



**ROSNEFT**

O I L C O M P A N Y

OPEN JOINT STOCK COMPANY

**Management's Discussion and Analysis of Financial Position and Results of Operations  
for the years ended December 31, 2006, 2005 and 2004**

*The following discussion of Rosneft's financial condition and results of operations are based on, and should be read in conjunction with, the Company's financial statements and the notes thereto for the periods ended 31 December 2004, 2005 and 2006 (the "**Financial Statements**"). Such terms as "Rosneft", "Company", "Group" and "we" in its different forms in this report mean OJSC Rosneft and its consolidated subsidiaries and affiliated companies. This report presents Rosneft's financial condition and results of operations on a consolidated basis. This report contains forward-looking statements that involve risks and uncertainties. Rosneft's actual results may differ materially from those discussed in such forward-looking statements as a result of various factors.*

## Overview

Rosneft is a vertically integrated oil and gas company with upstream and downstream operations located principally in Russia. Rosneft believes it is one of the world's largest publicly traded oil companies in terms of proved crude oil reserves and among the top ten in terms of crude oil production. According to DeGolyer and MacNaughton (“**D&M**”), Rosneft's independent reservoir engineers, as of 31 December 2006, under SPE classification, Rosneft had proved reserves of 20.09 billion boe, including proved crude oil reserves of approximately 15.96 billion barrels (2.20 billion tonnes) and proved gas reserves of approximately 701.07 bcm. Also according to D&M, as of 31 December 2006, Rosneft had proved and probable crude oil reserves of approximately 24.72 billion barrels (3.40 billion tonnes) and proved and probable gas reserves of approximately 1,133.86 bcm. Rosneft's reserves are located in Western Siberia, Timano-Pechora, the Russian Far East, Southern Russia and Eastern Siberia. Rosneft also has significant prospective crude oil resources in Western Siberia, the Russian Far East, which includes Sakhalin Island and the Kamchatka Peninsula, Southern Russia and Eastern Siberia. Rosneft has recently agreed to purchase additional reserves as a result of the auction for the sale of certain exploration and production assets of OJSC Yukos (“**Yukos**”) won by the Group in May 2007. See “—Significant Acquisitions—2007—Acquisition of Assets in Yukos Auctions—Eastern Siberia Assets”.

In 2006, Rosneft and its fully consolidated subsidiaries and proportionately consolidated joint venture produced 1,578.94 thousand barrels of crude oil per day (78.8 million tonnes in the year). Rosneft sold approximately 70% of this crude oil to customers outside Russia, comprising both sales to CIS countries and exports to international markets other than the CIS. Most of the remainder was refined at Rosneft's two main refineries and at third party refineries in Russia and then sold in the form of petroleum products in international and domestic markets. Rosneft has recently agreed to purchase certain third party refineries as a result of the auction for the sale of certain refining assets of Yukos won by the Group in May 2007. In addition, Rosneft is planning to make a bid in the auction for the sale of certain refining assets of Yukos in the Samara region. See “—Significant Acquisitions—2007—Acquisition of Assets in Yukos Auctions—Eastern Siberia Assets”. Rosneft has an integrated production, transportation, refining and marketing strategy and seeks to maximise netbacks by optimising its product mix and available transport routes.

Rosneft's total revenues increased to USD 33,099 million in 2006 from USD 23,863 million in 2005 and USD 5,262 million in 2004. Rosneft's net income was USD 3,533 million in 2006, USD 4,159 million in 2005 and USD 837 million in 2004.

Rosneft's total revenues have grown both organically (in part due to increases in hydrocarbon prices) and by acquisition. The most significant acquisition during the periods under review was the December 2004 purchase of Baikalfinancegroup, which had won an auction for the sale of 76.79% of the shares (100% of the common shares) of OJSC Yuganskneftegaz (“**Yuganskneftegaz**”), the second largest oil production enterprise in Russia at that time. As of 31 December 2006, Yuganskneftegaz accounted for approximately 71.2% of Rosneft's proved crude oil reserves. It accounted for approximately 70.0% of Rosneft's crude oil production in 2005 and 71.1% in 2006. The acquisition of Yuganskneftegaz contributed significantly to the increases in Rosneft's total revenues and net income from 2005. The increase in Rosneft's total revenues in 2006 was due mainly to organic growth.

## **Business Segments and Intersegment Sales**

The Company operates primarily in the Russian Federation. As geographical regions of the Russian Federation have similar economic and legal characteristics, the Company does not present geographic segments separately. The Company also carries out projects outside Russia, including projects in Kazakhstan, Turkmenistan and Algeria. These projects are at early stages and have had little to no impact to date on the financial condition or results of operations of the Company.

### ***Business Segments***

The activities of Rosneft are divided into two main business segments:

1. *Exploration and production (“upstream”)*. Geological exploration and development of fields, and crude oil and gas production; and
2. *Refining, marketing and distribution (“downstream”)*. Refining of crude oil, as well as the purchase, transportation, sale and transshipment of crude oil and petroleum products.

Rosneft does not separate its distribution and transportation divisions into a “midstream” segment. These activities are reflected in the “downstream” segment. Other types of activities are incorporated in the “other activities” segment and include banking and financial services and drilling and construction services provided to third parties.

### ***Intersegment Sales and Segment Presentation***

Rosneft’s two main business segments are interconnected: the majority of the revenues of one main segment is included in the expenses of the other main segment. In particular, the holding company, OJSC OC Rosneft, buys crude oil from its producing subsidiaries, part of which it sells in and outside Russia and the remainder of which it delivers to its proprietary or third party refineries in Russia for processing. Petroleum products are then either sold by the holding company through wholesale sales in the international or domestic markets or sold to the Company’s marketing subsidiaries for subsequent wholesale and retail sale in Russia. Following the Share Swap discussed below, OJSC OC Rosneft became the producer and owner of the crude oil previously produced by the subsidiaries that were merged into it.

It is difficult to determine market prices for crude oil in the Russian domestic market, mainly due to the significant intragroup turnover within the vertically integrated oil companies that dominate the market. Moreover, to the extent they exist, crude oil market prices in Russia can be significantly lower than they might otherwise be due to seasonal oversupply and regional imbalances. Prior to the Share Swap in 2006, transaction prices for crude oil between Rosneft companies were established taking into consideration market prices and transportation costs, but were also affected to a considerable degree by the capital investment requirements of different enterprises within the upstream segment. Accordingly, an analysis of individual segments in isolation from the analysis of other activities may present a distorted view of Rosneft’s financial and operating performance. For this reason, the Company’s management does not analyse each main business segment in isolation. The Company does, however, provide financial data by segment in Note 26 to the Financial Statements.

On 1 October 2006, twelve subsidiaries, Yuganskneftegaz, OJSC Purneftegaz, OJSC Selkupneftegaz, OJSC Severnaya Neft, OJSC Krasnodarneftegaz, OJSC Stavropolneftegaz, OJSC Sakhalinmorneftegaz, OJSC Komsomolskiy Refinery, OJSC Tuapsinskiy Refinery, OJSC Arkhangelsknefteprodukt, OJSC Nakhodkanefteprodukt and OJSC Tuapsenefteprodukt (the “**Merged Subsidiaries**”) were merged into the Company by means of a share swap (the “**Share Swap**”). Following the merger, the Company became the legal successor to the rights and obligations of the Merged Subsidiaries to the extent provided by Russian law. The Company leases the assets previously owned by the Merged Subsidiaries to wholly owned subsidiaries of the Company, which are limited liability operating and servicing companies each corresponding to a Merged Subsidiary and which operate these assets under service agreements. Revenues and costs from operations of the seven Merged Subsidiaries previously engaged in exploration and production were and continue to be accounted for under the upstream segment and revenues and costs from operations of the five Merged Subsidiaries previously involved in refining and marketing were and continue to be accounted for under the upstream segment

## ***Significant Acquisitions***

**2007**

### **Acquisition of Assets in Yukos Auctions**

#### ***Treasury stock***

On March 27, 2007 RN-Razvitie LLC, a wholly owned subsidiary of the Company, won the tender for the acquisition of 9.44% of the share capital of Rosneft and promissory notes of Yuganskneftegaz having a face value of RUB 3.558 billion (USD 136 million at the Central Bank of Russia (“**CBR**”) exchange rate in effect as at the date of the auction), from Yukos for a total consideration of RUB 197.84 billion (USD 7.59 billion at the CBR exchange rate in effect as at the date of the auction), or RUB 194.28 for 1 share (USD 7.45 at the CBR exchange rate in effect as at the date of the auction).

#### ***Eastern Siberia Assets***

On 3 May 2007, Neft-Aktiv LLC, a wholly owned subsidiary of the Company, won the auction for the sale of certain assets of Yukos. These assets comprise shares in various exploration and production and refining and marketing companies in Eastern Siberia. Neft-Aktiv LLC purchased these assets for a total consideration of RUB 175.70 billion (USD 6.82 billion at the CBR exchange rate in effect as at the date of the auction).

Rosneft is planning to make a bid in the auction that is expected to take place on 10 May 2007 for the sale of certain refining assets of Yukos in the Samara region.

#### ***Financing of the Acquisitions***

In March 2007, the Company and its wholly owned subsidiary RN-Razvitie LLC entered into loan agreements with a syndicate of international banks. The agreements provide for a USD 9.5 billion loan that has a 6 months term, a USD 6 billion loan that has a 12 months term and a USD 6.5 billion loan that has a 18 months term. These loan agreements bear interest at London inter-bank offered rate (“**LIBOR**”) plus 0.25-0.50% per annum, depending on the final repayment date. These loans were drawn to finance the acquisition of certain Yukos’ assets in the course of auctions for sales of these assets. The total amount drawn down under these loans through May 3, 2007 was USD 11,555 million.

#### ***Truboprovodny Consortium Burgas-Alexandroupolis LLC***

In January 2007, the Company participated in the creation of a joint venture, LLC Truboprovodny Consortium Burgas-Alexandroupolis, with equal equity contributions from the Company, OJSC AK Transneft (“**Transneft**”) and OJSC Gazprom (“**Gazprom**”). This joint venture was registered with a share capital of RUB 9 million (USD 0.4 million at the CBR exchange rate in effect as at the registration date). The joint venture is expected to design, construct and operate oil terminals in Burgas (Bulgaria) and Alexandroupolis (Greece), which will be connected by a long-distance pipeline crossing the Black Sea and the territories of Greece and Bulgaria. Rosneft has no funding commitments in connection with this joint venture.

#### ***OJSC Ohinskaya TETS***

In January 2007, the Company purchased 85.61% of the ordinary shares of OJSC Ohinskaya TETS for RUB 629 million (USD 24 million at the CBR exchange rate in effect as at the transaction date). OJSC Ohinskaya TETS is a combined heat and power station mainly servicing the production activities of RN-Sakhalinmorneftegaz LLC, one of the Company’s exploration and production wholly owned operating and service companies.

#### ***OJSC Verhnechonskneftegaz***

In January 2007, the Company purchased 339,582 newly issued ordinary shares of OJSC Verhnechonskneftegaz, an exploration and production company, for a total consideration of RUB 201 million (USD 8 million at the CBR exchange rate in effect as at the transaction date). As a result, the Company maintained its 25.94% share in this company. The other shareholders of OJSC Verhnechonskneftegaz are TNK-BP with a more than 60% share and Vostochno-Sibirskaya Gazovaya Kompaniya with a more than 10% share.

## **2006**

### ***Exponeft LLC***

In December 2006, the Company purchased 100% of LLC Exponeft for total consideration of RUB 335 million (USD 13 million at the CBR exchange rate in effect as at the transaction date). LLC Exponeft owns a network of filling stations in the Murmansk region.

### ***OJSC Nakhodka Oil Seatrade Port***

In June 2006, the Company purchased 97.51% of the shares of Nakhodka Oil Seatrade Port (“**Nefteport**”) for RUB 528 million (USD 20 million at the CBR exchange rate in effect as at the settlement date). The acquisition created USD 10 million in goodwill, which is attributed to synergies expected to result from the integration of Nefteport with the operations of Rosneft’s subsidiary LLC Nakhodkanefteprodukt.

Nefteport is one of the largest commercial trade seaport on Russia’s Pacific coast located in Novitskiy Bay on the west side of the Nakhodka Gulf. Nefteport has now been integrated into Rosneft’s technological and infrastructural chain for the storage and transshipment of oil products, enabling Rosneft to establish a single self-contained industrial complex in the Nakhodka Gulf, which the Company believes is one of the largest of its kind in Russia.

### ***OJSC Udmurtneft***

On 28 April 2006, Rosneft and China Petrochemical Corporation (“**Sinopec**”) entered into an option agreement granting to Rosneft an option to purchase a controlling interest in OJSC Udmurtneft (“**Udmurtneft**”) if Sinopec were to win the tender for purchasing 96.86% of Udmurtneft’s shares from OJSC TNK-BP (“**TNK-BP**”). In June 2006, TNK-BP announced its decision to sell 96.86% shares of Udmurtneft to Sinopec. Sinopec completed the purchase of Udmurtneft on 10 August 2006. In November 2006, Rosneft and Sinopec created a joint venture, Taihu Limited (“**Taihu**”), of which Rosneft owns 51% through its wholly-owned subsidiary, Rosneft International Ltd, and Sinopec owns 49% through its wholly-owned subsidiary, Sinopec Overseas Oil and Gas Ltd. Taihu purchased 96.86% of Udmurtneft’s shares via a wholly-owned subsidiary in December 2006 from Sinopec. Pursuant to a shareholder agreement entered into between Rosneft and Sinopec in respect of Taihu, key decisions regarding its business shall be subject to unanimous approval by both participants and none of the participants has a preferential voting right. As a result, the Company accounted for this investment using the equity method from December 2006. On 13 November 2006 Bank of China provided a credit facility to Taihu in the amount of USD 3.6 billion for financing the purchase of the 96.86% stake in Udmurtneft and the additional 3.14% shares from minority shareholders. The cash flows of Udmurtneft will be used directly, to repay this financing, without the recourse to the shareholders’ assets.

Udmurtneft is located in the Volga-Ural region. As of 31 December 2006, under SPE classification, it had proved crude oil reserves of 323.92 million barrels (45.87 million tonnes). Udmurtneft has 24 producing fields and, in 2006, it produced 119.65 thousand barrels of crude oil per day.

### ***Change in accounting for Sakhalin-1 PSA***

In February 2001, the Company entered into a sales and purchase agreement with Oil and Natural Gas Corporation (“**ONGC**”) in relation to the Company’s interest in the Sakhalin-1 production sharing agreement (“**PSA**”), which reduced the Company’s interest in the project to 20%. The Company recorded the investment in its retained share under the “carried interest” method. Commercial hydrocarbon production under Sakhalin-1 PSA commenced in October 2005. Accordingly, the Company’s share in Sakhalin-1 hydrocarbon reserves was reclassified as proved developed reserves.

On 31 July 2006, the Company repaid USD 1,339 million (including accumulated interest) to ONGC with respect to the Company’s costs carried by ONGC in previous years. Following this repayment the Company recovered the right to receive its pro rata income in the Sakhalin-1 project and commenced accounting for this investment using the proportionate consolidation method. Of the total amount repaid, USD 1,328 million was recorded as an addition to oil and gas property as of 31 December 2006 and effectively treated as capital expenditures.

## 2005

### *OJSC Verkhnechonskneftegaz*

In the fourth quarter of 2005, the Company purchased 25.94% of the ordinary shares of OJSC Verkhnechonskneftegaz, which holds the licence for the development of the Verkhnechonskoye oil and gas field, which is the largest field in the Irkutsk region. The purchase price was RUB 6,637 million (USD 230 million at the CBR exchange rate in effect as at the transaction date). The Company's interest in OJSC Verkhnechonskneftegaz is accounted for using the equity method.

## 2004

### *Yuganskneftegaz*

On 22 December 2004, Rosneft purchased for nominal consideration a 100% interest in Baikalfinancegroup LLC ("**Baikalfinancegroup**"), which had won an auction for the sale of 76.79% of the shares (100% of the common shares) of Yuganskneftegaz at a price of RUB 260,782 million (USD 9,398 million at the CBR exchange rate in effect as at the settlement date). The auction was conducted on 19 December 2004 by the Russian bailiff service to enforce tax liens against Yukos, which had previously controlled Yuganskneftegaz.

Following Rosneft's acquisition of Baikalfinancegroup, Rosneft made loans to Baikalfinancegroup to enable it to repay the principal of and interest on the debt it had incurred to finance its deposit for the auction, and to purchase and pay for the shares of Yuganskneftegaz it had won in the auction. Baikalfinancegroup purchased and paid for these shares on 31 December 2004.

The sources of the funds Rosneft loaned to Baikalfinancegroup and also used to meet Yuganskneftegaz' immediate working capital requirements included:

- Borrowings characterised as long-term loans in the aggregate amount of USD 6,465 million;
- Short-term borrowings in the aggregate amount of USD 1,442 million; and
- Funds, in the aggregate amount of approximately USD 1,746 million, accumulated from the sale of Rosneft's interests in the Prirazlomnoye and Shtokmanovskoye projects, including USD 1,344 million from the sale of Rosneft's 50% interest in CJSC Sevmorneftegaz described in more detail below under "*—Results of Operations—Other Income/(Expenses)—Gain on disposal of share in CJSC Sevmorneftegaz.*"

The borrowings characterised as long-term loans included USD 6,000 million obtained from Vnesheconombank, initially through the issue of promissory notes by the Company and its subsidiaries in December 2004. The financing was intended to be, and was, put on a long-term basis in January 2005, when OJSC Vnesheconombank ("*Vnesheconombank*") raised funds from two Chinese banks, China Development Bank and the Export-Import Bank of China, and loaned these funds to Rosneft, which used them to repay the promissory notes. The loan from Vnesheconombank is repayable in monthly instalments, with the final instalment being due in 2011. It initially carried interest at a rate of LIBOR plus 3% *per annum*, but in the first quarter of 2006 the interest rate was reduced to LIBOR plus 0.7% *per annum*. Rosneft secured this arrangement by entering into, and pledging its receivables under, a long-term contract for the supply of crude oil to China National United Petroleum Corporation ("**United**") in a total amount of 48.4 million tonnes to be delivered from 2005 through 2010 (4 million tonnes in 2005 and 8.88 million tonnes in each of the five years thereafter) at prices determined on the basis of a formula that takes into account standard international crude oil price indicators and adjusts for quality and other factors. Payments by United under the contract are guaranteed by United's parent company, China National Petroleum Corporation ("**CNPC**"), and China Development Bank and Export-Import Bank of China. The remaining USD 465 million of borrowings characterised as long-term loans came from Sberbank.

The short-term borrowings, obtained mainly from Sberbank and Vnesheconombank, were repaid, or refinanced in 2005 with other loans, including a portion of a 5-year loan raised in July 2005 from a syndicate of foreign banks in the amount of USD 2,000 million and carrying interest at a rate of LIBOR plus 1.8% *per annum*. This loan is repayable in monthly instalments and is secured by contracts for the export of crude oil. The interest rate on this loan was reduced to LIBOR plus 0.65% in April 2006.

The acquisition of Yuganskneftegaz contributed significantly to Rosneft's reserves, production and results of operations. However, it also increased Rosneft's indebtedness considerably and resulted in significant contingencies. These included contingencies relating to, among other things: challenges to the acquisition itself; tax claims against or related to Yuganskneftegaz; guarantee claims against Yuganskneftegaz; loan claims against Yuganskneftegaz; and breaches by Rosneft of covenants in its loan agreements arising from the incurrence of the acquisition indebtedness (subsequently waived by Rosneft's creditors). In addition, if certain shareholders of Yukos or its affiliated parties are successful in obtaining an arbitral award against the Russian Federation, those shareholders may seek to enforce that award against Rosneft. While certain of these contingencies have now been resolved, others remain open. These contingencies, if realised, may expose Rosneft to substantial liability. Rosneft is relatively highly leveraged and must observe certain financial and other restrictive covenants under the terms of its indebtedness, and any failure to comply with such covenants could put Rosneft into default. Following the merger of Yuganskneftegaz into Rosneft pursuant to the Share Swap, completed on 1 October 2006, certain of the claims against Yuganskneftegaz may have become claims against Rosneft. See “—Development of the Group—Consolidation via Share Swap”.

## **Development of the Group**

### **Stakes in Subsidiaries**

#### **2006**

##### ***OJSC Tuapsenefteprodukt***

In January 2006, Rosneft purchased 39.26% of the common shares (30.24% of the share capital) in OJSC Rosneft-Tuapsenefteprodukt, a company providing transshipment services for crude oil and petroleum products, increasing its stake in the common shares from 50.67% to 89.93% and in the total share capital from 38.00% to 68.24%. The purchase price was RUB 2,835 million (USD 100 million at the CBR exchange rate in effect as at the settlement date). The acquisition resulted in USD 34 million of goodwill, attributed to estimated benefits arising from obtaining over 75% of voting shares in this company.

##### ***OJSC Daltransgaz***

In February 2006, the Company purchased its 25% *pro rata* share of an additional issue of shares in OJSC Daltransgaz, a company operating an independent pipeline system, for RUB 722 million (USD 26 million at the CBR exchange rate in effect as at the settlement date), thus maintaining its share at 25% plus one share.

In August 2006, the Company purchased its 25% *pro rata* share of an additional issue of shares by OJSC Daltransgaz for RUB 525 million (USD 19 million at the CBR exchange rate in effect as at the settlement date), thus maintaining its stake at 25% plus one share.

##### ***OJSC Vserossiysky Bank Razvitiya Regionov***

In July 2006, the Company won an auction for the purchase of 25.49% of the common shares in OJSC Vserossiysky Bank Razvitiya Regionov (“**VBRR**”), a Russian full service bank making corporate loans to third parties, thereby increasing its stake in the common shares of VBRR from 50.98% to 76.47%. The purchase price was RUB 333 million (USD 12 million at the CBR exchange rate in effect as at the settlement date).

In September 2006, the shareholders of VBRR approved an additional share issue of 223,500 shares (RUB 10,000 per share at par value), all of which will be purchased by the Company. The total par value of the shares to be purchased is USD 85 million at the CBR exchange rate in effect as at 31 December 2006. As a result, the Company's ownership interest in VBRR will be increased to 94.00%. This additional share issue is planned to take place later in 2007.

#### **2005**

##### ***OJSC Krasnodarneftegaz***

In the first half of 2005, the Company purchased 38.66% of the common shares and 61.63% of the preferred shares in OJSC Rosneft-Krasnodarneftegaz, an exploration and production company, increasing its stake in the common shares from 58.97% to 97.91% and in the total share capital from 50.78% to 95.46%.

The purchase price was RUB 2,971 million (USD 110 million at the CBR exchange rate in effect as at the settlement date).

#### ***OJSC Selkupneftegaz***

In July 2005, the Company purchased 34% of the shares of OJSC Selkupneftegaz, an exploration and production company, increasing its stake from 66.00% to 100.00%. The purchase price was RUB 573 million (USD 20 million at the CBR exchange rate in effect as at the settlement date).

#### **2004**

##### ***Eniseyneft LLC***

In the first half of 2004, the Company purchased 100% of Losiem Commercial for RUB 2,003 million (USD 69 million at the CBR exchange rate in effect as at the settlement date). Losiem Commercial held a 40.00% minority interest in Eniseyneft LLC, an exploration and production company. The purpose of the transaction was to increase the Company's stake in Eniseyneft from 59.00% to 99.00%.

##### ***OJSC Tuapsinskiy Refinery***

In December 2004, Rosneft purchased 39.38% of the common shares and 49.79% of the preferred shares in OJSC Rosneft-Tuapsinskiy Refinery, a Russian oil refinery, increasing its stake in the common shares from 52.70% to 92.08% and in the total share capital from 39.53% to 81.51%. The purchase price was RUB 5,106 million (USD 184 million at the CBR exchange rate in effect as at the settlement date).

#### **Corporate Restructuring**

##### ***RN-Burenie LLC***

In March 2006, the Company created LLC RN-Burenie (“**RN-Burenie**”) following the Board of Directors' decision to optimise the Company's service arrangements. During the second quarter of 2006, drilling and other supporting assets were transferred from upstream subsidiaries to RN-Burenie. In the third quarter of 2006, the drilling divisions of the Company, namely LLC PNG-Burenie, LLC KNG-Burenie and LLC KNG-Sibir, were merged into LLC RN-Burenie.

#### **Consolidation via Share Swap**

Until the autumn of 2006, the Merged Subsidiaries had significant minority interests. See “Results of Operations—Minority Interest in Subsidiaries' Earnings.” On 1 October 2006, the Company exchanged 1,220,939,458 newly issued ordinary shares (11.52% of the Company's share capital) for shares of the Merged Subsidiaries held by third parties at specified exchange ratios and as approved by the respective shareholders. These subsidiaries were then merged into the Company. This Share Swap has been accounted for as a purchase. The fair value of purchase consideration, that is Rosneft shares, issued for the Share Swap, was determined based on the market value of the shares as of the date nearest to the date of all the terms of the deal were agreed to and amounted to US\$ 9,218 million. The excess of the fair value of the shares issued over the fair value of minority interests purchased in the amount of US\$ 69 million has been reflected as goodwill and relates to the refining and marketing segment. The Company attributes this goodwill to the synergy effects from the merger. The majority of the purchase price was allocated to oil and gas properties, property, plant and equipment and mineral rights. Where the fair value of the net assets purchased exceeded the purchase price, negative goodwill existed which has reduced, on a pro rata basis, amounts assigned to the long-term assets purchased.

As a result of the merger following the Share Swap, all licences for the development and production of hydrocarbons previously held by the Merged Subsidiaries operating in the exploration and production segment were transferred to the Company.

#### **Licences Won at Auctions**

The Company won a number of licences at auctions for blocks that have are not yet developed.

#### **2006**

##### ***Tukolandskiy, Vadinskiy and Pendomayakhskiy blocks***

In February 2006, the Company won auctions for licences for exploration and production in the Tukolandskiy, Vadinskiy and Pendomayakhskiy blocks in the Krasnoyarsk territory. The total cost of the

licences amounted to RUB 5,377 million (USD 199 million at the CBR exchange rate in effect as at the settlement date). These blocks are located in close proximity to the Vankorskoye field, which Rosneft started to develop in 2003. Consequently, they will be able to share certain infrastructure with the Vankorskoye field, thereby reducing development costs should commercial volumes of hydrocarbons be discovered. The licences expire in 2031.

#### ***Vostochno-Sugdinskiy block***

In March 2006, the Company obtained a licence for the exploration and production of crude oil and gas in the Vostochno-Sugdinskiy block as a result of an auction won in December 2005. The total cost of the licence was RUB 7,470 million of which RUB 300 million (USD 10 million at the CBR exchange rate in effect as at the settlement date) was paid in December 2005 in the form of an auction fee and the remaining consideration of RUB 7,170 million (USD 258 million at the CBR exchange rate in effect as at the settlement date) was paid in 2006. The licence expires in 2031.

#### ***Mogdinskiy and Sanarskiy blocks***

In April 2006, the Company won an auction for licences for the exploration and production of crude oil and gas in the Mogdinskiy and Sanarskiy blocks in the Irkutsk region. The total cost of the licences was RUB 2,523 million (USD 94 million at the CBR exchange rate in effect as at the settlement date). These blocks are located in close proximity to the Verkhnechonskoye field, currently under development, allowing for reduced development costs, should commercial volumes of hydrocarbons be discovered, through the share of certain infrastructure with the Verkhnechonskoye field. . The licences expire in 2031.

#### ***Danilovskoye block***

In June 2006, the Company won an auction for the exploration and production of crude oil and gas in the Danilovskoye block in the Irkutsk region. The total cost of the licence was RUB 1,210 million (USD 45 million at the CBR exchange rate in effect as at the settlement date). The licence expires in 2031.

#### ***Severo-Charskiy block***

In July 2006, Rosneft won an auction for the exploration and production of crude oil and gas in the Severo-Charskiy block located at the border of Taimir and Yamalo-Nenetsk autonomous district. The total cost of the licence was RUB 4,730 million (USD 177 million at the CBR exchange rate in effect as at the settlement date). This acquisition brought Rosneft's total number of licences at the Vankorskoye field in Eastern Siberia to 14. The licence expires in 2031.

#### ***Osoveysky block***

In July 2006, the Company won an auction for the exploration and production of crude oil and gas in the Osoveysky block in the Nenetsky autonomous district which is in close proximity to the developed Cherpayskoye, Khasyreiskoye and Nyadeiyuskoye fields in the Nenetsky autonomous district. The total cost of the licence was RUB 2,250 million (USD 84 million at the CBR exchange rate in effect as at the settlement date). The licence expires in 2026.

#### ***Kulindinsky block***

In August 2006, the Company won an auction for the exploration and production of crude oil and gas in the Kulindinsky block in the Evenkiysky autonomous district. The total cost of the licence amounted to RUB 1,561 million (USD 59 million at the CBR exchange rate in effect as at the settlement date). The Kulindinsky block is located in the territory of Tungus-Chusky region in the South-Eastern part of Evenkiya. The Company expects to benefit from synergies arising from the development of the Kulindinsky and Sanarsky blocks. The licence expires in 2031.

### **2005**

#### ***Vorgamusurskoe block***

On 19 May 2005, Rosneft won an auction for the exploration and production of the Vorgamusurskoe block in Timano-Pechora. The consideration for the licence was RUB 3,750 million (USD 134 million at the CBR exchange rate in effect as at the settlement date). The licence expires in 2030.

## **Strategic Partnership Agreement with OJSC Gazprom**

In November 2006, Rosneft and Gazprom signed a strategic partnership agreement. The parties intend to participate jointly in tenders and auctions for subsoil use rights and implement joint projects, the terms of which will be defined in separate agreements, involving in particular the creation of gas-processing and petrochemical facilities in Eastern Siberia and the Russian Far East. Both Rosneft and Gazprom will share equally in joint projects involving geological prospecting and development of gas deposits, except projects with third party participation. Pursuant to this agreement, Gazprom and its affiliated companies will purchase from Rosneft and its affiliated companies the excess of its actual production of natural gas at the West Siberian fields connected to the Unified Gas Supply system (the "UGSS"), the national gas pipeline network operated by Gazprom, over the levels of the Company's production in 2006.

The strategic partnership agreement is effective until the end of 2015.

## **Joint venture for the exploration and development Sakhalin-3**

On 26 March 2007, Rosneft and Sinopec entered into a shareholder and operating agreement for the exploration and development of a portion of the Veninsky block on the shelf of Sakhalin Island (Sakhalin-3 project). According to this agreement, a wholly owned subsidiary of the Company, Rosneft International Limited, and a wholly owned subsidiary of Sinopec, Sinopec Overseas Oil and Gas Limited, will hold the shares of Venin Holding Ltd., which was established in October 2006. Venin Holding Ltd. will in turn become the sole shareholder of Venineft LLC, the licence owner and operator of the Sakhalin-3 project. Rosneft will have a 74.9% stake in the project, the remaining 25.1% being held by Sinopec. The transfer of Rosneft's stake in Venineft LLC to Venin Holding Ltd. will be submitted for approval of Rosneft's Board of Directors.

## **Sakhalin-4, 5 - joint projects with British Petroleum ("BP")**

On 21 November 2006, Rosneft and BP entered into two shareholder and operating agreements for the exploration and development of the East Schmidovsky (Sakhalin-5) and West Schmidovsky (Sakhalin-4) blocks. The corporate structures of the two projects are the same. According to the agreements, Rosneft and BP will hold the shares of the incorporated in The Netherlands holding companies: Vostok-Shmidt Neftegaz Holdings B.V. and Zapad-Shmidt Neftegaz Holdings B.V. Rosneft will hold 51% and BP – 49% in these companies. Vostok-Shmidt Neftegaz Holdings B.V. and Zapad-Shmidt Neftegaz Holdings B.V. in turn become the sole shareholders of Russian companies: ZAO Vostok-Shmidt Neftegaz and ZAO Zapad-Shmidt Neftegaz, the license owners and operators of the respective Sakhalin-5 and Sakhalin-4 projects. The transfer of Rosneft's stake in ZAO Zapad-Shmidt Neftegaz and ZAO Vostok-Shmidt Neftegaz to Zapad-Shmidt Neftegaz Holdings B.V. and Vostok Shmidt Neftegaz Holdings B.V. will be submitted for the approval of Rosneft's Board of Directors.

The financing of the project is based on the carry financing principals, where BP has agreed to carry a full portion of Rosneft's financing of these projects on the geological phase.

## **West Kamchatka project**

On 8 December 2006, Rosneft and KKC Korea Kamchatka Co. Limited entered into a shareholder and operating agreement for the exploration and development of a West Kamchatka shelf area. KKC Korea Kamchatka Co. Limited is owned for 50% by Korean National Oil Corporation (KNOC) and for the rest 50% - by the Korean consortium consisting of 6 companies. According to the corporate structure of the project Kamchatneftgaz LLC, the license owner and operator of the West Kamchatka project, for 100% belongs to the holding project company West Kamchatka Holding B.V. incorporated in The Netherlands in 2005. The share participation in West Kamchatka Holding B.V. and in the project is: 60% - Rosneft and 40% - KKC Korea Kamchatka Co. Limited.

The financing of the project is based on the carry financing principals, where the Korean side has agreed to carry a full portion of Rosneft's financing of this project on the geological phase.

## Main Factors Affecting Results of Operations

In addition to the acquisition of Yuganskneftegaz described above under “—Significant Acquisitions—2004—Yuganskneftegaz,” the main factors that have affected Rosneft’s results of operations during the periods being analysed, and that can be expected to affect its results of operations in the future, are:

- Changes in crude oil, petroleum product prices and gas prices;
- RUB/USD exchange rate movements and inflation;
- Changes in mineral production tax and export customs duty; and
- Changes in transport tariffs.

Changes in prices, export customs duty and transport tariffs can have a significant impact on the mix of products and export routes the Company selects, as it seeks to maximise netback prices for the crude oil it produces. The Company’s net income has been negatively affected by a significant growth in export customs duties in 2006.

### Changes in Crude Oil, Petroleum Product Prices and Gas Prices

The prices of crude oil and petroleum products internationally and in Russia have a significant impact on the Company’s results of operations. World prices for crude oil are characterised by significant fluctuations that are determined by the global balance of supply and demand. The crude oil that Rosneft exports through the Transneft pipeline system is blended with oil of other producers that is of a different quality. The resulting Urals blend is traded at a discount to Brent.

Russian domestic market prices for crude oil are difficult to determine, mainly due to the significant intragroup turnover of the vertically integrated oil companies that dominate the market. Moreover, to the extent they exist, crude oil market prices in Russia can be significantly lower than they might otherwise be due to seasonal oversupply and regional imbalances.

The dynamics of petroleum product prices in the international and Russian markets are determined by a number of factors, the most important among them being the level of world prices for crude oil, supply and demand for petroleum products, competition in the different markets and distances from the refineries where the crude oil is refined into usable end products or intermediate products.

The table below sets forth the average crude oil and petroleum products prices worldwide and in Russia for the years indicated.

|                                     | For the year ended<br>31 December |        |        | % change from the years ended<br>31 December |              |
|-------------------------------------|-----------------------------------|--------|--------|--|--------------|
|                                     | 2006                              | 2005   | 2004   | 2005 to 2006                                 | 2004 to 2005 |
| <b>World market</b>                 |                                   |        |        |  |              |
|                                     | <b>(USD per barrel)</b>           |        |        | <b>(%)</b>                                   |              |
| Brent                               | 65.14                             | 54.38  | 38.21  | 19.8%  | 42.3%        |
| Urals (average Med+NWE)             | 61.27                             | 50.47  | 34.27  | 21.4%  | 47.3%        |
| Dubai-Oman (Singapore)              | 62.01                             | 49.88  | 33.97  | 24.3%  | 46.8%        |
|                                     | <b>(USD per tonne)</b>            |        |        | <b>(%)</b>                                   |              |
| Fuel oil 3.5% (average Med)         | 286.00                            | 222.00 | 147.00 | 28.8%  | 51.0%        |
| Gasoil 0.2% (average Med)           | 587.00                            | 508.00 | 356.00 | 15.6%  | 42.7%        |
| Naphtha (average Med)               | 547.00                            | 534.00 | 400.00 | 2.4%   | 33.5%        |
| <b>Russian market<sup>(1)</sup></b> |                                   |        |        |  |              |
|                                     | <b>(USD per tonne)</b>            |        |        | <b>(%)</b>                                   |              |
| Crude oil                           | 254.06                            | 213.15 | 148.94 | 19.2%  | 43.1%        |
| Fuel oil                            | 204.38                            | 145.30 | 84.16  | 40.6%  | 72.6%        |
| Diesel fuel                         | 557.79                            | 495.15 | 333.78 | 12.7%  | 48.3%        |
| High octane gasoline                | 740.10                            | 606.76 | 485.89 | 22.0%  | 24.9%        |
| Low octane gasoline                 | 597.17                            | 494.48 | 400.62 | 20.8%  | 23.4%        |

(1) Including VAT of 18%.

Sources: Platts (world market), Kortes (Russian market).

Rosneft's gas sales have been limited to date, but the Company's strategy anticipates a significant increase in its gas business. Gazprom controls access to the UGSS, and is a monopoly supplier of gas in Russia and the only exporter of gas produced in Russia. Pursuant to the strategic partnership agreement entered into between Rosneft and Gazprom in November 2006, Gazprom and its affiliated companies will purchase from Rosneft and its affiliated companies the excess of its actual production of natural gas at the West Siberian fields connected to the Unified Gas Supply system (the "UGSS"), the national gas pipeline network operated by Gazprom, over the levels of the Company's production in 2006. See "Strategic Partnership Agreement with Gazprom." The Russian government regulates the prices for the gas Gazprom sells in Russia. While the regulated price has been rising in Russia, and is expected to continue to rise to a level closer to parity with export netbacks, it is currently still significantly below the world prices levels. The regulated price has affected, and is likely to continue to affect, the pricing of the gas Rosneft sells to Gazprom from time to time or pursuant to the strategic partnership agreement entered into with Gazprom. Rosneft's average gas sale price was RUB 560 (USD 20.58) per thousand cubic meters, RUB 531 (USD 18.82) per thousand cubic meters and RUB 464 (USD 16.16) per thousand cubic meters in 2006, 2005 and 2004, respectively. These prices were affected by the appreciation of the rouble over the U.S. dollar.

For a discussion of the risks associated with crude oil, gas and petroleum products prices, see "—Quantitative and Qualitative Disclosures About Market risk—Prices for Crude Oil, Gas and Petroleum Products Risk".

### ***RUB/USD Exchange Rate Movements and Inflation***

The rouble – U.S. dollar exchange rate and inflation trends in the Russian Federation affect the Company's results of operations since most of Rosneft's revenues from sales of crude oil and petroleum products are denominated in U.S. dollars, while a substantial portion of its expenses are denominated in Russian roubles. Accordingly, any real appreciation of the rouble versus the U.S. dollar negatively affects Rosneft's margins. The rouble has appreciated against the U.S. dollar in real terms throughout the periods being analysed, and in nominal terms on average as well. Rosneft began to use currency hedging mechanisms in January 2007 in order to mitigate the effects of the fluctuation of the rouble against the U.S. dollar. See "—Quantitative and qualitative disclosures about Market risk—Foreign Currency Risk".

Whether the rouble appreciates or depreciates in real terms is a function of the relationship between movements in the nominal exchange rate and inflation. The table below sets forth information on exchange rate movements and inflation during the periods being analysed.

### ***Inflation and Exchange Rates***

|  | <b>For the year ended<br/>31 December</b> |             |             |
|--|---|-------------|-------------|
|  | <b>2006</b>                               | <b>2005</b> | <b>2004</b> |
| Rouble inflation (CPI) <sup>(1)</sup>  | 9.0%                                      | 10.9%       | 11.7%       |
| Rouble/U.S. dollar exchange rate at the beginning of the period <sup>(1)</sup> | 28.78                                     | 27.75       | 29.45       |
| Rouble/U.S. dollar exchange rate at the end of the period <sup>(1)</sup>       | 26.33                                     | 28.78       | 27.75       |
| Average rouble/U.S. dollar exchange rate during the period <sup>(1)</sup>      | 27.19                                     | 28.29       | 28.81       |
| Nominal appreciation/(depreciation) of the rouble                              | 9.3%                                      | (3.6)%      | 6.1%        |
| Real appreciation/(depreciation) of the rouble, as calculated                  | 19.1%                                     | 6.9%        | 18.5%       |
| Real appreciation/(depreciation) of the rouble <sup>(1)</sup>                  | 16.7%                                     | 3.9%        | 14.0%       |

(1) Source: CBR, State Statistics Committee of Russia.

### ***Changes in Mineral Production Tax and Export Customs Duty***

Mineral production tax and export customs duty accounted for between 27.5% and 52.8% of Rosneft's total revenues during the periods being analysed. The table below sets out the mineral production tax and export customs duty paid by Rosneft during these periods. When volumes of hydrocarbon sales remain unchanged, the mineral production tax and export customs duty reduce to a considerable degree the impact of upward or downward movements in crude oil export prices on the Company's net income from the export of crude oil after a time lag of several months from the change in the hydrocarbon prices.

## Rates of Mineral Production Taxes and Export Customs Duty

|  | For the year ended<br>31 December |        |       | % change from the<br>year ended<br>31 December |                 |
|--|-----------------------------------|--------|-------|--|-----------------|
|  | 2006                              | 2005   | 2004  | 2005 to<br>2006                                | 2004 to<br>2005 |
| <b>Mineral production tax</b>                  |                                   |        |       |  |                 |
| Crude oil (RUB per tonne)                      | 2,282                             | 1,883  | 1,042 | 21.2%  | 80.7%           |
| Gas (RUB per thousand cubic meters)            | 147                               | 135    | 107   | 8.9%   | 26.2%           |
| <b>Export customs duty<br/>(USD per tonne)</b> |                                   |        |       |  |                 |
| Crude oil                                      | 196.86                            | 130.02 | 55.77 | 51.4%  | 133.1%          |
| Light and medium distilled products            | 143.66                            | 91.53  | 39.15 | 57.0%  | 133.8%          |
| Fuel oil                                       | 77.41                             | 52.43  | 37.22 | 47.6%  | 40.9%           |

### Mineral Production Tax

In 2006, the rate of mineral production tax for crude oil increased by 21.2% compared with 2005, primarily due to an increase in Urals crude oil prices by more than 21%. This rate also increased by 80.7% in 2005 primarily due to increases in crude oil prices (by more than 47% in 2005), and an increase in the base rate.

The rate of mineral production tax for crude oil in 2005 and 2006 was calculated by multiplying the base rate per tonne of crude oil produced by the adjustment ratio equal to  $(P - 9) * R_t / 261$ , where “P” is the average Urals price per barrel during the previous month, and “R<sub>t</sub>” is the average rouble/U.S. dollar exchange rate established by the CBR during the previous month. In 2004, the following formula was used to calculate the adjustment ratio:  $(P - 8) * R_t / 252$ . The base rate was RUB 347 in 2004 and RUB 419 in both 2005 and in 2006. The rate of mineral production tax per thousand cubic meters of gas produced was RUB 107 in 2004, RUB 135 in 2005 and RUB 147 in 2006.

Mineral production tax was USD 4.98 per barrel of crude oil produced and USD 3.64 per barrel of oil equivalent produced in 2004, USD 8.81 and USD 7.71, respectively, in 2005, and USD 11.04 and USD 9.70, respectively, in 2006.

On 27 July 2006, the State Duma adopted a law amending the mineral production tax regime. The new legislation took effect on 1 January 2007. The key provisions of the law are:

- Certain mineral production tax-free periods for “greenfield” crude oil projects in the Republic of Sakha (Yakutiya), the Irkutsk region and Krasnoyarsk territory for up to 10 years for new production licences and 15 years for new combined exploration and production licences or up to 25 million tonnes of crude oil per licence during the tax-free period without paying mineral production tax. These mineral production tax-free periods do not apply to the extraction of natural gas; and
- Lower mineral production tax rates for “brownfield” fields that are 80% or more depleted.

This legislation is expected to benefit Rosneft as it has extensive “greenfield” interests in Eastern Siberia.

### Export Customs Duty

As described in the following table, the rate of export customs duty is linked to the average Urals price in the markets of the North-West of Europe and the Mediterranean in U.S. dollars per barrel of extracted crude oil (expressed in U.S. dollars per tonne).

### *Calculation of Export Customs Duty (from June 2004)*

| <u>Urals price</u><br>(USD/tonne)  | <u>Export customs duty</u><br>(USD/tonne)  |
|------------------------------------|--|
| Below 109.5 (15 USD/barrel)        | Export customs duty is not levied  |
| 109.5 to 146 (15 to 20 USD/barrel) | 35% of the difference between the average Urals price in USD per tonne and USD 109.5               |
| 146 to 182.5 (20 to 25 USD/barrel) | USD 12.78 plus 45% of the difference between the average Urals price in USD per tonne and USD 146  |
| Above 182.5 (25 USD/barrel)        | USD 29.2 plus 65% of the difference between the average Urals price in USD per tonne and USD 182.5 |

### *Calculation of Export Customs Duty (before June 2004)*

| <u>Urals price</u><br>(USD/barrel)   | <u>Export customs duty</u><br>(USD/tonne)   |
|--------------------------------------|---|
| Below 109.5 (15 USD/barrel)          | Export customs duty is not levied   |
| 109.5 to 182.5 (15 to 25 USD/barrel) | 35% of the difference between USD 109.5 and the average Urals price in USD per tonne                |
| Above 182.5 (25 USD/barrel)          | USD 25.53 plus 40% of the difference between the average Urals price in USD per tonne and USD 182.5 |

The level of export customs duty for crude oil has increased in line with the rise in oil prices in 2004, 2005 and 2006, from USD 7.51 per barrel of crude oil exported in 2004 to USD 18.22 in 2005 and USD 27.24 in 2006. The Russian government sets the rate of export customs duty every two months based on changes in the average world prices for the Urals crude oil.

Export duties for petroleum products are established by the Russian government depending on rates of crude oil export customs duties. Export duties are not payable on exports of crude oil and petroleum products to the CIS countries that are members of the Customs Union, which are Belarus, Kazakhstan, Kirgiziya and Tadzhikistan. Sales to these countries were USD 1,575 million (42.71 million barrels) in 2006, USD 1,190 million (39.51 million barrels) in 2005 and USD 270 million (12.53 million barrels) in 2004.

As a result of these taxes after a time lag of several months, the net income of businesses that export crude oil and petroleum products from Russia has a reduced sensitivity to changes in crude oil prices. Moreover, the impact of export customs duty on crude oil relative to the impact of excise taxes on petroleum products affects the choice to be made between exporting crude oil and refining it for sale both internationally and in Russia.

### *Changes in Transport Tariffs*

Rosneft transports most of its crude oil through the pipeline networks owned and operated by Transneft. In accordance with Article 4 of the Federal law dated 17 August 1995 No. 147-FZ "On natural monopolies", Transneft is a monopoly provider of crude oil transportation services via proprietary pipeline networks to customers within and outside the Russian Federation. The Russian Federation owns 75% of Transneft's share capital. Transneft charges its customers fees for transportation services in accordance with tariffs set by the Federal Tariffs Service ("FTS"), a governmental body regulating the natural monopolies. The overall expense per tonne for the transport of crude oil depends on the length of the transportation route from the producing field to the ultimate destination and the number of Transneft "districts" through which the crude oil is transported. Rosneft's crude oil tariff per tonne of crude oil transported via Transneft raised by 18% on average in 2006, by 11% on average in 2005 and by 18% on average in 2004.

Rosneft seeks to utilise alternative means of transportation to optimise netbacks, including the Northern route via Rosneft's Belokamenka export transshipment facility, the Nakhodka export transshipment facility for exports to Asia, the Far Eastern route via Rosneft's pipeline Okha-Komsomolsk-on-Amur located on the Sakhalin Island and the Southern route via the Caspian Pipeline Consortium ("CPC") pipeline.

In 2006, Rosneft exported approximately 12% of its petroleum products through the OJSC AK Transnefteprodukt ("Transnefteprodukt") pipeline system. Transnefteprodukt, wholly owned by the Russian

Federation and soon to be transferred to Transneft, is a monopoly provider of petroleum products transportation services via proprietary pipelines networks to customers within and outside the Russian Federation. The overall expense per tonne for the transport of petroleum products depends on the length of the transportation route to the ultimate destination. Petroleum products transported through the Transnefteprodukt pipeline system were produced at refineries owned by Yukos located in the Samara region under processing contracts. Rosneft's petroleum products tariff per tonne of petroleum products transported via Transneftproduct raised by 17% in 2006 compared to 2005. Rosneft did not incur petroleum products transportation expenses prior to 2005 as these expenses were paid by its customers.

Rosneft also depends on railway transportation, which accounted for approximately 33% of its export sales of crude oil in 2006, including crude oil produced by Yuganskneftegaz and Purneftegaz for sale to China, and approximately 22% of its export sales of petroleum products in 2006. The Russian railway system ("RZD") is a state-owned monopoly provider of railway transportation services. Rosneft's railway tariff per tonne of crude oil shipped increased by 23% on average in 2004, but declined by 9% on average in 2005, due to the favourable pricing Rosneft was able to negotiate on the basis of the high volume of crude oil it transports by rail. RZD's tariffs are subject to control by FTS and to antimonopoly regulations. In 2006 RZD has increased its tariffs by approximately 13% for domestic market and export via Russian ports.

## ***Production of Crude Oil, Petroleum Products and Gas***

Rosneft's ability to generate revenues depends on its production of crude oil and petroleum products. In addition, as noted elsewhere, an important part of Rosneft's strategy is to expand its production and sale of gas.

### **Production of Crude Oil**

Rosneft produces crude oil at seven production business units (previously fully consolidated production and development subsidiaries merged into Rosneft on 1 October 2006 as a result of the Share Swap) and four fully consolidated production and development subsidiaries. Rosneft also has a 20% share in the Sakhalin-1 project consolidated into the Group under the proportionate consolidation method starting from 31 July 2006. See "—Significant Acquisitions—Change in accounting for PSA Sakhalin-1 PSA". In addition, Rosneft produces oil at two producing joint ventures, which the Group accounts for using the equity method. Yuganskneftegaz and Purneftegaz in Western Siberia and Severnaya Neft in Timano-Pechora are Rosneft's most important production and development wholly owned operating and servicing companies, collectively accounting for approximately 89.7% of Rosneft's production in 2006 and for approximately 89.6% in 2005. Yuganskneftegaz accounted for approximately 71.1% and 70.0%, Purneftegaz 11.5% and 12.9% and Severnaya Neft 7.1% and 6.7% of Rosneft's production in 2006 and 2005, respectively.

The following table sets forth Rosneft's crude oil production during the periods being analysed:

|  | <b>For the year ended<br/>31 December</b> |             |             | <b>% change from<br/>the year ended<br/>31 December</b> |                         |
|--|---|-------------|-------------|---|-------------------------|
|  | <b>2006</b>                               | <b>2005</b> | <b>2004</b> | <b>2005 to<br/>2006</b>                                 | <b>2004 to<br/>2005</b> |
|  | <b>(millions of barrels)</b>              |             |             | <b>(%)</b>  |                         |
| Crude oil production by fully consolidated subsidiaries <sup>(1)</sup>                           | 576.31                                    | 535.16      | 148.26      | 7.7%  | 261.0%                  |
| Crude oil production, including the share in production of affiliated enterprises <sup>(2)</sup> | 582.70                                    | 540.39      | 153.14      | 7.8%  | 252.9%                  |

(1) Crude oil production by subsidiaries includes Rosneft's share of oil produced under the Sakhalin-1 PSA, starting from August 2006, net of 8.00% royalty of 0.17 million barrels and 2.07% government's share of 0.05 million barrels for the last five months of 2006.

(2) Crude oil production, together with the share in production of affiliates is Crude oil production by fully consolidated subsidiaries, as set forth above, plus 50% share of Rosneft in crude oil produced by Polar Lights and Aday Petroleum joint venture in Kazakhstan and 49% share of Rosneft in crude oil produced by Udmurteft.

In 2006, Rosneft increased its production of crude oil by 7.7%, to 576.31 million barrels compared with 535.16 million barrels in 2005. This growth was largely attributable to increased production by Yuganskneftegaz and Severnaya Neft. Yuganskneftegaz increased its production from 374.60 million barrels in 2005, to 409.61 million barrels in 2006 or by 9.3%, and Severnaya Neft increased its production from 35.66 million barrels in 2005 to 41.04 million barrels in 2006, or by 15.1%.

Commercial production of crude oil and gas started at Sakhalin-1 PSA in October 2005. Rosneft's net share of oil produced under Sakhalin-1 PSA for the five last months of 2006 amounted to 1,96 million barrels.

In 2005, Rosneft increased its production of crude oil by 261.0%, to 535.16 million barrels, mainly as a result of the acquisition of Yuganskneftegaz. Without Yuganskneftegaz, crude oil production increased by approximately 8.3% in 2005, to 160.56 million barrels. This organic growth was largely attributable to the oil fields of Severnaya Neft, where crude oil production grew by 43.2%, to 35.66 million barrels.

Yuganskneftegaz' 2005 crude oil production declined by 1.1% compared to 2004, primarily due to the substantial reduction of capital expenditure during the second half of 2004, while it was still owned by

Yukos. From January to May 2005, Rosneft focused on integrating the production of Yuganskneftegaz into Rosneft's operations, stabilising the production decline that commenced in 2004 mainly associated with a lack of investment, optimising the logistics and improving the profitability of crude oil production by the enterprise. As a result, the Company managed to reverse the production decline during the second quarter of 2005.

Daily crude oil production in 2006 was 1,578.94 thousand barrels as compared with 1,466.19 thousand barrels in 2005. Among the factors contributing to an increase in daily oil production was a raise in average well production rates from 101.7 barrels per day in 2005 to 109.0 barrels per day in 2006, in particular for newly drilled wells from 662.7 to 715.4 barrels per day.

Daily crude oil production in 2005 was 1,466.19 thousand barrels as compared with 405.09 thousand barrels in 2004, primarily resulting from the acquisition of Yuganskneftegaz. Among the factors contributing to an increase in daily oil production was a raise in average well production rates from 54.1 barrels per day in 2004 to 101.7 barrels per day in 2005, in particular for newly drilled wells from 502.5 to 662.7 barrels per day.

### Production of Gas

The table below sets forth Rosneft's gas production during the periods being analyzed:

|   | For the year ended<br>31 December |       |      | % change from<br>the year ended<br>31 December |                 |
|---|-----------------------------------|-------|------|--|-----------------|
|   | 2006                              | 2005  | 2004 | 2005 to<br>2006                                | 2004 to<br>2005 |
|   | (billions cubic meters)           |       |      | (% )   |                 |
| Gas production by subsidiaries <sup>(1)</sup>                                     | 13.56                             | 13.01 | 9.35 | 4.2%   | 39.1%           |
| Gas production, including the share in<br>production of affiliates <sup>(2)</sup> | 13.58                             | 13.03 | 9.36 | 4.2%   | 39.2%           |

(1) Gas production by subsidiaries includes Rosneft's net share of gas produced under Sakhalin-1 PSA starting from August 2006.

(2) Gas production, together with the share in production of affiliates, includes Rosneft's net share of gas produced under Sakhalin-1 PSA starting from August 2006, 50% share of Rosneft in gas produced by Polar Lights and 49% share of Rosneft in gas produced by Udmurtneft.

Gas production increased by 4.2% in 2006, to 13.56 bcm, primarily due to the growth of production in Krasnodarneftegaz, Selkupneftegaz and Purneftegaz. In 2006, the level of associated gas utilisation was 59.0%, compared to 62.5% in 2005, due to the time necessary for the development of additional facilities necessary to accommodate the growing gas production.

The Company has started developing a gas programme to increase the level of associated gas utilisation. This programme envisages the construction of associated gas gathering facilities, booster compression stations and underground gas storage facilities. In addition, the Company plans to improve the gas quality by constructing oil and gas separation equipment and gas treatments facilities.

Pursuant to the strategic partnership agreement entered into with Gazprom in November 2006, it is expected that Rosneft will participate in joint projects with Gazprom involving geological prospecting and development of gas deposits.

Gas production increased by 39.1% in 2005, to 13.01 bcm, taking into account the acquisition of Yuganskneftegaz. Gas production increased by 24.0% without Yuganskneftegaz, primarily due to growth of gas production in the fields of Krasnodarneftegaz, Purneftegaz and Selkupneftegaz. In 2005, the level of associated gas utilisation was 62.5%, compared to 74.7% in 2004. This decrease was due mainly to the low level of utilisation of associated gas in Yuganskneftegaz, which decreased to 47.9%. In 2005, the Company resumed the construction of a gas compressor station at Priobskoye field with the aim of reducing the flaring of associated gas; construction had ceased in the second half of 2004 while Yuganskneftegaz was under prior ownership.

## Production of Petroleum Products

Rosneft refines the crude oil it produces at its two major refineries, Tuapsinskiy Refinery on the Black Sea in the South of Russia and Komsomolskiy Refinery in the Russian Far East. Rosneft also arranges for the crude oil it produces to be processed at refineries owned by third parties. These operations have increased considerably from the beginning of 2005 as a result of acquiring Yuganskneftegaz and routing oil produced by it for processing at refineries within the Yukos group. Rosneft has recently agreed to purchase certain third party refineries as a result of the auction for the sale of certain refining assets of Yukos won by the Group in May 2007. In addition, Rosneft is planning to make a bid in the auction for the sale of certain refining assets of Yukos in the Samara region. See “—Significant Acquisitions—2007—Acquisition of Assets in Yukos Auctions—Eastern Siberia Assets.”

Rosneft also owns the MZ Nefteprodukt refinery in Moscow and mini-refineries in Gubkiy in the Yamalo-Nenetsky autonomous district, in Usinsk in the Komi Republic and in Nalchik in the Kabardino-Balkarskaya Republic.

The following table sets forth Rosneft’s petroleum product production from its crude oil during the periods being analysed:

|  | For the year ended 31 December |              |             | % change from the year ended 31 December |               |
|--|--------------------------------|--------------|-------------|--|---------------|
|  | 2006                           | 2005         | 2004        | 2005 to 2006                             | 2004 to 2005  |
|  | (millions of tonnes)           |              |             | (% )                                     |               |
| Petroleum products output by Tuapsinskiy, Komsomolskiy and mini-refineries | 10.49                          | 10.38        | 6.64        | 1.1%                                     | 56.3%         |
| Petroleum products output by third party refineries                        | 12.17                          | 10.88        | 0.44        | 11.9%                                    | 2,372.7%      |
| <b>Total</b>   | <b>22.66</b>                   | <b>21.26</b> | <b>7.08</b> | <b>6.6%</b>                              | <b>200.3%</b> |

In 2006, the Tuapsinskiy and Komsomolskiy refineries processed 78.04 million barrels of Rosneft-produced crude oil, 2.9% more than in 2005. Depth of refining by Komsomolskiy Refinery increased from 60.1% in 2005 to 60.7% in 2006, and by Tuapsinskiy Refinery from 55.8% in 2005 to 56.4% in 2006, yielding an aggregate of 10.38 million tonnes of petroleum products in 2006. The total output of petroleum products from Rosneft-produced crude oil, including output of mini-refineries and refineries controlled by third parties, increased by 6.6%, from 21.26 million tonnes in 2005 to 22.66 million tonnes in 2006. In 2006, 95.90 million barrels of Rosneft-produced crude oil were refined at third party refineries including Yukos-controlled refineries, yielding approximately 12.17 million tonnes of petroleum products.

In 2005, the Tuapsinskiy and Komsomolskiy refineries processed 75.81 million barrels of Rosneft-produced crude oil, 53.0% more than in 2004. The depth of refining by the Komsomolskiy Refinery increased from 59.6% in 2004 to 60.1% in 2005, and by Tuapsinskiy Refinery from 55.4% in 2004 to 55.8% in 2005, yielding 10.03 million tonnes of petroleum products in 2005. The total output of petroleum products from Rosneft-produced crude oil, including output of refineries owned by third parties, increased by 200.3%, from 7.08 million tonnes in 2004 to 21.26 million tonnes in 2005. In 2005, 85.42 million barrels of Rosneft-produced crude oil were refined at third-party refineries, yielding an aggregate of 10.88 million tonnes of petroleum products. The increase in petroleum product output in 2005 was due mainly to the increased availability of crude oil, arising principally from the acquisition of Yuganskneftegaz.

In addition to refining Rosneft-produced crude oil, the Komsomolskiy and Tuapsinskiy refineries also refine crude oil produced by third parties. Such throughput represented 1.1% of the total throughput of these refineries in 2006, 1.2% in 2005 and 27.5% in 2004.

The majority of the crude oil that Rosneft refined for third parties in 2006 was processed at Komsomolskiy Refinery. Both the Tuapsinskiy Refinery and the Komsomolskiy Refinery have also been operating at near full capacity during the periods being analysed.

## Results of Operations

The following table sets forth statement of income information both as absolute values and as a percentage of total revenues for the indicated periods:

|  | For the year ended 31 December |                 |                     |                 |                     |                 |
|--|--------------------------------|-----------------|---------------------|-----------------|---------------------|-----------------|
|  | 2006                           |                 | 2005                |                 | 2004                |                 |
|  | % of total revenues            |                 | % of total revenues |                 | % of total revenues |                 |
| (USD millions, except %)                                     |                                |                 |                     |                 |                     |                 |
| <b>Revenues</b>  |                                |                 |                     |                 |                     |                 |
| Oil and gas sales  | 23,499                         | 71.00%          | 16,152              | 67.69%          | 2,735               | 51.98%          |
| Petroleum products and processing fees                       | 9,250                          | 27.95%          | 7,374               | 30.90%          | 2,233               | 42.44%          |
| Support services and other revenues                          | 350                            | 1.05%           | 337                 | 1.41%           | 294                 | 5.58%           |
| <b>Total revenues</b>  | <b>33,099</b>                  | <b>100.00%</b>  | <b>23,863</b>       | <b>100.00%</b>  | <b>5,262</b>        | <b>100.00%</b>  |
| <b>Cost and expenses</b>                                     |                                |                 |                     |                 |                     |                 |
| Production and operating expenses                            | 2,197                          | (6.64)%         | 1,623               | (6.80)%         | 595                 | (11.31)%        |
| Cost of purchased oil, petroleum products and refining costs | 1,320                          | (3.99)%         | 637                 | (2.67)%         | 547                 | (10.40)%        |
| Selling, general and administrative expenses                 | 757                            | (2.29)%         | 589                 | (2.47)%         | 257                 | (4.88)%         |
| Pipeline tariffs and transportation costs                    | 3,226                          | (9.75)%         | 2,321               | (9.35)%         | 574                 | (10.91)%        |
| Exploration expenses   | 193                            | (0.58)%         | 164                 | (0.69)%         | 51                  | (0.97)%         |
| Depreciation, depletion and amortisation                     | 1,638                          | (4.95)%         | 1,472               | (6.17)%         | 307                 | (5.83)%         |
| Accretion expense  | 34                             | (0.10)%         | 35                  | (0.15)%         | 8                   | (0.15)%         |
| Taxes other than income tax                                  | 6,990                          | (21.12)%        | 5,326               | (22.32)%        | 1,011               | (19.21)%        |
| Export customs duty  | 11,140                         | (33.66)%        | 6,264               | (26.24)%        | 760                 | (13.42)%        |
| <b>Total cost and expenses</b>                               | <b>27,495</b>                  | <b>(83.08)%</b> | <b>18,341</b>       | <b>(76.86)%</b> | <b>4,056</b>        | <b>(77.08)%</b> |
| <b>Operating income</b>                                      | <b>5,604</b>                   | <b>16.92%</b>   | <b>5,522</b>        | <b>23.14%</b>   | <b>1,206</b>        | <b>22.92%</b>   |
| <b>Other income/(expenses)</b>                               |                                |                 |                     |                 |                     |                 |
| Interest income  | 135                            | 0.41%           | 81                  | 0.34%           | 65                  | 1.24%           |
| Interest expense   | (724)                          | (2.19)%         | (775)               | (3.25)%         | (159)               | (3.02)%         |
| (Loss)/gain on disposal of property, plant and equipment     | (95)                           | (0.29)%         | (74)                | (0.31)%         | 121                 | 2.30%           |
| (Loss)/gain on disposal of investments                       | 3                              | 0.01%           | (13)                | (0.05)%         | (30)                | (0.57)%         |
| Gain on disposal of share in CJSC Sevmorneftegaz             | –                              | –               | 1,303               | 5.46%           | –                   | –               |
| Equity share in affiliates' profits                          | 17                             | 0.05%           | 51                  | 0.21%           | 52                  | 0.99%           |
| Dividends and income from joint ventures                     | 15                             | 0.05%           | 10                  | 0.04%           | 46                  | 0.87%           |
| Other expenses, net  | (320)                          | (0.97)%         | (136)               | (0.57)%         | (196)               | (3.72)%         |
| Foreign exchange (loss)/gain                                 | (470)                          | (1.42)%         | 245                 | 1.03%           | 96                  | 1.81%           |
| <b>Total other income/(expenses)</b>                         | <b>(1,439)</b>                 | <b>(4.35)%</b>  | <b>692</b>          | <b>2.90%</b>    | <b>(5)</b>          | <b>(0.10)%</b>  |
| <b>Income before income tax and minority interest</b>        | <b>4,165</b>                   | <b>12.57%</b>   | <b>6,214</b>        | <b>26.04%</b>   | <b>1,201</b>        | <b>22.82%</b>   |
| Income tax expense   | (540)                          | (1.63)%         | (1,609)             | (6.74)%         | (298)               | (5.66)%         |
| <b>Income before minority interest</b>                       | <b>3,625</b>                   | <b>10.94%</b>   | <b>4,605</b>        | <b>19.30%</b>   | <b>903</b>          | <b>17.16%</b>   |
| Minority interest in subsidiaries' earnings                  | (92)                           | (0.28)%         | (446)               | (1.87)%         | (66)                | (1.25)%         |
| <b>Net income</b>  | <b>3,533</b>                   | <b>10.67%</b>   | <b>4,159</b>        | <b>17.43%</b>   | <b>837</b>          | <b>15.91%</b>   |

## Sales Revenues

The tables below analyses sales of crude oil, petroleum products and processing fees and gas volumes in 2006, 2005 and 2004:

|   | For the year ended 31 December |                    |                |                    |                |                    | % change from the year ended 31 December |               |
|---|--------------------------------|--------------------|----------------|--------------------|----------------|--------------------|--|---------------|
|   | 2006                           |                    | 2005           |                    | 2004           |                    | 2005 to 2006                             | 2004 to 2005  |
|   | (USD millions)                 | % of total revenue | (USD millions) | % of total revenue | (USD millions) | % of total revenue | (%)                                      | (%)           |
| <b>Crude oil</b>                                    |                                |                    |                |                    |                |                    |  |               |
| Export to non-CIS countries                         | 21,468                         | 64.8%              | 13,886         | 58.3%              | 2,102          | 39.9%              | 54.6%                                    | 560.6%        |
| Europe and other directions                         | 16,323                         | 49.3%              | 11,583         | 48.6%              | 1,749          | 33.2%              | 40.9%                                    | 562.3%        |
| Asia  | 5,145                          | 15.5%              | 2,303          | 9.7%               | 353            | 6.7%               | 123.4%                                   | 552.4%        |
| Export to CIS                                       | 1,620                          | 4.9%               | 1,491          | 6.2%               | 411            | 7.8%               | 8.7%                                     | 262.8%        |
| Domestic  | 214                            | 0.6%               | 600            | 2.5%               | 104            | 2.0%               | (64.3)%                                  | 476.9%        |
| <b>Gas</b>  | 197                            | 0.6%               | 175            | 0.7%               | 118            | 2.2%               | 12.6%                                    | 48.3%         |
| <b>Total oil and gas</b>                            | <b>23,499</b>                  | <b>70.9%</b>       | <b>16,152</b>  | <b>67.7%</b>       | <b>2,735</b>   | <b>51.9%</b>       | <b>45.5%</b>                             | <b>490.6%</b> |
| <b>Petroleum products</b>                           |                                |                    |                |                    |                |                    |  |               |
| Export to non-CIS countries                         | 5,093                          | 15.4%              | 4,445          | 18.6%              | 984            | 18.7%              | 14.6%                                    | 351.7%        |
| Europe and other directions                         | 3,152                          | 9.5%               | 2,827          | 11.8%              | 344            | 6.5%               | 11.5%                                    | 721.8%        |
| Asia  | 1,941                          | 5.9%               | 1,618          | 6.8%               | 640            | 12.2%              | 20.0%                                    | 152.8%        |
| Export to CIS                                       | 202                            | 0.6%               | 64             | 0.3%               | 0              | 0.0%               | 215.6%                                   | 100.0%        |
| Domestic  | 3,953                          | 12.0%              | 2,865          | 12.0%              | 1,240          | 23.6%              | 38.0%                                    | 131.0%        |
| Wholesale   | 3,239                          | 9.8%               | 2,369          | 9.9%               | 904            | 17.2%              | 36.7%                                    | 162.1%        |
| Retail  | 714                            | 2.2%               | 496            | 2.1%               | 336            | 6.4%               | 44.0%                                    | 47.6%         |
| <b>Refining services</b>                            | 2                              | 0.0%               | 0              | 0.0%               | 9              | 0.2%               | 100.0%                                   | (100.0)%      |
| <b>Total petroleum products and processing fees</b> | <b>9,250</b>                   | <b>28.0%</b>       | <b>7,374</b>   | <b>30.9%</b>       | <b>2,233</b>   | <b>42.5%</b>       | <b>25.4%</b>                             | <b>230.2%</b> |
| Support services and other revenues                 | 350                            | 1.1%               | 337            | 1.4%               | 294            | 5.6%               | 3.9%                                     | 14.6%         |
| <b>Total sales</b>                                  | <b>33,099</b>                  | <b>100.0%</b>      | <b>23,863</b>  | <b>100.0%</b>      | <b>5,262</b>   | <b>100.0%</b>      | <b>38.7%</b>                             | <b>353.5%</b> |

## Analysis of Crude Oil, Petroleum Products and Gas Sales Volumes

The following table analyses the crude oil, petroleum products and gas sales volumes for the years indicated:

|  | For the year ended 31 December |               |                         |               |                         |               | % change from the year ended 31 December |               |
|--|--------------------------------|---------------|-------------------------|---------------|-------------------------|---------------|--|---------------|
|  | 2006                           |               | 2005                    |               | 2004                    |               | 2005 to 2006                             | 2004 to 2005  |
|  | % of total sales volume        |               | % of total sales volume |               | % of total sales volume |               | %  |               |
|  | (millions of barrels)          |               |                         |               |                         |               |  |               |
| <b>Crude oil</b>                                   |                                |               |                         |               |                         |               |  |               |
| Export to non-CIS countries                        | 357.58                         | 62.1%         | 283.23                  | 54.7%         | 65.99                   | 43.3%         | 26.3%                                    | 329.2%        |
| Europe and other directions                        | 275.85                         | 47.9%         | 239.61                  | 46.3%         | 55.02                   | 36.1%         | 15.1%                                    | 335.5%        |
| Asia   | 81.73                          | 14.2%         | 43.62                   | 8.4%          | 10.97                   | 7.2%          | 87.4%                                    | 297.6%        |
| Export to CIS                                      | 43.53                          | 7.6%          | 48.33                   | 9.3%          | 17.76                   | 11.7%         | (9.9)%                                   | 172.1%        |
| Domestic   | 6.82                           | 1.2%          | 28.72                   | 5.6%          | 5.25                    | 3.5%          | (76.3)%                                  | 447.0%        |
| <b>Crude oil (millions of tonnes)</b>              |                                |               |                         |               |                         |               |  |               |
| Export to non-CIS countries                        | 48.88                          | 62.1%         | 38.71                   | 54.7%         | 9.02                    | 43.3%         | 26.3%                                    | 329.2%        |
| Europe and other directions                        | 37.71                          | 47.9%         | 32.75                   | 46.3%         | 7.52                    | 36.1%         | 15.1%                                    | 335.5%        |
| Asia   | 11.17                          | 14.2%         | 5.96                    | 8.4%          | 1.5                     | 7.2%          | 87.4%                                    | 297.3%        |
| Export to CIS                                      | 5.95                           | 7.6%          | 6.61                    | 9.3%          | 2.43                    | 11.7%         | (9.9)%                                   | 172.0%        |
| Domestic   | 0.93                           | 1.2%          | 3.93                    | 5.6%          | 0.72                    | 3.5%          | (76.3)%                                  | 445.8%        |
| <b>Total crude oil sales</b>                       | <b>55.76</b>                   | <b>70.9%</b>  | <b>49.25</b>            | <b>69.6%</b>  | <b>12.17</b>            | <b>58.5%</b>  | <b>13.2%</b>                             | <b>304.7%</b> |
| <b>Petroleum products</b>                          |                                |               |                         |               |                         |               |  |               |
| Export to non-CIS countries                        | 12.66                          | 16.1%         | 13.14                   | 18.6%         | 4.64                    | 22.3%         | (3.7)%                                   | 183.2%        |
| Europe and other directions                        | 7.85                           | 10.0%         | 8.27                    | 11.7%         | 1.49                    | 7.2%          | (5.1)%                                   | 455.0%        |
| Asia   | 4.81                           | 6.1%          | 4.87                    | 6.9%          | 3.15                    | 15.1%         | (1.2)%                                   | 54.6%         |
| Export to CIS                                      | 0.68                           | 0.9%          | 0.30                    | 0.4%          | 0                       | 0.0%          | 126.7%                                   | 100.0%        |
| Domestic   | 9.53                           | 12.1%         | 8.04                    | 11.4%         | 4.01                    | 19.2%         | 18.5%                                    | 100.5%        |
| Wholesale  | 8.43                           | 10.7%         | 7.07                    | 10.0%         | 3.18                    | 15.2%         | 19.2%                                    | 122.3%        |
| Retail   | 1.1                            | 1.4%          | 0.97                    | 1.4%          | 0.83                    | 4.0%          | 13.4%                                    | 16.9%         |
| <b>Total petroleum product sales</b>               | <b>22.87</b>                   | <b>29.1%</b>  | <b>21.48</b>            | <b>30.4%</b>  | <b>8.65</b>             | <b>41.5%</b>  | <b>6.5%</b>                              | <b>148.3%</b> |
| <b>Total crude oil and petroleum product sales</b> | <b>78.64</b>                   | <b>100.0%</b> | <b>70.73</b>            | <b>100.0%</b> | <b>20.82</b>            | <b>100.0%</b> | <b>11.2%</b>                             | <b>239.7%</b> |
| <b>Gas (billion cubic meters)</b>                  |                                |               |                         |               |                         |               |  |               |
| <b>Gas</b>   | 9.57                           |               | 9.3                     |               | 7.3                     |               | 2.9%                                     | 27.4%         |

Note: The total volume sold is different from the volume of crude oil produced due to changes in inventory levels, purchases for resale, own use of oil by Rosneft and losses during transportation and in refining. The petroleum products exported include tanker fuelling volumes, by which they differ from those amounts set forth in the main body of this report.

### Average Crude Oil and Petroleum Products Sales Prices Achieved by Rosneft

The unit prices in the following table may differ from unit prices of crude oil and petroleum products provided by information agencies due to the following factors:

- Seasonal and other production fluctuations;
- Different conditions of sales and supplies versus those cited in mass media;
- Different conditions in local markets;
- Discounts or mark-ups depending on crude oil or petroleum product quality, sales volume and timing of transactions; and
- Terms of individual contracts differing from average market prices.

The following table sets forth the average export and domestic prices of Rosneft in 2006, 2005 and 2004.

|  | For the year ended |                 |                  |                 |                  |                 |
|--|--------------------|-----------------|------------------|-----------------|------------------|-----------------|
|  | 2006               |                 | 31 December      |                 | 2004             |                 |
|  | (USD/<br>barrel)   | (USD/<br>tonne) | (USD/<br>barrel) | (USD/<br>tonne) | (USD/<br>barrel) | (USD/<br>tonne) |
| <b>Average export prices</b>                   |                    |                 |                  |                 |                  |                 |
| Crude oil export to non-CIS countries          | 60.04              | 439.20          | 49.20            | 360.01          | 31.85            | 233.04          |
| Europe and other directions                    | 59.18              | 432.88          | 48.55            | 354.96          | 31.79            | 232.58          |
| Asia   | 62.95              | 460.53          | 52.80            | 386.41          | 32.18            | 235.33          |
| Crude oil export to CIS                        | 37.21              | 272.23          | 30.85            | 225.57          | 23.14            | 169.14          |
| Petroleum products export to non-CIS countries | —                  | 402.60          | —                | 335.49          | —                | 212.07          |
| Europe and other directions                    | —                  | 401.76          | —                | 341.84          | —                | 230.87          |
| Asia   | —                  | 403.95          | —                | 332.24          | —                | 203.17          |
| Petroleum products export to CIS               | —                  | 295.17          | —                | 213.33          | —                | —               |
| <b>Average domestic prices</b>                 |                    |                 |                  |                 |                  |                 |
| Crude oil                                      | 31.36              | 229.40          | 20.89            | 152.67          | 19.81            | 144.44          |
| Gas (USD/thousand cubic meter)                 | —                  | 20.58           | —                | 18.82           | —                | 16.16           |
| Petroleum products                             | —                  | 414.54          | —                | 356.34          | —                | 309.23          |
| Wholesale                                      | —                  | 384.02          | —                | 335.08          | —                | 284.28          |
| Retail   | —                  | 648.44          | —                | 511.34          | —                | 404.82          |

Revenues were USD 33,099 million in 2006, a 38.7% increase over 2005 (USD 23,863 million). Revenues from the sale of crude oil and gas grew by 45.5%, and revenues from the sale of petroleum products by 25.4%, in 2006 compared with 2005. The growth in revenues was due to increased prices and increased sales volumes of crude oil and petroleum products. The growth in volumes was made possible by a 7.7% increase in crude oil production and a 6.6% increase in petroleum product production.

Revenues were USD 23,863 million in 2005, a 353.5% increase over 2004 (USD 5,262 million). Revenues from the sale of crude oil and gas grew by 490.6%, and revenues from the sale of petroleum products by 230.2%, in 2005 compared with 2004. The growth in revenues was due to increased prices and increased sales volumes of crude oil and petroleum products. The growth in volumes was made possible by a 261.0% increase in crude oil production, and a 200.3% increase in petroleum product production, resulting mainly from the acquisition of Yuganskneftegaz. The increase in petroleum product production was facilitated by the agreements entered into at the end of the first quarter of 2005 with Yukos-controlled refineries for the refining of crude oil produced by Yuganskneftegaz.

### **Crude Oil Export Sales to Non-CIS Countries**

In 2006, crude oil export revenues were USD 21,468 million compared to USD 13,886 million in 2005, an increase of USD 7,582 million, or 54.6%. The growth resulted from a 22.0% increase in average prices, which increased revenues by USD 3,934 million, and a 26.3% increase in sales volumes, which had a positive impact on revenues of USD 3,648 million. The price increases were attributable to the general growth of world prices; in particular, the average price for Urals crude oil Mediterranean rose by 21.4%. Sales volumes grew, mainly in respect of sales to Europe and other directions (including South and North America, Tunisia, Lebanon, Syria, Israel and Turkey), as these directions were the most profitable in 2006.

In 2005, crude oil export revenues were USD 13,886 million compared to USD 2,102 million in 2004, an increase of USD 11,784 million, or 560.6%. The growth resulted from a 54.5% increase in prices, which increased revenues by USD 4,865 million, and a 329.2% increase in sales volumes, which had a positive impact on revenues of USD 6,919 million. The price increases were attributable to the general growth of world prices; in particular, the average price for Urals crude oil Mediterranean increased by 47.3%. Sales volumes grew to both Europe and Asia, mainly due to the acquisition of Yuganskneftegaz.

### **Crude Oil Export Sales to CIS**

In 2006, revenues from sales of crude oil to the CIS were USD 1,620 million compared to USD 1,491 million in 2005, an increase of USD 129 million, or 8.7%. A 20.6% increase in prices, which would have increased revenues by USD 278 million, was offset in part by a 9.9% decrease in volumes, which had a negative impact on revenues of USD 149 million. The growth in volumes sold to Belarus was offset by a more significant reduction of volumes sold to Ukraine, a less profitable CIS market due to the applicability of export customs duty.

In 2005, revenues from sales of crude oil to the CIS were USD 1,491 million compared to USD 411 million in 2004, an increase of USD 1,080 million, or 262.8%. The primary contributors to growth were a 33.3% increase in prices, which increased revenues by USD 373 million, and a 172.1% increase in volumes, which had a positive impact on revenues of USD 707 million. Volumes grew due to the overall increase in crude oil production, resulting mainly from the acquisition of Yuganskneftegaz, and the increase in supplies to Belarus.

### **Crude Oil Domestic Sales**

The volume of crude oil sold in Russia decreased significantly in 2006. In 2006, domestic crude oil sales decreased by USD 386 million to USD 214 million. This resulted from a 76.3% decrease in sales volume, which accounted for USD 458 million of the decrease in revenues, and was partially offset by a 50.3% increase in average prices, which had a positive impact on revenues of USD 72 million. The decline in volumes resulted from the allocation of more crude oil to export sales and refining to achieve maximum netback prices as domestic sales of crude oil have a relatively low profitability in comparison to export sales.

The volume of crude oil sold in Russia increased in the first half of 2005. It took some time for the Company to put in place arrangements for the refining or export of the significant quantities of crude oil produced by Yuganskneftegaz after its acquisition in December 2004, which resulted in increased crude oil sales in the domestic market. In the second half of 2005, the volume of crude oil domestic sales was significantly reduced. Domestic crude oil sales revenues were USD 600 million in 2005, an increase of USD 496 million compared to 2004. The primary contributors to growth were a 5.7% increase in prices, accounting for USD 32 million of the revenue growth, and a 447.0% increase in sales volume, which had a positive impact on revenues of USD 464 million.

### **Petroleum Products Export Sales to Non-CIS Countries**

Revenue from the export of petroleum products was USD 5,093 million in 2006 compared to USD 4,445 million in 2005, an increase of USD 648 million, or 14.6%. The growth in revenue from the export of petroleum products was attributable to a 20.0% increase in prices, which increased revenues by USD 810 million, partially offset by a 3.7% decrease in sales volume, which had a negative impact on revenues of USD 162 million. The growth in average prices was due to the overall increase in world prices; in particular, the average price for fuel oil Mediterranean grew by 28.8%. The decrease in volumes was mainly attributable to the reduction of petroleum products export to Europe and other non-CIS countries.

Revenue from the export of petroleum products was USD 4,445 million in 2005 compared to USD 984 million in 2004, an increase of USD 3,461 million, or 351.7%. The growth in revenue from the

export of petroleum products was attributable to a 58.2% increase in prices, which increased revenues by USD 1,658 million, and a 183.2% growth in sales volume, which had a positive impact on revenues of USD 1,803 million. The growth in prices was due to the overall increase in world prices; in particular, the price for diesel fuel Mediterranean grew by 51.0%. The growth in volumes was mainly attributable to petroleum products exported to Europe.

#### **Petroleum Products Export Sales to CIS Countries**

In 2006, revenues from sales of petroleum products to the CIS were USD 202 million compared to USD 64 million in 2005, an increase of USD 138 million, or 215.6%. This growth primarily resulted from a 126.7% increase in volumes, which was mainly due to a shift of volumes to the CIS from other export destinations and increased sales of certain petroleum products for which the demand exists only in the CIS countries. The increase in volumes resulted in a USD 82 million increase in revenues and was accompanied by 38.4% increase in prices, which resulted in a USD 56 million increase in revenues.

The Company had no sales of petroleum products to CIS prior to 2005.

#### **Petroleum Products Domestic Sales**

Revenue from the sale of petroleum products on the domestic market was USD 3,953 million in 2006 compared to USD 2,865 million in 2005, an increase of USD 1,088 million, or 38.0%. The growth in revenue from domestic sales petroleum products was attributable to a 16.3% average price increase, which increased revenues by USD 557 million, and a 18.5% increase in sales volume, which had a positive impact on revenues of USD 531 million. The growth in sales prices was mainly attributable to the growth in world prices of petroleum products and inflation in Russia. The volume growth was mainly due to an increase in crude oil production and a decrease in domestic crude oil sales that was facilitated by the agreements entered into in the beginning of 2005 with Yukos-controlled refineries for the refining of crude oil produced by Yuganskneftegaz.

Revenue from the sale of petroleum products on the domestic market was USD 2,865 million in 2005 compared to USD 1,240 million in 2004, an increase of USD 1,625 million, or 131.0%. The growth in revenue from domestic sales of petroleum products was attributable to a 15.2% price increase, which increased revenues by USD 379 million, and a 100.5% increase in sales volume, which had a positive impact on revenues of USD 1,246 million. The volume growth was mainly due to the acquisition of Yuganskneftegaz.

#### **Gas Sales**

Revenue from the sale of gas was USD 197 million in 2006 compared to USD 175 million in 2005, an increase of USD 22 million, or 12.6%. The growth in revenue from gas sales was attributable to a 9.4% increase in prices, which increased revenues by USD 17 million, and a 2.9% growth in sales volume, from 9.3 bcm to 9.57 bcm, which had a positive impact on revenues of USD 5 million.

Revenue from the sale of gas was USD 175 million in 2005 compared to USD 118 million in 2004, an increase of USD 57 million, or 48.3%. The growth in gas sales was attributable to a 16.5% increase in prices, which increased revenues by USD 25 million, and a 27.4% growth in sales volume, from 7.3 bcm to 9.3 bcm, which had a positive impact on revenues of USD 32 million.

Rosneft sells gas to Gazprom and to other parties. In 2006, the regional structure of Rosneft's sales was as follows:

- In Western Siberia, 3.3 bcm were sold to Gazprom, 0.9 bcm to independent gas traders, 0.2 bcm to an independent company for further refining and 0.9 bcm to end consumers.
- In Southern Russia, 1.4 bcm were sold to end consumers, 1.2 bcm to independent gas traders and 1 bcm to Gazprom.
- In the Russian Far East, 0.7 bcm were sold to end consumers.

#### **Support Services and Other Revenues**

Support services and other revenues were USD 350 million in 2006, 3.9% higher than in 2005 (USD 337 million). This growth was mainly attributable to an increase in the volume and value of drilling services.

Support services and other revenues were USD 337 million in 2005, 14.6% higher than in 2004 (USD 294 million). This growth was mainly attributable to an increase in the volume and value of construction services.

## Costs and Expenses

The following table sets forth Rosneft's costs and expenses during the periods being analysed.

|  | For the year ended<br>31 December |               |              | % change from<br>the year ended<br>31 December |                 |
|--|-----------------------------------|---------------|--------------|--|-----------------|
|  | 2006                              | 2005          | 2004         | 2005 to<br>2006                                | 2004 to<br>2005 |
|  | (USD millions)                    |               |              | (%)  |                 |
| Production and operating expenses                            | 2,197                             | 1,623         | 595          | 35.4 %   | 172.8%          |
| Cost of purchased oil, petroleum products and refinery costs | 1,320                             | 637           | 547          | 107.2 %  | 16.5%           |
| Selling, general and administrative expenses                 | 757                               | 589           | 257          | 28.5 %   | 129.2%          |
| Pipeline tariffs and transportation costs                    | 3,226                             | 2,231         | 574          | 44.6 %   | 288.7%          |
| Exploration expenses   | 193                               | 164           | 51           | 17.7 %   | 221.6%          |
| Depreciation, depletion and amortisation                     | 1,638                             | 1,472         | 307          | 11.3 %   | 379.5%          |
| Accretion expense <sup>(1)</sup>                             | 34                                | 35            | 8            | (2.9)%   | 337.5%          |
| Taxes other than income tax                                  | 6,990                             | 5,326         | 1,011        | 31.2 %   | 426.8%          |
| Export customs duty  | 11,140                            | 6,264         | 706          | 77.8 %   | 787.3%          |
| <b>Total operating expenses</b>                              | <b>27,495</b>                     | <b>18,341</b> | <b>4,056</b> | <b>49.9 %</b>                                  | <b>352.2%</b>   |

(1) Unwinding of discount related to asset retirement obligations.

Costs and expenses were USD 27,495 million in 2006, or 49.9% higher than in 2005 (USD 18,341 million). The growth in costs and expenses was driven by higher amounts of export customs duty and mineral production tax, pipeline tariffs for transportation of oil and petroleum products, and by higher cost of crude oil purchases from Sakhalin-1 PSA. Costs and expenses accounted for 83.08% and 76.86% of Rosneft's total revenues in 2006 and 2005, respectively.

Costs and expenses were USD 18,341 million in 2005, or 352.2% higher than in 2004 (USD 4,056 million). The growth in costs and expenses was driven by higher export custom duties and taxes other than income taxes (mainly mineral production tax), as well as increased production and sales volumes of crude oil and petroleum products, due mainly to the acquisition of Yuganskneftegaz. Costs and expenses accounted for 76.86% and 77.08% of Rosneft's total revenues in 2005 and 2004, respectively.

### Production and Operating Expenses

In 2006, production and operating costs were USD 2,197 million compared to USD 1,623 million in 2005, a 35.4% increase. The main contributors (excluding rouble appreciation) were higher production volumes, an increase in staff and employees, salaries and an increase in the cost of materials used in the downstream segment.

The acquisition of Yuganskneftegaz accounted for USD 825 million (80.3%) of the USD 1,028 million increase in production and operating expense in 2005 compared to 2004. Without accounting for Yuganskneftegaz, these expenses grew by 34.1%, mainly due to an 8.3% increase in production volumes, the real appreciation of the Russian rouble, and higher electricity tariffs, raw material and supplies costs, as well as increases in well workover and enhanced oil recovery service costs. Average salaries and allowances were also raised throughout Rosneft during 2005.

Upstream production and operating expenses include costs related to raw materials and supplies, equipment maintenance and repair, wages and salaries, activities to enhance oil recovery, procurement of fuel and lubricants, electricity and other similar costs of production and exploration subsidiaries. Upstream operating expenses were USD 1,632 million in 2006, or USD 2.83 per barrel of crude oil produced and USD 2.49 per barrel of oil equivalent produced. Upstream operating expenses in 2006 net of Sakhalin-1 costs were USD 2.78 per barrel of crude oil produced and USD 2.44 per barrel of oil equivalent produced. These measures are defined below under "Key Financial Ratios."

Upstream operating expenses were USD 1,333 million in 2005, or USD 2.49 per barrel of crude oil produced and USD 2.18 per barrel of oil equivalent produced. Upstream operating expenses were USD 344 million in 2004, or USD 2.32 per barrel of crude oil produced and USD 1.69 per barrel of oil equivalent produced.

Downstream operating expenses include costs of services provided by third parties (such as transshipment and storage services), operating expenses of the marketing companies, operating expenses of refineries and other items.

Of the total production and operating expenses, the upstream and downstream segments accounted for USD 1,632 million and USD 353 million, respectively, in 2006, USD 1,333 million and USD 226 million, respectively, in 2005 and USD 344 million and USD 122 million, respectively, in 2004.

Other activities' operating expenses accounted for USD 212 million in 2006, USD 64 million in 2005 and USD 129 million in 2004.

The following table sets forth Rosneft's refining costs and volumes at its proprietary refineries during the periods being analysed (including refineries' operating expenses as well as selling, general and administrative expenses and taxes other than income taxes):

|  | For the year ended<br>31 December |       |      | % change<br>from the year ended<br>31 December |                 |
|--|-----------------------------------|-------|------|--|-----------------|
|  | 2006                              | 2005  | 2004 | 2005 to<br>2006                                | 2004 to<br>2005 |
| Refining costs for owned refineries<br>(Komsomolskiy Refinery + Tuapsinskiy<br>Refinery) (USD millions)    | 95                                | 63    | 63   | 50.8%  | 0 %             |
| Throughput at Rosneft-owned refineries<br>(Rosneft's and other parties' crude oil)<br>(millions of tonnes) | 10.79                             | 10.49 | 9.32 | 2.9%   | 12.6 %          |
| Refining cost per tonne (USD)  | 8.80                              | 6.01  | 6.76 | 46.4%  | (11.1)%         |

#### **Cost of Purchased Oil, Petroleum Products and Refining Costs**

The cost of purchased oil, petroleum products and refining costs includes crude oil and petroleum product procurement costs and costs of refining Rosneft's crude oil at third-party refineries. The costs of refining Rosneft's crude oil at third party refineries and petroleum products procurement costs, has been high in absolute terms since it is driven by the imbalance between Rosneft's crude oil production and its refining capacity, as well as by the geographical complexity of Rosneft's logistics. These factors explain the high proportion of crude oil refining costs paid to third-party refineries, as well as the need to purchase petroleum products from third parties, in 2005 and 2006.

The following table shows Rosneft's third-party refining costs and crude oil and petroleum product procurement costs during the periods being analysed:

|  | For the year ended<br>31 December |            |            | % change from the<br>year ended<br>31 December |                 |
|--|-----------------------------------|------------|------------|--|-----------------|
|  | 2006                              | 2005       | 2004       | 2005 to<br>2006                                | 2004 to<br>2005 |
| Refining fees paid to third party refineries<br>(USD millions)   | 506                               | 311        | 6          | 62.7%  | 5,083.3 %       |
| Rosneft crude oil throughput at third party<br>refineries (millions of tonnes)   | 13.11                             | 11.63      | 0.47       | 12.7%  | 2,374.5 %       |
| Refining fees per tonne (USD)  | 38.60                             | 26.74      | 12.77      | 44.4%  | 109.4 %         |
| Cost of procurement of petroleum products<br>from third parties by the downstream<br>segment <sup>(1)</sup> (USD millions) | 366                               | 231        | 541        | 58.4%  | (57.3)%         |
| Procurement of petroleum products from<br>third parties by the downstream segment <sup>(1)</sup><br>(millions of tonnes)   | 0.94                              | 0.72       | 1.85       | 30.6%  | (61.1)%         |
| Cost of procurement of crude oil from<br>third parties by the downstream segment <sup>(2)</sup><br>(USD millions)          | 448                               | 95         | —          | 371.6%   | 100.0%          |
| Procurement of crude oil from third<br>parties by the downstream segment <sup>(2)</sup><br>(millions of barrels)           | 18.36                             | 2.14       | —          | 757.9%   | 100.0%          |
| <b>Total cost of purchased oil, petroleum<br/>products and refining costs</b>  | <b>1,320</b>                      | <b>637</b> | <b>547</b> | <b>107.2%</b>                                  | <b>16.5%</b>    |

(1) The upstream segment also purchases petroleum products from third parties for use in its own operations. These purchases are reflected in production and operating expenses and are included in upstream operating expenses to calculate the relevant key performance indicators mentioned below.

(2) The Company purchased crude oil from Sakhalin-1 and Udmurtneft.

In 2006, the cost of purchased crude oil and petroleum products was USD 1,320 million, a 107.2% increase from USD 637 million in 2005, due to increases in refining fees paid to third party refineries and increased amounts of crude oil and petroleum products purchases.

In 2005, the cost of purchased oil, petroleum products and processing services was USD 637 million, a 16.5% increase from the USD 547 million reported in 2004. The increase was driven by the increased use of third party refineries to refine the greater volume of crude oil produced by Rosneft following the acquisition of Yuganskneftegaz in December 2004.

The cost of refining crude oil at third-party refineries is high relative to that of refining crude oil at Rosneft's refineries, since the processing fees charged by third parties are fully costed, while the cost of refining crude oil at Rosneft's refineries as reported above does not include depreciation, which is reported in depreciation, depletion and amortisation and taxes other than income tax. The need to rely on third-party refineries arose following the acquisition of Yuganskneftegaz, when Rosneft's crude oil production increased significantly. At the end of the first quarter of 2005, Rosneft entered into agreements with Yukos-controlled refineries for the refining of crude oil produced by Yuganskneftegaz. In 2006, third-party refining fees increased by 62.7% compared to 2005 which is explained by a 44.4% increase in processing cost per tonne at third parties' refineries compared to 2005 due to a revised agreement with Yukos to cover capital expenditures in certain refineries to meet the new quality standards EURO-2 and EURO-3 and due to expanding the product mix to include more expensive petroleum products, in particular, lubricants. This increase was accompanied by a 12.7% increase in the volumes of refining.

In some circumstances, it may be more economical for Rosneft to purchase petroleum products from third parties to supply, together with its own petroleum products, to Rosneft's marketing subsidiaries. The volume of petroleum products purchased from third parties during the periods being analysed amounted to 0.94 million tonnes in 2006, 0.72 million tonnes in 2005 and 1.85 million tonnes in 2004.

Until September 2006, Rosneft purchased almost all crude oil (approximately 7.32 million barrels) produced by the Sakhalin-1 PSA for USD 219 million. Approximately 4.61 million barrels of crude oil were supplied for refining to the Company's Komsomolskiy Refinery, and the rest was exported to Asia. Starting from September 2006, the Company no longer purchases oil from the Sakhalin-1 Consortium since the parties to the PSA commenced exports via the Consortium's own terminal in De-Kastri, which started operations in the fourth quarter of 2006. In 2005 Rosneft purchased 2.14 million barrels of crude oil produced by the Sakhalin-1 PSA in the fourth quarter of 2005 for the amount of USD 95 million.

In 2006, Rosneft started to purchase oil from Udmurtneft. The volume of oil purchased in 2006 was 11.04 million barrels accounting for USD 229 million.

### **General and Administrative Expenses**

General and administrative expenses include wages and salaries, banking commissions, third-party professional service fees for advisory, legal and audit services, insurance expenses, lease expenses with respect to non-core property, expenses to establish allowances for doubtful accounts and other general expenses.

General and administrative expenses in 2006 were USD 757 million, 28.5% higher than in 2005 (USD 589 million). This increase was mainly due to increased legal, banking, consultancy, valuation, audit and other professional services, which were USD 102 million in 2006 and salaries, bonuses and social benefits, which were USD 325 million in 2006. In addition, office rent and insurance costs increased in 2006. Following the decision of the High Arbitrage court of the Russian Federation, the Company accrued provision for commitments and contingencies of Severnaya Neft in the amount of USD 39 million in 2006 in connection with a number of licence-related matters. In October 2006, the High Arbitrage court ruled against Severnaya Neft in favour of the Nenets autonomous district. As a result, Severnaya Neft will make payments to the administration of the Nenets autonomous district under the licence terms, amounting to USD 24 million, including USD 5 million of penalties, for periods prior to 2004 and to USD 15 million for 2004-2006.-

General and administrative expenses were USD 589 million in 2005, 129.2% higher than in 2004 (USD 257 million), reflecting the first-time inclusion of the selling, general and administrative expenses of Yuganskneftegaz of USD 92 million, expenses relating to audit, legal, consultancy, valuation and other professional services (including those incurred in connection with Yuganskneftegaz' legal, tax and other cases) of USD 31 million; bank services and charges due to higher borrowings and a higher volume of operations of USD 52 million; direct write-offs and allowances for doubtful accounts of USD 88 million (including amounts owed to Yuganskneftegaz by Yukos following the payment by Yuganskneftegaz in 2005 of amounts Yukos had owed Transneft for the transportation of Yuganskneftegaz crude oil in 2004); salaries, pensions and social benefits to employees of USD 189 million.

### **Pipeline Tariffs and Transportation Costs**

Pipeline tariffs and transportation costs include costs to transport crude oil for refining at own and third-party refineries and to end customers, and to deliver petroleum products from refineries to end customers. Transportation costs include the cost of pipeline transportation, sea freight, railway and river tariffs, handling, port fees and customs costs and demurrage.

Pipeline tariffs and transportation costs grew to USD 3,226 million in 2006 from USD 2,231 million in 2005, a 44.6% increase due mainly to an increase in the volume of transported oil (e.g. non-CIS export crude oil volumes increased by 26.3%) and in the pipeline and railway tariffs of natural monopolies. Rosneft's crude oil export pipeline tariffs increased by 14.9% in 2006 compared to 2005. Rosneft's tariff per tonne of exported petroleum products transported via Transneft increased by 17.1% in 2006 compared to 2005.

Railway domestic tariffs increased by 17.0% and railway export tariffs increased by 6.0% in 2006 compared to 2005. The main driver of domestic railroad tariffs' growth was the overall increase in RZD tariffs and the curtailment of the discount in early 2006 granted to Rosneft by RZD in 2005, for crude oil supplies to Komsomolskiy Refinery in the Far East of the Russian Federation. Increased transportation volumes were due to oil supplies to China under the long-term contract signed in January 2005 with CNPC (see also "Crude Oil Export Sales" above) in connection with the acquisition of Yuganskneftegaz. See "—Significant Acquisitions—2004—Yuganskneftegaz." A discount for supplies to China was granted by RZD subject to Rosneft transporting the minimum annual volumes agreed in advance.

Crude oil exported to China was transported in part by rail, and the rail tariffs were significantly higher than pipeline tariffs. In addition, the reduction in domestic sales of crude oil in 2006 resulted in higher transportation costs, since Rosneft, rather than its customers, bears the cost of transporting crude oil to refineries or to the border for export or for sale to the CIS.

In 2006, Rosneft transported approximately 165.2 million barrels (22.6 million tonnes) of crude oil via Transneft to domestic refineries and approximately 100.6 million barrels (13.76 million tonnes) for export sales via Transneft and CPC, compared to approximately 157.9 million barrels (21.5 million tonnes) of deliveries to domestic refineries and 88.4 million barrels (12.08 million tonnes) for export sales in 2005.

Pipeline tariffs and transportation costs grew to USD 2,231 million in 2005 from USD 574 million in 2004 due to the greater volume of crude oil transported including from Yuganskneftegaz and higher tariffs. In 2005, Rosneft transported 465 million barrels (63.6 million tonnes) of crude oil via Transneft and 136 million barrels (18.6 million tonnes) via railways, compared to 123 million barrels (16.8 million tonnes) and 68 million barrels (9.3 million tonnes), respectively, in 2004. The increase in volumes transported was due mainly to the acquisition of Yuganskneftegaz. During 2005, Transneft raised its tariffs by 11.0% on average, though this was partly offset by a 9.0% decline in railway tariffs on average due to the favourable pricing arrangement described above under “—Main Factors Affecting Results of Operations—Changes in Transport Tariffs.”

### **Exploration Expenses**

Exploration expenses mainly represent expenses relating to exploratory drilling, seismic and other geological and geophysical costs. Exploratory drilling costs are generally capitalized if commercial reserves of oil and gas are discovered, or written off as expenses in the current period in the event of unsuccessful exploration results. In 2006, 2005 and 2004, exploration expenditures were USD 193 million, USD 164 million and USD 51 million, respectively.

In 2006, exploration expenses were USD 193 million, an increase of USD 29 million, or 17.7%, as compared to 2005. The increase was mainly due to exploration expenses at the Sakhalin-5 and Kurmangazy projects and to a change in accounting for Sakhalin-1 in favour of a proportional consolidation from 31 July 2006. See “—Significant acquisitions—Change in accounting for Sakhalin-1 PSA”.

In 2005, exploration expenses increased by USD 113 million, or 221.6%, to USD 164 million from USD 51 million in 2004. The increase was mainly due to Yuganskneftegaz’s expenses of USD 21 million (including expenses for geological and geophysical work) and a significant volume of exploratory work in the East Siberia region.

### **Depreciation, Depletion and Amortisation**

Depreciation, depletion and amortisation includes depreciation of oil and gas producing assets, and other production and non-production assets.

Depreciation, depletion and amortisation was USD 1,638 million in 2006 compared to USD 1,472 million in 2005. The 11.3% increase was mainly due to significant capital expenditures which resulted in increased balance sheet value of fixed assets in 2006 as compared to 2005 and a 7.7% increase in oil production, while the depletion rate remained relatively unchanged, at 6.6% in 2005 and 6.1% in 2006.

Depreciation, depletion and amortisation was USD 1,472 million in 2005 compared to USD 307 million in 2004. The 379.5% increase was mainly due to the addition of the fixed assets of Yuganskneftegaz to the fixed assets of the Company, as well as additional investments to develop and maintain production. The carrying value of the Yuganskneftegaz fixed assets was determined on the basis of their estimated fair value after reduction for “negative goodwill” recorded under U.S. GAAP. Depreciation of the fixed assets of Yuganskneftegaz amounted to USD 968 million during 2005.

### **Taxes Other than Income Tax**

Taxes other than income tax include mineral production tax, excise tax (mainly with respect to petroleum products), the unified social tax, property tax and other taxes. The basis for the calculation of mineral production tax is described under “—Main Factors Affecting Results of Operations—Changes in Mineral Production Tax and Export Customs Duties” above. Taxes other than income tax have increased throughout the periods being analysed, mainly due to the impact of mineral production tax.

The following table sets forth Rosneft's taxes other than income tax during the periods being analysed:

|  | For the year ended<br>31 December |              |              | % change from the<br>year ended<br>31 December |                 |
|--|-----------------------------------|--------------|--------------|--|-----------------|
|  | 2006                              | 2005         | 2004         | 2005 to<br>2006                                | 2004 to<br>2005 |
|  | (USD millions)                    |              |              | (% )   |                 |
| Mineral production tax                   | 6,342                             | 4,716        | 739          | 34.5%  | 538.2%          |
| Excise tax                               | 329                               | 286          | 88           | 15.0%  | 225.0%          |
| Social security                          | 154                               | 118          | 98           | 30.5%  | 20.4%           |
| Property tax                             | 107                               | 73           | 40           | 46.6%  | 82.5%           |
| Land tax                                 | 7                                 | 14           | 13           | (50.0)%  | 7.7%            |
| Transportation tax                       | 2                                 | 2            | 1            | 0.0%   | 100.0%          |
| Other taxes and payments                 | 49                                | 117          | 32           | (58.1)%  | 265.6%          |
| <b>Total taxes other than income tax</b> | <b>6,990</b>                      | <b>5,326</b> | <b>1,011</b> | <b>31.2%</b>                                   | <b>426.8%</b>   |

Taxes other than income tax increased by 31.2% in 2006 to USD 6,990 million, compared to USD 5,326 million in 2005. The growth in taxes resulted mainly from an increase in mineral production tax of USD 1,626 million, or 34.5%, caused by a 7.7% increase in crude oil production and a 21.2% increase in the tax rate.

Taxes other than income tax increased in 2005 to USD 5,326 million, compared to USD 1,011 million in 2004. The growth in taxes resulted mainly from an increase in mineral production tax of USD 3,977 million caused by higher production volumes, tax rates and oil prices. The higher production volume was mainly due to the acquisition of Yuganskneftegaz.

#### Export Customs Duty

Export customs duty payable by the Company includes crude oil and petroleum product export customs duties. Export customs duty is discussed above under "Main Factors Affecting Results of Operations—Changes in Mineral Production Tax and Export Customs Duties." Export customs duty has increased as a percentage of total revenue throughout the periods being analysed.

The following table sets forth Rosneft's export duties during the periods being analysed.

|                                    | For the year ended<br>31 December |              |            | % change from the<br>year ended<br>31 December |                 |
|------------------------------------|-----------------------------------|--------------|------------|--|-----------------|
|                                    | 2006                              | 2005         | 2004       | 2005 to<br>2006                                | 2004 to<br>2005 |
|                                    | (USD millions)                    |              |            | (% )   |                 |
| Export duty for crude oil          | 9,763                             | 5,322        | 535        | 83.4%  | 894.8%          |
| Export duty for petroleum products | 1,377                             | 942          | 171        | 46.2%  | 450.9%          |
| <b>Total export customs duties</b> | <b>11,140</b>                     | <b>6,264</b> | <b>706</b> | <b>77.8%</b>                                   | <b>787.3%</b>   |

Export customs duties were USD 11,140 million in 2006 compared to USD 6,264 million in 2005. The significant increase resulted from a 26.3% increase in the volumes of crude oil exported to the non-CIS countries and an increase in tariffs of export customs duties in the range of 47-57% depending on the type of hydrocarbons.

Export customs duties were USD 6,264 million in 2005 compared to USD 706 million in 2004. The increase resulted from greater volumes of crude oil and petroleum product exports and of domestic sales of petroleum products, as well as higher export customs duty.

### ***Operating Income***

As a result of the factors discussed above, operating income increased by 1.5% in 2006, 357.9% in 2005 and 81.6% in 2004.

As a percentage of total revenues, operating income was 16.92%, 23.14% and 22.92% in 2006, 2005 and 2004, respectively. As a percentage of total revenues, operating income before taxes other than income tax and export customs duty, was 71.70%, 71.70% and 55.55%, in 2006, 2005 and 2004, respectively.

### ***Other Income/(Expenses)***

#### **Interest Income**

Interest income increased by 66.7% to USD 135 million in 2006 from USD 81 million in 2005. Interest income increased by 24.6% to USD 81 million in 2005 from USD 65 million in 2004. These increases were mainly due to the growth in the Group's banking operations.

#### **Interest Expense**

Interest expense decreased by 6.6% to USD 724 million in 2006 compared to USD 775 million in 2005. In April 2006, the Company entered into a contract improving conditions of existing loan agreements which decreased interest rates to LIBOR plus 0.7% (previously LIBOR plus 3%) for loans totalling USD 5,730 million as of 31 December 2005 and decreasing interest rates to LIBOR plus 0.65% (previously LIBOR plus 1.8-2.2%) for loans totalling USD 3,177 million as of 31 December 2005.

Interest expense increased by 387.4%, to USD 775 million, in 2005 compared to USD 159 million in 2004. The increase was due to the substantial borrowings made to finance the acquisition of Yuganskneftegaz in December 2004. The financing of the Yuganskneftegaz acquisition had little impact on interest expense in 2004 since it occurred at year-end. During 2005, the Company refinanced current liabilities by raising long-term loans at lower interest rates.

#### **(Loss)/Gain on Disposal of Property, Plant and Equipment**

The Company disposes of property, plant and equipment from time to time. In 2006, loss from property, plant and equipment disposition were USD 95 million compared to a loss of USD 74 million in 2005 due to the write-off of certain social infrastructure assets which were financed by the Company's oil-related businesses. In 2004, customary losses on these dispositions were more than offset by a significant gain on the sale of an offshore drilling platform. As a result, Rosneft reported a USD 121 million gain in that year.

#### **Gain on Disposal of Share in CJSC Sevmorneftegaz**

In the first half of 2005, Rosneft sold a 50% interest in CJSC Sevmorneftegaz held by Purneftegaz to Gazprom for USD 1,344 million. Sevmorneftegaz is developing the Prirazlomnoye and Shtokmanovskoye fields in Yamalo-Nenetsky autonomous district. Under the terms of the sale, Gazprom paid for this interest in December 2004, while title to the interest passed to Gazprom in the second quarter of 2005. Gazprom also had the right to notify the Company not later than June 2005 of its intention to sell the purchased interest back to the Company, in which case the Company was obliged to repurchase and pay for it. Gazprom did not exercise this right. Accordingly, in June 2005, Rosneft recorded gain on the sale of its interest in CJSC Sevmorneftegaz in the amount of USD 1,303 million. As of 31 December 2004, the sale proceeds of USD 1,344 million were reflected as short-term debt on the Company's balance sheet, because of Gazprom's right to sell the interest back to the Company.

#### **Other Expenses, Net**

Other expenses, net, consist in 2006 principally of costs of court proceedings and judgments and arbitration and awards costs, as well as social expenditures and contributions to charity.

In 2006, other expenses, net, were USD 320 million, a 135.3% increase from 2005. This increase is mainly due to arbitration award and related expenses of USD 134 million accrued in 2006 as a result of an unfavourable award for the Company in the arbitration with Total E&P Vankor (see Note 25 to 2006 Financial Statements, "Commitments and contingencies"). In addition, in 2006 the Company spent USD 37 million for the construction of social facilities. The Company did not carry out such constructions in 2005. In 2005, other expenses, net, were USD 136 million, a 30.6% decrease from 2004.

#### **Foreign Exchange (Loss)/Gain**

Foreign exchange loss was USD 470 million in 2006 compared to a foreign exchange gain of USD 245 million in 2005. The loss resulted from the impact of the appreciation of the rouble against the U.S. dollar compared to its depreciation in 2005. As a result, the Company's rouble-denominated net monetary liability position increased when denominated in U.S. dollars but remained unchanged when denominated

in roubles. The rouble-denominated net monetary position was negative mainly due to Yuganskneftegaz current and deferred tax liabilities following its acquisition at the end of 2004 whereby accounts receivable were denominated in U.S. dollars due to a high proportion of export sales. The gain in 2005 resulted from the impact of the depreciation of the rouble against the U.S. dollar on the Company's rouble-denominated monetary net liability position.

Foreign exchange gain increased by 155.2% to USD 245 million in 2005 as compared with 2004. The increase resulted from the impact of the depreciation of the rouble against the U.S. dollar on the Company's rouble-denominated monetary net liability position.

#### **Income Tax Expenses**

The following table sets forth the Company's effective income tax rate under U.S. GAAP:

|   | <b>For the year ended 31 December</b> |             |             |
|---|---------------------------------------|-------------|-------------|
|   | <b>2006</b>                           | <b>2005</b> | <b>2004</b> |
|   | <b>%</b>                              | <b>%</b>    | <b>%</b>    |
| Effective income tax rate for Rosneft under U.S. GAAP | 13%                                   | 26%         | 25%         |

The Company does not pay taxes based on consolidated income before taxes under Russian law. Income tax is calculated for each subsidiary based on its profits in accordance with RAR. The U.S. GAAP effective profit tax rate during 2006 was lower than the maximum rate of 24% established by Russian tax legislation throughout the periods being analysed.

The most significant factors influencing the effective income tax rate is the payment of income tax at 20% by Yuganskneftegaz and Purneftegaz resulting from regional tax benefits, the creation of a bad debt provision in tax accounting in relation to accounts receivable from Yukos recorded at zero fair value in the consolidated financial statements which resulted in a decrease in the current income tax of USD 539 million, and a decrease by USD 75 million in the deferred tax asset valuation allowance related to property, plant and equipment due to a change in estimates resulting from new circumstances increasing the chances of realisability of this asset.

As discussed above under "Business Segments and Intersegment Sales," Rosneft subsidiaries engage in significant intragroup transactions for which Rosneft management determines transfer prices. Russian transfer pricing rules entered into force in 1999, giving Russian tax authorities the right to make transfer pricing adjustments and impose additional tax liabilities in respect of all controlled transactions, provided that the transaction price differs from the market price by more than 20%. Controlled transactions include transactions between related entities and certain other types of transactions between independent parties, such as foreign trade transactions with significant (by more than 20%) price fluctuations. The Russian transfer pricing rules are vaguely drafted, leaving wide scope for interpretation by Russian tax authorities and courts, especially when, as in the case of the domestic market for crude oil, market prices are difficult to determine. Due to the uncertainties in the interpretation of transfer pricing legislation, and the difficulty of determining domestic market prices for crude oil, the tax authorities may challenge Rosneft's transfer prices and propose adjustments. If such price adjustments are upheld by the Russian courts and implemented, Rosneft's future financial results could be adversely affected. In addition, Rosneft could face significant losses associated with the assessment of prior tax underpaid and related interest and penalties, which could have an adverse effect on Rosneft's financial condition and results of operations. For example, a significant adjustment was made in 2005 in the total amount of USD 922 million (including penalties and interest) in relation to transfer pricing claims against Yuganskneftegaz arising from transactions entered into from 1999 through 2003, prior to its acquisition by Rosneft. USD 836 million of the USD 922 million was taken as an adjustment to the fair value of the liabilities assumed as a result of the Yuganskneftegaz acquisition, and the remaining amount of USD 86 million was treated as current income tax expense and taxes other than income tax. Rosneft seeks to ensure that its transfer pricing complies with the transfer pricing rules.

Income tax expense was USD 540 million in 2006 compared to USD 1,609 million in 2005. Current income tax increased from USD 1,688 million in 2005 to USD 2,385 million in 2006, while deferred income tax benefit increased from USD 79 million in 2005 to USD 1,845 million in 2006, mainly due to the recognition of a deferred tax asset in the amount of USD 1,285 million recorded as a result of a favourable court decision on the Company's claim for the lost profits against Yukos rendered at the end of 2006, whereby taxable non-operating income relating to the amount awarded by the court was recognised for Russian accounting tax purposes but not under U.S. GAAP. Taxes paid in 2006 on this non-operating income are treated for U.S. GAAP purposes as the creation of a deferred tax asset resulting in

corresponding deferred tax benefit. This income is expected to reverse in 2007 when the non-operating income is recognised under U.S. GAAP when it is realised in the Yukos bankruptcy procedure.

Income tax was USD 1,609 million in 2005 compared to USD 298 million in 2004. Current income tax increased from USD 309 million to USD 1,688 million, while deferred income tax benefit increased from USD 11 million in 2004 to USD 79 million in 2005. The increase in current income tax was mainly connected with the growth of the Company's income before income taxes as a result of higher production volumes and market prices. Income tax expense in 2005 includes the tax of USD 313 million accrued on the proceeds from the divestment of Rosneft's interest in CJSC Sevmorneftegaz and the USD 86 million adjustment referred to above.

#### ***Minority Interest in Subsidiaries' Earnings***

As discussed above under "Development of the Group—Consolidation via Share Swap," there were significant minority interests in the Company's subsidiaries during the periods being analysed prior to the Share Swap in October 2006, which were eliminated as a result of the Share Swap.

Minority interest in subsidiaries' earnings was USD 92 million in 2006 compared to USD 446 million in 2005 including the USD 167 million effect on the minority interest of the divestment in 2005 of the 50% interest in Sevmorneftegaz described above. A further influence on minority interest was a decrease in the net income of Yuganskneftegaz in 2006 due to foreign exchange losses on current and deferred tax liabilities.

Minority interest in subsidiaries' earnings was USD 446 million in 2005 compared to USD 66 million in 2004. The main changes were caused by the generation of profit in Yuganskneftegaz, where minority interest amounted to USD 234 million, and in Purneftegaz, where minority interest increased by USD 150 million, mainly as a result of proceeds from the divestment of the 50% interest in Sevmorneftegaz described above.

#### ***Net Income***

As a result of the factors discussed above, net income before minority interest decreased by 21.3% in 2006 to USD 3,625 million from USD 4,605 million in 2005. Net income before minority interest increased by 410.0% in 2005 from USD 903 million.

Net income before minority interest adjusted for gain from the sale of Sevmorneftegaz increased by 0.3% in 2006, by 300.3% in 2005 and by 106.2% in 2004. As a percentage of total revenues, adjusted net income was 11.0%, 15.1% and 17.2% in 2006, 2005 and 2004, respectively.

## Liquidity and Capital Resources

### Cash Flows

The principal items of the statement of cash flows for 2006, 2005 and 2004 are as follows:

|   | For the year ended<br>31 December |         |          | % change from<br>the year ended<br>31 December |                 |
|---|-----------------------------------|---------|----------|--|-----------------|
|   | 2006                              | 2005    | 2004     | 2005 to<br>2006                                | 2004 to<br>2005 |
|   | (USD millions)                    |         |          | (%)  |                 |
| Net cash provided by/(used in) operating activities | 2,593                             | 2,941   | 700      | (11.8)%  | 320.1 %         |
| Net cash used in investing activities               | (6,516)                           | (2,322) | (10,162) | 180.6 %  | (77.2)%         |
| Net cash (used in)/provided by financing activities | 3,225                             | (458)   | 10,243   | 704.1 %  | (104.5)%        |

#### Net Cash Provided by/(Used in) Operating Activities

Net cash provided by operating activities was USD 2,593 million, USD 2,941 million and USD 700 million in 2006, 2005 and 2004, respectively. The increase in operating cash flow from 2004 was primarily due to higher net income, which increased by more than 4 times in the period 2004-2006 (USD 837 million in 2004 compared to USD 3,533 million in 2006). Net cash provided by operating activities before taking into account changes in operating assets and liabilities net of acquisitions was lower in 2006, amounting to USD 3,760 million compared with USD 4,663 million in 2005 and amounted to USD 1,045 million in 2004. The decrease in cash provided by operating activities in 2006 reflected the decline in net income. Net income declined, despite an increase in revenues, in significant part due to the increase in export customs duty, which grew faster than revenues, as well as due to payment of USD 1,285 million income tax on non-operating income resulting from a favourable court decision on the Company's claim for the lost profits against Yukos rendered at the end of 2006. See "—Main Factors Affecting Results of Operations—Changes in Mineral Production Tax and Export Customs Duty" and "—Results of Operations—Costs and expenses—Income tax expenses". Depreciation, depletion and amortisation and minority interest in subsidiaries' earnings, as non-cash charges to net income, had a significant positive impact in reconciling net income to operating cash flow in each year, while the adjustment for the gain on disposal of the Company's share in CJSC Sevmorneftegaz had a significant negative effect in 2005 due to the full payment being received in 2004. Depreciation, depletion and amortisation was USD 1,638 million, USD 1,472 million and USD 307 million in 2006, 2005 and 2004, respectively. Minority interest in subsidiaries' earnings was USD 92 million, USD 446 million and USD 66 million in 2006, 2005 and 2004, respectively.

Increase in operating assets and liabilities net of acquisitions amounted to USD 1,167 million, USD 1,722 million and USD 345 million in 2006, 2005 and 2004, respectively. The significant negative adjustment in 2006 resulted mainly from increases in accounts receivable (due to an increase in sales volumes and prices) and an increase in inventories. The increase in accounts receivable in 2006 compared to 2005 is due to the following factors:

- increase in input VAT of USD 556 million, which was mainly caused by a delay in the reimbursement of export VAT in connection with Yuganskneftegaz' merger to the Company due to significant unsettled tax liabilities of Yuganskneftegaz and an increase in input VAT in relation to the Vankorskoye field generating significant capital expenditure made whereas VAT is reimbursed only when the field begins to produce crude oil;
- increase in banking loans to customers of USD 275 million in connection with loans provided VBRR and Dalnevostochny Bank; and
- the increase in trade accounts receivable totalling USD 241 million resulting from increased sales and the appreciation of the rouble.

The increase in operating assets and liabilities net of acquisitions in 2005 resulted mainly from increases in accounts receivable, receivables relating to sales and export VAT, combined with a reduction in accounts payable and accrued liabilities. This increase was partially offset by increased income tax liabilities and other tax liabilities. These changes resulted from the significant increase in the scale of Rosneft's business following the acquisition of Yuganskneftegaz. In addition, the increase in accounts receivable also reflected a non-recurring change resulting from the initially low level of accounts receivable in Yuganskneftegaz, which normalised during 2005.

When businesses are purchased, changes in operating assets and liabilities shown in net cash provided by operating activities are only recorded from the date of acquisition. The initial contribution to operating assets and liabilities of businesses purchased are thus not recorded as a change thereto in the year of acquisition. The initial contribution of assets and liabilities from Yuganskneftegaz to Rosneft's balance sheet as of 31 December 2004 is shown under "Initial allocation" in Note 4 to the financial statements for the year ended 31 December 2005 ("**2005 Financial Statements**").

In 2005, Yuganskneftegaz' contribution was adjusted as shown under "Final allocation" in Note 4 to the 2005 Financial Statements. This final allocation is in effect Yuganskneftegaz' contribution to Rosneft's opening balance sheet for 2005 and was used for the purposes of calculating changes in operating assets and liabilities in the statement of cash flows. Rosneft's consolidated balance sheet as of 31 December 2004 was prepared using the initial allocation of assets and liabilities and has not been restated for this final allocation. However, the impact on Rosneft's consolidated statement of income has been accounted for retrospectively from 1 January 2005 on the basis of the opening balance sheet that reflects the final allocation.

The principal adjustments in the final allocation were:

- A reduction in accounts receivable;
- An increase in income tax and other tax liabilities; and
- A reduction in negative goodwill, reflected as an increase in oil and gas properties, net.

#### **Net Cash Used in Investing Activities**

Net cash used in investing activities was USD 6,516 million in 2006 compared to USD 2,322 million in 2005. The increase is principally due to higher capital expenditures amounting to USD 3,462 million, repayment of Sakhalin-1 financing in the amount of USD 1,339 million, acquisition of licences, net purchases of short-term investments and the acquisition of Yukos debt from a consortium of Western banks in the amount of USD 483 million, of which USD 463 million was included in the cash flow statement for 2006.

Net cash used for investing activities amounted to USD 2,322 million in 2005 compared to USD 10,162 million in 2004. This decrease was primarily attributable to the high outflows in 2004 resulting from the Yuganskneftegaz acquisition. As discussed more fully below, capital expenditures and acquisitions of entities (other than the Yuganskneftegaz acquisition) and additional shares in subsidiaries increased from USD 1,099 million in aggregate in 2004 to USD 2,310 million in 2005. The Company made a significant short-term loan to its parent, Rosneftegaz, in 2005, which was repaid during the course of the year.

#### **Net Cash Provided by/(Used in) Financing Activities**

Net cash provided by financing activities was USD 3,225 million in 2006 compared to net cash used in financing activities of USD 458 million in 2005. The change was primarily due to the USD 2,115 million of proceeds from the Ordinary Share issue as part of the Company's IPO.

Net cash used in financing activities decreased to USD 458 million in 2005 from USD 10,243 million of net cash provided by financial activities in 2004. The decrease was primarily attributable to Rosneft's lower needs for borrowings compared to the previous year, which was affected by the need to finance the Yuganskneftegaz acquisition. Proceeds from short-term debt in 2004 include proceeds of USD 1,344 million from the disposal of CJSC Sevmorneftegaz. The Company was able to refinance a significant part of its short-term debt with long-term borrowings in 2005.



## ***Debt Obligations***

Over the past years, Rosneft has raised significant amounts of funds through net additional short-term debt and long-term loans to supplement the net cash generated by Rosneft's operating activities in order to fund the capital expenditures required to develop Rosneft's upstream and downstream operations and to purchase new businesses, assets and licences, in particular in the upstream segment. Most of the additional debt was raised in 2004 in connection with the acquisition of Yuganskneftegaz in December 2004. See “—Significant Acquisitions—2004—Yuganskneftegaz.”

Rosneft's total loans and borrowings amounted to USD 13,829 million as of 31 December 2006, USD 12,203 million as of 31 December 2005 and USD 13,742 million as of 31 December 2004. As of 31 December 2006, 2005 and 2004, 68.2%, 85.5% and 18.0%, respectively, of Rosneft's borrowings were secured against crude oil export contracts. As of 31 December 2006, 2005 and 2004, pledged oil export as a percentage of total crude oil export sales to non-CIS countries was 31.8%, 44.8% and 42.8% respectively.

Rosneft's strategy has been to finance its growth primarily with long-term borrowings, which are predominantly denominated in U.S. dollars.

Rosneft's long-term borrowings (excluding the current portion of long-term debt) decreased to USD 7,402 million as of 31 December 2006 from USD 8,198 million as of 31 December 2005. The weighted average rate of interest on the Company's long-term loans, excluding bank loans raised for funding the acquisition of Yuganskneftegaz, denominated in U.S. dollars was 5.96% (LIBOR plus 0.64%) and 6.58% (LIBOR plus 2.19%) *per annum* as of 31 December 2006 and 2005, respectively.

Rosneft's long-term borrowings (excluding the current portion of long-term debt) decreased to USD 8,198 million as of 31 December 2005 from USD 9,022 million as of 31 December 2004. The weighted average rate of interest on the Company's long-term loans, excluding bank loans raised for funding the acquisition of Yuganskneftegaz, denominated in U.S. dollars was 6.58% and 5.50% (LIBOR plus 2.19% and LIBOR plus 3.10%) for 2005 and 2004, respectively. Rosneft's long-term borrowings raised for funding the acquisition of Yuganskneftegaz are described in “—Significant Acquisitions—2004—Yuganskneftegaz.”

As discussed in Note 17 to the Financial Statements and in the report of independent auditors included therein, as of 31 December 2004, the Company was not in compliance with certain provisions of its debt agreements, which constituted events of default, and as a result, the related debt became callable by the respective creditors as of that date. In July 2005, the creditors waived violations related to restrictive financial ratios and agreed to amend the financial ratio covenants in line with the Company's new structure and scope of activities. The creditors also waived other events of default arising from the breach of other covenant provisions. With effect from 1 January 2007, the creditors granted amendments to the loan agreements which remove these provisions and have included new waivers which state that the Company must:

- redeem, secure, discharge in full or restructure (and comply with any restructuring plans once it is agreed upon) all Yuganskneftegaz's tax liabilities by 3 January, 2008;
- pay any arbitration award relating to Moravel Litigation or the Yukos Capital S.a.r.l. Litigation if any such arbitration award is granted by a court of the Russian Federation, within the time frame provided for such payment under Russian Law.

These conditions also apply to certain new borrowings obtained throughout 2005 and 2006. Thus, as of 31 December, 2006 and 2005, long-term borrowings, for which creditors either waived events of default arising from the breach of certain covenant provisions or amended loan agreements thereof, amounted to USD 3,444 million and USD 2,831 million, respectively. This debt continued to be reflected as long-term in nature as of 31 December, 2006 and 2005. As of 31 December, 2006, the Company was in compliance with all restrictive financial and other covenants contained within its loan agreements.

Rosneft's short-term loans (including the current portion of long-term debt) increased to USD 6,427 million as of 31 December 2006 from USD 4,005 million as of 31 December 2005. The range of average rates of interest on Rosneft's short-term loans denominated in U.S. dollars ranged from LIBOR plus 0.75% to LIBOR plus 3.02% *per annum* in 2006. The rouble-denominated loans bore average interest rates ranging from 4% to 8% *per annum* in 2006.

Rosneft's short-term borrowings (including the current portion of long-term debt) decreased to USD 4,005 million as of 31 December 2005 from USD 4,720 million as of 31 December 2004. The range of

average rates of interest on Rosneft's short-term loans denominated in USD was LIBOR plus 1.0% to 3.32% *per annum* for the year 2005. The rouble-denominated loans bore average interest rates of 1.25% to 9% *per annum* for the year 2005. To refinance its short-term loans, the Company continues to raise external funding.

The following table shows the scheduled maturities of Rosneft's long-term debt outstanding as of 31 December 2006:

|                                  | <b>(USD millions)</b> |
|----------------------------------|-----------------------|
| 2007.....                        | 2,362                 |
| 2008.....                        | 2,468                 |
| 2009.....                        | 2,449                 |
| 2010.....                        | 2,114                 |
| 2011.....                        | 250                   |
| 2012 and after .....             | 121                   |
| <b>Total long-term debt.....</b> | <b>9,764</b>          |

In March 2007, RN-Razvitie LLC, a wholly owned subsidiary of the Company, won the tender for the acquisition of 9.44% of the share capital of Rosneft and promissory notes of Yuganskneftegaz from Yukos for a total consideration of RUB 197.84 billion (USD 7.59 billion at the CBR exchange rate in effect as at the date of the auction), or RUB 194.28 for 1 share (USD 7.45 at the CBR exchange rate as at the date of the auction). In May 2007, Neft-Aktiv LLC, a wholly owned subsidiary of the Company, won the auction for the sale of certain assets of Yukos for a total consideration of RUB 175.70 billion (USD 6.82 billion at the CBR exchange rate in effect as at the date of the auction). These acquisitions were financed by syndicated loans in the total aggregate amount of USD 22 billion. See “—Significant Acquisitions—2007—Acquisition of Assets in Yukos Auctions.”

In February 2007, the Company entered into a six month bridge loan with a consortium of international banks in the amount of USD 2.5 billion at an interest rate of LIBOR plus 0.25 to 0.30% *per annum*, depending on the final repayment date. These funds are expected to be used for temporary refinancing (until corresponding long-term loans are entered into) of short-term loans obtained from Russian banks in the fourth quarter of 2006 with less favourable terms.

Rosneft's plan for 2007 is to finance its budgeted capital expenditures, interest and dividends mainly out of operating cash flows, which Rosneft expects to increase through higher sales volumes (as a consequence of higher production volumes). Simultaneously, Rosneft intends to improve its debt profile. For this purpose, Rosneft intends to continue to rely mainly on long-term borrowings for its financing needs, decreasing the percentage of Rosneft's secured debt and decreasing the charges associated with Rosneft's debt. These activities are aligned with Rosneft's ongoing efforts to improve its operating performance.

#### **Guarantee**

In January 2007, the Company entered into a guarantee agreement in respect of all the obligations of Vankorneft under a letter of credit for the amount of USD 62 million expiring 730 days after the date of issue of the letters of credit. The Company evaluates the default risk of Vankorneft under the letter of credit as low.

## Key Financial Ratios

The Company monitors and evaluates its activities on an ongoing basis. Key financial ratios are given below for the years indicated:

|   | <b>For the year ended 31 December</b> |              |             |
|---|---------------------------------------|--------------|-------------|
|   | <b>2006</b>                           | <b>2005</b>  | <b>2004</b> |
| EBITDA margin                                       | 22.0%                                 | 29.5%        | 28.9%       |
| Adjusted net income margin before minority interest | 11.0%                                 | 15.1%        | 17.2%       |
| Return on average capital employed (ROACE)          | 18.2%                                 | 21.7%        | 7.5%        |
| Return on average equity (ROAE)                     | 23.1%                                 | 47.7%        | 19.6%       |
| Net debt to capital employed ratio                  | 0.38                                  | 0.54         | 0.68        |
| Net debt to EBITDA ratio                            | 1.83                                  | 1.57         | 8.36        |
| Current ratio                                       | 0.87                                  | 0.72         | 0.89        |
|   |                                       | <b>(USD)</b> |             |
| EBITDA/bbl  | 12.63                                 | 13.13        | 10.26       |
| EBITDA/boe  | 11.09                                 | 11.49        | 7.48        |
| Upstream capital expenditure/bbl                    | 4.85                                  | 3.00         | 3.83        |
| Upstream capital expenditure/boe                    | 4.26                                  | 2.63         | 2.79        |
| Upstream operating expenses/bbl                     | 2.83                                  | 2.49         | 2.32        |
| Upstream operating expenses/boe                     | 2.49                                  | 2.18         | 1.69        |
| Adjusted free cash flow before interest/bbl         | (0.26)                                | 3.16         | 0.11        |
| Adjusted free cash flow before interest/boe         | (0.23)                                | 2.77         | 0.08        |

The Company considers EBITDA/bbl, ROACE, ROAE, upstream operating expenses/bbl, upstream operating expenses/boe and the related indicators as important measures of its operating performance. In addition, these measures are frequently used by financial analysts, investors and other interested parties in the evaluation of oil and gas companies. These measures have limitations as analytical tools and should not be considered in isolation, or as a substitute for analysis of the Company's operating results as reported under U.S. GAAP.

EBITDA/bbl and EBITDA/boe are calculated for any period by dividing EBITDA for that period by the barrels of crude oil or barrels of oil equivalent, respectively, produced during that period. No adjustments to these measures are made to take into account the effect of changes in inventories during the period.

Upstream capital expenditures/bbl and upstream capital expenditures/boe are calculated for any period by dividing the capital expenditures in the upstream segment during that period by the barrels of crude oil or barrels of oil equivalent, respectively, produced during that period. No adjustments to these measures are made to take into account the effect of changes in inventories during the period.

Upstream operating expenses/bbl and upstream operating expenses/boe are calculated for any period by dividing the production and operating expenses of the upstream segment during that period by the barrels of crude oil or barrels of oil equivalent, respectively, produced during that period. No adjustments to these measures are made to take into account the effect of changes in inventories during the period.

Adjusted free cash flow before interest/bbl and adjusted free cash flow before interest/boe are calculated for any period by dividing adjusted free cash flow before interest during that period by the barrels of crude oil or barrels of oil equivalent, respectively, produced during that period. Adjusted free cash flow before interest is net cash provided by operating activities minus capital expenditures plus cash interest payments. Licence acquisition costs are not included in capital expenditures. No adjustments to these measures are made to take into account the effect of changes in inventories during the period.

Upstream operating expenses include lifting costs, and the costs of gathering, treating, processing and storing the crude oil and gas in the fields and delivering the crude oil and gas to a main pipeline (e.g., a Transneft trunk pipeline transshipment point). Upstream operating expenses exclude a portion of the costs relating to intersegment transactions, mainly operating leases relating to certain oil and gas facilities. Upstream operating expenses include for 2006 similar operating leases between Yuganskneftegaz and service

entities controlled by Yukos. One of these entities, CJSC Yukos-Mamontovo, has been transferred to Rosneft in April 2007 pursuant to a court decision and amounts in respect of these operating leases will be excluded as intersegment transactions going forward. The Company believes these exclusions are appropriate because if the leased oil and gas facilities had been owned by the upstream segment instead of being leased by it from another segment, depreciation expense would have accrued instead of lease expense, and that depreciation expense would not have been included in upstream operating expenses.

The following tables set forth relevant figures relating to these measures for the years indicated:

#### *Upstream Measures*

|   | <b>For the year ended<br/>31 December</b> |             |             |
|---|---|-------------|-------------|
|   | <b>2006</b>                               | <b>2005</b> | <b>2004</b> |
| Upstream capital expenditures <sup>(1)</sup> (USD millions) | 2,795                                     | 1,606       | 568         |
| Upstream operating expenses (USD millions)                  | 1,632                                     | 1,333       | 344         |
| Barrels of crude oil produced (millions)                    | 576.31                                    | 535.16      | 148.26      |
| Barrels of oil equivalent produced (millions)               | 656.03                                    | 611.76      | 203.28      |

(1) Does not include licence acquisition costs.

#### *Calculation of Adjusted Free Cash Flow before Interest*

|  | <b>For the year ended<br/>31 December</b> |              |             |
|--|---|--------------|-------------|
|  | <b>2006</b>                               | <b>2005</b>  | <b>2004</b> |
|  | <b>(USD millions)</b>                     |              |             |
| Net cash provided by operating activities      | 2,593                                     | 2,941        | 700         |
| Capital expenditures <sup>(1)</sup>            | (3,462)                                   | (1,944)      | (829)       |
| Free cash flow                                 | (869)                                     | 997          | (129)       |
| Cash interest payments <sup>(2)</sup>          | 719                                       | 696          | 146         |
| <b>Adjusted free cash flow before interest</b> | <b>(150)</b>                              | <b>1,693</b> | <b>17</b>   |

(1) Does not include licence acquisition costs.

(2) Cash interest payments, whether capitalised or expensed, as reflected in the statement of cash flows.

#### *Calculation of EBITDA Margin*

|   | <b>For the year ended<br/>31 December</b> |              |              |
|---|---|--------------|--------------|
|   | <b>2006</b>                               | <b>2005</b>  | <b>2004</b>  |
|   | <b>(USD millions, except %)</b>           |              |              |
| Net income                                  | 3,533                                     | 4,159        | 837          |
| Minority interest in subsidiaries' earnings | 92  | 446          | 66           |
| Income tax expense                          | 540                                       | 1,609        | 298          |
| Total other (income)/expenses               | 1,439                                     | (692)        | 5            |
| Operating income                            | 5,604                                     | 5,522        | 1,206        |
| Accretion expense <sup>(1)</sup>            | 34  | 35           | 8            |
| Depreciation, depletion and amortisation    | 1,638                                     | 1,472        | 307          |
| EBITDA                                      | 7,276                                     | 7,029        | 1,521        |
| Total revenues                              | 33,099                                    | 23,863       | 5,262        |
| <b>EBITDA margin</b>                        | <b>22.0%</b>                              | <b>29.5%</b> | <b>28.9%</b> |

(1) Unwinding of discount related to asset retirement obligations.

*Calculation of Adjusted Net Income Margin before Minority Interest*

|  | <b>For the year ended 31<br/>December</b> |              |              |
|--|---|--------------|--------------|
|  | <b>2006</b>                               | <b>2005</b>  | <b>2004</b>  |
|  | <b>(USD millions, except %)</b>           |              |              |
| Net income   | 3,533                                     | 4,159        | 837          |
| Minority interest in subsidiaries' earnings  | 92  | 446          | 66           |
| Gain on disposal of share in CJSC Sevmorneftegaz <sup>(1)</sup>                      | —   | (1,303)      | —            |
| Tax on gain on disposal of share in CJSC Sevmorneftegaz <sup>(1)</sup>               | —   | 313          | —            |
| Adjusted net income before minority interest in subsidiaries' earnings               | 3,625                                     | 3,615        | 903          |
| Sales revenues   | 33,099                                    | 23,863       | 5,262        |
| <b>Adjusted net income margin before minority interest in subsidiaries' earnings</b> | <b>11.0%</b>                              | <b>15.1%</b> | <b>17.2%</b> |

(1) These items are excluded because they are unusual both in terms of their magnitude and nature.

*Calculation of Capital Employed and Related Indicators*

|  | <b>For the year ended 31<br/>December</b> |               |               |
|--|---|---------------|---------------|
|  | <b>2006</b>                               | <b>2005</b>   | <b>2004</b>   |
|  | <b>(USD millions)</b>                     |               |               |
| Short-term loans and current portion of long-term debt           | 6,427                                     | 4,005         | 4,720         |
| Long-term debt   | 7,402                                     | 8,198         | 9,022         |
| Cash and cash equivalents  | (505)                                     | (1,173)       | (1,033)       |
| Net debt   | 13,324                                    | 11,030        | 12,709        |
| Shareholders' equity   | 21,875                                    | 7,433         | 3,335         |
| Minority interest in subsidiaries' earnings                      | 225                                       | 1,860         | 2,535         |
| Equity   | 22,100                                    | 9,293         | 5,870         |
| <b>Capital employed</b>  | <b>35,424</b>                             | <b>20,323</b> | <b>18,579</b> |
| <b>Average equity, including minority interest<sup>(1)</sup></b> | <b>15,697</b>                             | <b>7,582</b>  | <b>4,611</b>  |
| <b>Average capital employed<sup>(2)</sup></b>                    | <b>27,874</b>                             | <b>19,451</b> | <b>12,055</b> |

(1) Average equity including minority interest is calculated as a simple average of the equity including minority interest at the start and end of the given period.

(2) The average capital employed is calculated as a simple average of the capital employed at the start and end of the given period. In 2004, the acquisition of Yuganskneftegaz took place at the end of the year and this acquisition significantly increased the capital employed at 31 December 2004 and hence the average capital employed in 2004 shown in the above table.

### *Calculation of Return on Average Capital Employed (ROACE)*

|   | <b>For the year ended 31 December</b> |              |             |
|---|---------------------------------------|--------------|-------------|
|   | <b>2006</b>                           | <b>2005</b>  | <b>2004</b> |
|   | <b>(USD millions, except %)</b>       |              |             |
| Operating income  | 5,604                                 | 5,522        | 1,206       |
| Income tax expense  | (540)                                 | (1,609)      | (298)       |
| Income tax on gain on disposal of share in CJSC Sevmorneftegaz <sup>(1)</sup> | —                                     | 313          | —           |
| Return used for calculation of ROACE  | 5,064                                 | 4,226        | 908         |
| Average capital employed  | 27,874                                | 19,451       | 12,055      |
| <b>ROACE</b>  | <b>18.2%</b>                          | <b>21.7%</b> | <b>7.5%</b> |

Note: As described above, the average capital employed in 2004 increased because of the acquisition of Yuganskneftegaz at the end of the year. As Yuganskneftegaz made no contribution to Rosneft's consolidated income in 2004, ROACE shown in the above table for 2004 is accordingly reduced by this effect.

(1) This item is excluded because it is unusual both in terms of its magnitude and nature.

### *Calculation of Return on Average Equity (ROAE)*

|  | <b>For the year ended</b>       |              |              |
|--|---------------------------------|--------------|--------------|
|  | <b>31 December</b>              |              |              |
|  | <b>2005</b>                     | <b>2005</b>  | <b>2005</b>  |
|  | <b>(USD millions, except %)</b> |              |              |
| Adjusted net income before minority interest in subsidiaries' earnings | 3,625                           | 3,615        | 903          |
| Average equity, including minority interest                            | 15,697                          | 7,582        | 4,611        |
| <b>ROAE</b>  | <b>23.1%</b>                    | <b>47.7%</b> | <b>19.6%</b> |

## **Policies and Estimates**

The preparation of consolidated financial statements in conformity with U.S. 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 Rosneft's significant accounting policies, please refer to Note 2 of the Financial Statements. Certain of these accounting policies involve judgements and uncertainties to such an extent that there is a reasonable likelihood that materially different amounts would have been reported under different conditions, or if different assumptions had been used, and actual amounts may differ from these estimates. The following critical accounting policies require significant judgements, assumptions and estimates and should be read in conjunction with the Annual Financial Statements.

### ***Oil and Gas Accounting***

Accounting for oil and gas exploratory activity is subject to special accounting rules that are unique to the oil and gas industry.

Oil and gas properties and the related expenses are reflected pursuant to the successful efforts method in accordance with SFAS 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*. In accordance with the said method, expenses for the exploration of an oil field, inclusive of the expenses on prospecting, geological and geophysical work, as well as drilling dry wells, are charged to expense when incurred. The costs of exploratory wells that find oil and gas reserves are capitalised pending determination of whether proved reserves have been found. If proved reserves are not found, exploratory well costs are expensed as a dry hole.

Acquisition costs of unproved reserves are not amortised. Such costs are reclassified into expenses related to the proved reserves as of the date of respective reserve reclassification. Costs related to the purchase of the title to unproved reserves are subject to review with respect to impairment. If such impairment is recognised, the expenses must be written off as expenses of the respective period.

Costs, including "internal" costs relating to drilling and equipping of development wells, including development dry holes, as well as costs required for drilling and equipping of injection wells in the process of oil and gas reserves development, are capitalised. These costs are included in oil and gas properties in the consolidated balance sheet.

Depletion expense of acquisition costs of proved oil and gas properties is calculated using the unit-of-production method based on total proved reserves. Depletion expense of other capitalised costs related to oil and gas production is calculated using the unit-of-production method based on proved developed reserves. Management of the Company considers each extraction division as the appropriate level for these calculations.

### ***Oil and Gas Reserves***

The process of estimating reserves is inherently judgemental. SEC standard proved oil and gas reserves are estimated quantities of crude oil and gas which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic and operating conditions (*i.e.*, prices and costs as of the date that the estimate is made). Prices include consideration of changes in existing prices provided only by contractual arrangements, but not on escalations based upon judgements about future conditions. Actual prices and costs are subject to change due, in significant part, to factors beyond Rosneft's control. These factors include world oil prices, energy costs and increases or decreases of oil field service costs. Due to inherent uncertainties and the limited nature of reservoir data, estimates of underground reserves are subject to changes over time as additional information becomes available. The determination of estimated proved reserves is a significant element in arriving at the results of operations of exploration and production activities. The Company uses independent reservoir engineers, D&M, to estimate all of its oil and gas reserves. D&M prepared two Reserves Reports in accordance with SEC definitions, the first reporting proved reserves through the economic lives of Rosneft's fields and the second reporting proved reserves through the expiration of Rosneft's licences. For purposes of the Financial Statements, proved reserves are considered to be those through the economic lives of the fields, as discussed more fully below. The estimates of proved reserves impact well capitalisation, undeveloped lease impairments and the depreciation rates of proved properties, wells and equipment. Reduction in reserve estimates may result in the need for impairments of proved properties and related assets. The data in the

relevant Reserves Report was also used for the assessment of impairment of long-lived assets and for the required supplemental disclosure of oil and gas activities.

The Company's oil and gas fields are located principally on the territory of the Russian Federation. The Company obtains licences from the governmental authorities to explore and produce oil and gas from these fields. The Company's existing production licences generally expire during the period from 2009 to 2031. Expiration dates of licences for the most significant fields are between 2013 and 2019, and the licence for the largest field, Priobskoye, expires in 2019. The economic lives of the licenced fields extend significantly beyond these dates. Under Russian law, the Company is entitled to renew the licences to the end of the economic lives of the fields, provided certain conditions are met. Article 10 of the Subsoil Law, Concerning Subsurface Resources, provides that a licence to use a field "shall be" extended at its scheduled termination at the initiative of the subsoil user if necessary to finish production of the field, provided that there are no violations of the conditions of the licence.

The legislative history of Article 10 indicates that the term "shall" replaced the term "may" in August 2004, clarifying that the subsoil user has an absolute right to extend the licence term so long as it has not violated the conditions of the licence. In 2006, no licences came up for renewal. In 2005, the Company extended the terms of 39 of its production licences for the period equivalent to the expected life of the fields. There were no unsuccessful licence renewal applications.

The Company's current production plans are based on the assumption, which management considers to be reasonably certain, that the Company will be able to extend all other existing licences. These plans have been designed on the basis that the Company will be producing crude oil through the economic lives of the fields and not with a view to exploiting the Company's reserves to maximum effect only through the licence expiration dates. Accordingly, management has included in proved reserves in the supplementary information on oil and gas exploration and production activities of the consolidated financial statements as of and for the year ended 31 December 2006 all reserves that otherwise meet the standards for being characterised as "proved" and that the Company estimates it can produce through the economic lives of its licenced fields.

Proved reserves should generally be limited to those volumes that can be produced through the licence expiration date unless there is a long and clear track record which supports the conclusion that extension of the licence will be granted as a matter of course. The Company believes that extension of the licences will occur as a matter of course, as described above.

### ***Business Acquisitions***

Accounting for the acquisition of a business requires the allocation of the purchase price to the various assets and liabilities of the purchased business. For most assets and liabilities, purchase price allocation is accomplished by recording the asset or liability at its estimated fair value. The most difficult estimations of individual fair values are those involving properties, plants and equipment and identifiable intangible assets. Determining the fair value of assets purchased and liabilities assumed requires judgement by management and often involves the use of significant estimates and assumptions, including assumptions with respect to future cash inflows and outflows, discount rates, licence and other asset lives and market multiples. Management of the Company uses all available information to make these fair value determinations and, for major business acquisitions, typically engages an outside appraisal firm to assist in the fair value determination of the purchased long-lived assets. The Company has, if necessary, up to one year after the acquisition closing date to finish these fair value determinations and finalise the purchase price allocation.

### ***Income Tax***

The computation of income tax expense requires the interpretation of complex tax laws and regulations and the use of judgement in determining the nature and timing of accounting for differences between financial reporting and income tax reporting. This is particularly evident in the Russian Federation where tax legislation is constantly changing (specifically, the statutory profits tax rate) and is subject to interpretation by the tax authorities. Changes in the Russian statutory tax rate can significantly affect deferred tax liability. As prescribed by U.S. GAAP, any changes to the statutory tax rate are recognised in the period the tax law is enacted rather than the effective date of the change.

A valuation allowance for a deferred tax asset is recorded when management believes that it is more likely than not that this tax asset will not be realised.

### ***Recognition of Obligations Related to the Retirement of Assets***

The Company has conditional obligations related to the retirement of assets used in prospecting and extraction activities. The Company's activities in the sphere of prospecting, development and extraction of oil and natural gas are connected with the use of the following assets: oil wells, equipment and nearby areas, installations for the collection and primary refining of oil, the tanker pool and pipeline connections to the main pipeline. As a rule, licences and other regulatory documents stipulate requirements with respect to the retirement of such assets after the completion of extraction. The said requirements oblige the Company to retire oil wells, dismantle the equipment, restore the sites and undertake other related actions. The Company's estimates of these obligations are based on current regulatory or licence requirements, as well as actual dismantlement and other related costs. The Company calculates obligations related to the retirement of assets pursuant to SFAS 143, *Accounting for Asset Retirement Obligations*.

### ***Environmental Liabilities***

Environmental expenditures are expensed or capitalised, depending upon their future economic benefit. Expenditures that relate to an existing condition caused by past operations and do not have a future economic benefit are expensed. Liabilities for these expenditures are recorded on an undiscounted basis when environmental assessments or clean-ups are probable and the costs can reasonably be estimated.

### ***Guarantees***

The fair value of a guarantee is determined and recorded as a liability at the time when the guarantee is issued. The initial guarantee amount is subsequently remeasured to reflect the changes in the underlying liability. The expense is included in the related line items of the consolidated income statement, based on the nature of the guarantee. When the likelihood of performing on a guarantee becomes probable, a liability is accrued, provided it is reasonably determinable on the basis of the facts and circumstances at that time.

### ***Accounting for Contingencies***

Certain conditions may exist as of the date of financial statements which may further result in a loss to the Company, but which will only be resolved when one or more future events occur or fail to occur. The Company's management makes an assessment of such contingent liabilities which is based on assumptions and is a matter of opinion. In assessing loss contingencies related to legal or tax proceedings that involve the Company or unasserted claims that may result in such proceedings, the Company after consultation with legal or tax advisors evaluates the perceived merits of any legal or tax proceedings or unasserted claims as well as the perceived merits of the amount of relief sought or expected to be sought therein.

If the assessment of a contingency indicates that it is probable that a loss will be incurred and the amount of the liability can be estimated, then the estimated liability is accrued in the Company's consolidated financial statements. If the assessment indicates that a potentially material loss contingency is not probable, but is reasonably possible, or is probable but cannot be estimated, then the nature of the contingent liability, together with an estimate of the range of possible loss if determinable and material, would be disclosed.

### ***Recognition of Revenues***

Revenues are recognised when title passes from the seller to the customer, the contract price is fixed or determinable and collectability of the receivable is reasonably assured. Specifically, domestic sales of crude oil and gas, as well as petroleum products and materials are recognised when title passes. For export sales, title generally passes at the border of the Russian Federation, and the Company covers transportation expenses, duties and taxes on those sales. Revenues include excise taxes and custom duties.

Sales of support services are recognised as services performed, provided that the service price can be determined and no significant uncertainties regarding the receipt of revenues exist.

Revenues are shown net of value added tax.

## **Impairment of Long-Lived Assets**

Long-lived assets, including blocks with proved crude oil and gas reserves, are assessed for potential impairment in accordance with SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*.

Crude oil and gas properties are assessed whenever events or circumstances indicate potential impairment.

If the carrying value of crude oil and gas properties is not recoverable through undiscounted cash flows, impairment is recognised. The impairment is determined on the basis of the estimated fair value of crude oil and gas properties, which, in turn, is measured by discounting future net cash flows or with reference to current market prices of crude oil and gas properties, if available. Discounted future cash flows from crude oil and gas fields are based on management estimates of future prices that rely on recent actual prices and published prices for forward transactions; such prices are applied to forecast production volumes at particular fields, with further discounting for the expected risk level.

Such estimates also involve assessment of ability to renew licences and lease of production equipment and wells.

## **Quantitative and Qualitative Disclosures about Market Risk**

### ***Prices for Crude Oil, Gas and Petroleum Products Risk***

Rosneft's operating results and financial condition depend substantially upon prevailing prices of crude oil, gas and petroleum products. Historically, prices for oil have fluctuated widely for many reasons, including:

- Global and regional supply and demand, and expectations regarding future supply and demand, for crude oil and petroleum products;
- Geopolitical uncertainty;
- Weather conditions and natural disasters;
- Access to pipelines, railways and other means of transporting crude oil, gas and petroleum products;
- Prices and availability of alternative fuels;
- The ability of the members of OPEC, and of other crude oil producing nations, to set and maintain specified levels of production and prices;
- Political, economic and military developments in oil producing regions, particularly the Middle East;
- Russian and foreign governmental regulations and actions, including export restrictions and taxes; and
- Global and regional economic conditions.

Substantially all of Rosneft's crude oil and petroleum products are sold on the spot market or under short-term contracts at market sensitive prices. Market prices for export sales of crude oil and petroleum products are subject to volatile trading patterns in the commodity futures market as discussed above in more detail. 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. Rosneft does not use any derivative instruments to hedge its production in order to decrease its price risk exposure.

### ***Foreign Currency Risk***

Over the past ten years, the rouble has fluctuated dramatically against the U.S. dollar. In the majority of instances, the rouble has depreciated against the U.S. dollar, although in each of the past three years, it has generally appreciated modestly against the U.S. dollar. Historically, the CBR has imposed various currency trading restrictions in attempts to support the rouble or to maintain a rate of devaluation in line with inflation.

The functional and reporting currency of Rosneft is the U.S. dollar. Rosneft's principal exchange rate risk involves changes in the value of the U.S. dollar relative to the rouble and, to a much lesser extent, relative to other currencies, including the euro. In addition, all of Rosneft's export revenues, including the exports of crude oil and petroleum products, are denominated in U.S. dollars or are correlated with U.S. dollar-denominated prices for crude oil and petroleum products.

As of 31 December 2006, approximately USD 4,071 million of Rosneft's indebtedness was denominated in roubles (out of USD 13,829 million of its total indebtedness at that date). Decreases in the value of the U.S. dollar relative to the rouble will increase the cost in U.S. dollars of Rosneft's rouble denominated costs and expenses and of its debt service obligations for rouble-denominated indebtedness. A depreciation of the U.S. dollar relative to the rouble will also result in foreign exchange losses as the U.S. dollar value of Rosneft's rouble-denominated indebtedness is increased.

A hypothetical, instantaneous and unfavourable 100 basis points change in currency exchange rates on 31 December 2006 would have resulted in additional interest expense of approximately USD 33 million per year, reflecting the increased costs in U.S. dollars of servicing Rosneft's rouble-denominated indebtedness held as of 31 December 2006. A hypothetical, instantaneous and unfavourable 100 basis points change in currency exchange rates as of 31 December 2006 would have resulted in an estimated foreign

exchange loss of approximately USD 41 million on rouble denominated indebtedness held as of 31 December 2006.

Starting from January 2007, the Company entered into agreements for forward sale of U.S. dollar-denominated revenue at fixed exchange rate in order to hedge currency risk. Monthly sale volumes are USD 200 million starting from March 2007. The counterparty's credit rating is BBB-.

### ***Liquidity Risk***

Liquidity risk arises when the maturity of assets and liabilities do not match. The Company has had negative working capital as of recent balance sheet dates, principally due to the increase in short-term debt arising out of the acquisition of Yuganskneftegaz combined with the significant write-down of Yuganskneftegaz's accounts receivable. While the Company presently has no committed liquidity facilities in place, the Company believes that it will be able to meet its liquidity needs.

### ***Credit Risk***

Rosneft's financial instruments that are potentially exposed to concentrations of credit risk consist primarily of accounts receivable, cash and cash equivalents, VAT recoverable by Rosneft as well as loans receivable and advances. A significant portion of Rosneft's trade accounts receivable is due from domestic and export trading companies. Rosneft does not generally require collateral to limit the exposure to loss; however, often letters of credit and prepayments are used. Although collection of these receivables could be influenced by economic factors affecting these entities, Rosneft believes there is no significant risk of loss to Rosneft beyond allowances already recorded.

Rosneft deposits available cash primarily with financial institutions in Russia. Deposit insurance of deposits of legal entities is not offered to financial institutions operating in Russia. To manage this credit risk, Rosneft allocates available cash across a variety of Russian banks and Russian affiliates of international banks. Management periodically reviews the creditworthiness of the banks in which it deposits cash.

VAT recoverable, representing amounts paid to suppliers, is recoverable from the tax authorities via offset against VAT payable to the tax authorities on revenue or direct cash receipts from the tax authorities. Management periodically reviews the recoverability of the balance of prepaid VAT and believes it is fully recoverable within one year.

Credit risk for off-balance sheet financial instruments is defined as the possibility of sustaining a loss as a result of another party to a financial instrument failing to perform in accordance with the terms of the contract. Rosneft does not believe that its off-balance sheet instruments are material.

### ***Interest Rate Risk***

Rosneft is exposed to interest rate risk on its indebtedness that bears interest at floating rates and, to a lesser extent, on its indebtedness that bears interest at fixed rates. As of 31 December 2006, Rosneft had loans and borrowings outstanding with a principal amount of approximately USD 12,175 million of which approximately USD 9,588 million bore interest at fixed rates and approximately USD 2,587 million bore interest at floating rates determined by reference to the London inter-bank offered rate ("**LIBOR/ EURIBOR**") for U.S. dollar deposits.

Rosneft undertakes debt obligations to support general corporate purposes including capital expenditures, acquisitions financing 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 Rosneft's debt obligations. A hypothetical, instantaneous and unfavourable change of 100 basis points in the interest rate applicable to floating-rate financial liabilities held as of 31 December 2006 would have resulted in additional net interest expense of approximately USD 96 million per year. The above sensitivity analysis is based on the assumption of an unfavourable 100 basis point movement of the interest rates applicable to each homogenous category of financial liabilities. A homogeneous category is defined according to the currency in which financial liabilities are denominated and assumes the same interest rate movement within each homogeneous category (e.g., U.S. dollars, roubles).

As it relates to fixed rate financial liabilities, a hypothetical, instantaneous 100 basis points decrease in interest rates would have resulted in a USD 7.5 million increase in the fair value of long-term debt outstanding as of 31 December 2006. However, Rosneft's sensitivity to decreases in interest rates and

corresponding increases in the fair value of its debt portfolio would unfavorably affect results and cash flows only to the extent that it elected to repurchase or otherwise retire all or a portion of its fixed-rate debt portfolio at prices above carrying value.

Rosneft currently does not use financial instruments, such as interest rate swaps and forward rate agreements, to manage these market risks. The Company plans to use interest rate swaps starting from 2007.