

## LUKOIL Management Discussion and Analysis

### Nine months ended September 30, 2002 compared to nine months ended September 30, 2001

#### Results of operations

The table below details certain unaudited 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 the items expressed as a percentage of revenues.

	Nine months ended September 30,			
	2001		2002	
<b>Revenues</b>				
Sales (including excise and export tariffs).....	10,395	99.0%	11,033	99.3%
Equity share in income of affiliates.....	103	1.0%	75	0.7%
<b>Total revenues .....</b>	<b>10,498</b>	<b>100.0%</b>	<b>11,108</b>	<b>100.0%</b>
<b>Costs and other deductions</b>				
Operating expenses.....	1,465	14.0%	1,452	13.1%
Costs of purchased crude oil and petroleum products and other operating costs.....	2,110	20.1%	2,125	19.1%
Selling expenses.....	716	6.8%	1,028	9.3%
General and administrative expenses .....	944	9.0%	942	8.5%
Depreciation, depletion and amortization.....	676	6.4%	704	6.4%
Taxes other than income taxes.....	763	7.3%	1,436	12.9%
Excise and export tariffs.....	1,170	11.1%	1,378	12.4%
Exploration expense.....	64	0.6%	70	0.6%
Loss on disposal and impairment of assets .....	50	0.5%	68	0.6%
<b>Income from operating activities.....</b>	<b>2,540</b>	<b>24.2%</b>	<b>1,905</b>	<b>17.1%</b>
Interest expense.....	(164)	-1.5%	(175)	-1.5%
Interest and dividend income .....	128	1.2%	103	0.9%
Currency translation loss.....	28	0.3%	36	0.3%
Other non-operating income .....	43	0.4%	60	0.6%
Minority interest.....	(50)	-0.5%	(42)	-0.4%
<b>Income before income taxes.....</b>	<b>2,525</b>	<b>24.1%</b>	<b>1,887</b>	<b>17.0%</b>
Current income taxes .....	(706)	-6.7%	(627)	-5.6%
Deferred income tax benefit.....	87	0.8%	87	0.7%
<b>Net income.....</b>	<b>1,906</b>	<b>18.2%</b>	<b>1,347</b>	<b>12.1%</b>
Basic earnings per share of common stock.....	2.42		1.66	
Diluted earnings per share of common stock.....	2.39		1.66	
Add back non-recurring charges for settlement of tax claims.....	-	0.0%	103	0.9%
<b>Net income excluding non-recurring items</b>	<b>1,906</b>	<b>18.2%</b>	<b>1,450</b>	<b>13.0%</b>
Basic EPS, excluding non-recurring items.....	2.42		1.78	
Diluted EPS, excluding non-recurring items .....	2.39		1.78	

## Sales

The following set out our sales volumes and realized prices for the nine months ended September 30, 2001 and 2002.

Sales breakdown	Nine months ended September 30,			
	2001		2002	
	(millions of US dollars)			
Crude oil .....	3,868	37.2%	3,551	32.2%
Refined products .....	5,711	54.9%	6,550	59.4%
Other .....	816	7.9%	932	8.4%
<b>Total sales .....</b>	<b>10,395</b>	<b>100.0%</b>	<b>11,033</b>	<b>100.0%</b>

Sales volumes	Nine months ended September 30,			
	2001		2002	
Crude oil	(thousands of barrels)			
International sales .....	137,657	32.1%	149,592	33.7%
Domestic sales .....	77,229	18.0%	47,549	10.7%
Refined products	(thousands of tonnes)			
International sales .....	16,174	27.7%	19,572	32.3%
Domestic sales .....	12,952	22.2%	14,069	23.3%

Realized average sales prices	Nine months ended September 30,			
	2001		2002	
	(\$/barrel)	(\$/tonne)	(\$/barrel)	(\$/tonne)
Average realized price international				
- crude oil .....	22.37		21.32	
- refined products .....		232.41		231.58
Average realized price within Russia				
- crude oil .....	10.22		7.61	
- refined products .....		150.66		143.40

	2001		2002	
	(thousands barrels)	(thousands tonnes)	(thousands barrels)	(thousands tonnes)
Crude oil produced .....	378,140	51,588	388,945	53,062
Crude oil produced by affiliates .....	51,105	6,972	47,153	6,433
Crude oil purchased .....	42,955	5,860	44,185	6,028
Gas produced .....		3,054		2,978
Refined products produced on Group's refineries .....		22,048		23,414
Refined products produced on associated refinery (Nizhegorodnefteorgsintez) .....		3,398		5,567
Refined products purchased .....		3,183		4,721

Our sales increased by \$638 million, or 6.1%, from the nine months of 2001 to the nine months of 2002. Our revenues from sales of crude oil decreased by \$317 million, or 8.2%, and our sales of refined products increased by \$839 million, or 14.6%. The main reason for the sales increase was the increase in export and domestic prices of refined products and crude oil in the third quarter of 2002, as well as increase of export volumes and volume of refined products as a percentage of total volume sold. Furthermore, the total volume of crude oil and refined products sold reached 60.5 million tonnes, that is 3.6% more than for the same period of 2001. Other sales increased by \$116 million, or 14.2%.

The proportion of our sales volumes represented by refined products was 55.6% compared to 49.9% in the 2001 period. This is the result of the company's strategy to increase the share of exports in the total

volume of sales, which was realized mainly through increase of refined products exports. The proportion of our international sales volumes, including both crude oil and refined products, reached 66.0% for the nine months of 2002 compared to 59.2% in the same period of 2001.

The increase in our sales was principally due to the following:

*International crude oil*

Revenues from our crude oil sales outside Russia increased by \$110 million, or 3.6%. A decrease in the average realized prices from \$22.37 per barrel in 2001 to \$21.32 per barrel in 2002, or 4.6%, which resulted from the decrease in the price of Urals blend, was offset by the increase in sales volumes of 11.9 million barrels, or 8.7%.

*Domestic crude oil*

Our revenues from crude oil sales on the domestic market decreased by \$427 million, or 54%, as a result of decreases in prices and volumes. The average realized price decreased by \$2.61 per barrel, or 26%, to \$7.61 per barrel for the nine months of 2002. Volumes of domestic crude oil sales decreased by 29.7 million barrels, or 38.5%. This change primarily resulted from an increase in refining volumes, including processing at “LUKOIL-Nizhegorodnefteorgsintez”, and from an increase in export volumes.

*International refined products*

Our revenues from sales of refined products outside Russia increased by \$773 million, or 20.6%. This was a result of an increase in volumes sold of 3.4 million tonnes, or 21%. The average realized prices on refined products decreased slightly by \$0.83 per tonne, or 0.4%.

*Domestic refined products*

Our revenues from sales of refined products on the domestic market increased by \$66 million, or 3.4%. Volumes of domestic refined products sales increased by 1.1 million tones, or 8.6%. The average realized price on refined products sold within Russia decreased by \$7.3 per tonne, or 4.8%.

**Equity share in income of affiliates**

Our equity share in income of affiliates accounted for using the equity method was \$75 million. This was \$28 million, or 27%, less than in the previous period. In general, this change was caused by a decrease in oil prices and an increase in expenses of affiliates.

**Operating expenses**

	<b>Nine months ended September 30,</b>	
	<b>2001</b>	<b>2002</b>
	(millions of US dollars)	
Operating expenses.....	3,575	3,577
Including: Extraction expenses .....	1,055	1,016
Refining expenses.....	331	305
Processing costs on the affiliated refinery.....	79	131
Costs of purchased crude oil and petroleum products and other operating costs.....	2,110	2,125

Operating expenses primarily include the costs of purchased crude oil and petroleum products and direct operating costs and labor costs associated with our exploration and production and refining, marketing and distribution activities. Operating expenses increased slightly by \$2 million, or less than 1%, in comparison with the same period of 2001.

Our extraction expenses decreased by \$39 million, or 3.7%. At the same time average extraction costs per barrel decreased from \$2.79 per barrel during nine months of 2001 to \$2.61 per barrel during nine months of 2002. The decrease in the average extraction costs per barrel resulted from our cost reduction policy, primarily from shutting-in unproductive wells and from increasing oil flows as a result of using artificial stimulation and other technologies.

Volume of oil extracted during the nine months of 2002 was 53.1 million tonnes (389 million barrels), while during nine months of 2001 it was 51.6 million tonnes (378 million barrels). Average daily production in 2002 reached 1,425 thousand barrels per day, that is 2.9% more than in the same period of 2001 (average daily production for that period was 1,385 thousand bbls per day).

Our extraction expenses include expenditures on current repairs of extraction equipment, labor costs, expenses of artificial stimulation of reservoirs, fuel and electricity costs and other costs. Starting from the nine months of 2002 we changed our method of determining of our extraction expenses per barrel. Beginning January 1, 2002, we excluded other operating expenses of our oil production companies from extraction expenses. These other operating expenses are related to sale of other services and goods (such as electricity power, heat, etc.) and are included in other operating costs. Extraction expenses for the period ended September 30, 2001 were recalculated and are presented on a basis comparable with 2002.

Refining expenses at our refineries decreased by \$26 million, or 7.9%, from the nine months of 2001 to nine months of 2002. This was primarily caused by the closure of the Petrotel SA refinery in July 2001. Operating expenses of Nizhegorodnefteorgsintez were included in our refining expenses starting from August 2002, when it became a subsidiary.

Our processing costs on the affiliated refinery (Nizhegorodnefteorgsintez) increased by \$52 million, or 66%, in comparison with the nine months of 2001. An increase in processing costs was caused by an increase of volumes processed by 2.2 million tonnes, or 64%. During the nine months of 2002 processing volumes on Nizhegorodnefteorgsintez increased to 7.4 million tonnes. Nizhegorodnefteorgsintez became a consolidated subsidiary in August 2002.

Other operating expenses, including costs of purchased crude oil and petroleum products, increased by \$15 million, or 0.7%, in comparison with the prior period. Costs of purchased crude oil and petroleum products increased due to increase in prices, as described above, and an increase in volumes purchased (crude oil by 1.2 million barrels, refined products by 1.5 million tonnes).

#### **Selling, general and administrative expenses**

Our selling expenses, which include primarily transportation costs, increased by \$312 million, or 43.5%, in comparison with the nine months 2001. An increase in expenses was principally caused by an increase of all transport tariffs, the increase in sales volumes described above and a change in product mix – increase in volume of refined products sold as a percentage of total volume sold.

Our general and administrative expenses decreased by \$2 million, or less than 1%, in comparison to the nine months of 2001. 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 and other expenses.

#### **Depreciation, depletion and amortization**

Depreciation, depletion and amortization expenses include depletion of assets fundamental to production, depreciation of other productive and non-productive assets, amortization of goodwill (for 2001 only) and intangible assets and provision for abandonment and site restoration costs. Our depreciation, depletion and amortization expenses increased by \$28 million, or 4.1%, in comparison to the prior period. This increase was caused by an increase in costs of the depreciable assets in comparison with the end of the third quarter of 2001.

#### **Taxes other than income taxes**

Taxes other than income taxes include extraction tax, road user's tax, property tax and social taxes. Beginning January 1, 2002 some taxes, including royalty tax, mineral replacement tax and excise on crude oil sales, were canceled and replaced with a unified extraction tax. This unified extraction tax led to an increase of these expenses by \$499 million (including an effect of excise tax on sale of crude oil, discussed below), or 92%, in comparison to the same period in 2001. Other taxes increased by \$57 million.

	<b>Nine months ended September 30,</b>			
	<b>2001</b>		<b>2002</b>	
	<b>Russian</b>	<b>International</b>	<b>Russian</b>	<b>International</b>
	(millions of US dollars)			
Extraction tax .....	-	-	1,046	-
MRT .....	168	-	14	-
Royalty .....	262	-	-	-
Social security taxes and contributions .....	147	3	154	4
Road taxes .....	74	-	86	-
Property taxes .....	59	8	66	9
Other taxes .....	36	6	28	29
<b>Total .....</b>	<b>746</b>	<b>17</b>	<b>1,394</b>	<b>42</b>
		<u><u>763</u></u>		<u><u>1,436</u></u>

### **Excises and export tariffs**

Our excise and export tariffs include duties on refined products sales, crude oil and refined products export duties. Excises and export tariffs increased by \$208 million, or 17.8%, compared to the prior period (or, excluding the effect of excise tax on sale of crude oil, \$397 million, or 38%). The increase in total amount of excises and export tariffs expenses resulted mainly from increase of export duties rates, primarily on crude oil. The increase in international excise taxes on refined products resulted from an increase in excise taxes and fuel sales taxes due to increase in volumes of products sold across our international group as well as the increase in our refining.

	<b>Nine months ended September 30,</b>			
	<b>2001</b>		<b>2002</b>	
	<b>Russian</b>	<b>International</b>	<b>Russian</b>	<b>International</b>
	(millions of US dollars)			
Excise tax on refined products .....	152	211	273	583
Excise tax on sale of crude oil .....	117	-	-	-
Export duties .....	690	-	522	-
<b>Total .....</b>	<b>959</b>	<b>211</b>	<b>795</b>	<b>583</b>
		<u><u>1,170</u></u>		<u><u>1,378</u></u>

### **Non recurring items**

During the third quarter of 2002 our effective income tax rate increased as a result of a settlement of claims with tax authorities in respect to income tax and other taxes relief received in 2001. The Company agreed to settle these claims without prejudice and accrued a provision of \$103 million in third quarter. The whole amount was paid to the budget in December 2002. Management is not expecting any other claims from tax authorities related to tax relief received in prior periods.

### **Exploration expenses**

Exploration expenses changed insignificantly in comparison with the prior period. The increase was \$6 million.

**Three months ended September 30, 2002 compared to three months ended  
September 30, 2001**

**Company's results of operations**

The table below details certain unaudited income and expense items of 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 the items expressed as a percentage of revenues.

	<b>Three months ended September 30,</b>			
	<b>2001</b>		<b>2002</b>	
<b>Revenue</b>				
Sales (including excise and export tariffs) .....	3,577	99.0%	4,392	99.1%
Equity share in income of affiliates.....	37	1.0%	40	0.9%
<b>Total revenues .....</b>	<b>3,614</b>	<b>100.0%</b>	<b>4,432</b>	<b>100.0%</b>
<b>Costs and other deductions</b>				
Operating expenses.....	491	13.6%	479	10.8%
Costs of purchased crude oil and petroleum products and other operating costs.....	939	26.0%	947	21.4%
Selling expenses.....	244	6.7%	403	9.1%
General and administrative expenses .....	482	13.3%	351	7.9%
Depreciation, depletion and amortization.....	229	6.3%	226	5.1%
Taxes other than income taxes.....	271	7.5%	628	14.2%
Excise and export tariffs.....	362	10.0%	593	13.4%
Exploration expense.....	20	0.6%	20	0.4%
Loss on disposal and impairment of assets .....	38	1.1%	42	0.9%
<b>Income from operating activities.....</b>	<b>538</b>	<b>14.9%</b>	<b>743</b>	<b>16.8%</b>
Interest expense.....	(35)	-1.0%	(49)	-1.1%
Interest and dividend income .....	46	1.3%	35	0.8%
Currency translation gain .....	45	1.2%	52	1.1%
Other non-operating income (expense) .....	31	0.9%	(10)	-0.2%
Minority interest.....	1	0.0%	(11)	-0.3%
<b>Income before income taxes.....</b>	<b>626</b>	<b>17.3%</b>	<b>760</b>	<b>17.1%</b>
Current income taxes .....	(219)	-6.0%	(271)	-6.1%
Deferred income tax benefit.....	66	1.8%	18	0.4%
<b>Net income.....</b>	<b>473</b>	<b>13.1%</b>	<b>507</b>	<b>11.4%</b>
Basic earnings per share of common stock.....	0.43		0.62	
Diluted earnings per share of common stock.....	0.43		0.62	
Add back non-recurring charges for settlement of tax claims.....	-	0.0%	103	0.9%
<b>Net income excluding non-recurring items</b>	<b>473</b>	<b>13.1%</b>	<b>610</b>	<b>12.3%</b>
Basic EPS, excluding non-recurring items.....	0.43		0.75	
Diluted EPS, excluding non-recurring items .....	0.43		0.75	

## Sales

The following is a breakdown of our sales from the three months ended September 30, 2001 and 2002.

	Three months ended September 30,			
	2001		2002	
	(millions of US dollars)			
Sales of crude oil.....	1,473	41.2%	1,333	30.4%
Sales of refined products .....	1,800	50.3%	2,653	60.4%
Other sales .....	304	8.5%	406	9.2%
<b>Total sales.....</b>	<b>3,577</b>	<b>100.0%</b>	<b>4,392</b>	<b>100.0%</b>

*Revenues.* Our sales for the three months ended September 30, 2002 increased by \$815 million, or 22.8%, compared to the three months ended September 30, 2001. Our revenues from sales of crude oil decreased by \$140 million, or 9.5%, and our sales of refined products increased by \$853 million, or 47.4%. The increase in sales of refined products resulted from higher volumes of refined product sales internationally, which increased by 12%, and higher volumes sold on the domestic market, which increased by 26%, as well as an increase in sales prices. Other sales increased by \$102 million, or 33%.

*Operating expenses.* Our total operating expenses for the three months ended September 30, 2002 decreased by \$4 million, or 0.3% as compared to the same period in 2001, primarily due to a decrease in extraction expenses of \$23 million. This decrease was partially offset by an increase in refining expenses, caused by inclusion of Nizhegorodnefteorgsintez's operating expenses in our refining expenses, and increase in volume of crude oil and refined products purchased.

Our average operating costs per barrel extracted decreased to \$2.66 per barrel for the three months ended September 30, 2002 from \$2.92 for the three months ended September 30, 2001 (see above).

*Selling, general and administrative.* Our selling expenses for the three months ended September 30, 2002 increased by \$159 million, or 65%, as compared to the same period in 2001, primarily due to increases in transportation costs and port costs as a result of higher volumes transported and higher tariffs.

Our general and administrative expenses for the three months ended September 30, 2002 decreased by \$131 million, or 27.4%, as compared to the same period in 2001. The reduction in expenses is mainly the result of carrying out a restructuring program, including sale of non core business.

*Taxes other than income taxes.* Our taxes other than income taxes for the three months ended September 30, 2002 increased by \$357 million, or 132%, due to changes in tax legislation that replaced royalty, mineral replacement tax and excise on crude oil with one unified extraction tax.

*Excise and export tariffs.* Excise and export tariffs increased by \$231 million, or 64%, mainly due to an increase in volume of petroleum products sold and the average excise tax on refined products in Russia and Eastern Europe.

## Liquidity and capital resources

The unaudited consolidated statement of cash flows excludes the effect of non-cash transactions. Non-cash transactions include barter transactions and mutual settlements.

### Cash flows

	For the nine months ended September 30,	
	2001	2002
	(\$ millions)	
Net cash provided by operating activities .....	1,762	1,698
Net cash used in investing activities.....	(2,208)	(1,752)
Net cash provided by financing activities .....	756	57

### Cash flows provided by operating activities

Our primary source of cash flow is funds generated from our operations. Net funds generated from our operations for the nine months ended September 30, 2002 amounted to \$1,698 million. \$1,347 million of these funds were generated by net income from our operations. Major items adjusting net income to arrive at operating cash flow were depreciation of \$704 million and a decrease of accounts payable of \$481 million.

Net funds generated from our operations for the nine months ended September 30, 2001 amounted to \$1,762 million. \$1,906 million of these funds were generated by net income from our operations. Major items adjusting net income to arrive at operating cash flow were depreciation of \$676 million and a decrease of accounts payable of \$684 million.

### Cash flows used in investing activities

For the nine months ended September 30, 2002, net cash flows used in investing activities amounted to \$1,752 million, as compared to \$2,208 million during the same period in 2001. This decrease was primarily due to a reduction in our capital expenditures program.

### Cash flows provided by financing activities

For the nine months ended September 30, 2002 net cash flows provided by financing activities amounted to \$57 million, as compared to \$756 million during the same period in 2001. This decrease was primarily due to a reduction of our capital expenditures program to a level that allowed the company to finance its capital expenditures through cash flows from operations opposed to borrowings.

### Working capital and liquidity

Our working capital (current assets less current liabilities) was \$2.0 billion at September 30, 2002 and \$1.9 billion at December 31, 2001. We believe that our liquidity reserves, including credit facilities available, provide sufficient working capital to meet our requirements for at least the next twelve months.

As of September 30, 2002 our short-term borrowings (including the current portion of long-term debt and Customers accounts placed in banking subsidiaries) was \$1.5 billion and our long-term debt (excluding the current portion) was \$2.1 billion.



## Analysis of capital expenditures

Set forth below are our capital expenditures and investments for the nine months 2002 and 2001:

	<b>Nine months ended September 30,</b>	
	<b>2001</b>	<b>2002</b>
	(\$ millions)	
Exploration and production		
- Russia.....	1,112	775
- International.....	53	212
Total exploration and production.....	<u>1,165</u>	<u>987</u>
Refining, marketing and distribution and other		
- Russia.....	536	392
- International.....	96	155
Total refining, marketing and distribution and other.....	<u>632</u>	<u>547</u>
<b>Total cash and non-cash capital expenditures</b> .....	<b><u>1,797</u></b>	<b><u>1,534</u></b>
<b>Acquisitions and investments in affiliates</b>		
Exploration and production		
- Russia.....	315	85
- International.....	-	-
Total exploration and production.....	<u>315</u>	<u>85</u>
Refining, marketing and distribution and other		
- Russia.....	9	16
- International.....	34	30
Total refining, marketing and distribution and other.....	<u>43</u>	<u>46</u>
<b>Less cash acquired</b> .....	<b><u>(52)</u></b>	<b><u>(3)</u></b>
<b>Total cash capital expenditures</b> .....	<b><u>306</u></b>	<b><u>128</u></b>

Total capital expenditures for the nine months of 2002 decreased by \$263 million, or 15%, compared to the same period in 2001. Expenditures of exploration and production entities decreased by \$178 million, or 15%, to \$987 million primarily due to a less intensive drilling program in mature oil fields. Capital expenditures in refining, marketing and distribution decreased by \$85 million, or 13%, to \$547 million.

Cost of acquisitions (excluding the cash of the acquired companies) totaled \$128 million during the nine months of 2002 compared to \$306 million during the nine months of 2001. In 2002 we purchased minority interests in our subsidiaries from KOMITEK group and purchased a controlling interest in an exploration company Nakhodkaneftegaz. The decrease of \$178 million, or 58%, was primarily due to an absence of significant acquisitions during the nine months of 2002 compared to the same period in 2001.