

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

You should read the following management's discussion in conjunction with our unaudited consolidated interim condensed financial information as of and for the three months ended March 31, 2006. The interim condensed financial information has been prepared in accordance with International Accounting Standard 34 "Interim financial reporting" ("IAS 34"). This financial information should be read together with the consolidated financial statements for the year ended December 31, 2005 prepared in accordance with International Financial Reporting Standards ("IFRS").

OVERVIEW

We are the world's largest natural gas company, and the world's largest publicly-traded hydrocarbons company, in terms of reserves, transportation and production volumes. Our revenues are primarily derived from sales of natural gas to western and central Europe, Russia and other former Soviet Union countries.

We divide our operations into the following five main business segments:

- Production of gas – exploration and production of gas;
- Transport – transportation of gas;
- Distribution – domestic and export sale of gas;
- Production of crude oil and gas condensate – exploration of oil and gas condensate, sales of crude oil and gas condensate;
- Refining – processing of oil, gas condensate and other hydrocarbons, and sales of refined products.

Other activities primarily comprise banking, construction and media.

Our five main business segments are mutually dependent, with a significant portion of the revenues of one segment comprising a part of the costs of another segment. In particular, our Distribution segment purchases natural gas from our Production of gas segment and transportation services from our Transport segment. Our Refining segment purchases crude oil and gas condensate from the Production of crude oil and gas condensate segment. We establish internal transfer prices with reference to the specific funding requirements of the individual subsidiaries within each segment. Accordingly, the results of operations of these segments on a stand-alone basis do not necessarily represent each segment's underlying financial position and results of operations as if it were a stand-alone business. For this reason, we do not analyze any of our main segments separately in the discussion that follows.

RESULTS OF OPERATIONS

(RR million)	Three months ended March 31	
	2006	2005
Sales (net of excise tax, VAT and customs duties)	585,777	339,181
Operating expenses	(355,267)	(220,414)
Operating profit	230,510	118,767
Finance income	36,569	14,969
Finance expense	(18,552)	(14,252)
Share of net income of associated undertakings and jointly controlled entities	5,988	4,214
Gains on disposal of available-for-sale financial assets	1,215	815
Profit before profit tax	255,730	124,513
Current profit tax expense	(62,788)	(28,568)
Deferred profit tax expense	(2,043)	(3,548)
Total profit tax expense	(64,831)	(32,116)
Profit for the period	190,899	92,397
Attributable to:		
Equity holders of OAO Gazprom	185,157	91,628
Minority interest	5,742	769

Sales

The following table sets out our volumes and realized prices for the three months ended March 31, 2006 and 2005.

	Three months ended March 31	
	2006	2005
(RR million unless indicated otherwise)		
<i>Sales of gas</i>		
<i>Europe</i>		
Gross sales ⁽¹⁾	315,257	208,022
Excise tax	(481)	-
Customs duties	(86,436)	(55,450)
Net sales	228,340	152,572
Volumes in billion cubic meters (bcm)	45.6	43.9
Average price, U.S.\$ per mcm ⁽²⁾ (including excise tax and customs duties) ⁽³⁾	242.5	170.3
Gross average price, RR per mcm ⁽²⁾ (including excise tax and customs duties)	6,906.8	4,739.6
<i>FSU</i>		
Gross sales (net of value added tax (VAT))	72,722	29,233
Excise tax	-	(88)
Customs duties	(11,486)	(4,963)
Net sales	61,236	24,182
Volumes in bcm	28.8	19.2
Average price, U.S.\$ per mcm ⁽²⁾ (including excise tax and customs duties, net of VAT) ⁽³⁾	88.8	54.6
Gross average price, RR per mcm ⁽²⁾ (including excise tax and customs duties, net of VAT)	2,528.1	1,520.2
<i>Russia</i>		
Gross sales (net of VAT)	124,909	106,520
Excise tax	(845)	(1,124)
Net sales	124,064	105,396
Volumes in bcm	111.5	106.2
Gross average price, RR per mcm ⁽²⁾ (including excise tax, net of VAT)	1,120.7	1,003.1
<i>Total sales of gas</i>		
Gross sales (net of VAT)	512,888	343,775
Excise tax	(1,326)	(1,212)
Customs duties	(97,922)	(60,413)
Net sales	413,640	282,150
Volumes in bcm	185.9	169.3
Net sales of refined products (net of excise tax, VAT and customs duties)	98,623	33,825
Net sales of crude oil and gas condensate (net of excise tax, VAT and customs duties)	45,121	2,207
Gas transportation sales (net of VAT)	8,905	6,601
Other revenues (net of VAT)	19,488	<u>14,398</u>
Total sales (net of excise tax, VAT and customs duties)	585,777	339,181

Notes:

⁽¹⁾ VAT is not charged on sales to Europe.

⁽²⁾ One mcm is equivalent to 35,316 cubic feet.

⁽³⁾ Calculated on the basis of average rate.

Total sales (net of excise tax, VAT and customs duties) increased by RR246,596 million, or 73%, to RR585,777 million in the three months ended March 31, 2006 compared to the three months ended March 31, 2005.

Net sales of gas accounted for 71% of total net sales in the three months ended March 31, 2006 (83% in the three months ended March 31, 2005). The changes in sales structure were caused by increase in sales of crude oil and refined products subsequent to acquisition of a controlling interest in October 2005 in OAO Siberian Oil Company (OAO Sibneft), renamed to OAO Gazprom neft effective from June 2006.

Net sales of gas increased from RR282,150 million in the three months, ended March 31, 2005 to RR413,640 million in the three months, ended March 31, 2006, or by 47%.

Net sales of natural gas to Europe increased in the three months, ended March 31, 2006 compared to the three months ended March 31, 2005 by RR75,768 million, or 50%. This increase resulted primarily from a 42% increase in gross average realized U.S. dollar export gas prices, as well as a 4% increase in sales volumes. The increase in export gas prices was caused by increase in world prices for hydrocarbons, that are used as price-determinants in gas supply contracts. The increase in sales volumes was primarily due to increased volumes sold to customers in United Kingdom, Germany and Turkey.

Net sales of natural gas to FSU countries increased in the three months, ended March 31, 2006 compared to the three months ended March 31, 2005 by RR37,054 million, or 153%, to RR61,236 million. This increase was due to a 69% increase in prices in RR terms (net of excise tax, customs duties and VAT) and a 50%, or 10.0 bcm, increase in sales volumes. The increase in prices in RR terms was primarily due to the increase in sales prices to Ukraine.

Net sales of natural gas in the domestic market increased by RR18,668 million, or 18%, to RR124,064 million in the three months ended March 31, 2006 compared to the three months ended March 31, 2005. This increase was primarily due to the increase in domestic gas tariffs set by the FTS and increase in sales volumes by 5% or 5.3 bcm.

Sales of refined products increased by RR64,798 million, or 192%, to RR98,623 million in the three months ended March 31, 2006 compared to RR33,825 million in the three months ended March 31, 2005. The increase was primarily due to the consolidation of OAO Gazprom neft and its subsidiaries (Gazprom neft) from October 2005. The acquired subsidiary contributed revenue of RR58,415 million, or 59% of the total net sales of refined products for the three months ended March 31, 2006. The growth in the domestic and export prices of refined products also contributed to the increase. Sibur and its affiliated petrochemical companies accounted for 24% and 63% of the total sales of refined products for the three months ended March 31, 2006 and 2005, respectively. Sales of refined products (net of excise tax, VAT and customs duties) accounted for 17% and 10% of our total sales (net of excise tax, VAT and customs duties) in the three months ended March 31, 2006 and 2005, respectively.

Subsequent to the acquisition of OAO Sibneft in October 2005 the Group's crude oil production significantly increased and became one of its principal activities. Sales of crude oil (net of VAT and customs duties), included in sales of crude oil and gas condensate, for the three months, ended March 31, 2006 amounted to RR40,604 million.

Gas transportation sales increased by RR2,304 million, or 35%, to RR8,905 million in three months ended March 31, 2006 from RR6,601 million in three months ended March 31, 2005. This increase was primarily due to an increase in volumes of gas transported for RosUkrEnergo AG and an increase in prices.

Other revenues increased by RR5,090 million, or 35%, to RR19,488 million in the three months ended March 31, 2006 compared to RR14,398 million in the three months ended March 31, 2005. Other revenues represent activities including media, construction works and sales of other services and goods.

Operating expenses

Operating expenses increased by 61% in the three months ended March 31, 2006 to RR355,267 million from RR220,414 million in the three months ended March 31, 2005. Operating expenses as a percentage of sales decreased from 65% in the three months, ended March 31, 2005 to 61% in the three months, ended March 31, 2006. The table below presents a breakdown of operating expenses in each period:

	Three months ended March 31	
	2006	2005
(RR million)		
Purchased oil and gas	59,895	19,791
Taxes other than on income	53,891	27,697
Staff costs	49,288	38,606
Depreciation	46,487	35,188
Transit of gas, oil and refined products	42,447	28,117
Materials	17,247	14,657
Repairs and maintenance	17,129	12,065

(RR million)	Three months ended March 31	
	2006	2005
Cost of goods for resale, including refined products	14,663	3,367
Electricity and heating expenses	12,065	8,905
Charge for impairment provisions	5,450	1,509
Social expenses	4,569	3,292
Other	<u>32,136</u>	<u>27,220</u>
	355,267	220,414

Purchased oil and gas

Cost of purchased oil and gas increased by 203% to RR59,895 million in the three months ended March 31, 2006 from RR19,791 million in the three months ended March 31, 2005. The increase primarily relates to the increase in gas purchases in Middle Asia for further reselling to RosUkrEnergo AG. The consolidation of Gazprom neft increased the cost of oil purchases by RR15,482 million in the three months ended March 31, 2006.

Taxes other than on income

Taxes other than on income consist of:

(RR million)	Three months ended March 31	
	2006	2005
Natural resources production tax	43,799	22,731
Property tax	5,333	3,730
Other taxes	4,759	1,236
Taxes other than on income	53,891	27,697

Natural resources production tax increased by 93% to RR43,799 million in the three months ended March 31, 2006 from RR22,731 million in the three months ended March 31, 2005 due to Gazprom neft consolidation of RR18,152 million and due to the change in tax legislation. From January 1, 2006, the natural resources production tax rate for natural gas increased from RR135 per mcm to RR147 per mcm. The increase in property tax can be explained by the increase of the tax base due to the revaluation of fixed assets for statutory reporting purposes, which we performed as of January 1, 2006 (except for the revaluation of trunk pipelines, which are exempted from the property tax base).

Staff costs

Staff costs increased by 28% to RR49,288 million in the three months ended March 31, 2006 from RR38,606 million in the three months ended March 31, 2005. The increase primarily resulted from an increase in average base salaries by 10% effective from April 1, 2005 and October 1, 2005. Staff costs, related to Gazprom neft, amounted to RR3,175 million in the three months ended March 31, 2006.

Depreciation

Depreciation increased by 32% to RR46,487 million in the three months ended March 31, 2006 from RR35,188 million in the three months, ended March 31, 2005. The increase primarily resulted from our growing fixed assets base and consolidation of Gazprom neft, that stands for RR7,364 million of the increase.

Transit of gas, oil and refined products

Transit of gas, oil and refined products increased by 51% to RR42,447 million in the three months ended March 31, 2006 from RR28,117 million in the three months ended March 31, 2005. The increase is explained by the increase in oil and refined products transit costs by RR9,593 million due to Gazprom neft consolidation and increase in gas transportation volumes and tariffs.

Materials

Cost of materials increased by 18% to RR17,247 million in the three months ended March 31, 2006 from RR14,657 million in the three months ended March 31, 2005. The increase was primarily related to increased volumes of purchases by the Transport and Refining segments and higher prices of materials.

Repairs and maintenance

Cost of repairs and maintenance increased by 42% to RR17,129 million in the three months ended March 31, 2006 from RR12,065 million in the three months ended March 31, 2005. The increase was primarily due to an increase in the volume of repairs and maintenance services rendered by third-party providers mainly in the Transport segment.

Cost of goods for resale, including refined products

Cost of goods for resale, including refined products increased by 335% to RR14,663 million in the three months ended March 31, 2006 from RR3,367 million in the three months ended March 31, 2005. The increase was primarily due to Gazprom neft consolidation, that represented RR11,149 million of the increase.

Other operating expenses

Other expenses increased by 18% to RR32,136 million in the three months ended March 31, 2006 from RR27,220 million in the three months ended March 31, 2005. Other expenses include bank charges, security services, legal and consulting services and advertising. The increase in these expenses was primarily caused by the increase in our overall business activities.

Operating profit

As a result of the factors discussed above, our operating profit increased by RR111,743 million, or 94%, from RR118,767 million in the three months ended March 31, 2005 to RR230,510 million in the three months ended March 31, 2006. Our operating profit margin increased from 35% in the three months ended March 31, 2005 to 39% in the three months ended March 31, 2006.

Finance income and expense

(RR million)	Three months ended March 31	
	2006	2005
Exchange gain	28,673	9,778
Exchange loss	(6,289)	(7,680)
Interest income	7,840	4,383
Interest expense	(12,263)	(6,572)
Gains on and extinguishment of restructured liabilities	56	808
Net finance income	18,017	717

Exchange gain increased by 193% to RR28,673 million in the three months ended March 31, 2006, compared to RR9,778 million in the three months ended March 31, 2005. Exchange loss decreased by 18% to RR6,289 million in the three months ended March 31, 2006 from RR7,680 million in the three months ended March 31, 2005. The change reflects the impact of the 3.5% appreciation of the RR against the U.S. dollar (in which a major part of our borrowings is denominated) and the 2.1% appreciation of the RR against the euro in the three months ended March 31, 2006 compared to the 0.3% depreciation of the RR against the U.S. dollar and the 4.7% appreciation of the RR against euro in the three months ended March 31, 2005.

Interest income increased by 79% to RR7,840 million in the three months ended March 31, 2006 from RR4,383 million in the three months ended March 31, 2005 mainly due to an increase in our deposits held in external banks and bank current accounts. Interest expense increased by 87% from RR6,572 million in the three months ended March 31, 2005 to RR12,263 million in the three months ended March 31, 2006 due to increased borrowings.

Share of net income of associated undertakings and jointly controlled entities

Share of net income of associated undertakings and jointly controlled entities increased by RR1,774 million to RR5,988 million in the three months ended March 31, 2006 compared to RR4,214 million in the three months ended

March 31, 2005. The increase was due to share in net profit of OAO NGK Slavneft which became an associate with acquisition of OAO Sibneft in 2005 which was partially offset by the group's share in net loss of RosUkrEnergo.

Profit tax

Total profit tax expense increased by RR32,715 million, or 102%, to RR64,831 million in the three months ended March 31, 2006 compared to RR32,116 million in the three months ended March 31, 2005 primarily due to increased profit before tax.

Our overall effective profit tax rate in the three months ended March 31, 2006 compared to the three months ended March 31, 2005 decreased from 26% to 25%.

Profit for the period attributable to equity holders of OAO Gazprom

As a result of the factors discussed above, our profit for the period attributable to equity holders of OAO Gazprom increased by RR93,529 million, or 102%, from RR91,628 million in the three months ended March 31, 2005 to RR185,157 million in the three months ended March 31, 2006.

Profit for the period attributable to minority interest

Minority interest increased by 647% to RR5,742 million in the three months ended March 31, 2006 compared to RR769 million in the three months ended March 31, 2005. The increase was primarily due to consolidation of earnings of OAO Gazprom neft, as a result of acquisition of the 75.68% interest in OAO Sibneft in 2005.

LIQUIDITY AND CAPITAL RESOURCES

The following table summarizes our statements of cash flows for the three months ended March 31, 2006 and 2005:

(RR million)	Three months ended March 31	
	2006	2005
Net cash provided by operating activities	194,310	129,075
Net cash used for investing activities	(56,038)	(53,681)
Net cash used for financing activities	(109,143)	(16,443)

Net cash provided by operating activities

Net cash provided by operating activities amounted to RR194,310 million in the three months ended March 31, 2006 compared to RR129,075 million in the three months ended March 31, 2005. This was primarily due to higher sales and operating profit, which rose mainly due to the upward trend in gas prices, partially offset by an increase in operating expenses and profit tax.

Net cash used for investing activities

Net cash used for investing activities amounted to RR56,038 million in the three months ended March 31, 2006 compared to RR53,681 million in the three months ended March 31, 2005 as investing activities remained consistent from year to year.

Net cash used for financing activities

Net cash used for financing activities amounted to RR109,143 million in the three months ended March 31, 2006 compared to RR16,443 million in the the three months ended March 31, 2005. This increase was primarily due to early repayment of a portion of the loan from Dresdner Bank AG, that was received to finance purchase of OAO Sibneft and higher repayments of borrowings.

CAPITAL EXPENDITURES

Total capital expenditures (including cash advances to contractors and suppliers, which are recorded within long-term accounts receivable and prepayments, and excluding the effect of acquisitions of subsidiaries and reclassifications) by segment for the three months ended March 31, 2006 and 2005 in nominal RR terms, amounted to the following:

	Three months ended March 31	
	2006	2005
(RR million)		

Transport	29,263	20,087
Production of gas	16,225	15,879
Production of crude oil and gas condensate	9,301	1,740
Distribution	2,856	885
Refining	2,171	2,447
Other ⁽¹⁾	2,028	3,013
Total	61,844	44,051

Note:

- (1) Primarily includes expenditures for service activities such as drilling, transportation services (other than transportation of gas, oil and refined products) and repair.

Total capital expenditures (including cash advances to contractors and suppliers, which are recorded within other long-term accounts receivable and prepayments, and excluding the effect of acquisitions of subsidiaries and reclassifications) increased by RR17,793 million, or 40%, from RR44,051 million in the three months ended March 31, 2005 to RR61,844 million in the three months ended March 31, 2006. The increase of our capital expenditures in the Transport segment was primarily due to increased capital expenditure on the construction of major transportation projects, including the pipeline from the northern region of the Tyumen Oblast to Torzhok, North-European gas pipeline and the gas transportation system in the Urengoy region. Capital expenditures in the production of crude oil and gas condensate segment have increased as a result of Gazprom neft consolidation.

DEBT OBLIGATIONS

Our net debt balance (defined as the sum of short-term borrowings, current portion of long-term borrowings, short-term promissory notes payable, long-term borrowings, long-term promissory notes payable and restructured tax liabilities, net of cash and cash equivalents and balances of cash and cash equivalents restricted as to withdrawal under the terms of certain borrowings and other contractual obligations) decreased by RR130,069 million, or 16%, from RR797,465 million as of December 31, 2005 to RR667,396 million as of March 31, 2006.