# Management's Discussion and Analysis

*The following discussion should be read in conjunction with the audited consolidated financial statements prepared in accordance with US GAAP and the related notes, published simultaneously with this MD&A. This discussion includes forward-looking statements that involve risks and uncertainties. Actual results could differ materially from those anticipated in the forward–looking statements as a result of numerous factors, including certain factors discussed later in this MD&A.*

*For financial reporting purposes, Tatneft converts metric tonnes of crude oil to barrels using a conversion factor of 7.123. This factor represents a blend of varying conversion factors specific to each of Tatneft's fields. Because the proportion of actual production by field varies from period to period, total reserves and production volumes for the Group in barrels converted from tonnes using the blended rate may differ from total reserves and production calculated on a field by field basis. Translations of cubic meters to cubic feet were made at the rate of 35.31 cubic feet per cubic meter. Translations of barrels of crude oil into barrels of oil equivalent ("BOE") were made at the rate of 1 barrel per BOE and of cubic feet into BOE at the rate of 6 thousand cubic feet per BOE.*

## Background

OAO Tatneft (the "Company") and its subsidiaries (jointly referred to as the "Group" or "Tatneft") is one of the largest vertically integrated oil companies in Russia in terms of crude oil production and proved oil reserves. The Company is an open joint-stock company organized under the laws of the Russian Federation with the headquarters located in City of Almetyevsk, Tatarstan. The principal business of the Group is to explore for, develop, produce and market crude oil and refined products. The Group is also involved in petrochemical (tires) production and expanding its activities to further develop its refining segment.

As of December 31, 2009 OAO Svyazinvestneftekhim, a company wholly owned by the government of Tatarstan, together with its subsidiary, hold approximately 36% of the Company's voting stock. These shares were contributed to Svyazinvestneftekhim by the Ministry of Land and Property Relations of Tatarstan in 2003. Tatarstan also holds a "Golden Share", a special governmental right, in the Company. The exercise of its powers under the Golden Share enables the Tatarstan government to appoint one representative to the Board of Directors and one representative to the Revision Committee of the Company as well as to veto certain major decisions, including those relating to changes in the share capital, amendments to the Charter, liquidation or reorganization of the Company and "major" and "interested party" transactions as defined under Russian law. The Golden Share currently has an indefinite term. The Tatarstan government, including through OAO Svyazinvestneftekhim, also controls or exercises significant influence over a number of the Company's suppliers and contractors, such as the electricity producer OAO Tatenergo and the petrochemicals company OAO Nizhnekamskneftekhim.

The majority of the Group's crude oil and gas production and other operations are located in Tatarstan, a republic of the Russian Federation situated between the Volga River and the Ural Mountains and located approximately 750 kilometers southeast of Moscow.

The Group currently holds most of the exploration and production licenses and produces substantially all its crude oil in Tatarstan.

As of January 1, 2010, the Group's total proved reserves of crude oil and condensate were 862 million tonnes or 6,141 million barrels (790 million tonnes or 5,625 million barrels and 862 million tonnes or 6,140 million barrels at January 1, 2009 and 2008, respectively).

## Key financial and operational results

| | 2009 | Change to 2008, % | 2008 | Change to 2007, % | 2007 |
|---|---|---|---|---|---|
| Sales (millions of RR) | 380,648 | (14.33)% | 444,332 | 24.72% | 356,276 |
| Net income attributable to Group shareholders (millions of RR) | 54,372 | 546.29% | 8,413 | (80.56)% | 43,279 |
| EBITDA [(*)] (millions of RR) | 82,853 | 229.83% | 25,120 | (64.25)% | 70,269 |
| Basic and Diluted net income per share of common stock (RR) | | | | | |
| Common……………. | 24.25 | 539.84% | 3.79 | (80.56)% | 19.50 |
| Preferred……………... | 24.15 | 584.14% | 3.53 | (81.68)% | 19.27 |
| Crude oil production by the Group (thousand of tonnes) | 26,107 | 0.2% | 26,060 | 0.5% | 25,933 |
| Crude oil production by the Group (thousand of barrels) | 185,957 | 0.2% | 185,628 | 0.5% | 184 719 |
| Gas production by the Group (millions of cubic meters) | 797.6 | 4.7% | 762.1 | 3.2% | 738.5 |
| Refined gas products produced (thousand of tonnes) | 1,072.9 | (0.5)% | 1,078.7 | (6.5)% | 1,154 |
| Crude and condensate proved reserves (millions of bbl) | 6,141 | 9.2% | 5,625 | (8.4)% | 6,140 |

[(*)] *As defined on page 19*

Decrease in our revenue in 2009 in comparison to 2008 accounts for the effect of lower crude oil prices. At the same time, stabilization and growth of crude oil prices (compared to a significant drop at the end of 2008), decrease of total costs and other deductions including resulting from the decrease of tax burden on the industry, as well as stabilization and relative recovery of the financial markets, in 2009 compared to 2008, all contributed to a significant increase of our income in 2009 compared to 2008.

During the first seven months of 2008 our performance was supported by an increase in average crude oil market prices compared to 2007 despite effect of increasing cost of purchased crude oil, taxes other than income taxes and transportation tariffs. Expansion of the world's financial and economic crisis resulting in, *inter alia*, a slump in crude oil market prices, which started in the third quarter and was most significant in the fourth quarter of 2008, a loss from the ruble devaluation, high level of export duties rates (calculated based on a much higher oil price than the market price realized at the time of sales) and a substantial drop in value of the Group's financial investments in the fourth quarter led to a decrease in our net income in 2008 compared to 2007. In 2008 there were a number of significant nonrecurring and exceptional items many of which are related to the world's financial and economic crisis.

## Segment information

Our operations are currently divided into the following main segments:

- **Exploration and production** – consists of the Company's oil and gas extraction and production divisions, well repair and reservoir oil yield improvement subdivisions, pumping equipment repair centers, security and logistics. Most oil and gas exploration and production activities are concentrated within OAO Tatneft.

- **Refining and marketing** – consists of our participation in OAO TANECO, a company established to build and operate a refining and petrochemical complex in Nizhnekamsk, Tatarstan; our gas production, transportation and refining division Tatneftegaspererabotka; OOO Tatneft-AZS-Center, OOO Tatneft-AZS-Zapad, OOO Tatneft-AZS-Sibir and OOO Tatneft-AZS-Yug, management companies for the Tatneft branded gas stations network in Russia; and certain other oil trading and ancillary companies.

- **Petrochemicals -** our petrochemicals segment has been consolidated under a management company, Tatneft-Neftekhim, which manages OAO Nizhnekamskshina, one of the largest tire manufacturers in Russia, and the companies technologically integrated with it, including OAO Nizhnekamsk Industrial Carbon Plant, ZAO Yarpolymermash-Tatneft, OAO Nizhnekamskiy Mekhanicheskiy Zavod and OOO Nizhnekamskiy Shinny Zavod CMK. OOO Tatneft-Neftekhimsnab and OOO Trading House Kama are responsible for procuring supplies and marketing products produced by the companies within this segment, respectively.

These segments are determined by the way management recognizes the segments within the Group for making operating decisions and how they are evident from the Group structure.

## Executive overview

### Recent developments and outlook

*E&P activities in Tatarstan*

One of the Company's primary strategic goals is to maintain current levels of crude oil production from its licensed fields in Tatarstan. In 2009 the Group increased production by 0.2% from its fields compared to 2008. Due to the relative maturity of the Company's main producing fields significant portion of all crude oil produced by the Company in Tatarstan was extracted using various enhanced recovery techniques. In 2009 the Company put 280 new wells into operation in Tatarstan. The Company continues exploration activities in Tatarstan with 10 new fields discovered in 2009.

Effective from January 1, 2007 the Company benefits from the differentiated taxation of crude oil production from certain of its fields in Tatarstan, including the Company's largest field - Romashkinskoye (more fully discussed in the Taxation subsection of Certain Macroeconomic Factors Affecting the Group's Results of Operations below).

*E&P activities outside of Tatarstan*

The Group continues to expand its operations outside of Tatarstan. The Group produces crude oil in Samara and Orenburg regions. Outside of Russia, in Syria, the Group has made a commercial crude oil discovery with estimated recoverable reserves of 4.9 million tonnes, and continues exploratory drilling with a view of making new discoveries. In Libya in 2009 the Company continued its exploratory program, involving 2D and 3D seismic and exploratory wells drilling. In 2009 the Group obtained two new production licenses in the Kalmykia Republic and one new production license in the Samara region.

Tatneft is planning to continue expansion and diversification of its reserve base by gaining access, including through establishing strategic alliances, to reserves outside of Tatarstan. The Group is carrying out exploration and production projects in the Kalmykia Republic, the Ulyanovsk, Samara, Orenburg and Nenets Autonomous Region. Outside of the Russian Federation, Tatneft is engaged in projects in Libya, Syria and other countries.

*Highly viscous oil (natural bitumen) production*

The Company continued a pilot project to produce highly viscous oil (natural bitumen) from the Ashalchinskoye and Mordovo-Karmalskoye fields in Tatarstan using parallel steam injection and producing wells. In 2009 three pairs of wells produced 18.4 thousand tonnes of highly viscous oil. The Company continues to assess the economic parameters and expansion of the activities relating to highly viscous oil production in Tatarstan.

The Group benefits from a zero unified production tax rate related to the production of highly viscous oil in Tatarstan.

*Crude oil refining and marketing*

The Group continued the construction by OAO TANECO ("TANECO"), formerly known as ZAO Nizhnekamsk Refinery, of a new refining and petrochemicals complex in Nizhnekamsk, Tatarstan. In 2009 majority of expenditures related to the construction were primarily financed from a US$ 2 billion senior secured credit facility arranged by ABN AMRO (now RBS), BNP Paribas (Suisse) SA, Citibank International PLC, Bayerische Hypo-und Vereinsbank AG, Sumitomo Mitsui Finance Dublin and WestLB AG in 2008 as well as from the Company's own funds.

*Petrochemicals*

In 2009 the core entity of the Group's petrochemicals segment – OAO Nizhnekamskshina produced 9.4 million tires in comparison to 11.9 million tires in 2008. The decrease was associated with the decline in, and in certain circumstances a temporary halt on, production of vehicles by major clients of Nizhnekamskshina, which was a reaction to the economic crisis.

A new advanced rubber mix production line was launched in 2007 with monthly capacity of 1,200 tonnes, which allows Nizhnekamskshina to produce modern high performance tires. The Group continued to invest in the modernization and upgrading of Nizhnekamskshina's production facilities to strengthen its market competitiveness, including the construction of a new plant to produce modern solid steel cord tires for trucks and other heavy load vehicles, which was officially launched in December 2009. The new plant will produce up to 1.2 million tires per year.

## Changes in the Group Structure

In June 2009, Osmand Holdings Ltd ("Osmand"), a subsidiary of the Company, issued additional shares to investors who contributed a 17.05% ownership interest in Ak Bars Bank valued at RR 3,442 million. As a result of this transaction, the Group's ownership interest in Osmand decreased to 29.5%. Therefore the Company deconsolidated Osmand and began accounting for this investment under the equity method as at December 31, 2009.

In December 2008 the Group submitted a redemption request to IPCG Fund to redeem a part of its holdings in the Fund. The IPCG Fund accepted this request subject to certain conditions which were met in May 2009. The redemption was performed (on a non cash basis) by delivering to the Group of 51% shares in TANECO. As a result, the Group currently owns 91% in TANECO. Subsequent to this redemption the Group's interest in IPCG Fund increased from 35.74% to 49.07% as a result of other transactions.

At December 31, 2009, 2008 and 2007 IPCG Fund owned an indirect ownership interest in Bank Zenit of 41.92%, 41.92% and 41.81%, respectively.

In March 2007, the Group disposed of 1,138 million of Bank Zenit shares for RR 1,787 million, decreasing the Company's ownership in Bank Zenit to 28.35%. In June 2007 Bank Zenit carried out a private placement of 1,545 million newly issued ordinary shares to a private investor unrelated to the Group, resulting in the dilution of the Group's ownership in Bank Zenit to 24.56%.

In December 2007, the Company acquired equity interests in AmRUZ Trading AG ("AmRUZ") and Seagroup International Inc. ("Seagroup"). These entities primary activities are ownership interests in Closed Joint Stock Company Ukrtatnafta ("Ukrtatnafta"), the owner of the Kremenchug refinery, which constitute 8.34% and 9.96% of the outstanding common shares in Ukrtatnafta, respectively. The Company acquired 49.6% of AmRUZ for US $23.9 million (RR 591 million) and 100% of Seagroup for US$ 57.1 million (RR 1,402 million). The AmRUZ purchase agreement also contains an option allowing the Company to acquire an additional 49.1% in AmRUZ for US $23.7 million. As the exercise of the option is subject to certain contingencies, the acquisition of AmRUZ is accounted for under the equity method.

## Resource base

As determined by the Group's independent petroleum engineering consultants, Miller and Lents, Ltd., the following information presents the balances of our crude oil and condensate reserves as of January 1, 2010, 2009 and 2008 in conformity with the standards of the Petroleum Resources Management System (PRMS), which was prepared by the Oil and Gas Reserves Committee of the Society of Petroleum Engineers (SPE).

Due to recent changes in the regulations, average, first-day-of-the-month prices during the reporting period for 2009 (year-end prices for the prior periods), and year-end costs, are used upon estimation of the Group's reserves.

| Net crude and condensate reserves (in mmbbl) | At January 1, 2010 | Changes in 2009 | | At January 1, 2009 | Changes in 2008 | | At January 1, 2008 |
|---|---|---|---|---|---|---|---|
| | | Production | Revision | | Production | Revision | |
| Proved reserves | 6,141 | (186) | 702 | 5,625 | (186) | (329) | 6,140 |
| Probable reserves | 1,911 | | | 642 | | | 2,141 |
| Possible reserves | 48 | | | 248 | | | 610 |

Most evaluated properties are located in the Volga-Ural Oil Basin and include approximately 100 developed and producing oil fields, containing approximately 29,200 active completions.

## Operational highlights

### Crude oil and gas production

Tatneft undertakes exploration and production activities in Tatarstan and outside of Tatarstan in Russia: in, Samara, Orenburg and Ulyanovsk regions, in the Kalmyk Republic, and Nenets Autonomous District. Outside of Russia, we have exploration activities in Libya and Syria. The table below summarizes the results of our exploration and production activities (daily volumes represent year average):

| | 2009 | 2008 | 2007 |
|---|---|---|---|
| Crude oil daily production, (thousand bbl per day) | 509.5 | 508.6 | 506.1 |
| Gas daily production (thousand boe per day) | 12.9 | 12.3 | 11.9 |
| Crude oil extraction expenses (RR per bbl) | 153.5 | 157.7 | 119.1 |
| | | (RR millions) | |
| Sales of crude oil | 300,077 | 346,261 | 270,960 |
| Crude oil extraction expenses | 28,549 | 29,273 | 22,009 |
| Exploration expenses | 3,540 | 3,770 | 1,577 |
| Unified production tax | 53,571 | 77,235 | 58,049 |

Crude oil production of the Group (including production of consolidated subsidiaries OAO Ilekneft, OOO Tatneft-Samara, ZAO Tatneft-Severny and ZAO Kalmtatneft) increased by 0.2% to 26.1 million metric tonnes in 2009 compared to 2008 (in 2008 increased by 0.5% to 26.06 million metric tonnes compared to 2007). Our gas production increased by 4.7% to 797.6 million cubic meters in 2009 from 762.1 million cubic meters in 2008 (in 2008 increased by 3.2% from 738.5 million cubic meters in 2007).

### Refining and marketing

| | 2009 | 2008 | 2007 |
|---|---|---|---|
| Refining of crude oil throughput (thousand bbl per day) | 10.48 | 10.45 | 10.66 |
| Refining of gas products throughput (thousand boe per day) | 10.91 | 11.02 | 10.62 |
| Number of petrol (gas) stations in Russia* | 484 | 464 | 420 |
| Number of petrol (gas) stations outside of Russia* | 136 | 138 | 141 |

** including stations rented from third parties*

**Export of crude oil from Russia**

The Group is using transportation services of Transneft, the state-owned monopoly owner and operator of Russia's trunk crude oil and export pipelines, upon export of its crude oil. During 2009, the Group exported from Russia approximately 68% of all its crude oil sold compared with approximately 65% in 2008 (67% in 2007).

In 2009 the Company delivered 30% (47% and 54% in 2008 and 2007, respectively) of its own crude oil for export through Transneft's Druzhba pipeline (mainly to Poland, Czech Republic and Hungary); 44% (46% and 30% in 2008 and 2007, respectively) of crude oil was shipped through Russian Black Sea ports (mainly Novorossiysk); 10% (6% and 11% in 2008 and 2007, respectively) of crude oil exported through Baltic Sea port Primorsk and 16% (1% and 4% in 2008 and 2007, respectively) of crude oil was shipped through Ukrainian port Yuzhnyi.

## Certain Macroeconomic and Other Factors Affecting the Group's Results of Operations

The Group's results of operations and the period to period changes therein have been and will continue to be affected by various factors outlined below.

**Crude oil prices**

The primary driver of our revenue is the selling price of crude oil and refined products. In the first half of 2008, the crude oil prices were the highest ever in real terms. Starting from July 2008 crude oil prices began to decline reaching their lowest level since July 2004 ($33.6 per barrel at the end of December 2008). From the beginning of 2009, the Brent crude oil price began to grow stabilising during the second half of 2009 at around $70 per barrel, and reaching its maximum of $78.86 per barrel in November.

Substantially all the crude oil we sell on export and domestic markets is Urals blend. The table below shows average and the end of the period crude oil prices for 2009, 2008 and 2007, respectively.

| | **Average for the year ended December 31** | | | | | **At December 31** | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | **2009** | **Change to 2008, %** | **2008** | **Change to 2007, %** | **2007** | **2009** | **Change to 2008, %** | **2008** | **Change to 2007, %** | **2007** |
| Brent crude | 61.5 | *(36.6)%* | 97.0 | *33.7%* | 72.5 | 77.7 | *112.5%* | 36.5 | *(61.9)%* | 96.0 |
| Urals crude (*CIF Mediterranean*)* | 61.0 | *(35.4)%* | 94.5 | *35.9%* | 69.5 | 77.1 | *113.6%* | 36.1 | *(61.4)%* | 93.6 |
| Urals crude (*CIF Rotterdam*)* | 61.0 | *(35.5)%* | 94.6 | *36.5%* | 69.3 | 76.9 | *115.6%* | 35.7 | *(61.5)%* | 92.6 |

*Source: Platts*

* The Company sells crude oil for export on various delivery terms. Therefore, our average realized sales prices differ from average reported market prices.

There is no independent or uniform market price for crude oil in Russia primarily because a significant portion of crude oil destined for sale in Russia is produced by vertically integrated Russian oil companies and is refined by the same vertically integrated companies. Crude oil that is not exported from Russia, refined by the producer or sold on previously agreed terms, offered for sale in the domestic market at prices determined on a transaction-by-transaction basis. However, there may be significant price differences between regions for similar quality crude oil as a result of the competition and economic conditions in those regions.

**Transportation of crude oil and refined products**

Due to the fact that main Russian crude oil production regions are remote from the main crude oil and refined products markets oil companies are dependent on the extent of diversification of transport infrastructure and access to it. Thus, transportation cost is an important factor affecting our operations and financial results.

The Group transports substantially all of the crude oil that it sells in export and local markets through trunk pipelines in Russia that are controlled by Transneft.

Transportation of crude oil is based on contracts with Transneft and its subsidiaries, which set forth the basic obligations of the contracting parties, including the right of Transneft to blend or substitute a company's oil with oil of other producers. The Group's crude oil is blended in the Transneft pipeline system with other crude oil of varying qualities to produce an export blend commonly referred to as Urals. The Group benefits from this blending since the quality of its crude oil is generally lower than that produced by some other oil companies due to the relatively high sulfur content.

A significant portion of crude oil and refined products transported by pipeline is delivered to marine terminals for onward transportation. There are constraints present in Russia's oil shipment terminals due to geographic location, weather conditions, and port capacity limitations. However, government sponsored and private programs are seeking to improve port facilities.

Transneft establishes and collects on prepayment terms a ruble tariff on domestic shipments and an additional US dollar tariff on exports. The Federal Tariff Service ("FST") is authorized to periodically review and set the tariff rates applicable for each segment of the pipeline. The tariffs are dependent on transport destination, delivery volume, distance of transportation, and several other factors. Tariffs are revised by FST at least annually.

## Inflation and foreign currency exchange rate fluctuations

A significant part of the Group's revenues are derived from export sales of crude oil which are denominated in US dollars. The Group's operating costs are primarily denominated in Rubles. Accordingly, the relative movements of Ruble inflation and Ruble/US dollar exchange rates can significantly affect the results of operations of the Group. For instance, operating margins are generally adversely affected by an appreciation of the Ruble against the US dollar, because in the inflatory economy this will generally cause costs to increase relative to revenues. The Group has not historically used financial instruments to hedge against foreign currency exchange rate fluctuations.

The following table shows the rates of inflation in Russia, the period-end and average Ruble/US dollar exchange rates, the rates of nominal appreciation or devaluation of the Ruble against the US dollar, and the rates of real change in the value of the Ruble against the US dollar for the periods indicated.

| | **2009** | **2008** | **2007** |
|---|---|---|---|
| Ruble inflation | 8.8% | 13.3% | 11.9% |
| Period-end exchange rate (Ruble to US$) | 30.24 | 29.38 | 24.55 |
| Average exchange rate (Ruble to US$) | 31.72 | 24.85 | 25.57 |
| Nominal (devaluation) / appreciation of the Ruble | (2.9)% | (19.7)% | 6.8% |
| Real Ruble appreciation / (devaluation) | 5.7% | (5.3)% | 20.0% |

*Sources: Federal Service of State Statistics and the Central Bank of Russia*

At present, the Ruble is not a freely convertible currency outside the Commonwealth of Independent States. Certain exchange restrictions and controls still exist related to converting Rubles into other currencies.

## Taxation

The Group is subject to numerous taxes that have a significant effect on its results of operations. Russian tax legislation is and has been subject to varying interpretations and frequent changes.

In addition to income taxes, the Group is also subject to:

- unified natural resources production tax (or unified production tax);
- export duties;
- excise taxes on refined products;
- value added taxes;
- property taxes;
- land taxes;

- vehicle (transportation) taxes;
- other local taxes and levies; and
- tax penalties and interest.

These taxes, except for value added taxes, are reflected in Taxes other than income taxes in the Group's consolidated statements of operations and comprehensive income. In addition, the Group is subject to payroll-based taxes, which are included as salary costs within Selling, general and administrative expenses or Operating expenses, as appropriate.

The table below presents a summary of statutory tax rates that the Company and the majority of its subsidiaries were subject to in the respective periods:

| **Tax** | **2009** | **Change to 2008, %** | **2008** | **Change to 2007, %** | **2007** | **Taxable base** |
|---|---|---|---|---|---|---|
| Income tax – maximum rate | 20% | *(16.7)%* | 24% | - | 24% | Taxable income |
| VAT | 18% | - | 18% | - | 18% | Added value |
| Property tax – maximum rate | 2.2% | - | 2.2% | - | 2.2% | Taxable property |
| | (in RR per metric tonne, except for figures in percent) | | | | | |
| Unified production tax, average rates[1] | 2,299 | *(31.0)%* | 3,329 | *34.8%* | 2,470 | Metric tonne produced (crude oil) |
| *Refined products excise tax:* | | | | | | |
| High octane gasoline | 3,629 | - | 3,629 | - | 3,629 | Metric tonne produced and sold domestically[2] |
| Low octane gasoline | 2,657 | - | 2,657 | - | 2,657 | |
| Diesel fuel | 1,080 | - | 1,080 | - | 1,080 | |
| Motor oils | 2,951 | - | 2,951 | - | 2,951 | |
| Straight run gasoline | 3,900 | *46.8%* | 2,657 | - | 2,657 | |
| | (in US $ per metric tonne, except for figures in percent) | | | | | |
| Crude oil export duty, average rates | 179.3 | *(49.5)%* | 355.2 | *72.0%* | 206.5 | Metric tonne exported |
| *Refined products export duty average rates:* | | | | | | |
| Light refined products (gasoline products) and mid refined products (diesel fuel) | 133.1 | *(47.1)%* | 251.6 | *66.1%* | 151.5 | Metric tonne exported |
| Fuel oil *(mazut)* | 71.7 | *(47.1)%* | 135.6 | *66.2%* | 81.6 | |

(1) *Without taking into account differentiated taxation*
(2) *Excise taxes are paid on refined products produced and sold domestically. Excise taxes are paid by the companies that sell refined products to the end customers, while producers and intermediary re-sellers accrue excise tax and subsequently recover it subject to certain conditions set by the legislation.*

Due to decline in international crude oil prices the tax rates specific to the oil industry decreased substantially during 2009 compared to the previous year. Unified production tax decreased by 31%, average crude oil export duties by 50%, and average refined products export duties by 47%.

The decrease in unified production tax rates in 2009 was a result of decrease in the average Urals blend price by 35% as well as changes in the tax calculation (see "Unified production tax rate" below). Excise taxes on refined products remained at the same level as in 2008, except for excise tax for straight run gasoline which increased by 47% in 2009.

**Unified production tax rate.** Effective from January 1, 2007, the rate of the unified production tax is differentiated. The base tax rate for the production of oil was set at RR 419 per metric tonne and was adjusted depending on the international market price of Urals blend and the ruble exchange rate. This tax rate is applied with a discount based on the levels of international oil prices and the levels of depletion of the related oil fields as determined under Russian reserves classification guidelines. Such formula benefits producers with oil fields having a depletion level 80% and above as determined by the Russian reserves classification. The Company receives a benefit of 3.5% per field for each percent of depletion in excess of the 80% threshold. As Romashkinskoye field, the Company's largest, along with certain other fields, is more than 80% depleted, the Company received a benefit from these fields in 2009 of RR 6.96 billion (RR 8.31 billion and RR 5.07 billion in 2008 and 2007, respectively).

Effective from January 1, 2009, the unified production tax rate calculation was changed. The threshold crude oil price up to which the tax rate is zero was raised from $9.00 to $15.00 per barrel. This leads to a $1.3 per barrel decrease in crude oil extraction tax expenses in Russia. Also, the list of regions where, depending on the period and volume of production, a zero crude oil production tax rate applies has been extended. In particular, it now includes Caspian offshore and the Nenets Autonomous District (the Company has operations in the latter).

Also a zero unified production tax rate applies to the production of highly viscous crude oil (defined as crude oil of more than 200 Megapascal second in reservoir conditions) where the direct (segregated) method of accounting for produced oil is used. Since April 2007, the Company's production of highly viscous crude oil (bitumen) from the Ashalchinskoye and Mordovo-Karmalskoye fields was subject to a zero unified production tax rate, resulting in tax benefit during 2009 attributed to that production of RR 55 million (RR 57 million and RR 20 million in 2008 and 2007, respectively).

**Crude oil export duties.** Prior to October 1, 2008, the Russian government set export tariff rates for two-month periods. The rates in a specific two-month period were based on Urals blend international market prices in the preceding two months. Thus, the calculation method that the Russian government employed to determine export tariff rates resulted in a two-month gap between movements in crude oil prices and the revision of the export duty rate based on those crude oil prices.

This approach changed in September 2008. The Russian government set the specific crude oil export duty rate for October and November 2008 at $372.20 and $287.30 per tonne respectively, in order to compensate oil companies for the negative effect of rapid decline in crude oil prices. Beginning from December 2008, the crude oil export duty rate is revised monthly on the basis of crude oil price monitoring in the immediately preceding one-month period.

The Government determines the export duty rate, which is dependent on the average Urals price for the monitoring period according to the following table:

| Quoted Urals price (P), US$ per tonne | Maximum Export Duty Rate |
|---|---|
| 0 – 109.50 | 0% |
| 109.50 – 146.00 | 35.0% * (P - 109.50) |
| 146.00 – 182.50 | US$ 12.78 + 45.0% * (P - 146.00) |
| >182.50 | US$ 29.20 + 65.0% * (P - 182.50) |

The export duty rate on crude oil decreased by 50% in 2009 to US$ 179.3 per tonne (US$ 24.6 per barrel) from US$ 355.2 per tonne (US$ 48.7 per barrel) in 2008. The decrease was associated with the decrease of average Urals prices by 35% to US$ 61.0 per barrel in 2009 compared to US$ 94.5 per barrel in 2008.

Starting from 2007, crude oil exported from Russia to Belorussia became subject to export duties. The latest amendments made by customs authorities set a multiplier of 0.356 for 2009 (0.335 for 2008 and 0.293 for 2007) to be applied to the regular export duty rate set by the Russian government for calculation of export duty on crude oil exports from Russia to Belorussia.

In 2010, under the agreement between the Russian Federation and Belorussia, crude oil exported from Russia to Belorussia up to total amount of 6.3 million tonnes will not be subject to export duty. Volumes of crude oil above this limit will be taxed at a regular export duty rate.

**Property tax.** The maximum property tax rate in Russia is 2.2%. Exact tax rates are set by the local authorities.

**Value added tax (VAT).** The Group is subject to value added tax (or VAT) of 18% on most purchases. VAT payments are recoverable against VAT received on domestic sales. Export sales are not subject to VAT. Input VAT related to export sales is recoverable from the Russian government. The Group's results of operations exclude the impact of VAT.

**Income tax.** Before 2009, operations in the Russian Federation were subject to an income tax rate of 24%. The Federal income tax rate was 6.5% and a regional income tax rate varied from 13.5% to 17.5% at the discretion of the individual regional administrations. Starting from January 1, 2009, the total income tax rate was decreased to 20%, including federal part which decreased to 2.0% and the regional part which varies now between 13.5% and 18.0%.

## Year ended December 31, 2009 compared to the years ended December 31, 2008 and December 31, 2007.

The table below details certain income and expense items from our consolidated statements of operations and comprehensive income for the periods indicated.

| RR millions | 2009 | Change to 2008, % | 2008 | Change to 2007, % | 2007 |
|---|---|---|---|---|---|
| **Sales and other operating revenues** | **380,648** | **(14.3)%** | **444,332** | **24.7%** | **356,276** |
| **Costs and other deductions** | | | | | |
| Operating | 59,334 | (10)% | 65,961 | 10.6% | 59,623 |
| Purchased oil and refined products | 38,243 | (35.1)% | 58,919 | 36.1% | 43,297 |
| Exploration | 3,540 | (6.1)% | 3,770 | 139.1% | 1,577 |
| Transportation | 14,325 | 24% | 11,556 | 37.1% | 8,431 |
| Selling, general and administrative | 26,710 | (27)% | 36,571 | 63.6% | 22,349 |
| Depreciation, depletion and amortization | 11,917 | 17.5% | 10,139 | (2.3)% | 10,379 |
| Loss on disposals of property, plant and equipment and investments and impairments | 1,284 | (23.8)% | 1,684 | (67.9)% | 5,253 |
| Taxes other than income taxes | 153,797 | (29.2)% | 217,271 | 48.5% | 146,299 |
| Maintenance of social infrastructure and transfer of social assets | 2,789 | (34.5)% | 4,258 | 82% | 2,340 |
| **Total costs and other deductions** | **311,939** | **(23.9)%** | **410,129** | **36.9%** | **299,548** |
| Earnings/(losses) from equity investments | 510 | 105.3% | (9,556) | (265.1)% | 5,789 |
| Foreign exchange loss | (920) | (85)% | (6,135) | 133.9% | (2,623) |
| Interest income | 4,216 | 12.3% | 3,753 | 35% | 2,779 |
| Interest expense, net of amounts capitalized | (626) | 7.9% | (580) | 866.7% | (60) |
| Other income /(expenses), net | 2,637 | 174.7% | (3,531) | 88,175% | (4) |
| **Total other income/ (expenses)** | **5,817** | **136.2%** | **(16,049)** | **(372.9)%** | **5,881** |
| **Income before income taxes and non-controlling interest** | **74,526** | **310.5%** | **18,154** | **(71)%** | **62,609** |
| Current income tax expense | (17,527) | 9.3% | (16,043) | (15.1)% | (18,895) |
| Deferred income tax (expense)/ benefit | (29) | (100.4)% | 6,701 | 945.4% | 641 |
| **Total income tax expense** | **(17,556)** | **87.9%** | **(9,342)** | **(48.8)%** | **(18,254)** |
| **Net income** | **56,970** | **546.5%** | **8,812** | **(80.1)%** | **44,355** |
| Less: net income attributable to non-controlling interest | (2,598) | 551.1% | (399) | (62.9)% | (1,076) |
| **Net income attributable to Group shareholders** | **54,372** | **546.3%** | **8,413** | **(80.6)%** | **43,279** |

The analysis of the main financial indicators of the above financial information is provided below.

## Sales and other operating revenues

A breakdown of sales and other operating revenues (by product type) is provided in the following table:

| **RR millions** | **2009** | **2008** | **2007** |
|---|---|---|---|
| Crude oil | 300,077 | 346,261 | 270,960 |
| Refined products | 42,934 | 55,544 | 43,226 |
| Petrochemicals | 19,849 | 21,993 | 23,180 |
| Corporate and other sales | 17,788 | 20,534 | 18,910 |
| **Total sales and other operating revenues** | **380,648** | **444,332** | **356,276** |

*2009 vs 2008*

Sales and other operating revenues decreased in 2009 by 14.3% to RR 380,648 million from RR 444,332 million in 2008. The decrease was mainly attributed to an overall decrease in crude oil and refined product prices.

*2008 vs 2007*

Sales and other operating revenues increased in 2008 by 24.7% to RR 444,332 million from RR 356,276 million in 2007. Main reasons of the increase were an overall increase in crude oil and refined product prices and increased volumes of crude oil sold to non-CIS destinations.

### *Sales of crude oil*

Sales of crude oil decreased by 13.3% to RR 300,077 in 2009 from RR 346,261 million in 2008 (in 2008 increased by 27.8% compared to RR 270,960 million in 2007). The table below provides an analysis of the changes in sales of crude oil:

| | **2009** | **Change to 2008, %** | **2008** | **Change to 2007, %** | **2007** |
|---|---|---|---|---|---|
| **Domestic sales of crude oil** | | | | | |
| Revenues (RR millions) | 55,070 | *(16.3)%* | 65,806 | *19.7%* | 54,954 |
| Volume (thousand tonnes) | *8,638* | *(5.7)%* | *9,162* | *2.3%* | *8,957* |
| Realized price (RR per tonne) | *6,375* | *(11.2)%* | *7,183* | *17.1%* | *6,135* |
| **CIS export sales of crude oil [1]** | | | | | |
| Revenues (RR millions) | 16,829 | *6.5%* | 15,800 | *(72.7)%* | 57,893 |
| Volume (thousand tonnes) | *1,640* | *3.3%* | *1,587* | *(70.6)%* | *5,401* |
| Realized price (RR per tonne) | *10,262* | *3.1%* | *9,956* | *(7.1)%* | *10,719* |
| **Non-CIS export sales of crude oil** | | | | | |
| Revenues (RR millions) | 228,178 | *(13.8)%* | 264,655 | *67.4%* | 158,113 |
| Volume (thousand tonnes) | *16,575* | *6%* | *15,637* | *26.2%* | *12,394* |
| Realized price (RR per tonne) | *13,766* | *(18.7)%* | *16,925* | *32.7%* | *12,757* |

*[1] CIS is an abbreviation for Commonwealth of Independent States*

### *Sales of refined products*

Sales of refined products decreased by 22.7% to RR 42,934 million in 2009 from RR 55,544 million in 2008 (in 2008 increased by 28.5% compared to RR 43,226 million in 2007). The table below provides an analysis of the changes in sales of refined products:

| | 2009 | Change to 2008, % | 2008 | Change to 2007, % | 2007 |
|---|---|---|---|---|---|
| **Domestic sales of refined products** | | | | | |
| Revenues (RR millions) | 37,406 | *(23.2)%* | 48,707 | *31.6%* | 37,013 |
| Volume (thousand tonnes) | *2,660* | *(8)%* | *2,892* | *(1.6)%* | *2,939* |
| Realized price (RR per tonne) | *14,062* | *(16.5)%* | *16,842* | *33.7%* | *12,594* |
| **CIS export sales of refined products** | | | | | |
| Revenues (RR millions) | 1,189 | *76.7%* | 673 | *(74.8)%* | 2,669 |
| Volume (thousand tonnes) | *112* | *111.3%* | *53* | *(64.7)%* | *150* |
| Realized price (RR per tonne) | *10,616* | *(16.4)%* | *12,698* | *(28.6)%* | *17,793* |
| **Non-CIS export sales of refined products** | | | | | |
| Revenues (RR millions) | 4,339 | *(29.6)%* | 6,164 | *73.9%* | 3,544 |
| Volume (thousand tonnes) | *340* | *(16.7)%* | *408* | *24%* | *329* |
| Realized price (RR per tonne) | *12,762* | *(15.5)%* | *15,108* | *40.3%* | *10,772* |

***Sales of petrochemical products***

The table below provides an analysis of petrochemical products sales.

| **RR millions** | **2009** | **Change to 2008, %** | **2008** | **Change to 2007, %** | **2007** |
|---|---|---|---|---|---|
| Tires sales | 18,864 | *(11.1)%* | 21,209 | *(5.8)%* | 22,516 |
| Other petrochemicals sales | 985 | *25.6%* | 784 | *18.1%* | 664 |
| **Total sales of petrochemical products** | **19,849** | ***(9.7)%*** | **21,993** | ***(5.1)%*** | **23,180** |

The decrease in sales of petrochemical products was primarily due to the lower volumes of tires sold. The Group's production of tires in 2009 decreased by 21% compared to the corresponding period of 2008 and amounted to 9.4 million tires (decreased by 4% in 2008 compared to 2007), due to decrease in demand.

***Other sales***

Other sales decreased by 13.4% to RR 17,788 million in 2009 from RR 20,534 million in 2008 (increased by 8.6% in 2008 compared to RR 18,910 million in 2007). Other sales primarily represent sales of materials and equipment and various oilfield services provided by the Group to third parties (such as drilling, well construction and repairs, and geophysical works).

## Costs and other deductions

**Operating expenses.** Operating expenses include the following costs:

| **RR millions** | **2009** | **2008** | **2007** |
|---|---|---|---|
| Crude oil extraction expenses | 28,549 | 29,273 | 22,009 |
| Petrochemical production expenses | 16,771 | 18,415 | 18,287 |
| Other operating expenses | 13,565 | 18,763 | 19,168 |
| Change in operating expenses in inventory of crude oil produced by the Group* | 449 | (490) | 159 |
| **Total operating expenses** | **59,334** | **65,961** | **59,623** |

** This change includes extraction expenses related to crude oil produced by the Group in one period but sold to third parties in the different reporting period.*

Operating expenses include the following main categories: lifting expenses connected with extraction of crude oil, refining and processing expenses, cost of petrochemicals production, cost of materials other than oil and gas, and other direct costs.

***Crude oil extraction expenses.*** The Group's extraction ("lifting") expenses relate to oil and gas production and are incurred by the Company's oil and gas producing divisions and subsidiaries. They include expenditures related to maintenance services, repairs and insurance of extraction equipment, labor costs, expenses on artificial stimulation of reservoirs, fuel and electricity costs, materials and goods consumed in oil and gas production, and other similar costs.

Expenses of the Company's oil and gas production units and subsidiaries consisting of the purchase of services and goods (such as electricity, heat, etc.) that are unrelated to their core activities, accretion of the Company's asset retirement obligations, and the change in crude oil and refined products inventory, have been excluded from extraction expenses and are included in other operating costs.

*2009 vs 2008*

In 2009 lifting expenses averaged to RR 153.5 per barrel compared to RR 157.7 per barrel in 2008. The decrease of 2.6% was primarily a result of reduction in certain equipment repairs as well as other costs.

*2008 vs 2007*

In 2008 lifting expenses increased by 32.4% compared to RR 119.1 per barrel in 2007 which was primarily a result of increases in equipment service costs, repair expenses and electricity tariffs.

***Petrochemical production expenses.*** Petrochemical production expenses primarily include the costs of raw materials, labour, maintenance and electricity consumed in the production of petrochemical products.

*2009 vs 2008*

Cost of petrochemical products decreased by 8.9% to RR 16,771 million in 2009 compared to 2008 primarily due to decrease in volumes of petrochemicals produced.

*2008 vs 2007*

In 2008 cost of petrochemical products increased by 0.7% to RR 18,415 million compared to 2007 primarily due to increases in the electricity tariffs, salary and repair expenses. This growth was relatively insignificant due to the lower volume of tires and other petrochemicals produced in 2008 compared to 2007.

***Other operating expenses*** include accretion of the asset retirement obligation and the costs of other services, goods and materials not related to the core oil and gas production activities of the Group.

*2009 vs 2008*

Other operating expenses decreased to RR 13,565 million, or by 27.7%, compared to 2008 primarily due to decrease of costs of other services.

*2008 vs 2007*

Other operating expenses decreased to RR 18,763 million, or by 2.1%, compared to 2007 due to decrease of costs of other services. Also, other operating expenses in 2008 included part of revaluation of pension obligations of the Group to its employees in the amount of RR 855 million.

**Cost of purchased crude oil and refined products.** A summary of purchased oil and refined products for 2009, 2008 and 2007, respectively, is as follows:

| **RR millions** | **2009** | **2008** | **2007** |
|---|---|---|---|
| Purchased crude oil (RR millions) | 9,420 | 20,873 | 13,359 |
| Volume (thousand tonnes) | 845 | *1,656* | *1,334* |
| Average price per tonne (RR) | *11,148* | *12,603* | *10,014* |
| | | | |
| Purchased refined products (RR millions) | 28,823 | 38,046 | 29,938 |
| Volume (thousand tonnes) | *2,007* | *2,331* | *2,403* |
| Average price per tonne (RR) | *14,361* | *16,319* | *12,460* |
| **Total purchased oil and refined products** | **38,243** | **58,919** | **43,297** |

*2009 vs 2008*

Purchases of crude oil in 2009 decreased by 55% to RR 9,420 million from RR 20,873 million in 2008 due to decrease in volumes of purchased crude oil for trading by 49% as well as decrease in average purchase price per tonne by 12%.

Purchases of refined products decreased by 24% to RR 28,823 million in 2009 from RR 38,046 million in 2008 primarily due to decrease in volumes of refined products purchased as well as decrease in average purchase price per tonne by 12%.

*2008 vs 2007*

Purchases of crude oil in 2008 increased by 56% to RR 20,873 million from RR 13,359 million in 2007 due to increase in volumes of purchased crude oil for trading by 24% as well as increase in average purchase price per tonne by 26%.

Purchases of refined products increased by 27% to RR 38,046 million in 2008 from RR 29,938 million in 2007 due to increase in average purchase price per tonne by 31%.

**Exploration expenses.** Exploration expenses consist primarily of exploratory drilling, geological and geophysical costs, and the costs of carrying and retaining undeveloped properties.

*2009 vs 2008*

Exploration expenses decreased to RR 3,540 million in 2009 from RR 3,770 million in 2008. Exploration expenses in 2008 included accumulated prior years' exploration expenditures in the amount of RR 1,455 million of first-time consolidated E&P companies under provisions of ASC-810 (previously FIN 46R). Increase by 53% excluding an effect of this one-off adjustment was primarily due to increased exploration expenses in Libya.

*2008 vs 2007*

Exploration expenses increased to RR 3,770 million in 2008 from RR 1,577 million in 2007 mainly due to first-time consolidation of exploratory companies under provision of ASC-810. Such activities have not yet resulted in the discovery of proved crude oil or gas reserves. Investments in these companies were previously accounted for under the equity method. Accumulated losses of these companies amounted to RR 1,455 million were recorded in our 2008 financial statements.

**Transportation expenses**. Transportation expenses relate to the delivery of our own crude oil produced as well as purchased crude oil and refined products, which are mostly carried out using Transneft pipeline for deliveries of crude oil to our customers.

*2009 vs 2008*

Transportation costs increased by 24% to RR 14,325 million in 2009 from RR 11,556 million in 2008 due to an increase in transportation tariffs and shift of some export volumes from Druzhba pipeline to port Yuzhnyi in Ukraine.

*2008 vs 2007*

Transportation costs increased by 37.1% to RR 11,556 million in 2008 from RR 8,431 million in 2007 due to an increase in transportation tariffs.

**Selling, general and administrative expenses.** Certain selling, general and administrative expenses are by nature fixed costs, which are not directly related to production, such as payroll, general business costs, insurance, advertising, share based compensation, legal fees, consulting and audit services, charity and other expenses, including bad debt provisions.

*2009 vs 2008*

In 2009 selling, general and administrative expenses decreased by RR 9,861 million to RR 26,710 million compared to 2008, primarily as a result of decrease in our bad debt provision on accounts receivables. In 2008 the Group recorded a bad debt provision on accounts receivables related to its crude oil sales to Ukraine prior to October 2007 in the amount of RR 10,786 million (US$ 439.4 mln). During 2009 part of the receivable was collected in the amount of RR 3,174 million resulting in a decrease of the bad debt provision amount to RR 10,111 million (US$ 334.3 mln) as of December 31, 2009.

*2008 vs 2007*

In 2008 selling, general and administrative expenses increased by RR 14,222 million to RR 36,571 million compared to 2007, primarily as a result of an increase in our bad debt provision on Ukrainian sales prior to October 2007 in the amount of RR 10,786 million (see Commitments and Contingent Liabilities section on page 22). Also, Selling, general and administrative expenses in 2008 included part of revaluation of pension obligations of the Group to its top management in the amount of RR 803 million.

**Loss on disposals of property, plant and equipment and impairment of investments**.

*2009 vs 2008*

In 2009 loss on disposals of property, plant and equipment and impairment of investments was RR 1,284 million compared to RR 1,684 million in 2008. The loss in 2009 primarily included an impairment of our direct investments in Ukrtatnafta in the amount of RR 606 million.

*2008 vs 2007*

During 2008 the loss on disposals of property, plant and equipment and impairment of investments included the following charges:

- impairment under SFAS 144 (now ASC 360) provisions of US GAAP of long-lived assets of OAO LDS-1000, the owner and operator of an ice hockey arena in the city of Kazan, acquired in April 2006, in the amount of RR 2,587 million;
- provision related to indirect shareholding interests in Ukrtatnafta in the amount of RR 2,004 million (see Commitments and Contingent Liabilities section on page 22);
- a write-off of an unrecoverable debt of a third-party company under liquidation in the amount of RR 960 million;
- accumulated prior years' losses of a company in petrochemical segment first time consolidated in the Group's financial statements in the amount of RR 689 million.

**Taxes other than income taxes.** Taxes other than income taxes include the following:

| | 2009 | 2008 | 2007 |
|---|---|---|---|
| Export duties | 97,169 | 136,541 | 85,327 |
| Unified production tax | 53,571 | 77,235 | 58,049 |
| Property tax | 1,916 | 1,493 | 1,398 |
| Excise taxes | 346 | 328 | 300 |
| Penalties and interest | 94 | 121 | 205 |
| Other | 701 | 1,553 | 1,020 |
| **Total taxes other than income taxes** | **153,797** | **217,271** | **146,299** |

*2009 vs 2008*

During 2009 taxes other than income taxes decreased by 29.2% to RR 153,797 million from RR 217,271 million in 2008. The decrease was primarily a result of the reduction in export duty and unified production tax rates, which are linked to crude oil market prices. In 2009 compared to 2008, export duties paid by the Group decreased by 28.8%. The Group's unified production tax expense decreased by 30.6%. Our expenses on excise taxes increased to RR 346 million from RR 328 million in 2008. Other taxes include land tax and non-recoverable VAT.

*2008 vs 2007*

During 2008 taxes other than income taxes increased by 48.5% to RR 217,271 million from RR 146,299 million in 2007. The increase was primarily due to an increase in export duty and unified production tax rates, which are linked to crude oil market prices partly offset by the introduction of differentiated rate of unified production tax. In 2008 compared to 2007, our export duties increased by 60% compared to an increase in export duty rate by 72%. The Group's unified production tax increased by 33.1% compared to an increase in unified production tax rate by 35%. Our expenses on excise tax increased to RR 328 million from RR 300 million in 2007, due to the increase in production and selling domestically of taxable refined products (mainly diesel fuel and gasoline).

Effective January 1, 2007, the tax rate formula for unified production tax was modified to provide a benefit for fields whose depletion rate is 80% or above as determined under Russian reserves classification. Under these new rules, the Company receives a benefit of 3.5% per field for each percent of depletion in excess of the 80% threshold. As Romashkinskoye field, the Company's largest, along with certain other fields is more than 80% depleted, the Company received a benefit in 2009 of RR 6.96 billion in comparison to RR 8.31 billion in 2008 and RR 5.07 billion in 2007, driven by a fluctuation in crude oil prices in the respective periods used in the calculation formula of such tax as well as further changes in the tax legislation effective from January 1, 2009 (see "Certain Macroeconomic and Other Factors Affecting the Group's Results of Operations - Taxation – Unified Production Tax Rate" on page 9).

Since April 2007, the Company applied a zero unified production tax rate to production of highly viscous crude oil (bitumen) from Ashalchinskoye and Mordovo-Karmalskoye fields, resulting in 2009 tax benefit of RR 55 million in comparison to RR 57 million in 2008 and RR 20 million in 2007.

**Maintenance of social infrastructure and transfer of social assets.** Social infrastructure expenses relate primarily to housing, schools and cultural buildings in Tatarstan.

*2009 vs 2008*

Maintenance of social infrastructure expenses and transfer of social assets decreased to RR 2,789 million in 2009 from RR 4,258 million in 2008 (which included a one-off adjustment).

*2008 vs 2007*

Maintenance of social infrastructure expenses and transfer of social assets increased to RR 4,258 million in 2008 from RR 2,340 million in 2007, which was mainly due to the disposal of a medical facility, a social asset of the Group, at the amount of RR 1,379 million.

**Other income (expenses)**

*2009 vs 2008*

The Group recorded a gain from equity investments amounted to RR 510 million in 2009 compared to a RR 9,556 million loss in 2008. This gain in 2009 was mainly due to an increase of the Bank Zenit gains, RR 513 million of which was attributed to the Group compared to the RR 112 million loss attributed to the Group in 2008, as well as lower loss received from participation in IPCG Fund (RR 141 million) compared to the RR 9,470 million loss attributed to the Group in 2008.

The Group also recorded foreign exchange loss amounted to RR 920 million in 2009 compared to a foreign exchange loss of RR 6,135 million in 2008. This was mainly due to foreign exchange loss on dollar denominated sales of crude oil partly offset by foreign exchange gain in the amount of RR 430 million on US dollars denominated debt incurred under the long-term secured credit facility for the construction of TANECO's refinery and petrochemical complex.

Interest income increased by 12.3% to RR 4,216 million in 2009 compared to 2008 due to an increase of interest income received on our short-term certificates of deposit.

Interest expense, net of amounts capitalised increased from RR 580 million in 2008 to RR 626 million in 2009 which was a result of increase in other debt, beyond the syndicated credit facilities.

Other income, net, in 2009 amounted to RR 2,637 million compared with RR 3,531 million of other expenses, net, in 2008. The change was primarily due to increase in realized gain on our trading marketable securities.

*2008 vs 2007*

The Group recorded losses from equity investments amounted to RR 9,556 million in 2008 compared to a RR 5,789 million gain in 2007. This loss was mainly due to IPCG Fund's losses amounted to RR 9,470 million attributed to the Group compared to RR 4,545 million gain in 2007.

Our foreign exchange loss increased from RR 2,623 million in 2007 to RR 6,135 million in 2008 due to decrease of the average exchange rate of the Russian Ruble against the US dollar in 2008 compared to 2007. This loss was mainly due to foreign exchange loss in the amount of RR 6,582 million on US dollars denominated debt under the long-term secured credit facility for the construction of TANECO's refinery and petrochemical complex.

Interest income increased by 35% to RR 3,753 million in 2008 compared to 2007 due to increase of interest income received on our short-term and long-term certificates of deposit. Interest expense increased from RR 60 million to RR 580 million in 2008 in comparison to 2007, which was a result of an increase in loans amounts other than under the syndicated credit facilities.

Other expenses, net in 2008 amounted to RR 3,531 million compared with RR 4 million of other expenses, net in 2007. The change was primarily due to realized losses recorded on our trading investments.

**Income taxes**

The effective income tax rate in 2009 was 23.6%, compared to the statutory tax rate of 20% in the Russian Federation. This difference was due to non deductible or partially deductible expenses incurred during the reporting period.

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

| RR millions | 2009 | 2008 | 2007 |
|---|---|---|---|
| Net income attributable to Group shareholders | 54,372 | 8,413 | 43,279 |
| Add back: | | | |
| Non-controlling interest | 2,598 | 399 | 1,076 |
| Income tax expense | 17,556 | 9,342 | 18,254 |
| Depreciation, depletion and amortization | 11,917 | 10,139 | 10,379 |
| Interest expense | 626 | 580 | 60 |
| Interest and dividend income | (4,216) | (3,753) | (2,779) |
| **EBITDA** | **82,853** | **25,120** | **70,269** |

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

## Credit ratings

In December 2009, Fitch Ratings affirmed the Group's long –term foreign currency issuer default rating at BB with a stable outlook.

In June 2009, Moody's affirmed the Group's a corporate family rating at Ba2 with a stable outlook.

A rating is not a recommendation to buy, sell or hold securities and may be subject to revision, suspension or withdrawal at any time by the assigning rating organization. The ratings do not address the marketability of any of our securities or their market price. Any change in the credit ratings of Tatneft or our securities could adversely affect the price that a subsequent purchaser will be willing to pay for our securities. We recommend that you analyze the significance of each rating independently from any other rating.

## Financial Condition Summary Information

The following table shows certain key financial indicators:

| RR millions | At December 31, 2009 | At December 31, 2008 | At December 31, 2007 |
|---|---|---|---|
| Current assets | 135,914 | 116,620 | 126,595 |
| Long-term assets | 359,828 | 276,360 | 243,624 |
| **Total assets** | **495,742** | **392,980** | **370,219** |
| Current liabilities | 110,894 | 32,043 | 38,428 |
| Long-term liabilities | 71,341 | 96,078 | 63,233 |
| **Total liabilities** | **182,235** | **128,121** | **101,661** |
| **Shareholders' equity** | **313,507** | **264,859** | **268,558** |
| Working capital | 25,020 | 84,577 | 88,167 |

**Working capital position**

As of December 31, 2009 working capital of the Group amounted to RR 25,020 million compared to RR 84,577 million as of December 31, 2008 (RR 88,167 million as of December 31, 2007). The decrease in the working capital was attributable to an increase in current liabilities, in particular current portion of long-term debt under the US$ 2 billion secured credit facility for the construction of TANECO's refinery and petrochemical complex.

## Liquidity and Capital Resources

The following table shows a summary from the Consolidated Statements of Cash Flows:

| RR millions | 2009 | 2008 | 2007 |
|---|---|---|---|
| Net cash provided by operating activities | 66,603 | 47,852 | 48,033 |
| Net cash used for investment activities | (91,328) | (61,735) | (39,624) |
| Net cash provided by / (used for) financing activities | 24,148 | 14,291 | (2,268) |
| Increase in cash and cash equivalents | (577) | 408 | 6,141 |

**Net cash provided by operating activities**

Our primary source of cash flow is funds generated from our operations. Net cash provided by operating activities increased by 39.2% to RR 66,603 million in 2009 from RR 47,852 million in 2008 which was primarily attributed to the reduced costs in 2009 (in 2008 decreased by 0.4% from RR 48,033 million in 2007 primarily due to lower cash generation capacity of the Group in the fourth quarter of 2008).

**Net cash used for investing activities**

Net cash used for investing activities increased by 47.9% to RR 91,328 million in 2009 from RR 61,735 million in 2008 (in 2008 increased by 55.8% from RR 39,624 million in 2007), which was primarily due to an increase in expenditures related to the construction of TANECO's refinery and petrochemical complex.

**Net cash provided by / (used for) financing activities**

Cash flow provided by financing activities amounted to RR 24,148 million in 2009 compared to RR 14,291 million in 2008 (compared to RR 2,268 million used for financing activities in 2007). This was primarily due to net debt proceeds of RR 34,721 million in 2009 compared with net debt proceeds of RR 29,749 million in 2008 (in 2007- net debt proceeds of RR 9,283 million in 2007).

**Additions to property, plant and equipment**

The following additions to property, plant and equipment (by segment) were made in 2009, compared to 2008 and 2007:

| RR millions | 2009 | 2008 | 2007 |
|---|---|---|---|
| Exploration and production | 16,455 | 23,391 | 19,445 |
| Refining and marketing | 64,805 (1) | 26,613 | 10,754 |
| Petrochemicals | 5,947(2) | 6,263 | 2,061 |
| Corporate and other | 2,052 | 4,207 | 2,175 |
| **Total additions to property, plant and equipment** | **89,259** | **60,474** | **34,435** |

(1) *Includes RR 64,086 million expenditures related to the refinery construction by TANECO*
(2) *Includes RR 5,334 million expenditures related to the new solid steel cord tires plant*

**Analysis of Debt**

At December 31, 2009, long-term debt, including the current portion of long-term debt, amounted to RR 79,831 million as compared to RR 44,889 million at December 31, 2008 (RR 9,326 million at December 31, 2007). The related increase was due to an increase in the long-term foreign currency denominated debt through drawdowns under the US$ 2 billion secured credit facility for the construction of TANECO's refinery and petrochemical complex (RR 60,488 million (US$ 2 billion) under this credit facility were outstanding as of December 31, 2009) and a dual (3 and 5 year) tranches secured syndicated pre-export facility for up to US$ 1.5 billion arranged by WestLB AG, Bayerische Hypo- und Vereinsbank AG, ABN AMRO Bank N.V. (RBS), OJSC Gazprombank, Bank of Moscow and Nordea Bank in October 2009 (RR 7,561 million (US$ 250 million) under this credit facility were outstanding as of December 31, 2009).

The aggregate maturities of total long-term debt, including current portion as of December 31, 2009 are as follows:

| RR millions | At December 31, 2009 |
|---|---|
| 2010 | 63,243 |
| 2011 | 12,889 |
| 2012 | 2,700 |
| 2013 | - |
| 2014 | - |
| 2015 | 31 |
| 2016 and thereafter | 968 |
| **Total long-term debt** | **79,831** |

## Contractual obligations, other contingencies and off balance sheet arrangements

### Social commitments

The Group contributes significantly to the maintenance of local infrastructure and the welfare of its employees within Tatarstan, which includes contributions towards the construction, development and maintenance of housing, hospitals and transport services, recreation and other social needs. Such funding is periodically determined by the Board of Directors after consultation with governmental authorities and recorded as expenditures when incurred.

### Guarantees

The Group has no outstanding guarantees at December 31, 2009, 2008 and 2007.

### Commitments and Contingent Liabilities

The Group is subject to various lawsuits and claims arising in the ordinary course of business. The outcomes of such contingencies, lawsuits or other proceedings cannot be determined at present. In the case of all known contingencies the Group accrues a liability when the loss is probable and the amount is reasonably estimable. Based on currently available information, management believes that it is remote that future costs related to known contingent liability exposures would have a material adverse impact on the Group's consolidated financial statements.

*Ukrtatnafta*

Historically, and in particular during the course of 2007, there have been a number of attempts by Ukraine to challenge AmRUZ and Seagroup's acquisition of shares in Ukrtatnafta, and in particular, by the State Property Fund and NJSC Naftogaz of Ukraine ("Naftogaz"). Naftogaz is 100% owned by the Ukrainian Government and also owner of record of 43% Ukrtatnafta's common shares.

The challenges were suspended in April 2006 when the Supreme Court of Ukraine ruled the payment for Ukrtatnafta shares made with promissory notes issued by AmRUZ and Seagroup was lawful. However, in May 2007 the Ministry of Fuel and Energy of Ukraine ("MFEU") resumed its attempts and, as a result, succeeded in obtaining alleged and doubtful court decisions, after which it announced the transfer into Naftogaz's custody the 18.3% of Ukrtatnafta's shares, representing the entire holdings of AmRUZ and Seagroup in Ukrtatnafta. Subsequent to these actions, MFEU effectively began to exclude the Group from exercising their shareholder rights related to Ukrtatnafta.

In October 2007 the existing management of Ukrtatnafta, as appointed by its shareholders, was forcibly removed based on an alleged court order. Subsequently, individuals who obtained the ability to manage Ukrtatnafta took certain actions effectively assisting MFEU in taking control over the shares in Ukrtatnafta owned by SeaGroup and AmRUZ. In addition, Ukrtatnafta subsequently refused to settle its payables to ChMPKP Avto (Note 4), a Ukrainian intermediary that previously purchased crude from the Group for deliveries to Ukrtatnafta. Following this forced change of control of Ukrtatnafta, the Company (originally the key crude supplier to the Kremenchug refinery) suspended its crude oil deliveries to Ukrtatnafta and initiated legal proceedings against the Ukrainian owners in international arbitration.

In May 2008, Tatneft commenced international arbitration against Ukraine on the basis of the agreement between the Government of the Russian Federation and the Cabinet of Ministries of Ukraine on the Encouragement and Mutual Protection of Investments of November 27, 1998 ("Russia-Ukraine BIT"). The arbitration concerns losses suffered by Tatneft as a consequence of the forcible takeover of Ukrtatnafta. Tatneft requested the arbitral tribunal declare Ukraine has breached the Russian-Ukraine BIT and to order MFEU to restore Ukrtatnafta's lawful management and pay compensation in excess of US$2.4 billion.

In November 2009 the Business Court of the City of the Poltava Region invalidated the initial purchase of 8.6% of Ukrtatnafta shares by the Company without payment of any compensation to the Company. This decision became effective but is currently under further appeal.

There are a number of legal proceedings currently in process in the Ukraine, Russian Federation and international courts to recover the Group's assets. As a result of the ongoing legal dispute over shareholding interests, as of December 31, 2009 the Company has fully provided for its investments in Ukrtatnafta.

## Market risks

We are exposed to market risks from changes in both foreign currency exchange rates and interest rates. We are exposed to foreign exchange risk to the extent that our costs are denominated in currencies other than rubles. We are subject to market risk from changes in interest rates that may affect the cost of our financing. We do not use financial instruments, such as foreign exchange forward contracts, foreign currency options, interest rate swaps and forward rate agreements, to manage these market risks. We also do not hold or issue derivative or other financial instruments for trading purposes.

### Interest rate risk

We are exposed to interest rate risk on our indebtedness that bears interest at floating rates and to a lesser extent, on our indebtedness that bears interest at fixed rates. At December 31, 2009 we had approximately RR 88,074 million in loans outstanding, of which approximately RR 18,988 million bore interest at fixed rates and approximately RR 69,086 million bore interest at floating rates determined by reference to the LIBOR for US dollar loans (for details please refer to Note 11 "Debt" of the audited consolidated financial statements).

We undertake debt obligations to support general corporate purposes including capital expenditures and working capital needs. Upward fluctuations in interest rates increase the cost of new debt and the interest cost of outstanding variable rate borrowings. Fluctuations in interest rates can also lead to significant fluctuations in the fair value of our debt obligations. However, our sensitivity to decreases in interest rates and corresponding increases in the fair value of our debt portfolio would unfavorably affect our results and cash flows only to the extent that we elected to repurchase or otherwise retire all or a portion of our fixed-rate debt portfolio at prices above carrying value.

### Foreign currency risk

Our principal exchange rate risk involves changes in the value of the ruble relative to the US dollar. At December 31, 2009, approximately RR 85,682 million of our indebtedness was denominated in US dollars (out of approximately RR 88,074 million of our total indebtedness at that date). Depreciation in the value of the ruble relative to the US dollar will increase the cost in rubles of our foreign currency denominated costs and expenses and of our debt service obligations for foreign currency denominated indebtedness. A depreciation of the ruble relative to the US dollar will also result in foreign exchange losses as the ruble value of our foreign currency denominated indebtedness is increased. We believe that the risks associated with our foreign currency exposure are mitigated by the fact that a significant portion of our revenues are US dollar denominated and thus more closely match our foreign currency costs and debt service obligations. Furthermore, accounts receivable of RR 22,130 million at December 31, 2009 were also US dollar based and serve to mitigate our exposure to foreign currency fluctuations. As of December 31, 2009, the ruble had depreciated against the US dollar by approximately 2.9% since December 31, 2008. We recognized a net foreign currency translation loss of RR 920 million in 2009.

### Commodity instruments

Substantially all of our crude oil and refined products are sold under short-term contracts and on the sport market at market sensitive prices. Market prices for export sales of crude oil and refined products are subject to volatile trading patterns in the commodity futures market. Average selling prices can differ from quoted market prices due to the effects of uneven volume distributions during the period, quality differentials, different delivery terms compared to quoted benchmarks, different conditions in local markets and other factors. Domestic prices generally follow the trend of world market prices but are volatile due to the nature of the Russian market. We do not use any derivative instruments to hedge our crude oil or refined products sales in order to decrease our price risk exposure.

## Critical accounting policies

The preparation of consolidated financial statements in conformity with US GAAP requires management to select appropriate accounting policies and to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and the disclosure of contingent assets and liabilities. For a full description of our significant accounting policies, please refer to Note 3 of our audited consolidated financial statements.

### Forward-looking statements

Certain statements in this document are not historical facts and are ''forward-looking'' (as such term is defined in the US Private Securities Litigation Reform Act of 1995). 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:

- projections of revenues, income (or loss), earnings (or loss) per share, dividends, capital structure or other financial items or ratios;
- 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.

Words such as ''believes,'' ''anticipates,'' ''expects,'' ''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. We caution readers 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 effect of, and changes in, Russian or Tatarstan government policy;
- the effect of terrorist attack or other geopolitical instability, either within Russia or elsewhere;
- 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 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 to make decisions with respect to our shares, American Depositary Shares (ADSs) or other securities, investors and others should carefully consider the foregoing factors and other uncertainties and events, especially in light of the difficult political, economic, social and legal environment in which we operate. Such forward-looking statements speak only at the date on which they are made, and 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.