3.4%, compared to 2004.

Other operating expenses include natural gas extraction expenses, operating expenses of our gas processing plants, and the costs of other services provided and goods not related to primary activities (such as electricity, heat, etc.) sold by our production and marketing companies, and operating expenses of other non-core businesses of the Group. Other operating expenses also include transportation costs associated with the delivery of crude oil from the Group's exploration and production entities to the Group's refineries, processing fees paid to third parties' refineries, and the amount of the change in crude oil and refined products inventory originated within the Group. Other operating expenses increased by $304 million compared to 2004. The increase was explained by increased volumes of our crude oil refined on the third parties' refineries, growth of volume of the other products sales (primarily gas and gas refined products), and as a result of change in crude oil and refined product inventory originated within the Group in the fourth quarter of 2005.

Cost of purchased crude oil, petroleum and chemical products increased by $9,274 million in 2005, or 91.6%, compared to the previous year due to a significant increase in volumes of sales of purchased crude oil and refined products in 2005 by 10,094 thousand tonnes, or about 29.5%, compared to 2004 and growth of market prices on crude oil and petroleum products.

Transportation expenses

The increase in the total volume of sales together with the increase in transportation tariffs led to growth of our transportation expenses in 2005 by $735 million, or 26.4%, compared to 2004.

According to the Federal Statistics Service of the Russian Federation, in 2005 transportation tariffs increased as follows: transportation of oil by pipeline transport – 33.3% (including certain specific tariffs established for individual parts of the Transneft pipeline which did not have a material impact on transportation expenses of the Group), transportation of refined products by pipeline transport – 24.8%, railway transport – 13.3%.

Sea shipping tariffs decreased in 2005 by 14.9%, compared to 2004 (calculated as weighted average by volumes transported to different locations). At the same time, a significant increase of tariffs and demurrage cost in the fourth quarter of 2005 led to an increase of transportation expenses by approximately $70 million.

Selling, general and administrative expenses

Our selling, general and administrative expenses increased by $554 million, or 27.4%, compared to 2004. The above-mentioned expenses include general business expenses, payroll costs (excluding extraction entities' and refineries' production staff costs), insurance costs (except for property insurance related to oil and gas, and refinery equipment), costs of maintenance of social infrastructure, movement in bad debt provision and other expenses.

The increase in selling, general and administrative expenses was a result of general expansion of our operations primarily outside of Russia. Also, the expenses were affected by an increase in expenses related to a share-based compensation program for management in 2005, which was $263 million compared to $65 million in 2004. At the same time we partially mitigated an effect of the real ruble appreciation.

Selling, general and administrative expenses for 2005 also included $66 million of expenses related to our Finnish subsidiaries acquired in March 2005 and $20 million of expenses related to Nelson, which we acquired in October-December of 2005.

Depreciation, depletion and amortization

Depreciation, depletion and amortization expenses include depletion of assets fundamental to production, depreciation of other productive and non-productive assets and certain intangible assets. Our depreciation, depletion and amortization expenses increased by $240 million, or 22.3%, compared to 2004. The increase was a result of the Company's capital expenditures and corresponding growth of depreciable assets, also the increase included $41 million of depreciation, depletion and amortization expenses related to Nelson acquired in 2005.

Taxes other than income taxes

Taxes other than income taxes include mineral extraction tax, property tax and social taxes.

	2005		2004	
	In Russia	International	In Russia	International
	(millions of US dollars)			
Mineral extraction tax	5,590	–	2,971	–
Social security taxes and contributions	284	40	302	28
Property tax	210	23	91	20
Other taxes	162	25	60	33
	6,246	**88**	**3,424**	**81**
Total		**6,334**		**3,505**

The increase in taxes other than income taxes resulted primarily from a $2,619 million increase in mineral extraction tax, which is linked to international crude oil prices (see "Tax burden" on page 6). Property tax in Russia increased in 2005 primarily due to recalculation of domestic property tax related to 2002 and 2003. In 2005 the Group recognized an expense of $163 million in relation to the results of tax audits of the Group companies for periods prior to the 2004 financial year. The amount of such additional taxes recognized as other taxes was approximately $150 million.

Excise and export tariffs

Our excise and export tariffs include taxes on sales of refined products and export tariffs on export of crude oil and refined products. Excise and export tariffs increased by $4,683 million, or 89.2%, compared to 2004. The increase in export tariff expenses resulted from an increase in export tariff rates (see "Tax burden" on page 6). The increase in international excise taxes on refined products resulted from an increase in volumes of products sold across our international group, primarily in the USA, and due to commencement of our operations in Finland.

	2005		2004	
	In Russia	International	In Russia	International
	(millions of US dollars)			
Excise tax and sales taxes on refined products	654	2,679	547	1,774
Export tariffs	6,590	8	2,913	14
	7,244	**2,687**	**3,460**	**1,788**
Total		**9,931**		**5,248**

Exploration expenses

During 2005 the amount charged to exploration expense increased in comparison with the previous year by $146 million, or by 85.4%. This is attributable to the fact that during 2005 the Group completed drilling the first two exploratory wells of the Yalama (D-222) and Tyub-Karagan exploration projects. Both exploratory wells were dry and their costs in the amount of $105 million were charged to expense. Notwithstanding the fact that the initial exploratory wells were not successful, the Group continues to perform further geological studies and is using the results of the first exploratory drilling in its analysis to assess potential placement of hydrocarbon deposits and to determine drilling programs for the second exploratory wells in both fields.

Gain (loss) on disposals and impairments of assets

Gain on disposals of assets in 2005 amounted to $52 million compared to $213 million loss in 2004.

In 2005 we recognized an $152 million gain on the sale our 30% interest in OOO Narianmarneftegaz to ConocoPhillips, a gain of $4 million on the sale of our 38% interest in ZAO Globalstroy-Engineering and a gain of $25 million on the sale of the entire interest in ZAO Arktikneft. Also in 2005 the Group recognized an additional impairment loss of $12 million related to sale of our ownership interests in OAO Bank Petrocommerce.

In 2004 we recognized an impairment loss in relation to our decision to sell our ownership interests in OAO Bank Petrocommerce in the amount of $35 million and an impairment loss of $70 million in relation to our decision to sell our ownership interest in OOO LUKOIL-Burenie.

Other losses relate to disposals of a number of non-core assets and individually insignificant impairments on non-performing business units.

Interest expense

Interest expense in 2005 decreased by $25 million compared to 2004 primarily due to the sale of our ownership interest in OAO Bank Petrocommerce in the third quarter of 2004. However the decrease was compensated in the fourth quarter of 2005 by accrued interest expense related to the loan of $1,934 million, which the Group obtained to finance the acquisition of Nelson.

Income taxes

Our total income tax expense increased by $707 million, or 40.2%, compared to 2004, due to an increase of income before income tax by $2,902 million, or 48.3%.

Our effective income tax rate in 2005 was 27.7% (in 2004 it was 29.3%), which is higher than the maximum statutory rate for the Russian Federation (24%). This is attributable to the fact that some costs incurred during the period are not tax deductible or only deductible to a certain limit.

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

	2005	**2004**
	(millions of US dollars)	
Income before income taxes	**8,910**	**6,008**
Add back:		
Depreciation and amortization	1,315	1,075
Interest expense	275	300
Interest and dividend income	(96)	(180)
EBITDA	**10,404**	**7,203**

Year ended December 31, 2004 compared to the year ended December 31, 2003

Results of operations

The table below details certain income and expense items from our consolidated statements of income for the periods indicated. All items are presented in millions of US dollars, except for earnings per share data and percentage of changes to 2003.

	2004	Change from 2003	2003
Revenues			
Sales (including excise and export tariffs)	33,845	53.0%	22,118
Equity share in income of affiliates	213	17.7%	181
Total revenues	**34,058**	**52.7%**	**22,299**
Costs and other deductions			
Operating expenses	(2,880)	13.1%	(2,546)
Cost of purchased crude oil, petroleum and chemical products	(10,124)	71.3%	(5,909)
Transportation expenses	(2,784)	35.7%	(2,052)
Selling, general and administrative expenses	(2,024)	12.4%	(1,800)
Depreciation, depletion and amortization	(1,075)	16.8%	(920)
Taxes other than income taxes	(3,505)	42.7%	(2,456)
Excise and export tariffs	(5,248)	77.7%	(2,954)
Exploration expenses	(171)	25.7%	(136)
Gain from sale of interest in the Azeri, Chirag, Guneshli project	–	–	1,130
Loss on disposals and impairments of assets	(213)	208.7%	(69)
Income from operating activities	**6,034**	**31.5%**	**4,587**
Interest expense	(300)	9.9%	(273)
Interest and dividend income	180	29.5%	139
Currency translation gain	135	(8.8)%	148
Other non-operating income	21	90.9%	11
Minority interest	(62)	72.2%	(36)
Income before income taxes	**6,008**	**31.3%**	**4,576**
Current income taxes	(1,614)	71.9%	(939)
Deferred income taxes	(146)	114.7%	(68)
Total income tax expense	**(1,760)**	**74.8%**	**(1,007)**
Net income	**4,248**	**19.0%**	**3,569**
Cumulative effect of change in accounting principle, net of tax	–	–	132
Net income	**4,248**	**14.8%**	**3,701**
Earnings per share of common stock (in US dollars):			
Basic	5.20	15.0%	4.52
Diluted	5.13	15.3%	4.45
Exclusion of special items:			
Cumulative effect of change in accounting principle, net of tax	–	–	(132)
Gain from sale of interest in the Azeri, Chirag, Guneshli project	–	–	(1,130)
Pension curtailment	–	–	(53)
Net income excluding special items	**4,248**	**78.0%**	**2,386**

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

Special items

In December 2003 we took the decision to replace the Group's existing defined benefit pension plan with a new plan. The new plan is principally a defined contribution plan. This resulted in the recognition of a curtailment gain of $53 million.

Net income for 2003 includes a non-taxable gain from the sale of our interest in the Azeri, Chirag, Guneshli project of $1,130 million.

Sales revenue

Sales breakdown	2004		2003	
	(millions of US dollars)			
Crude oil				
Export and sales on international markets other than CIS	10,338	30.5%	6,411	29.0%
Export and sales to CIS	602	1.8%	433	2.0%
Domestic sales	181	0.5%	374	1.7%
	11,121	**32.8%**	**7,218**	**32.7%**
Refined products				
Export and sales on international markets				
Wholesale	11,403	33.7%	7,214	32.6%
Retail	3,914	11.6%	2,266	10.3%
Domestic sales				
Wholesale	3,429	10.1%	2,608	11.8%
Retail	1,236	3.7%	842	3.8%
	19,982	**59.1%**	**12,930**	**58.5%**
Petrochemicals				
Export and sales on international markets	1,021	3.0%	671	3.0%
Domestic sales	332	1.0%	251	1.1%
	1,353	**4.0%**	**922**	**4.1%**
Other	**1,389**	**4.1%**	**1,048**	**4.7%**
Total sales	**33,845**	**100.0%**	**22,118**	**100.0%**

Sales volumes

	2004		2003	
	(thousands of barrels)			
Crude oil				
Export and sales on international markets other than CIS	307,523		246,889	
Export and sales to CIS	29,877		29,826	
Domestic sales	11,999		43,826	
Crude oil	(thousands of tonnes)			
Export and sales on international markets other than CIS	41,954	38.6%	33,682	34.3%
Export and sales to CIS	4,076	3.7%	4,069	4.1%
Domestic sales	1,637	1.5%	5,979	6.1%
	47,667	**43.8%**	**43,730**	**44.5%**
Refined products	(thousands of tonnes)			
Export and sales on international markets				
Wholesale	35,946	33.1%	30,193	30.8%
Retail	5,480	5.0%	3,802	3.9%
Domestic sales				
Wholesale	16,981	15.6%	17,967	18.3%
Retail	2,743	2.5%	2,506	2.5%
	61,150	**56.2%**	**54,468**	**55.5%**
Total sales volume of crude oil and refined products	**108,817**	**100.0%**	**98,198**	**100.0%**

Realized average sales prices

	2004		2003	
	($/barrel)	($/tonne)	($/barrel)	($/tonne)
Average realized price international				
Oil (excluding CIS)	33.62	246.42	25.97	190.35
Oil (CIS)	20.13	147.57	14.50	106.25
Refined products				
Wholesale		317.24		238.94
Retail		714.19		596.02
Average realized price within Russia				
Oil	15.09	110.58	8.53	62.54
Refined products				
Wholesale		201.94		145.15
Retail		450.64		335.90

During 2004 sales revenues increased by $11,727 million, or 53.0%, compared to 2003.

The total volume of crude oil and refined products sold amounted 108.8 million tonnes, which is 10.8% more than that sold in 2003. Our revenues from crude oil sales increased by $3,903 million, or 54.1%. Our sales of refined products increased by $7,052 million, or 54.5%.

Sales of crude oil and refined products on the international market, including the CIS, accounted for 80.4% of total sales volume in 2004 compared to 73.1% in 2003.

The increase in sales was principally due to the following:

- favorable price conditions: international crude oil market prices were at a ten-year high
- increase in total volume of crude oil production
- increase in marketing activities
- decrease of crude oil sales in Russia and increase in volumes exported on international markets

Sales of crude oil

During 2004 the Company decreased its sales of crude oil on the domestic market compared to the previous year by 4,342 thousand tonnes, or 72.6%. This change was caused by an increase in volumes exported by the Company's domestic producers and an increase in the Group's refineries throughput.

During 2004 we increased exports of crude oil on international markets by the Company's domestic producers by 8,168 thousand tonnes. The increase in export sales, along with an increase in the average realized export price of crude oil on international markets (other than CIS) from $25.97 to $33.62 per barrel, allowed us to obtain an additional $2,012 million in revenues.

Sales of refined products

Sales of refined products made up 59.1% of our total sales revenues (56.2% in terms of volumes sold) compared to 58.5% (55.5% – in terms of volumes) in 2003.

The average realized wholesale price on refined products outside of Russia increased by $78.30 per tonne, or 32.8%. Volumes of refined products sold outside of Russia increased by 5,753 thousand tonnes, or 19.1%. As a result, our revenues from wholesale of refined products outside of Russia increased by $4,189 million, or 58.1%.

In 2004 we increased retail sales of refined products outside of Russia by 1,678 thousand tonnes, or by 44.1% as compared to 2003. The increase was a result of continuing development of the existing retail chains in other regions and structural changes in the retail network we operate. In particular, we acquired Beopetrol in Serbia in 2003 and the additional retail network in the USA in May 2004. Retail sales primarily include sales of gasoline, diesel oil and other refined products (heating oil, lubricants, etc.). Average retail prices increased up to $714.19 per tonne, or by 19.8%. As a result, our revenues from retail sales increased by $1,648 million, or 72.7%. Revenue from retail sales was 25.6% of total sales of refined products outside of Russia in 2004.

Wholesale of refined products within Russia in 2004 decreased by 986 thousand tonnes, or 5.5%, as compared to the same period in 2003. The decrease was caused by an increase in retail sales and increase in export of refined products. It was compensated by an increase of the average domestic realized price on refined products of $56.79 per tonne, or 39.1%. As a result, our revenues from wholesale of refined products on the domestic market increased by $821 million, or 31.5%.

Retail sales within Russia in 2004 increased by 237 thousand tonnes, or 9.5%, as compared to 2003. Average retail prices increased up to $450.64 per tonne, or by 34.2%. As a result, our revenues from retail sales increased by $394 million, or 46.8%. Revenue from retail sales was 26.5% of total sales of refined products in Russia in 2004.

Sales of petrochemical products

Revenues from sales of petrochemical products increased by $431 million, or 46.7%, during 2004. This was mainly due to an increase of production volume up to 2,240 thousand tonnes, or by 7.8%, compared to 2003, and an increase in average realized prices.

Sales of other products

Other sales increased by $341 million, or 32.5%, as a result of sales of other products produced by the Company, and also increased activity in providing other services to third parties.

Equity share in income of affiliates

Our share in the income of affiliates in 2004 increased by $32 million, or 17.7%, compared to 2003, primarily due to an increase in the net income of ZAO Turgay-Petroleum. ZAO Turgay-Petroleum, our 50% interest affiliate company, is a partner in the Turgay Petroleum joint venture developing the Kumkol field in Kazakhstan. The Group's share in the net income of ZAO Turgay-Petroleum in 2004 amounted $45 million that represents an increase of $17 million as compared to 2003.

Operating expenses

Operating expenses include the following types of costs:

	2004	2003
	(millions of US dollars)	
Crude oil extraction expenses	1,556	1,458
Refining expenses	532	454
Petrochemical expenses	207	174
Other operating expenses	585	460
Total operating expenses	**2,880**	**2,546**
Cost of purchased crude oil, petroleum and chemical products	**10,124**	**5,909**

Compared to 2003, operating expenses increased by $334 million, or 13.1%.

Crude oil extraction expenses. Our extraction expenses include expenditures related to repairs of extraction equipment, labor costs, expenses of artificial stimulation of reservoirs, fuel and electricity costs and other similar costs.

Expenses of the Company's production enterprises related to the sale of services and goods (such as electricity, heat, etc.) that do not relate to core activities have been excluded from extraction expenses and are included in other operating costs.

Crude oil extraction expenses rose by $98 million, or 6.7%, compared to the respective period of 2003. The increase in total extraction expenses resulted from an increase in volumes of oil produced by our subsidiaries from 76.1 million tonnes in 2003 to 82.4 million tonnes in 2004 as well as an 18.5% real ruble appreciation during the 2004. Despite these facts our average extraction cost per barrel slightly decreased from $2.61 to $2.58 per barrel, or 1.1% (average extraction cost calculated using an average tonnes to barrels conversion rate of 7.33). The decrease was caused by an increase in an average daily oil flow per well from 9.7 tonnes a day in the 2003 to 10.7 tonnes a day in the 2004, or 10.3%, and restructuring of our oil producing assets in the Perm region.

Refining expenses at our refineries increased by $78 million, or 17.2%, in 2004 compared to 2003.

Refining expenses of our domestic refineries increased by 18.7%, or $63 million. This was primarily caused by an appreciation in the exchange rate of the ruble to the US dollar and an increase in volumes produced.

Refining expenses of our international refineries increased by 12.8%, or $15 million due to the recommencement of operations of our Romanian refinery Petrotel-LUKOIL after modernization and an increase in volumes produced.

Operating expenses of petrochemical companies increased by $33 million, or 19.0%, compared to 2003, as result of an appreciation in the exchange rate of the ruble to the US dollar and an increase in volumes produced.

Other operating expenses include the costs of other services provided and goods not related to primary activities (such as electricity, heat, etc.) sold by our production companies, and operating expenses of other non-core businesses of the Group. Other operating expenses also include costs associated with the delivery of crude oil from the Group's exploration and production entities to the Group's refineries, as well as the amount of the change in crude oil and refined products inventory at the Group's marketing entities. Other operating expenses increased by $125 million, or 27.3%, as compared to 2003 primarily as a result of change in crude oil and refined products inventory in 2004.

Cost of purchased crude oil, petroleum and chemical products increased by $4,215 million in 2004, or 71.3%, compared to the prior period due to a significant increase in volumes of refined products purchased for resale in 2004 by 6,394 thousand tonnes and growth of market prices on crude oil and petroleum products.

Transportation expenses

The increase in the total volume of sales led to an increase in transportation expenses. However, the main factor in the increase of $732 million, or 35.7%, in these expenses compared to 2003 was the increase in the transportation tariffs.

During 2004, transportation tariffs increased as follows: pipeline transport – 10.9%, including increase of Transneft's tariff – 13.3%, sea shipping – 46.7% (weighted average by volumes transported to different locations), railway transport – 21.6%.

Selling, general and administrative expenses

Our selling, general and administrative expenses increased by $224 million, or 12.4%, compared to 2003. The above-mentioned expenses include general business expenses, payroll costs (excluding extraction entities' and refineries' production staff cost), insurance costs, costs of maintenance of social infrastructure, movement in bad debt provision and other expenses.

The increase in selling, general and administrative expenses was primarily caused by 18.5% real appreciation of the ruble during 2004. It was partly compensated by movements in the bad debt provision. During 2004 the bad debt provision increased by $48 million, thus increasing general expenses, while for 2003 the bad debt provision increased by $79 million. Also, in 2004 the Company accrued $65 million of compensation to management in relation to the share-based compensation program, compared to $26 million in 2003.

Depreciation, depletion and amortization

Depreciation, depletion and amortization expenses include depletion of assets fundamental to production, depreciation of other productive and non-productive assets and certain intangible assets. Our depreciation, depletion and amortization expenses increased by $155 million, or 16.8%, in comparison to 2003. The increase was a result of the Company's capital expenditure program and corresponding growth of depreciable assets. This increase was partly compensated by upward revisions of the Company's proved reserves and, consequently, an increase in estimated useful economic life of fixed assets.

Taxes other than income taxes

Taxes other than income taxes include mineral extraction tax, property tax and social taxes.

	2004		2003	
	in Russia	**International**	**in Russia**	**International**
	(millions of US dollars)			
Mineral extraction tax	2,971	–	1,966	–
Social security taxes and contributions	302	28	235	21
Property tax	91	20	123	16
Other taxes	60	33	59	36
	3,424	**81**	**2,383**	**73**
Total		**3,505**		**2,456**

The increase in taxes other than income taxes resulted primarily from a $1,005 million increase in mineral extraction tax, which is linked to international crude oil prices. Social taxes and contributions in Russia increased by $67 million, or 28.5%, as compared to 2003. As allowed by the current legislation we recalculated domestic property tax for 2002 and 2003 that resulted in $36 million decrease in property tax charge for 2004.

Excise and export tariffs

Our excise and export tariffs include taxes on sales of refined products and export tariffs on export of crude oil and refined products. Excise and export tariffs increased by $2,294 million, or 77.7%, compared to 2003. The increase in export tariff expenses resulted from an increase in export tariff rates and also an increase in volumes exported. The increase in international excise taxes on refined products resulted from an increase in excise taxes and fuel sales taxes and from an increase in volumes of products sold across our international group, primarily in the USA.

	2004		2003	
	in Russia	**International**	**in Russia**	**International**
	(millions of US dollars)			
Excise tax and sales taxes on refined products	547	1,774	449	1,106
Export tariffs	2,913	14	1,392	7
	3,460	**1,788**	**1,841**	**1,113**
Total		**5,248**		**2,954**

Exploration expenses

During 2004 the amount charged to exploration expense increased in comparison with 2003 by $35 million, or by 25.7%.

Loss on disposal and impairment of assets

Loss on disposal and impairment of assets in 2004 was $213 million compared to $69 million in 2003. In the second quarter of 2004 we recognized an impairment loss of $35 million in relation to our decision to sell our ownership interest in OAO Bank Petrocommerce. In the third quarter of 2004 we recognized an impairment loss of $70 million in relation to our decision to sell our ownership interest in OOO LUKOIL-Burenie.

Interest expense

Interest expense in 2004 increased by $27 million compared to 2003 primarily due to an increase of LIBOR rates in 2004.

Income taxes

Our total income tax expense increased by $753 million, or 74.8%, compared to 2003 while our income before income tax increased by $1,432 million, or 31.3% (excluding gain on sale of interest in Azeri, Chirag, Guneshli, our income before income tax increased by $2,562 million, or 74.3%).

Our effective tax rate in 2004 was 29.3% (in 2003 it was 29.2%, excluding the effect of gain on sale of interest in Azeri, Chirag, Guneshli), which is higher than the maximum statutory rate for the Russian Federation (24%). This is attributable to the fact that some costs incurred during the period are not tax deductible or only deductible to a certain limit. Moreover, despite the impairment losses recorded in the consolidated financial statements, the disposals of OAO Bank Petrocommerce and OOO LUKOIL-Burenie resulted in a taxable gain under Russian tax legislation. In 2004 income tax expense included $28 million related to these disposals, thus increasing our effective tax rate.

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

	2004	2003
	(millions of US dollars)	
Income before income taxes	**6,008**	**4,576**
Add back:		
Depreciation and amortization	1,075	920
Interest expense	300	273
Interest and dividend income	(180)	(139)
EBITDA	**7,203**	**5,630**

Liquidity and capital resources

	2005	2004	2003
	(million US dollars)		
Net cash provided by operating activities	6,097	4,180	2,936
Net cash used in investing activities	(6,225)	(3,741)	(2,792)
Net cash provided by (used in) financing activities	539	(650)	(4)
Net debt	3,354	2,620	3,376
Current ratio	2.14	1.89	1.50
Total debt to equity	19%	19%	28%
Long term debt to long term debt and equity	13%	11%	12%
Total net debt to cash flow from operations	0.55	0.63	1.15

Our primary source of cash flow is funds generated from our operations. During 2005 cash generated by operating activities was $6,097 million, an increase of $1,917 million compared to 2004. In 2005 cash inflow from operating activity was impacted by the following factors:

- increase in revenue
- increase in amount of income tax paid
- increase in volume of export sales and, consequently, prepayment of custom fees, export duties and transportation tariffs.

Moreover, in 2005 our operating cash inflows were significantly affected by an increase of working capital (excluding effect of acquisitions) by $1,540 million compared to January 1, 2005. This was mainly caused by:

- an increase in trade accounts and notes receivable by $942 million, which was resulted from an increase in the price of crude oil and refined products and expansion of marketing activities
- an increase of inventory by $735 million, which was resulted from increased volumes of crude oil and refined products in stock and increased purchase prices.

At the same time, this change in working capital was partly compensated by an increase in trade accounts and notes payable by $194 million, which was resulted from an increase in volumes of purchased crude oil and refined products and growth of related prices.

During 2005 the Company spent $6,856 million on capital investments and acquisitions of interests in other companies, which was $3,131 million more than in 2004. In 2005 we paid $2,874 million (an increase of $2,397 million compared to 2004) mainly for the acquisitions of Nelson, OAO Primorieneftegaz, Oy Teboil Ab and Suomen Petrooli Oy, remaining interest in ZAO SeverTEK, equity interest in OOO Geoilbent and increase of our share in LUKOIL Neftochim Burgas. Cash flows from investing activities include $588 million of cash received primarily from the sale of interests in OOO Narianmarneftegaz, ZAO Globalstroy-Engineering and ZAO Arktikneft.

In 2005 the result of our financing activity was an inflow of $539 million compared to an outflow of $650 million in 2004. This change is explained by the loan of $1,934 million we received for financing acquisition of Nelson. Also in 2005 we repaid short-term borrowings by $468 million more than in 2004.

The Company made payments of $746 million, $661 million, and $467 million for dividends in 2005, 2004 and 2003, respectively.

The Company has sufficient borrowing capacity to meet unanticipated cash requirements. As of December 31, 2005 the Company had available unutilized short-term credit facilities with a number of banks in the amount of $1,264 million.

During 2005 the Group systematically worked at decreasing the level of secured debt, mainly represented by the pledge of export receivables and fixed assets. As of December 31, 2005 the level of secured debt was 35% of the total debt, while as of December 31, 2004 – 48%.

Analysis of capital expenditures

	2005	2004	2003
	(millions of US dollars)		
Exploration and production			
Russia	2,487	2,100	1,537
International	431	189	247
Total exploration and production	2,918	2,289	1,784
Refining, marketing and distribution			
Russia	654	677	911
International	475	393	264
Total refining, marketing and distribution	1,129	1,070	1,175
Chemicals			
Russia	59	55	28
International	18	16	11
Total chemicals	77	71	39
Other	53	17	20
Total capital expenditures*	**4,177**	**3,447**	**3,018**
Acquisitions of subsidiaries **			
Exploration and production			
Russia	778	23	989
International	1,959	143	–
Total exploration and production	2,737	166	989
Refining, marketing and distribution			
Russia	27	1	23
International	229	305	257
Total refining, marketing and distribution	256	306	280
Chemicals			
Russia	–	–	–
International	–	–	–
Total chemicals	–	–	–
Other	–	5	–
Less cash acquired	**(119)**	**–**	**(44)**
Total	**2,874**	**477**	**1,225**

* Including non-cash transactions.
** Including prepayments related to acquisitions of subsidiaries and minority shareholding interest.

Capital expenditures, including non-cash transactions, during 2005 amounted to $4,177 million, $730 million more than in the previous year. The growth was mainly caused by expenditures in our exploration and production segment, which increased by $629 million compared to 2004. The growth in exploration and production capital expenditures in new regions amounted to $367 million. The capital expenditures in traditional exploration regions of the Western Siberia increased by $110 million.

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

Exploration and production	**2005**	**2004**	**2003**
	(millions of US dollars)		
Northern Timan-Pechora	673	379	363
Yamal	216	325	116
Caspian region	259	77	118
Total	**1,148**	**781**	**597**

2006 Capital Expenditures Program

The Company estimates 2006 capital expenditures will be $5,068 million, which is about 21.3% higher than capital expenditures in 2005. About $3,400 million, or 67.1% of the total, is budgeted for exploration and production activities, with $266 million of that outside of Russia. Exploration and production expenditures will target the most promising exploratory prospects in the Caspian region and major development projects in Timano-Pechora region as well as on the maintenance and increase of production on existing fields in the other regions. Refining, marketing and distribution capital spending is estimated to be $1,015 million, with $366 million of that outside of Russia. Refining, marketing and distribution expenditures in Russia will be allocated to upgrading our refineries and selling facilities. International refining, marketing and distribution capital spending will target our distribution infrastructure in the USA, Hungary, Romania and the other countries, as well as our refineries in Bulgaria, Ukraine and Romania.

The capital expenditures in our chemical segment are estimated to be $85 million. The Company may amend the capital expenditures program during the year depending on economic conditions and financial performance of the Group.

Credit rating

The Company has a credit rating of BB by Standard and Poor’s, which is three grades below the Russian country credit rating of BBB. Our bonds issued in 2002 are also rated BB.

Moody’s rated the Company at Ba1, which is two grades below the Russian country rating of Baa2.

At the beginning of 2006 Fitch Ratings assigned the Company foreign currency and local currency Issuer Default Ratings (IDR) of BBB- and Short-term rating of F3. The outlooks for IDR are Stable. The Fitch’s Russian country rating is BBB.

Guarantees, off-balance-sheet agreements and contractual obligations, and other contingencies

Financial Guarantees

		Commitment Expiration by Period					
Millions of dollars	**Total**	**2006**	**2007**	**2008**	**2009**	**2010**	**After**
Guarantees of equity affiliate's debt	454	42	129	80	93	110	–
Guarantees of third party's debt	19	15	4	–	–	–	–

As of December 31, 2005 the Company provided guarantees of $454 million for loans of equity investee and $19 million for third parties. Guarantees issued in regard to LUKARCO, equity investee, primarily relate to borrowings for capital projects. These guarantees were undertaken to enhance the credit standing of the affiliated operations and to achieve lower interest rates. Under the terms of the guarantee, the Company would be required to perform should an affiliate be in default of its loans. There are no assets held as collateral for the obligations of affiliate.

Capital commitments and contractual obligations

The Company and its subsidiaries have significant capital commitments in respect to development of oil and gas fields in Russia. These commitments are regulated by law and described in the individual license agreements. Management believes that a significant portion of these commitments will be fulfilled by the services to be performed by Eurasia Drilling Company and ZAO Globalstroy-Engineering as discussed below. We also have long-term lease obligations for retail outlets in the USA and vessels.

The Group owns and operates refineries in Bulgaria (LUKOIL Neftochim Bourgas AD) and Romania (Petrotel-LUKOIL). As a result of Bulgaria and Romania joining the European Union in 2007, LUKOIL Neftochim Bourgas AD and Petrotel-LUKOIL are required to upgrade their refining plants to comply with the requirements of European Union legislation in relation to the quality of produced petroleum products and environmental protection. These requirements are stricter than existing Bulgarian and Romanian legislation. The Group estimates the amount of future capital commitment required to upgrade LUKOIL Neftochim Bourgas AD and Petrotel-LUKOIL to be approximately $607 million and $60 million, respectively.

In connection with the sale of LUKOIL-Burenie (now named Eurasia Drilling Company) the Group signed a five year contract for drilling services. Under the terms of the contract drilling services will be provided by Eurasia Drilling Company during the next four years totaling $2,276 million.

The Company has signed a four-year agreement for the provision of construction, engineering and technical services with ZAO Globalstroy-Engineering. The volume of these services is based on the Group's capital construction program, which is re-evaluated on an annual basis. The Group estimates the amount of capital commitment under this agreement for 2006 to be approximately $850 million.

Group companies have investment commitments relating to oil deposits in Iraq of $495 million to be spent within 3 years from when exploitation becomes possible. Due to significant changes in the political and economic situation in Iraq the future of this contract is not clear, however, the Group is actively pursuing its legal right to this contract in Iraq in alliance with ConocoPhillips.

The following table displays our total on and off balance sheet contractual obligations:

Millions of dollars	**Total**	**2006**	**2007**	**2008**	**2009**	**2010**	**After**
On balance sheet							
Short term debt	316	316	–	–	–	–	–
Long-term bank loans and borrowings	4,107	471	483	2,374	240	328	211
Long-term non-bank loans and borrowings	126	19	34	25	9	9	30
Long-term loans and borrowings from related parties	65	–	–	–	–	–	65
3.5% Convertible US dollar bonds	94	28	66	–	–	–	–
7.25% Russian ruble bonds	208	–	–	–	208	–	–
Capital lease obligations	74	19	17	15	10	9	4
TOTAL	**4,990**	**853**	**600**	**2,414**	**467**	**346**	**310**
Off balance sheet							
Operating lease obligations	1,140	316	180	108	88	88	360
Obligation under contract with Eurasia Drilling Company	2,276	378	571	661	666	–	–
Capital commitment in LUKOIL-Neftochim Bourgas AD	607	80	168	186	173	–	–
Capital commitment in LUKOIL-Petrotel	60	5	9	3	7	12	24
Obligation under contract with ZAO Globalstroy-Engineering	850	850	–	–	–	–	–
Capital commitments in PSAs	479	339	60	34	4	2	40
Capital commitments under oil and gas license agreements in Russia	1,495	421	424	206	226	103	115

Litigation and claims

On November 27, 2001, Archangel Diamond Corporation ("ADC"), a Canadian diamond development company, filed a lawsuit in the District Court of Denver, Colorado, against OAO "Arkhangelskgeoldobycha" ("AGD"), a Group company, and the Company (together the "Defendants"). ADC claims, among other things, that the Defendants interfered with the transfer of a diamond exploration license to Almazny Bereg, a joint venture between ADC and AGD. The total damages claimed by ADC are approximately $4.8 billion, including compensatory damages of $1.2 billion and punitive damages of $3.6 billion. On October 15, 2002, the District Court of Denver, Colorado dismissed ADC's action against the Defendants based on lack of personal jurisdiction. On November 22, 2002, the Denver District Court denied ADC's request for reconsideration of the Court's October 15th order dismissing the case. ADC subsequently filed an appeal on November 27, 2002 with the Court of Appeals in the State of Colorado. On March 25, 2004, the Court of Appeals upheld the October 15, 2002 decision of the District Court. On April 17, 2004, ADC filed a motion for rehearing that was denied on June 17, 2004. ADC then filed a petition for writ of certiorari with the Colorado Supreme Court on July 16, 2004. On January 10, 2005, the Colorado Supreme Court granted certiorari on a narrow issue: whether the Court of Appeals erred by concluding that a trial court may decide a motion to dismiss for lack of personal jurisdiction by weighing and resolving factual issues without an evidentiary hearing. The Colorado Supreme Court declined to review ADC's other requested issue concerning jurisdiction. On November 21, 2005, the Colorado Supreme Court affirmed the lower courts' findings that no specific jurisdiction exists over the Defendants. By virtue of this finding, AGD (the holder of the diamond exploration license) was dismissed from the lawsuit. The Supreme Court found however, that the trial court erred by not holding an evidentiary hearing concerning the existence of general jurisdiction, which is whether the Company had systematic and continuous contacts in the State of Colorado at the time the lawsuit was filed. Therefore, the lawsuit was initially remanded to the trial court to hold an evidentiary hearing on the issue of general jurisdiction. However, in response to a petition for rehearing filed by the Company, the Supreme Court issued a modified opinion on December 19, 2005 remanding this case to the Court of Appeals to consider any remaining issues that were not addressed by the Court of Appeals' previous decision. On March 2, 2006, the Court of Appeals granted the Company's motion to permit supplemental briefing on the issue of forum non convenience. Briefs on this issue were filed by the Company and ADC on March 27, 2006. The Company has filed a motion requesting oral argument on forum non convenience; the Court of Appeals has not ruled on this request. No other timetable has been established for the proceedings in the Court of Appeals. Management does not believe that the ultimate resolution of this matter will have a material adverse effect on the Group's financial condition.

On February 20, 2004, the Stockholm District Court overturned the decision of the Arbitral Tribunal of the Arbitration Institute of the Stockholm Chamber of Commerce made on June 25, 2001 dismissing ADC's action against AGD based on lack of jurisdiction. ADC's lawsuit against AGD was initially filed with the Arbitral Tribunal of the Arbitration Institute of the Stockholm Chamber of Commerce claiming alleged non-performance under an agreement between the parties and its obligation to transfer the diamond exploration license to Almazny Bereg. This lawsuit claimed compensation of damages amounting to $492 million. In March 2004, AGD filed an appeal against the Stockholm District Court decision with the Swedish Court of Appeals. On November 15, 2005, the Swedish Court of Appeals denied AGD's appeal and affirmed the Stockholm District Court decision. On December 13, 2005, AGD filed an appeal against the Swedish Court of Appeals decision with the Swedish Supreme Court. The decision of the Swedish Supreme Court is expected to be issued during 2006. Management does not believe that the ultimate resolution of this matter will have a material adverse effect on the Group's financial condition.

The Group is involved in various other claims and legal proceedings arising in the normal course of business. While these claims may seek substantial damages against the Group and are subject to uncertainty inherent in any litigation, management does not believe that the ultimate resolution of such matters will have a material adverse impact on the Group's operating results or financial condition.

Quantitative and qualitative disclosures about market risks

Interest rate risk

We are exposed to changes in interest rates, primarily associated with our variable rate short-term and long-term borrowings. We do not utilize any interest rate swaps or other derivatives to hedge against the risk of changes in interest rates on our variable rate debt. As of December 31, 2005 our long-term borrowings that are sensitive to change in interest rates totaled $3,805 million (for details please refer to Note 12 "Long term debts" of the consolidated financial statement). Utilizing the actual fixed interest rates in effect and the balance of our variable rate debt as of December 31, 2005 and assuming a 10% change in interest rates and no change in the balance of debt outstanding, the potential effect on annual interest expense would not be material to our results of operations.

Foreign currency risk

The countries in which our principal operations are located have been subject to hyperinflation and during the last 10 years the local currency has been subject to large devaluations. As a result we are subject to the risk that the local currency may suffer future devaluation that may subject us to losses, depending on our net monetary asset position. We currently do not use any formal hedging arrangements to minimize the effect of these potential losses. Additionally, because we have operations in a number of other countries we are required to conduct business in a variety of foreign currencies and, as a result, we are subject to foreign exchange rate risk on cash flows related to sales, expenses, financing and investment transactions. The impacts of fluctuations in foreign currency exchange rates on our geographically diverse operations are varied. We recognized a net foreign currency translation loss of $134 million in 2005, and gains of $135 million and $148 million for the years ended December 31, 2004 and 2003, respectively.

Appreciation of ruble against the US dollar in 2005 had a negative impact on our operating profit and cash flows since it lead to an increase of our costs in dollar terms and a decrease of amount of the export cash revenue in the ruble terms. As mentioned above, a substantial part of our revenue is denominated in US dollars or, to some extent, bound to the oil prices quoted in US dollars, while a significant part of our costs is ruble denominated.

Commodity instruments

The Group participates in certain petroleum products marketing and trading activity outside of its physical crude oil and petroleum products businesses. The Group's derivative activity is limited to these marketing and trading activities and hedging of commodity price risks. Currently this activity involves the use of futures and swaps contracts together with purchase and sale contracts that qualify as derivative instruments. The Company maintains a system of controls over these marketing and trading activities that includes policies covering the authorization, reporting and monitoring of derivative activity. We do not believe our derivative activities pose material credit or market risks to our operations, financial condition or liquidity. The Group recognized an expense from the use of derivative instruments of $171 million, $55 million and $37 million during 2005, 2004 and 2003, respectively. The fair value of derivative contracts outstanding and recorded on the consolidated balance sheet as of December 31, 2005 was a net liability of $26 million (a net asset of $28 million and a net liability $1 million in 2004 and 2003, respectively).

Critical accounting policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to select appropriate accounting policies and to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. See Note 2, "Summary of significant accounting policies," for descriptions of the Company's major accounting policies. Certain of these accounting policies involve judgments and uncertainties to such an extent that there is a reasonable likelihood that materially different amounts would have been reported under different conditions, or if different assumptions had been used.

Successful Efforts Accounting for Oil and Gas Activities

Accounting for oil and gas activities is subject to special accounting rules that are unique to the oil and gas industry. Property acquisitions, successful exploratory wells, all development costs and support equipment and facilities are capitalized. Artificial stimulation and well work-over costs are included in operating expenses as incurred.

Property Acquisition Costs

For individually significant undeveloped properties, management periodically performs impairment test based on exploration and drilling efforts to date. For undeveloped properties that individually are relatively small, management exercises judgment and determines a periodic property impairment charge as required that is reported in exploration expense.

Exploratory Costs

For exploratory wells, drilling costs are temporarily capitalized, or "suspended", on the balance sheet, pending a judgmental determination of whether potentially economic oil and gas reserves have been discovered by the drilling effort. If a judgment is made that the well did not encounter potentially economic oil and gas quantities, the well costs are expensed as a dry hole and are reported in exploration expense. Exploratory wells that are judged to have discovered potentially economic quantities of oil and gas and that are in areas where a major capital expenditure would be required before production could begin, remain capitalized on the balance sheet as long as additional exploratory appraisal work is under way or firmly planned. There is no periodic impairment assessment of suspended exploratory well costs. Management continuously monitors the results of the additional appraisal drilling and seismic work and expenses the suspended well costs as dry holes when it judges that the potential field does not warrant further exploratory efforts in the near term.

Other exploratory expenditures, including geological and geophysical costs are expensed as incurred.

Proved Oil and Gas Reserves

Proved oil and gas reserves are the estimated quantities of crude oil, natural gas liquids including condensate and natural gas that geological and engineering data demonstrate with reasonable certainty can be recovered in future years from known reservoirs under existing economic and operating conditions. Reserves are considered proved if they can be produced economically as demonstrated by either actual production or conclusive formation tests. Proved reserves do not include additional quantities of oil and gas reserves that may result from extensions of currently proved areas or from applying secondary or tertiary recovery techniques not yet tested and determined to be economic. Proved developed reserves are expected to be produced through existing wells and with existing facilities and operating methods.

The estimates are made using all available geological and reservoir data as well as historical production data. Estimates are reviewed and revised as appropriate. Revisions occur as a result of changes in prices, costs, fiscal regimes, reservoir performance or a change in the Company's plans.

The Group has included within proved reserves quantities, which the Group expects to produce after the expiry dates of its current production licenses. These licenses expire between 2011 and 2026, with the most significant expiring between 2011 and 2014. We believe the licenses will be extended to produce subsequent to their current expiry dates. The Group is in the process of extending all of its production licenses in the Russian Federation. The Group has already extended a portion of these licenses and expects to extend the remaining licenses for indefinite periods. To date there have been no unsuccessful license renewal applications.

Impairment Of Long-Lived Assets

Long lived assets, such as oil and gas properties, other property, plant, and equipment, and purchased intangibles subject to amortization, are assessed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset group may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset group to the estimated undiscounted future cash flows expected to be generated by that group. If the carrying amount of an asset group exceeds its estimated undiscounted future cash flows, an impairment charge is recognized by writing down the carrying amount to the estimated fair value of the asset group, generally determined as discounted future net cash flows. Assets to be disposed of are separately presented in the balance sheet and reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated. The assets and liabilities of a disposed group classified as held for sale are presented separately in the appropriate asset and liability sections of the balance sheet.

Asset Retirement Obligations

Under various laws, contracts, permits and regulations, the Company has legal obligations to remove tangible equipment and restore the land or seabed at the end of operations at production sites. The largest asset retirement obligations of the Company relate to wells and oil and gas production facilities and pipelines. In accordance with SFAS No. 143, *"Accounting for Asset Retirement Obligations"*, the Company records the fair value of liabilities associated with such obligations when incurred. See Note 2 of the financial statements which describes the Company's adoption of SFAS No. 143 effective January 1, 2003. Estimating the future asset retirement obligations costs necessary for this accounting calculation involves significant estimates and judgments by management. Most of these obligations are many years in the future and the contracts and regulations often have vague descriptions of what removal practices and criteria will have to be met when the removal event actually occurs. Asset removal technologies and costs are constantly changing, as well as political, environmental, safety and public relations considerations.

Contingencies

The Company is required to both determine whether a loss is probable based on judgment and interpretation of laws and regulations and determine that the loss can be reasonably estimated. When the loss is determined it is charged to income statement. The Company's management must continually monitor known and potential contingent matters and make appropriate provisions by charges to income statement when warranted by circumstance.

Pension Benefits

Determination of the projected benefit obligations for the Company's defined benefit pension plan is important to the recorded amounts for such obligations on the balance sheet and to the amount of benefit expense in the income statement. This also impacts the required Company contributions into the plans. The actuarial determination of projected benefit obligations and Company contribution requirements involves judgment about uncertain future events, including estimated retirement dates, salary levels at retirement, mortality rates, lump-sum election rates and rates of return on plan assets. The judgmental assumptions used in the actuarial calculations significantly affect periodic financial statements and funding patterns over time. Benefit expense is particularly sensitive to the discount rate and return on plan assets assumptions. Due to the specialized nature of these calculations, the Company engages outside actuarial firms to assist in the determination of these projected benefit obligations.

Recent Accounting Pronouncements

In December 2004, the FASB issued SFAS No. 123(R) "Share-Based Payment", which revises SFAS No. 123 and supersedes Accounting Principles Board (APB) Opinion No. 25 regarding stock-based employee compensation plans. SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be valued at fair value on the date of grant, and to be expensed over the applicable vesting period. The Group will adopt the provisions of SFAS No. 123(R) in the first quarter 2006 and is currently assessing the effect of adoption.

In April 2005, the FASB staff issued FASB Staff Position ("FSP") No. FAS 19-1 "Accounting for Suspended Well Costs". FSP No. 19-1 amends SFAS No. 19 "Financial Accounting and Reporting by Oil and Gas Producing Companies" to revise the criteria for continued capitalization of costs in relation to exploratory wells and exploratory-type stratigraphic wells. As amended, SFAS No. 19 allows continued capitalization of such costs for more than one year, provided (a) the well has found a sufficient quantity of reserves to justify its completion as a producing well and (b) the company is making sufficient progress assessing the reserves and the economic and operating viability of the project. If either condition is not met or if a company obtains information that raises substantial doubt about the economic or operational viability of the project, the exploratory well would be assumed impaired, and its costs, net of any salvage value, would be charged to expense. Following adoption of the changes, certain exploration costs which would have been charged to the income statement will remain capitalized and will instead be subject to depreciation, depletion and amortization in future periods. FSP No. 19-1 also requires certain additional disclosures in relation to suspended well costs. The adoption of the provisions of FSP No. 19-1 during 2005 did not have a material impact on the Group's results of operations, financial position or cash flows.

Forward-looking statements

Certain statements in this document are not historical facts and are “forward-looking.” We may from time to time make written or oral forward-looking statements in reports to shareholders and in other communications. Examples of such forward-looking statements include, but are not limited to:

• statements of our plans, objectives or goals, including those related to products or services;
• statements of future economic performance; and
• statements of assumptions underlying such statements.

Forward looking statements that may be made by us from time to time (but that are not included in this document) may also include projections or expectations of revenues, income (or loss), earnings (or loss) per share, dividends, capital structure or other financial items or ratios. Words such as “believes,” “anticipates,” “expects,” “estimates,” “intends” and “plans” and similar expressions are intended to identify forward-looking statements but are not the exclusive means of identifying such statements. By their very nature, forward-looking statements involve inherent risks and uncertainties, both general and specific, and risks exist that the predictions, forecasts, projections and other forward-looking statements will not be achieved. You should be aware that a number of important factors could cause actual results to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward-looking statements.

These factors include:
• inflation, interest rate and exchange rate fluctuations;
• the price of oil;
• the effects of, and changes in, Russian government policy;
• the effects of competition in the geographic and business areas in which we conduct operations;
• the effects of changes in laws, regulations, taxation or accounting standards or practices;
• our ability to increase market share for our products and control expenses;
• acquisitions or divestitures;
• technological changes; and
• our success at managing the risks of the aforementioned factors.

This list of important factors is not exhaustive. When relying on forward-looking statements, you should carefully consider the foregoing factors and other uncertainties and events, especially in light of the political, economic, social and legal environment in which we operate. Such forward-looking statements speak only as of the date on which they are made, and, subject to any continuing obligations under the Listing Rules of the U.K. Listing Authority, we do not undertake any obligation to update or revise any of them, whether as a result of new information, future events or otherwise. We do not make any representation, warranty or prediction that the results anticipated by such forward-looking statements will be achieved, and such forward-looking statements represent, in each case, only one of many possible scenarios and should not be viewed as the most likely or standard scenario.