

## **Open Joint Stock Company “Oil Company “LUKOIL” Summary of 2008 performance results and main objectives for 2009**

The year 2008 was complex and contradictory for the Company. It was notable for oil price growth that was unprecedented in scope and duration in the first half of the year, followed by a price collapse in the second half. Despite this, OAO “LUKOIL” was able to achieve strong financial results and operating efficiency, and increase the production and refining of hydrocarbons. The second half of the year was the latest test of the Company’s durability, which we once again passed with flying colours.

The Company’s net profit in the reporting year was USD 9.144 billion. Return on capital employed was 17.4%. Despite the high level of capital costs that the Company incurred in maintaining production at old deposits and developing new ones, upgrading refineries and expanding the filling station network, and increasing the scale of the Company’s operations, the Company’s free cash flow was a record USD 3.775 billion.

Despite the adverse economic conditions in the second half of the year and the effects of the crisis on the oil market, the Company used its accumulated production and investment capacities to continue the active implementation of its development strategy. OAO “LUKOIL” has not interrupted its normal investment cycle and is launching key projects that will support the Company’s stable, gradual development and growth in shareholder value in future. In 2008 LUKOIL Group organisations began production at the Yuzhnaya Khylichuya deposit – one of the largest deposits in Timan-Pechora, continued to actively expand refining capacity (among other things, a 49% share was acquired in a joint venture to manage the ISAB oil refining complex – one of Europe’s largest and most technologically advanced refineries) and the retail network. In addition, the Company introduced a new business sector in 2008 – Power Generation.

However, 2008 did bring a number of difficulties to the Company. Besides the aforementioned unprecedented fall in oil prices, these included significant increases in the cost of financing. However, thanks to a well-considered financial policy and the resulting stable financial position, OAO “LUKOIL” did not experience any difficulties in paying its debt and financing its operations from available sources.

One positive aspect of 2008 was the decrease in the tax burden on oil companies in Russia. The basis price of oil when calculating mineral extraction tax was raised, and a number of concessions on this tax were introduced that were of substantial value to the LUKOIL Group. The procedure for calculating export duties was changed, and further revisions are under discussion. These innovations entered into force from the end of 2008 and start of 2009. They will have a substantial positive effect on the Company’s operating cash flow and will provide additional stimulus to invest funds in promising projects.

**Financial performance excluding subsidiaries.** Revenues (net) from the sale of goods, products, work and services (less VAT, excise and similar mandatory payments) were 624 billion roubles; net profits were 67.2 billion roubles.

### **Exploration work and reserves of oil and gas.**

The bulk of oil and gas exploration work was concentrated in Western Siberia, Perm krai, Volgograd oblast, Timan-Pechora oil-and-gas province, and the Caspian Sea.

Over the course of the year, eight new fields were discovered, along with 18 new deposits at previously discovered fields. The main growth in liquid hydrocarbon reserves result from exploration work came from the Caspian Sea, Western Siberia, Timan-Pechora, and Perm krai. The main growth in gas reserves came from the Caspian, Western Siberia, and foreign projects in Uzbekistan and Kazakhstan.

As at 1 January 2009, the Company's proved hydrocarbon reserves under the SPE international classification was 19.334 billion barrels of oil equivalent, including 14.458 billion barrels of oil and 29.253 trillion ft.<sup>3</sup> of gas. The LUKOIL Group's proven hydrocarbon reserves dropped by 5.1% in 2008. Taking production into account, the decrease was 1.1%, whereas the reduction in oil stocks was 3.5%, and the growth in gas was 7.2%

The assessment of hydrocarbon reserves under the SPE international classification in 2008 occurred under conditions of a rapidly deteriorating situation on global commodity markets. On the valuation date, the price of Urals oil was USD 34.8/bbl, versus USD 93.7/bbl one year earlier. The 63% drop in the price of oil affected the economic rationale for developing some of the Company's reserves, and as a result 1.1 billion barrels were transferred from proved reserves to other categories. However, these reserves had not been scheduled for development in the near future, and their transfer to a lower category did not affect the Company's current plans. When the price of oil again rises, the Company expects that the greater part of the reserves demoted for economic reasons will return to the proved category.

### **Oil and gas production.**

The production of hydrocarbons by the LUKOIL Group rose by 1.0% in 2008, to 803 million barrels of oil equivalent; average production was 2.194 million BOE/day.

Oil production by the LUKOIL Group (including the share of production by associates) in 2008 was 95,450 thousand tonnes (1,921 thousand bbl/day), which is 1.5% lower than in 2007. The main reason for the decrease in oil production by the LUKOIL Group was the natural decrease in production in traditional production areas, especially in Western Siberia, as well as interruptions in energy supply to LUKOIL Group fields in this region. The Company plans to stabilise Western Siberian production in the near future through the use of the latest recovery enhancement technologies and the construction of our own power generation capacities.

The production of merchantable gas (after internal consumption, formation pumping and transport losses) in the reporting year was 17.020 billion m<sup>3</sup> (1.642 billion ft<sup>3</sup>/day). The average daily production of merchantable gas rose by 21.3% year-on-year, primarily due to the successful development of the Uzbek project Kandym–Khauzak–Shady.

Eleven new oil fields were put into development in 2008. The Company's largest achievement was the commissioning of the Yuzhnaya Khylochuya field in Timan-Pechora in the middle of the year, which made it possible to halt the decrease in oil production. The proved oil reserves in the Yuzhnaya Khylochuya field exceed 500 million barrels. The projected level of oil production at the field, which is scheduled to be reached in 2009, is 7.5 million tonnes/year (about 150,000 bbl/day).

The Nakhodkinskoe deposit in the Bolshekhetskaya Depression accounted for the bulk of the Company's natural gas production in Russia (more than 95%). In 2008, more than 8.3 billion m<sup>3</sup> of gas was produced, which is 7.7% more than in 2007. Thus, production at the Company's largest Russian gas deposit rebounded to the 2006 level after a drop in 2007, which was related to decreased purchases of gas by OAO Gazprom. The main increase in gas production in international projects was secured by the Khauzak-Shady facility commissioned at the end of 2007, which was developed as part of the Kandym–Khauzak–Shady project in Uzbekistan. The production of merchantable gas here was 2.340 billion m<sup>3</sup>, or almost 56% of the Company's total production of merchantable gas abroad. In the second half of 2008 the production of natural gas at the Khauzak–Shady facility reached its designed level (3 million t/year). Test drilling continued on the plot (27,000 m of headway in formations) and 12 new wells were brought on-stream with a gas yield of 452,300 m<sup>3</sup>/day.

In the sector of exploration and development, the bulk of R&D was aimed at developing rational complexes of geological–geophysical research, improvement of reserve assessment methods (work continued on creating a method for calculating reserves in reservoirs with a

complex structure), and also on the development and improvement of methods to ensure enhanced recovery and optimise technological solutions when developing undrilled areas and deposits. Special attention is given to technologies aimed at ensuring environmental safety during the development of fields, especially offshore fields.

### **Oil refining.**

In 2008 the LUKOIL Group continued to take active measures to develop the oil refining segment, both by modernising and expanding existing facilities and by participating in promising new projects.

The amount of oil refined by the Company (including processing at third-party refineries) rose by 8.8% in 2008 compared to 2007, to 61.76 million tonnes. Group refineries together with ISAB refined 56.28 million tonnes (7.9% more than in 2007).

The signal event for the Company in the oil refining sector in 2008 was the signing of an agreement with the Italian company ERG S.p.A on the foundation of a joint venture to manage the ISAB oil refining complex. The ISAB complex is one of the largest and most modern in the Mediterranean region. The integration of the complex into the Group's oil refining assets will help to increase LUKOIL's total refining capacity by 13%, and its foreign refining capacity by 60%.

In April 2008 the Odessa refinery in Ukraine was relaunched after completion of reconstruction that began in 2005. Among other things, one of the atmospheric-vacuum distillation units was rebuilt, with an increase in capacity from 2.4 million to 2.8 million tonnes per year. Also upgraded were the hydro-treatment complex and a number of general refinery facilities, and a visbreaking unit was built. After reconstruction, the refinery is ready to produce Euro-3 automotive gasolines, Euro-4 diesel, jet fuel, and also petroleum bitumen and liquefied gas. The economic effect from the reconstruction is estimated at USD 505 million.

### **Processing of stock at the Group's gas processing plants.**

In 2008 the Company's gas processing plants processed 3.265 billion m<sup>3</sup> of raw materials and 866.2 thousand tonnes of broad fraction of light hydrocarbons, which generally corresponds to the 2007 level. The output of the Company's refineries included 2.568 billion m<sup>3</sup> of stripped gas, 965,000 tonnes of liquefied gases and 841,000 tonnes of liquid hydrocarbons (stable natural gasoline, isopentane and hexane–heptane fractions, broad fractions of light hydrocarbons).

### **Manufacturing of petrochemicals.**

Output at LUKOIL Group petrochemical plants was 1.462 million tonnes in 2008. The 28% drop in production compared to 2007 was due to the fact the operations of OOO Karpatneftekhim were suspended in May 2008 for reconstruction.

As part of the strategy to develop the LUKOIL Group's petrochemical sector, measures were taken in 2008 to modernise existing facilities and create new facilities. The Company's capital expenditures in the petrochemical sector totalled USD 121 million.

In May 2008 operations at the Karpatneftekhim petrochemical plant were suspended in order to carry out large-scale reconstruction. In particular, work is continuing at the plant to build a unit to produce chlorine and caustic soda by membrane electrolysis, with an annual capacity of 182 thousand tonnes of gaseous chlorine and 200 thousand tonnes of caustic soda. A unit to produce PVC suspension with a capacity of 300 thousand tonnes per year is also under construction.

At OOO Stavrolen, the liquefied hydrocarbon gas storage facility was rebuilt, with the aim of increasing the output and volume of processing of gas materials from 200 thousand to 400 thousand tonnes per year. The polypropylene production unit with an annual capacity of 120 thousand tonnes, which was commissioned in 2007, was also upgraded in 2008. The bulk of

work on the assembly of a new polyethylene compounding line was also completed; the line is scheduled to be launched in the second quarter of 2009.

### **Power generation.**

In 2008, as part of the *Strategic Development Program for 2008–2017*, a new business sector was created: Electric Power. In the long-term perspective, this segment will become an important factor in the growth of the Company's capitalisation.

The new segment will bring together all aspects of the energy business, from generation to transportation and distribution of heat and electrical power, to reliably supply the Company's own needs and those of third-party consumers of heat and electricity. As at the end of 2008, besides OAO YuGK TKG-8, which was acquired in the reporting year, and the company's power stations at fields in Russia, the Electric Power business sector included enterprises generating electrical and heat energy in Bulgaria, Romania and Ukraine.

Total production of electricity by organisations in the Electric Power business sector of OAO "LUKOIL" in 2008 was more than 15.7 billion kWh (OAO YuGK TKG-8 accounted for 93% of total electrical power production). Total production of heat energy exceeded 18.1 million Gcal (OAO YuGK TKG-8's share in the total production was 85%).

### **Oil and gas supply.**

Total oil shipments by the Company in 2008 reached 101.3 million tonnes, which corresponds to the 2007 level. During the reporting year, the situation on the Russian oil market remained relatively favourable, which was due to an increase in the refining margin and growth in export duties. In view of this and with the aim of maximising profits, the Company promptly redirected oil from low-efficiency exports to the country's domestic market, and also to Russian refineries owned by the Group and by third parties.

A total of 2.10 million tonnes of oil were sold in Russia in 2008, which is 31% higher than in 2007. The Company processed 44.18 million tonnes at its own refineries in Russia, which is 3.8% more than in 2007. To generate additional profits from the current macroeconomic situation, the Company shipped 3.19 million tonnes of oil for processing at third-party Russian refineries. A total of 236 thousand tonnes of oil was purchased in Russia during the reporting year, compared with 47 thousand tonnes in 2007. The increase in oil purchases was due to the growth in refining volumes in a situation where the Company's Russian oil production was declining.

Oil exports from Russia by OAO "LUKOIL" subsidiaries (taking into account oil purchased from third-party producers) were 6.8% or 39.30 million tonnes lower than in 2007, as a result of the reorientation of part of export flows to the domestic market. Oil shipments to foreign LUKOIL Group refineries and to ISAB totalled 12.10 million tonnes, a record 25.8% higher than in 2007, as a result of the relaunching of production at the Odessa refinery after modernisation and the acquisition of a new refinery. In addition to shipments at its own refineries, the Company also supplied oil to third-party refineries for processing. In the reporting year, such shipments totalled 2.29 million tonnes, which is more than twice the 2007 figure.

In 2008 sales of natural gas, associated petroleum gas, stripped gas and dry gas by Russian organisations of the LUKOIL Group were 12.066 billion m<sup>3</sup>, which is 4.7% more than in 2007. Of this, 9.397 billion m<sup>3</sup> was sold to OAO Gazprom (including 7.856 billion m<sup>3</sup> of natural gas from the Company's Nakhodkinskoe deposit) and 2.669 billion m<sup>3</sup> to other consumers.

### **Retail sale of oil products.**

As at the end of 2008, the LUKOIL Group retail network covered 25 countries and included 204 oil facilities with a total reservoir capacity of 3.06 million m<sup>3</sup> and 6,748 filling stations (including those operating as franchises).

The Company's retail sales of oil products continued to increase in the reporting year: the retail network sold 14.16 million tonnes of oil products, 11.0% more than in 2007. Group average retail sales per filling station (both company-owned and leased) were 7.3 t/day. The growth in retail sales was mainly achieved by increasing sales on the Russian market and the acquisition of new assets.

2008 was notable for the large increase in the number of stations – by 11%. This result was achieved first and foremost thanks to major acquisitions. Most importantly, an agreement was signed on the acquisition of 100% of the shares in the Turkish company Akpet for USD 555 million. This company owns 689 filling stations, eight oil-product terminals with a total capacity of 300 thousand m<sup>3</sup>, five storage facilities for liquefied gas, three aircraft fuelling complexes, and also a factory to produce and package motor oils. Filling stations were also acquired in Bulgaria, Croatia, Montenegro and Russia.

### **Stock market.**

The share price of OAO “LUKOIL” went through considerable fluctuations in 2008, mirroring the situation on the Russian and international stock markets: on the one hand, a historical record price (USD 113.20 per share) was reached during the reporting year, but, on the other hand, in the second half of the year the value of shares fell sharply to the level of four years ago.

OAO “LUKOIL's” share price grew rapidly in the first half of the year, mainly due to significant growth in the price of oil. However, a fall in prices began in the second half of the year as the global financial crisis quickly picked up steam. The most serious consequences for the Company were the considerable drop in the price of oil and the significant flight of capital from emerging markets. The following factors exerted pressure on the share quotations: the tense situation surrounding Georgia and South Ossetia, corporate conflicts and investigations, and other negative factors. Ultimately, the Russian stock market had one of the worst showings among emerging markets.

As a result, the share price of OAO “LUKOIL” fell by 63.2% over the reporting period (based on trading results on OAO RTS Stock Exchange), and equalled USD 32 per share at year end 2008. It should be noted that the RTS index dropped by 72.4%, and the MICEX by 67.2%. Thus, the Company's shares outperformed the Russian stock indexes that determine the average position and movement of share prices of Russian issuers. OAO “LUKOIL's” capitalization as at 31 December 2008 equalled USD 27.2 billion.

Despite the difficult situation on the stock market and in the economy in general, OAO “LUKOIL” shares were still among the most liquid securities of Russian issuers in Russia and abroad. For example, the Company's shares were among the three leaders in terms of trading volume on the Russian organised securities market in 2008. The percentage of OAO “LUKOIL” shares in trading volume on the main trading floors (ZAO MICEX, OAO RTS Stock Exchange) equalled 12.8% and 14.2%, respectively, in 2008.

The programme of American Depositary Receipts and Global Depositary Receipts for Company shares continued in the reporting year; these ADRs and GDRs were traded on the London, Frankfurt, Munich and Stuttgart exchanges, and also on the over-the-counter market in the USA. At year end 2008 the total number of ADRs issued for ordinary shares equalled 579 million shares (68.0% of the Company's charter capital). Based on the results for 2008, OAO “LUKOIL” ADRs had the third-highest trading volume of the ADRs of foreign companies listed on the London Stock Exchange in the IOB system (17.1% of total average monthly trading volume in this system).

LUKOIL reacts promptly and effectively to changes in market trends, which enables it to function successfully and maintain its investment appeal despite the instability of the global financial system. In particular, the LUKOIL Group has decided to reduce its planned capital

expenditures in 2009, which will facilitate a positive cash inflow over the course of 2009 and for the year as a whole. The reduction in the programme of capital expenditures has been achieved without affecting key growth projects, which will ensure positive production indicators for the Company in 2009. This, together with the possible restoration of the fair price of oil to USD 50-70 per barrel, will become the guarantee for growth in the market value of stock in future.

#### **Streamlining of the corporate structure.**

Thirty-eight companies were divested from the LUKOIL Group in 2008 through the sale of shares and equity interests in their charter capitals to third parties, as well as through liquidation and consolidation with other LUKOIL Group companies. At the same time, 30 subsidiaries were created and another 34 were purchased. Thus, in 2008 the total number of companies included in the LUKOIL Group increased by 26, bringing the total from 293 to 319.

In total, shares and equity interests in the charter capitals of subsidiaries and associates worth USD 3 million were sold outside the LUKOIL Group in 2008. USD 5.398 billion was spent on acquisitions and consolidation. The LUKOIL Group's largest purchases in the reporting year were equity interests in OAO YuGK TGC-8 and the ISAB complex (Italy).

**Main objectives of the Company for 2009.** The Company will make every effort in 2009 to ensure stable and successful operations under market conditions, with the aim of increasing share capitalisation.

The Company's main objectives for 2009 are:

- streamlining and reduction of capital and operating costs without damaging key growth projects;
- development of a programme to ensure positive cash flows in conditions of financial crisis;
- replenishment of proved reserves equal to at least 100% of production;
- growth in gas production and processing;
- accelerated growth in oil refining and performance of work to upgrade the Company's refining facilities;
- continued development and streamlining of marketing and distribution assets;
- further improvement in business segment performance through the use of modern technology, streamlining of the corporate structure and cost controls.

**Board of Directors of OAO "LUKOIL"**