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

You should read the following discussion and analysis of our financial condition and results of operations as of 31 December 2009 and for the year then ended in conjunction with our audited consolidated financial statements as of and for the years ended 31 December 2009 and 2008. The consolidated financial statements and the related notes thereto have been prepared in accordance with International Financial Reporting Standards (IFRS).

The financial and operating information contained in this "Management's Discussion and Analysis of Financial Condition and Results of Operations" comprises information of OAO "NOVATEK" and its consolidated subsidiaries (hereinafter jointly referred to as "we" or the "Group").

## OVERVIEW

We are Russia's largest independent natural gas producer and the second-largest producer of natural gas in Russia after Gazprom. In terms of proved natural gas reserves, we are the second largest holder of natural gas resources in Russia after Gazprom, under the Petroleum Resources Management System (PRMS) reserve reporting methodology.

Our exploration, development, production and processing of natural gas, gas condensate, crude oil and related oil products have been conducted primarily within the Russian Federation, and we sell our natural gas volumes exclusively in the Russian domestic market. We export our stable gas condensate directly to international markets while our liquefied petroleum gas and crude oil are generally delivered to both international (including CIS) and domestic markets. We generally sell oil products produced from our unstable gas condensate on the domestic market, but occasionally engage in limited trading operations through our wholly-owned Swiss based trading subsidiary, RUNITEK, by purchasing and reselling refined products on international markets.

In 2009, we geographically expanded our sales of stable gas condensate through deliveries to the Asian-Pacific region, namely South Korea, China and Singapore. The diversification of our stable gas condensate sales provides us with revenue stability, access to new markets and opportunities for higher margins. The ability to market our stable gas condensate to various geographical regions becomes more crucial as we eventually expand the production of wet gas at our fields and increase the processing at the Purovsky Gas Condensate Processing Plant (Purovsky Plant).

Our ongoing exploration work at existing fields in 2009 resulted in the discovery of two new gas condensate deposits at the Yurkharovskoye field as well as one new gas, gas condensate and oil deposit at the Yarudeyskoye field. We also completed the appraisal of reserves at the North Yubileyny license area in accordance with the Russian reserve classification standards.

In November 2009, we established a wholly-owned subsidiary in Poland named "Novatek Polska Sp.z.o.o." to expand our LPG trading activities within this country. "Novatek Polska Sp.z.o.o." commenced its commercial operations in January 2010.

In June 2009, we acquired 100% of the participation interest in OOO "EkropromStroy", the company that manages the construction of the Group's new office building located in Moscow. We plan to relocate all of our Moscow based administrative personnel into this office building upon its estimated completion in the fourth quarter of 2010. The acquisition and construction of this building enables us to meet our increasing demands for additional office space as the company continues to expand its operations.

In May 2009, we acquired 51% of the outstanding ordinary shares of OAO "Yamal LNG", the license holder for the exploration and development of the South-Tambeyskoye field, with natural gas and gas condensate proved reserves of 380 billion cubic meters (bcm) and 14 million tons, respectively, in accordance with SEC classifications as of 31 December 2009. The acquisition of the South-Tambeyskoye field significantly increases the Group's resource base consistent with our long-term business strategy as well as serving as a platform for future production growth and diversification of our natural gas sales.

In November 2008, we launched the second phase expansion of our Purovsky Plant, which now enables us to process approximately five million tons of unstable gas condensate per annum.

In September 2008, we completed and launched the first stage of the second phase development at our Yurkharovskoye field with a total natural gas capacity exceeding seven bcm per annum. In October 2009, we launched the second stage of the second phase development at our Yurkharovskoye field, providing the Group with the potential to increase annual productive capacity at the field by another seven bcm of natural gas and approximately 600 thousand tons of unstable gas condensate.

## SELECTED DATA

| *millions of Russian roubles except as stated* | Year ended 31 December: 2009 | 2008 | Change % |
|---|---|---|---|
| **Financial results** | | | |
| Total revenues (net of VAT and export duties) | 89,954 | 79,272 | 13.5% |
| Operating expenses | (56,130) | (46,916) | 19.6% |
| Profit attributable to NOVATEK shareholders | 26,043 | 22,899 | 13.7% |
| EBITDA [(1)] | 39,566 | 36,702 | 7.8% |
| EBITDAX [(2)] | 40,132 | 37,819 | 6.1% |
| Earnings per share (in Russian roubles) | 8.59 | 7.54 | 13.9% |
| **Operating results** | | | |
| Natural gas sales volumes (mmcm) | 32,937 | 33,274 | (1.0%) |
| Stable gas condensate sales volumes (thousand tons) | 2,170 | 1,583 | 37.1% |
| Liquefied petroleum gas sales volumes (thousand tons) | 749 | 618 | 21.2% |
| Crude oil sales volumes (thousand tons) | 198 | 270 | (26.7%) |
| Oil product sales volumes (thousand tons) | 11 | 66 | (83.3%) |
| Oil product export trading volumes (thousand tons) | - | 93 | n/a |
| **Cash flow results** | | | |
| Net cash provided by operating activities | 36,454 | 31,514 | 15.7% |
| Capital expenditures | 17,872 | 31,810 | (43.8%) |
| Free cash flow [(3)] | 18,582 | (296) | n/a |

(1) EBITDA represents net income before finance income (expense) and income taxes from the statement of income, and depreciation, depletion and amortization and share-based compensation from the statement of cash flows.

(2) EBITDAX represents EBITDA as defined above excluding exploration expenses.

(3) Free cash flow represents the excess of Net cash provided by operating activities over Capital expenditures.

## SELECTED MACRO-ECONOMIC DATA

| *Exchange rate of Russian rouble to US dollar* | 1 quarter | | 2 quarter | | 3 quarter | | 4 quarter | | Year | | Change |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | **2009** | **2008** | **2009** | **2008** | **2009** | **2008** | **2009** | **2008** | **2009** | **2008** | **Y-o-Y, %** |
| At the beginning of the period | 29.38 | 24.55 | 34.01 | 23.52 | 31.29 | 23.46 | 30.09 | 25.25 | 29.38 | 24.55 | 19.7% |
| At the end of the period | 34.01 | 23.52 | 31.29 | 23.46 | 30.09 | 25.25 | 30.24 | 29.38 | 30.24 | 29.38 | 2.9% |
| Average for the period | 33.93 | 24.26 | 32.21 | 23.63 | 31.33 | 24.25 | 29.47 | 27.26 | 31.72 | 24.85 | 27.6% |

| *Crude oil prices, USD / bbl* | 1 quarter | | 2 quarter | | 3 quarter | | 4 quarter | | Year | | Change |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | **2009** | **2008** | **2009** | **2008** | **2009** | **2008** | **2009** | **2008** | **2009** | **2008** | **Y-o-Y, %** |
| **WTI [1]** | | | | | | | | | | | |
| At the end of the period | 49.7 | 101.6 | 69.9 | 140.0 | 70.6 | 100.6 | 79.4 | 44.6 | 79.4 | 44.6 | 78.0% |
| Average for the period | 43.3 | 97.8 | 59.8 | 123.8 | 68.2 | 118.2 | 76.1 | 59.1 | 62.1 | 99.8 | (37.8%) |
| **Brent [2]** | | | | | | | | | | | |
| At the end of the period | 46.5 | 102.7 | 68.1 | 138.9 | 65.7 | 93.7 | 77.7 | 36.6 | 77.7 | 36.6 | 112.3% |
| Average for the period | 44.5 | 96.7 | 59.1 | 121.2 | 68.1 | 115.1 | 74.5 | 55.5 | 61.7 | 97.3 | (36.6%) |
| **Urals [2]** | | | | | | | | | | | |
| At the end of the period | 45.5 | 99.8 | 68.0 | 135.4 | 65.8 | 92.4 | 77.0 | 35.9 | 77.0 | 35.9 | 114.5% |
| Average for the period | 43.7 | 93.2 | 58.5 | 117.4 | 67.8 | 113.4 | 74.2 | 54.6 | 61.2 | 94.8 | (35.4%) |

[1] Based on prices quoted by New York Mercantile Exchange (NYMEX).

[2] Based on prices quoted by Intercontinental Exchange (ICE).

| *Export duties, USD / ton [1]* | 1 quarter | | 2 quarter | | 3 quarter | | 4 quarter | | Year | | Change |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | **2009** | **2008** | **2009** | **2008** | **2009** | **2008** | **2009** | **2008** | **2009** | **2008** | **Y-o-Y, %** |
| **Crude oil, stable gas condensate** | | | | | | | | | | | |
| At the end of the period | 115.3 | 333.8 | 152.8 | 398.1 | 238.6 | 495.9 | 271.0 | 192.1 | 271.0 | 192.1 | 41.1% |
| Average for the period | 111.8 | 314.3 | 133.5 | 359.4 | 224.4 | 463.3 | 247.6 | 283.9 | 179.3 | 355.2 | (49.5%) |
| **LPG** | | | | | | | | | | | |
| At the end of the period | 0.0 | 237.2 | 0.0 | 280.5 | 0.0 | 346.4 | 105.0 | 141.8 | 105.0 | 141.8 | (26.0%) |
| Average for the period | 0.0 | 224.1 | 0.0 | 254.4 | 0.0 | 324.4 | 35.0 | 203.6 | 8.8 | 251.6 | (96.5%) |

[1] Export duties are determined by the government of the Russian Federation in US dollars and are paid in Russian roubles.

## CERTAIN FACTORS AFFECTING OUR RESULTS OF OPERATIONS

### Current financial market conditions

The continuation of a global and/or regional financial crisis may negatively affect all borrowers by limiting access to capital markets, despite signs of the financial markets willingness to price recent transactions. Even though expectations of a prolonged economic downturn have receded, the general consensus amongst the international and domestic banking community calls for a continuing period of tight credit market conditions and increasing margin spreads, although there is a willingness in the capital markets to consider quality grade issuers to access funds. Furthermore, there is a heightened awareness over excess borrowings, potential liquidity problems and the ability of a company's balance sheet to withstand a period of prolonged market turbulence.

We have continued to monitor the credit situation very closely and have taken various measures to ensure the integrity of our financial condition and mitigate counter-party credit exposure from our natural gas and liquid hydrocarbon sales. In addition, we have taken proactive steps to ensure the safety of our excess funds deposited with both domestic and international banks as well as limited our exposure from prepayments to various service providers. Presently, our cash and deposits are diversified and maintained in well capitalized banks with a minimum risk of default.

We have reviewed our capital expenditure program for the upcoming year and have concluded that we have sufficient liquidity, through current internal cash flows and short-term borrowing facilities, to adequately fund our core natural gas business operations and planned capital expenditure program. As a result of this assessment, we have not made any major adjustments to our capital expenditure program as of the 31 December 2009. Some of the ongoing capital projects started during 2009 will be completed during 2010.

Management will continue to closely monitor the economic environment in Russia as well as the domestic and international capital markets to determine if any further corrective and/or preventive measures are required to sustain and grow our business. In addition, we will continue to assess the trends in the capital markets for opportunities to access long-term funding at a reasonable cost to the Company commensurate with our credit rating and our capital requirements.

### Natural gas prices

As an independent natural gas producer, we are not subject to the Russian government's regulation of natural gas prices. Historically, we have sold most of our natural gas at prices higher than the regulated prices set by the government for Gazprom's domestic gas sales, although the prices we can achieve on the domestic market are strongly influenced by the prices regulated by the Federal Tariffs Service (FTS), a governmental agency, and present market conditions. In 2009, the weighted average FTS price for the primary regions where we delivered our natural gas increased by RR 213 per mcm, or 13.6%, to RR 1,776 per mcm compared to RR 1,563 per mcm in 2008.

The specific terms for delivery of natural gas affect our average realized prices. Natural gas sold "ex-field" is sold primarily to wholesale gas traders, in which case the buyer is responsible for the payment of gas transportation tariffs. Sales to wholesale gas traders allow us to diversify our natural gas sales without incurring additional commercial expenses. Historically we have realized higher prices and net margins for natural gas volumes sold directly to end-customers, as the gas transportation tariff is included in the contract price and no retail margin is lost to wholesale gas traders. However, the recent shift in our sales mix has demonstrated that the historical norm may or may not prevail in the present or future market situations.

In April 2009, we renegotiated the sales terms for natural gas volumes sold to one of our largest wholesale gas traders. Under the new sales terms, natural gas sales volumes are purchased by the trader on a delivered basis to the regions where the natural gas is to be consumed. These volumes were classified as end-customers' sales under a separate category, 'traders in remote points'. The new terms contributed to an overall decrease in our total average natural gas netback price (excluding transportation expense) of 1.8% in 2009 compared to 2008, and was primarily due to additional transportation expense incurred for these volumes and distances delivered (see "Transportation expenses" below). In an environment of economic uncertainty and its affect on the demand for natural gas, the change in the terms for this classification of sales allowed us to continue growing our natural gas production volumes by 6.3% during 2009 over the 2008 production levels, and also enabled us to correspondingly increase our stable gas condensate and LPG sales volumes. The renegotiated terms were valid through the end of 2009, and we have no current plans to continue natural gas sales to traders in remote points in 2010.

In November 2006, the FTS approved and published a plan to liberalize the price of natural gas sold on the Russian domestic market by the year 2011. As part of the liberalization plan, the FTS approved four quarterly increases in the regulated price for natural gas in 2009 for an average total increase of 15.9%. Moreover, in December 2009, the FTS approved an increase in the regulated price for natural gas by 15% effective from 1 January 2010. We expect further increases in the regulated price for natural gas as part of the Russian Federation government's efforts to liberalize the price of natural gas on the Russian domestic market. The FTS will continue to approve the effective increase on an annual basis and reserves the right to modify the percentages published as well as potentially prolong the timetable toward market price liberalization based on market conditions and other factors.

As a result of continued economic instability, in both global and domestic markets, our pricing strategy for natural gas emphasized increasing market share and maintaining production growth during 2009. In 2009, our average natural gas price to end-customers, excluding traders in remote points, and ex-field price increased by 6.3% and 7.2%, respectively, as compared to 2008 (see "Natural gas sales" below).

The following table shows our average realized natural gas sales prices (net of VAT) for the years ended 31 December 2009 and 2008:

| | Year ended 31 December: | | Change |
|---|---|---|---|
| *Russian roubles per mcm* | **2009** | **2008** | **%** |
| **Average natural gas price [(1)]:** | | | |
| *End-customers* | *1,933* | *1,818* | *6.3%* |
| *Traders in remote points* | *1,836* | *-* | *n/a* |
| *E-trading* | *-* | *1,412* | *n/a* |
| **Average natural gas price to end-customers** | **1,900** | **1,806** | **5.2%** |
| **Average natural gas transportation expense:** | | | |
| *End-customers* | *(809)* | *(718)* | *12.7%* |
| *Traders in remote points* | *(1,054)* | *-* | *n/a* |
| *E-trading* | *-* | *(132)* | *n/a* |
| **Average natural gas transportation expense for sales to end-customers** | **(893)** | **(701)** | **27.4%** |
| **Average natural gas netback price:** | | | |
| *End-customers* | *1,124* | *1,100* | *2.2%* |
| *Traders in remote points* | *782* | *-* | *n/a* |
| *E-trading* | *-* | *1,280* | *n/a* |
| **Average natural gas netback price on end-customer sales** | **1,007** | **1,105** | **(8.9%)** |
| **Average natural gas price ex-field (wholesale traders)** | **1,049** | **979** | **7.2%** |
| **Total average natural gas price excluding transportation expense** | **1,020** | **1,039** | **(1.8%)** |

[(1)] Includes cost of transportation.

During 2009, there was no activity on the electronic trading platform for natural gas since the current legislation which regulates electronic trading expired at the end of 2008 and is presently under review.

### Crude oil, stable gas condensate, liquefied petroleum gas and oil products prices

Crude oil, stable gas condensate, liquefied petroleum gas ("LPG") and oil products prices on international markets have historically been volatile depending on, among other things, the balance between supply and demand fundamentals, the ability and willingness of oil producing countries to sustain or change production levels to meet changes in global demand and potential disruptions in global crude oil supplies due to war, geopolitical developments, terrorist activities or natural disasters. Crude oil, stable gas condensate, LPG and oil products prices on the domestic market also fluctuate depending on supply and demand fundamentals amongst other factors. Crude oil that we sell bound for international markets is transported through the Transneft pipeline system where it is blended with other crude oil of varying qualities to produce an export blend commonly referred to as “Urals blend”, which normally (or historically) trades at a discount to the international benchmark Brent crude oil. The actual prices we receive for our liquid hydrocarbons on both the domestic and international markets are dependent on many external factors beyond the control of management.

Volatile movements in benchmark crude oil prices can have a positive and/or negative impact on the ultimate prices we receive for our liquid volumes sold on both the domestic and international markets, amongst many other factors. During 2009, the average benchmark crude oil prices were more than 35% lower than in 2008.

Our stable gas condensate, LPG (excluding obligatory domestic deliveries at regulated prices), crude oil and oil products prices on both international and domestic markets include transportation expense in accordance with the specific terms of delivery.

In 2009, our stable gas condensate export delivery terms were delivery to the port of destination ex-ship (DES), priced at cost and freight (CFR) or priced at cost, insurance and freight (CIF), while in 2008, our delivery terms were either DES or CFR. Our average export stable gas condensate contract price, including export duties, in 2009 was approximately USD 530 per ton compared to approximately USD 853 per ton in 2008.

In 2009, our crude oil export delivery terms were delivery at frontier (DAF Feneshlitke, Hungary, and Adamova Zastava, Germany) while in 2008, our delivery terms were DAF Adamova Zastava, Germany. Our average crude oil export contract price, including export duties, was approximately USD 441 per ton compared to USD 419 per ton in 2008. The increase in our average realized contract price was due to the fact that in 2008 we sold 100% of our export volumes in the fourth quarter when the average crude oil price on international markets was significantly lower than the average 2009 price.

During 2009, we purchased 13 thousand tons of crude oil from third parties at an average price of RR 6,423 per ton and resold these volumes in the domestic market.

The following table shows our average realized stable gas condensate and crude oil sales prices (net of VAT and export duties, where applicable) for the years ended 31 December 2009 and 2008 (prices in US dollars were translated from Russian roubles using the average annual exchange rate):

| | Year ended 31 December: | | Change |
|---|---|---|---|
| *Russian roubles (RR) or US dollars (USD) per ton* | **2009** | **2008** | **%** |
| **Stable gas condensate** | | | |
| Net export price, RR per ton | 10,989 | 12,249 | (10.3%) |
| Net export price, USD per ton | 346.4 | 492.9 | (29.7%) |
| Domestic price, RR per ton | 6,483 | 8,135 | (20.3%) |
| **Crude oil** | | | |
| Net export price, RR per ton | 8,093 | 2,925 | 176.7% |
| Net export price, USD per ton | 255.1 | 117.7 | 116.7% |
| Domestic price, RR per ton | 6,051 | 7,881 | (23.2%) |

Our LPG export delivery terms during 2009 were delivery at frontier (DAF) at the border of the customer’s country and carriage paid to (CPT) the Port of Temryuk, southern Russia, while during 2008 the export delivery terms were DAF at the border of the customer’s country. In 2009, our average export LPG contract price, including export duties, was approximately USD 439 per ton compared to USD 745 per ton in 2008. In 2009, as well as in 2008, our LPG CIS delivery terms were DAF at the border of the customer’s country. During 2008 and the second half of 2009, we were obliged to sell a portion of our LPG domestic sales volumes at regulated prices while the remaining portion of our sales was sold under commercial terms. In 2009, we sold 301 thousand tons at an average commercial price of RR 8,112 per ton and 20 thousand tons at the regulated price of RR 5,750 per ton in the domestic market, compared to 437 thousand tons at an average commercial price of RR 10,393 per ton and 48 thousand tons at the regulated price of RR 4,500 per ton, respectively, in 2008. In addition, in 2009, we sold 14 thousand tons of LPG produced at the Purovsky Plant through our wholly-owned subsidiary OOO “NOVATEK-Refuelling Complexes” at an average price of RR 11,745 per ton.

Domestic sales of oil products produced from our unstable gas condensate were priced free carrier (FCA) at the Surgut railroad station (located in the Khanty-Mansiysk Autonomous Region).

In 2009, OOO "NOVATEK-Refuelling Complexes" purchased 2,361 tons of liquefied petroleum gas, diesel fuel and petrol from third parties and subsequently resold 2,238 tons through its retail and small wholesale stations for approximately RR 19,684 per ton. In 2008, we purchased 77 tons of liquefied petroleum gas, diesel fuel and petrol, from third parties, and subsequently resold 56 tons of these volumes for approximately RR 24,132 per ton.

The following table shows our average realized liquefied petroleum gas and oil products sales prices excluding trading activities with oil products (net of VAT and export duties, where applicable) for the years ended 31 December 2009 and 2008 (prices in US dollars were translated from Russian roubles using the average annual exchange rate):

| | Year ended 31 December: | | Change |
|---|---|---|---|
| *Russian roubles (RR) or US dollars (USD) per ton* | **2009** | **2008** | **%** |
| **LPG** | | | |
| Net export price, RR per ton | 13,416 | 12,333 | 8.8% |
| Net export price, USD per ton | 422.9 | 496.2 | (14.8%) |
| CIS price, RR per ton | 10,694 | 11,853 | (9.8%) |
| Domestic price, RR per ton | 7,962 | 9,810 | (18.8%) |
| Domestic price (retail and small wholesale stations), RR per ton | 11,745 | - | n/a |
| **Oil products** | | | |
| Net export price, RR per ton | 9,498 | 3,720 | 155.3% |
| Net export price, USD per ton | 299.4 | 149.7 | 100.0% |
| Domestic price, RR per ton | 5,419 | 7,026 | (22.9%) |

**Transportation tariffs**

The methodology of calculating transportation tariffs for natural gas produced in the Russian Federation for shipments to consumers located within the customs territory of the Russian Federation and the member states of the Customs Union Agreement (Belarus, Kazakhstan, Kyrgyzstan and Tajikistan) consists of two parts: a rate for the utilization of the trunk pipeline and a transportation rate per mcm per 100 kilometers (km). The rate for utilization of the trunk pipeline is based on an "input/output" function, which is determined by where natural gas enters and exits the trunk pipeline and includes a constant rate for end-customers using Gazprom's gas distribution systems. The constant rate is deducted from the utilization rate for end-customers using non-Gazprom gas distribution systems.

In December 2008, the FTS approved four quarterly increases in the transportation tariff for natural gas in 2009 for an average total increase of 15.7% for the year.

In December 2009, the FTS approved a 12.3% average increase for the 2010 transportation tariff for natural gas effective 1 January 2010. The increase is applicable to both the rate for utilization of the trunk pipeline and transportation rate per mcm per 100 km, the former had a range of RR 29.21 to RR 1,630.97 (excluding VAT) per mcm and the latter was RR 9.15 (excluding VAT) per mcm per 100 km, as at 31 December 2009. The increases in regulated transportation tariffs are passed on to our end-customers pursuant to delivery terms in the majority of our contracts.

We transport most of our crude oil through the pipeline network owned and operated by Transneft, Russia's state-owned monopoly crude oil pipeline operator. Our transportation tariffs for the transport of crude oil through Transneft's pipeline network are also set by the FTS. The overall expense for the transport of crude oil depends on the length of the transport route from the producing field to the ultimate destination.

Our stable gas condensate (to the Port of Vitino on the White Sea), LPG and oil products are transported by rail which is owned and operated by Russian Railways, Russia's state-owned monopoly railway operator. Our transportation tariffs for transport by rail are also set by the FTS and vary depending on product and length of transport route. On 27 March 2009, the FTS announced specific discount co-efficients to be applied to the existing rail road transportation tariffs related to export deliveries of LPG and stable gas condensate shipped from the Limbey rail station, located in close proximity to our Purovsky Plant. We applied a co-efficient of 0.72 to the existing rail tariff for our stable gas condensate volumes shipped to export markets from 7 April 2009 and a co-efficient of 0.35 for our LPG export deliveries at the Russian Federation cross-border points for volumes in excess of 90 thousand tons which we reached in the middle of April 2009. The specific discount co-efficients remained in effect throughout 2009.

In January 2010, the FTS revised the discount co-efficients to existing rail road transportation tariffs related to export deliveries of LPG and stable gas condensate shipped from the Limbey rail station. The discount co-efficient for stable gas condensate is set of 0.89 for companies with annual shipped volumes of more than 2,235 thousand tons and the discount co-efficient for LPG is set at 0.35 for export volumes in excess of 105 thousand tons. The revised discount co-efficients are expected to remain in effect throughout 2010.

We deliver our stable gas condensate and oil products produced from our unstable gas condensate to international markets using the loading and storage facilities at the Port of Vitino on the White Sea and tankers for transportation to US, European and countries of the Asian-Pacific region. The costs associated with tanker transportation are determined by the distance to the final destination, tanker availability, seasonality of deliveries and standard shipping terms.

**Transportation transactions with related parties**

All natural gas producers and wholesalers operating in Russia transport their commercial volumes of natural gas through the Unified Gas Supply System (UGSS), which is owned and operated by OAO Gazprom, a State monopoly and a shareholder of OAO NOVATEK since October 2006. As an independent natural gas producer, we utilize the UGSS to transport our natural gas to end-customers at the regulated tariffs established by the FTS.

**Our tax burden**

We have not employed any tax minimization schemes using offshore or domestic tax zones in the Russian Federation.

We are subject to a wide range of taxes imposed at the federal, regional, and local levels, many of which are based on revenue or volumetric measures. In addition to income tax, significant taxes to which we are subject include VAT, unified natural resources production tax (UPT), export duties, property tax, social taxes and contributions.

In practice, Russian tax authorities often have their own interpretation of tax laws that rarely favors taxpayers, who have to resort to court proceedings to defend their position against the tax authorities. Differing interpretations of tax regulations exist both among and within government ministries and organizations at the federal, regional and local levels, creating uncertainties and inconsistent enforcement. Tax declarations, together with related documentation such as customs declarations, are subject to review and investigation by a number of authorities, each of which may impose fines, penalties and interest charges. Generally, taxpayers are subject to an inspection of their activities for a period of three calendar years immediately preceding the year in which the audit is conducted. Previous audits do not completely exclude subsequent claims relating to the audited period. In addition, in some instances, new tax regulations have been given retroactive effect.

## OIL AND GAS RESERVES

In December 2008, the US Securities and Exchange Commission (SEC) released the Final Rule for the *Modernization of Oil and Gas Reporting*, which requires the disclosure of oil and gas proved reserves by significant geographic area, using a 12 month average beginning-of-the-month price for the year, rather than year-end prices, and allows the use of reliable technologies to estimate proved oil and gas reserves, if the technologies have demonstrated reliable estimates about reserves. Furthermore, companies are required to report on the independence and qualifications of its reserve preparer or auditor, and file reports when a third party is relied upon to prepare reserve estimates or conduct an audit of the company's reserves.

OAO NOVATEK does not file with the SEC nor is obliged to report its reserves in compliance with these standards. However, we have consistently disclosed proved oil and gas reserves in the Group's IFRS consolidated financial results. As part of management's continued efforts to improve investor confidence and provide transparency regarding the Group's oil and gas reserves, we have provided additional information about our hydrocarbon reserves based on the widely-industry accepted Petroleum Resources Management System (PRMS) reserves reporting classification, which in addition to total proved reserves discloses information on the Group's probable and possible reserves.

Our proved reserves estimates are appraised by the Group's independent petroleum engineers, DeGolyer and MacNaughton (D&M). The Group's total proved reserves, comprised of proved developed and proved undeveloped reserves as of 31 December 2009 and 2008, were appraised using both reporting and disclosure requirements promulgated by the SEC and the recently issued PRMS reserves reporting classification. Proved reserves disclosed in the *Unaudited Supplemental Oil and Gas Disclosures* in the Group's IFRS consolidated financial statements are presented under the SEC reserve reporting methodology, which requires that 100% of the reserves attributable to all consolidated subsidiaries (whether or not wholly owned) shall be included for the reporting year.

The table below provides the comparison of the Group's estimated reserves under SEC and PRMS classifications based on the Group's equity ownership interest in the respective fields.

| | **Natural gas** | | | |
|---|---|---|---|---|
| | **SEC** | | **PRMS** | |
| *Based on our equity ownership interest in the fields* | ***Billions of cubic feet*** | ***Billions of cubic meters*** | ***Billions of cubic feet*** | ***Billions of cubic meters*** |
| **Total proved reserves at 31 December 2007** | **23,067** | **653** | **24,856** | **704** |
| Changes attributable to: | | | | |
| Revisions of previous estimates, extensions and discoveries | 2,363 | 67 | 2,154 | 60 |
| Production | (1,073) | (30) | (1,073) | (30) |
| **Total proved reserves at 31 December 2008** | **24,357** | **690** | **25,937** | **734** |
| Changes attributable to: | | | | |
| Revisions of previous estimates, extensions and discoveries | 4,091 | 115 | 2,778 | 79 |
| Acquisitions | 6,844 | 194 | 10,551 | 299 |
| Production | (1,142) | (32) | (1,142) | (32) |
| **Total proved reserves at 31 December 2009** | **34,150** | **967** | **38,124** | **1,080** |

| Based on our equity ownership interest in the fields | **Crude oil, gas condensate and natural gas liquids** | | | |
|---|---|---|---|---|
| | **SEC** | | **PRMS** | |
| | ***Millions of barrels*** | ***Millions of metric tons*** | ***Millions of barrels*** | ***Millions of metric tons*** |
| **Total proved reserves at 31 December 2007** | **406** | **49** | **497** | **61** |
| Changes attributable to: | | | | |
| Revisions of previous estimates, extensions and discoveries | 67 | 8 | 75 | 8 |
| Production | (21) | (2) | (21) | (2) |
| **Total proved reserves at 31 December 2008** | **452** | **55** | **551** | **67** |
| Changes attributable to: | | | | |
| Revisions of previous estimates, extensions and discoveries | 42 | 4 | 33 | 4 |
| Acquisitions | 60 | 7 | 91 | 11 |
| Production | (25) | (3) | (25) | (3) |
| **Total proved reserves at 31 December 2009** | **529** | **63** | **650** | **79** |

| Based on our equity ownership interest in the fields | **Combined natural gas, crude oil, gas condensate and natural gas liquids in millions of barrels of oil equivalent** | |
|---|---|---|
| | **SEC** | **PRMS** |
| **Total proved reserves:** | | |
| At 31 December 2007 | 4,678 | 5,100 |
| At 31 December 2008 | 4,963 | 5,354 |
| At 31 December 2009 | 6,853 | 7,711 |

Unlike the SEC's reserves reporting methodology, which only allows the reporting of proved reserves, the PRMS reserve classification standards allows for the reporting of reserves estimates for probable and possible reserves as presented in the following table:

| *Under PRMS classification (based on our equity ownership interest in the fields)* | **Natural gas** | | **Crude oil, gas condensate and natural gas liquids** | |
|---|---|---|---|---|
| | ***Billions of cubic feet*** | ***Billions of cubic meters*** | ***Millions of barrels*** | ***Millions of metric tons*** |
| **Probable reserves:** | | | | |
| At 31 December 2007 | 11,436 | 325 | 338 | 41 |
| At 31 December 2008 | 9,969 | 282 | 298 | 36 |
| At 31 December 2009 | 13,520 | 383 | 375 | 46 |
| **Possible reserves:** | | | | |
| At 31 December 2007 | 8,284 | 235 | 466 | 59 |
| At 31 December 2008 | 7,729 | 219 | 566 | 73 |
| At 31 December 2009 | 9,416 | 267 | 696 | 89 |

The Group's PRMS proved reserves aggregated approximately 1.08 trillion cubic meters (tcm) of natural gas and 79 million tons of gas condensate and crude oil as of 31 December 2009. Combined, these proved reserves represent approximately 7.7 billion barrels of oil equivalent.

Our total PRMS proved reserves have increased by 44.0% during 2009, primarily due to the acquisition in May 2009 of our 51% equity stake in OAO "Yamal LNG", the holder of the license to the South-Tambeyskoye field, and ongoing development activities at the Yurkharovskoye field.

The increase in the Group's PRMS probable and possible reserves during 2009 was primarily due to the acquisition of OAO "Yamal LNG", as well as new discoveries at the Yurkharovskoye and Yarudeyskoye fields.

The Group's reserves are all located in the Russian Federation, in the Yamal-Nenets Autonomous Region (Western Siberia), thereby representing one geographical area.

The below table contains information about reserve/production ratios for the years ended 31 December 2009 and 2008 under both reserves reporting methodologies:

| | **SEC** | | **PRMS** | |
|---|---|---|---|---|
| | **At 31 December:** | | **At 31 December:** | |
| *Number of years (based on our equity ownership interest in the fields)* | **2009** | **2008** | **2009** | **2008** |
| Total proved reserves to production | 29 | 23 | 33 | 23 |
| Total proved and probable reserves to production | - | - | 45 | 32 |
| Total proved, probable and possible reserves to production | - | - | 55 | 40 |

The Group's oil and gas estimation and reporting process involves an annual independent third party appraisal as well as internal technical appraisals of reserves. The Group maintains its own internal reserve estimates that are calculated by qualified technical staff working directly with the oil and gas properties. The Group periodically updates reserves estimates during the year based on evaluations of new wells, performance reviews, new technical information and other studies.

The Group provides D&M annually with engineering, geological and geophysical data, actual production histories and other information necessary for reserve determinations. The method or combination of methods used in the analysis of each reservoir is tempered by experience with similar reservoirs, stages of development, quality and completeness of basic data, and production history. Our reserves estimates were prepared using standard geological and engineering methods generally accepted in the petroleum industry. The Group's and D&M's technical staffs meet to review and discuss the information provided, and upon completion of the process, senior management reviews and approves the final reserves estimates issued by D&M.

The Reserves Management and Assessment Group (RMAG) is comprised of qualified technical staff from various departments – geological and geophysical, gas and liquids commercial operations, capital construction, production, financial planning and analysis and includes technical and financial representatives from the Group's subsidiaries, which are the principal holders of the mineral licenses. The person responsible for overseeing the work of the RMAG is a member of the Management Board.

The approval of the final reserves estimates is the sole responsibility of senior management.

## OPERATIONAL HIGHLIGHTS

### Oil and gas production costs

Our oil and gas production costs are derived from our results of operations for oil and gas producing activities as reported in the *Unaudited Supplemental Oil and Gas Disclosures* in our consolidated financial statements for the years ended 31 December 2009 and 2008. Oil and gas production costs do not include general corporate overheads or their associated tax effects. The following tables set forth certain operating information with respect to our oil and gas production costs during the years presented in millions of Russian roubles and on a barrel of oil equivalent (boe) basis in Russian roubles and US dollars:

| *millions of Russian roubles* | Year ended 31 December: 2009 | 2008 | Change % |
|---|---|---|---|
| **Production costs:** | | | |
| Lifting cost | 3,797 | 3,525 | 7.7% |
| Taxes other than income tax | 7,840 | 7,062 | 11.0% |
| Transportation expenses | 28,482 | 16,013 | 77.9% |
| **Total production costs before DD&A** | **40,119** | **26,600** | **50.8%** |
| Depreciation, depletion and amortization (DD&A) | 5,139 | 4,234 | 21.4% |
| **Total production costs** | **45,258** | **30,834** | **46.8%** |

| *RR per boe* | Year ended 31 December: 2009 | 2008 | Change % |
|---|---|---|---|
| **Production costs:** | | | |
| Lifting cost | 16.0 | 16.0 | 0.0% |
| Taxes other than income tax | 33.1 | 32.0 | 3.4% |
| Transportation expenses | 120.1 | 72.6 | 65.4% |
| **Total production costs before DD&A** | **169.2** | **120.6** | **40.3%** |
| Depreciation, depletion and amortization (DD&A) | 21.7 | 19.2 | 13.0% |
| **Total production costs** | **190.9** | **139.8** | **36.6%** |

| *USD per boe* | Year ended 31 December: 2009 | 2008 | Change % |
|---|---|---|---|
| **Production costs:** | | | |
| Lifting cost | 0.50 | 0.64 | (21.9%) |
| Taxes other than income tax | 1.04 | 1.29 | (19.4%) |
| Transportation expenses | 3.78 | 2.92 | 29.5% |
| **Total production costs before DD&A** | **5.32** | **4.85** | **9.7%** |
| Depreciation, depletion and amortization (DD&A) | 0.68 | 0.77 | (11.7%) |
| **Total production costs** | **6.00** | **5.62** | **6.8%** |

Production costs consist of amounts directly related to the extraction of natural gas, gas condensate and crude oil from the reservoir and other related costs; including production expenses, taxes other than income taxes (production taxes), insurance expenses and shipping/transportation/handling costs to end-customers. The average production cost on a boe basis is calculated by dividing the applicable costs by the respective barrel of oil equivalent of our hydrocarbons produced during the year. Natural gas, gas condensate and crude oil volumes produced by our fields are converted to a barrel of oil equivalent based on the relative energy content of each fields' hydrocarbons.

## Hydrocarbon sales volumes

Our natural gas sales volumes decreased marginally due to a reduction in our purchases from third parties and an increase in natural gas volumes injected into underground storage during 2009. Our liquids sales volumes (crude oil, stable gas condensate, LPG and oil products) increased primarily due to an increase in our unstable gas condensate production.

*Natural gas sales volumes*

| *millions of cubic meters* | Year ended 31 December: 2009 | 2008 | Change % |
|---|---|---|---|
| **Production from:** | | | |
| Yurkharovskoye field | 17,731 | 11,540 | 53.6% |
| East-Tarkosalinskoye field | 11,509 | 14,744 | (21.9%) |
| Khancheyskoye field | 3,043 | 4,115 | (26.1%) |
| Other fields | 70 | 31 | 125.8% |
| **Total natural gas production** | **32,353** | **30,430** | **6.3%** |
| **Purchases from:** | | | |
| Gazprom | - | 1,905 | n/a |
| Other | 1,000 | 980 | 2.0% |
| **Total natural gas purchases** | **1,000** | **2,885** | **(65.3%)** |
| **Total production and purchases** | **33,353** | **33,315** | **0.1%** |
| Purovsky Plant and own usage | (43) | (39) | 10.3% |
| Decrease (increase) in pipeline and underground gas storage facilities | (373) | (2) | n/m |
| **Total natural gas sales volumes** | **32,937** | **33,274** | **(1.0%)** |
| *Sold to end-customers* | *14,751* | *15,357* | *(3.9%)* |
| *Sold to traders in remote points* | *7,668* | *-* | *n/a* |
| *E-trading sales* | *-* | *438* | *n/a* |
| ***Subtotal sold to end-customers*** | ***22,419*** | ***15,795*** | ***41.9%*** |
| ***Sold ex-field*** | ***10,518*** | ***17,479*** | ***(39.8%)*** |

In 2009, our total consolidated natural gas production increased by 1,923 mmcm, or 6.3%, compared to 2008 due to an increase in production at our Yurkharovskoye field resulting from the launch of the first two stages of the field's second phase of development in September 2008 and October 2009, respectively. In 2009, we optimized oil and gas revenues through the management of our fields' operational and production flexibility. By reducing natural gas production, primarily from the dry gas layers at the East-Tarkosalinskoye field and, to a lesser degree, the wet gas layers at both the East-Tarkosalinskoye and Khancheyskoye fields, we were able to grow natural gas production at the Yurkharovskoye field, thus increasing unstable gas condensate production. The decision to reduce production was largely due to a decrease in demand from end-customers, the cessation of sales on the electronic natural gas exchange and normal seasonality consumption patterns.

At 31 December 2009, our cumulative natural gas volumes stored in Gazprom's underground gas storage facilities (UGSF) totaled 584 mmcm, representing an increase of 284 mmcm in 2009, compared to the balance of 300 mmcm at 31 December 2008, and an increase of 260 mmcm in 2008. Our total natural gas inventory balance (including UGSF, UGSS and our own pipeline infrastructure) at 31 December 2009 was 744 mmcm compared to 372 mmcm at 31 December 2008. We expect our volumes of natural gas injected into underground gas storage facilities and maintained in the UGSS to continue fluctuating period-to-period depending on market conditions, storage capacity constraints and our development plans to sustain and/or grow production during periods of seasonality.

In 2009, our natural gas purchases decreased by 1,885 mmcm, or 65.3%, compared to 2008, primarily due to our ability to meet domestic market demand from our own production.

*Liquids sales volumes*

| *thousands of tons* | Year ended 31 December: 2009 | 2008 | Change % |
|---|---|---|---|
| **Production from:** | | | |
| Yurkharovskoye field | 1,484 | 889 | 66.9% |
| East-Tarkosalinskoye field | 896 | 932 | (3.9%) |
| Khancheyskoye field | 618 | 651 | (5.1%) |
| Other fields | 40 | 91 | (56.0%) |
| **Total liquids production** | **3,038** | **2,563** | **18.5%** |
| **Purchases from:** | | | |
| Other | 13 | 98 | (86.7%) |
| **Total liquids purchases** | **13** | **98** | **(86.7%)** |
| **Total production and purchases** | **3,051** | **2,661** | **14.7%** |
| Losses and own usage [(1)] | (21) | (21) | 0.0% |
| Decreases (increases) in liquids inventory balances | 98 | (10) | n/m |
| **Total liquids sales volumes** | **3,128** | **2,630** | **18.9%** |
| *Stable gas condensate export* | *2,115* | *1,578* | *34.0%* |
| *Stable gas condensate domestic* | *55* | *5* | *n/m* |
| ***Subtotal stable gas condensate*** | ***2,170*** | ***1,583*** | ***37.1%*** |
| *LPG export* | *405* | *90* | *350.0%* |
| *LPG CIS* | *9* | *43* | *(79.1%)* |
| *LPG domestic* | *321* | *485* | *(33.8%)* |
| *LPG sold through domestic retail and small wholesale stations* | *14* | *-* | *n/m* |
| ***Subtotal LPG*** | ***749*** | ***618*** | ***21.2%*** |
| *Crude oil export* | *69* | *17* | *305.9%* |
| *Crude oil domestic* | *129* | *253* | *(49.0%)* |
| ***Subtotal crude oil*** | ***198*** | ***270*** | ***(26.7%)*** |
| *Oil products export (international trading activities)* | *-* | *93* | *(100.0%)* |
| *Oil products export* | *1* | *20* | *(95.0%)* |
| *Oil products domestic* | *10* | *46* | *(78.3%)* |
| ***Subtotal oil products*** | ***11*** | ***159*** | ***(93.1%)*** |

(1) Losses associated with processing at the Purovsky Plant and Surgutsky refinery as well as during rail road, trunk pipeline and tanker transportation.

In 2009, our liquids production increased by 475 thousand tons, or 18.5%, to 3,038 thousand tons compared to 2,563 thousand tons in 2008, due to the expansion of unstable gas condensate production capacity at our Yurkharovskoye field resulting from the launch of the first two stages of the field's second phase of development in September 2008 and October 2009, respectively. The increase was offset by a decrease in unstable gas condensate production at our East-Tarkosalinskoye and Khancheyskoye fields due to decreases in their natural gas production (see "Natural gas sales volumes" above) and a decrease in crude oil production at our Ust-Purpeisky license area due to its disposal in April 2009.

At 31 December 2009, we had 111 thousand tons of stable gas condensate in transit or storage and recognized as inventory until such time as it is delivered to customers as compared to 220 thousand tons as of 31 December 2008. In 2009, our stable gas condensate in transit or storage and recognized as inventory decreased by 109 thousand tons compared to a decrease of four thousand tons in 2008. The remaining change in liquids inventory balances related to changes in other liquid hydrocarbon products.

## RESULTS OF OPERATIONS FOR THE YEAR ENDED 31 DECEMBER 2009 COMPARED TO THE YEAR ENDED 31 DECEMBER 2008

The following table and discussion is a summary of our consolidated results of operations for the years ended 31 December 2009 and 2008. Each line item is also shown as a percentage of our total revenues.

| | Year ended 31 December: | | | |
|---|---|---|---|---|
| *Millions of Russian roubles* | **2009** | **% of total revenues** | **2008** | **% of total revenues** |
| **Total revenues** (**net of VAT and export duties**) | **89,954** | ***100.0%*** | **79,272** | ***100.0%*** |
| *including:* | | | | |
| natural gas sales | 53,623 | *59.6%* | 45,650 | *57.6%* |
| liquids sales | 33,280 | *37.0%* | 30,426 | *38.4%* |
| Operating expenses | (56,130) | *(62.4%)* | (46,916) | *(59.2%)* |
| Other operating income (loss) | (291) | *(0.3%)* | (236) | *(0.3%)* |
| **Profit from operations** | **33,533** | ***37.3%*** | **32,120** | ***40.5%*** |
| Finance income (expense) | (831) | *(0.9%)* | (3,384) | *(4.3%)* |
| Share of income (loss) of associated companies | (202) | *(0.3%)* | (147) | *(0.2%)* |
| **Profit before income tax** | **32,500** | ***36.1%*** | **28,589** | ***36.1%*** |
| Total income tax expense | (6,778) | *(7.5%)* | (5,662) | *(7.1%)* |
| **Profit (loss)** | **25,722** | ***28.6%*** | **22,927** | ***28.9%*** |
| Non-controlling interest | 321 | *0.4%* | (28) | *(0.0%)* |
| **Profit attributable to NOVATEK shareholders** | **26,043** | ***29.0%*** | **22,899** | ***28.9%*** |

## Total revenues

The following table sets forth our sales (net of VAT and export duties, where applicable) for the years ended 31 December 2009 and 2008:

| *Millions of Russian roubles* | Year ended 31 December: 2009 | 2008 | Change % |
|---|---|---|---|
| **Natural gas sales** | **53,623** | **45,650** | **17.5%** |
| *End-customer* | *28,513* | *27,915* | *2.1%* |
| *Traders in remote points* | *14,080* | *-* | *n/a* |
| *E-trading* | *-* | *619* | *n/a* |
| ***Subtotal of end-customers sales*** | ***42,593*** | ***28,534*** | ***49.3%*** |
| ***Ex-field sales*** | ***11,030*** | ***17,116*** | ***(35.6%)*** |
| **Stable gas condensate sales** | **23,599** | **19,374** | **21.8%** |
| *Export* | *23,245* | *19,334* | *20.2%* |
| *Domestic* | *354* | *40* | *n/m* |
| **Liquefied petroleum gas sales** | **8,253** | **6,376** | **29.4%** |
| *Export* | *5,429* | *1,112* | *388.2%* |
| *CIS* | *99* | *507* | *(80.5%)* |
| *Domestic* | *2,725* | *4,757* | *(42.7%)* |
| **Crude oil sales** | **1,335** | **2,043** | **(34.7%)** |
| *Export* | *554* | *48* | *n/m* |
| *Domestic* | *781* | *1,995* | *(60.9%)* |
| **Oil products sales** | **93** | **2,633** | **(96.5%)** |
| *Export* | *10* | *2,186* | *(99.5%)* |
| *Domestic* | *83* | *447* | *(81.4%)* |
| **Total oil and gas sales** | **86,903** | **76,076** | **14.2%** |
| Sales of polymer and insulation tape | 1,873 | 2,098 | (10.7%) |
| Other revenues | 1,178 | 1,098 | 7.3% |
| **Total revenues** | **89,954** | **79,272** | **13.5%** |

*Natural gas sales*

In 2009, our revenues from sales of natural gas increased by RR 7,973 million, or 17.5%, compared to 2008 largely due to an increase in natural gas prices as sales volumes remained relatively consistent year-on-year. Revenues from the sale of natural gas accounted for 59.6% and 57.6% of our total revenues in 2009 and 2008, respectively. The increase in natural gas sales as a percentage of total revenues was primarily due to higher natural gas prices and a decrease in liquids prices that was partially offset by an increase in liquids volumes sold.

In 2009, our average realized natural gas price per mcm increased by RR 256 per mcm, or 18.7%, to RR 1,628 per mcm from RR 1,372 per mcm in 2008. Our proportion of natural gas sold to end-customers, including traders in remote points and e-trading sales, to total natural gas sales volumes, increased from 47.5% in 2008 to 68.1% in 2009 due primarily to the initiation of natural gas sales on a delivered basis to traders in remote points beginning in April 2009. The average realized prices of our natural gas sold directly to end-customers and traders in remote points (including transportation expense) and sold ex-field were higher by 5.2% and 7.2%, respectively, in 2009 compared to 2008. In 2008, our sales of natural gas to end-customers were primarily to energy utility and large industrial companies. The majority of natural gas volumes sold to end-customers in 2009 were delivered to energy utility companies and traders in remote points (previously recorded as ex-field sales).

As of 1 January 2009, trading on the electronic exchange has been suspended, pending the prolongation of legislation regulating the electronic trading of natural gas; therefore, we had no e-trading sales during 2009 as compared to 438 mmcm in 2008.

*Stable gas condensate sales*

In 2009, our revenues from sales of stable gas condensate increased by RR 4,225 million, or 21.8%, compared to 2008 primarily due to an increase in volumes sold, which were offset by significantly lower average realized prices due primarily to declining benchmark crude oil prices.

In 2009, we sold 2,170 thousand tons of stable gas condensate, of which 2,115 thousand tons, or 97.5%, was exported to the United States, Europe and Asian-Pacific region, and the remaining 55 thousand tons were sold domestically. In 2008, we exported 1,578 thousand tons of stable gas condensate, or 99.7% of our total sales volumes, to markets in the United States and Europe. In 2009, our total stable gas condensate sales volumes increased by 587 thousand tons, or 37.1%, primarily due to an increase in our unstable gas condensate production and, to a lesser extent, a decrease in stable gas condensate inventory balances.

We delivered our stable gas condensate to international markets using the loading and storage facilities at the Port of Vitino on the White Sea and via leased tankers.

In 2009, our average realized price, excluding export duties, for stable gas condensate sold on the export market decreased by USD 146.5 per ton, or 29.7%, to USD 346.4 per ton (DES, CFR and CIF) from USD 492.9 per ton (DES and CFR) in 2008 due to a 37.9% decrease in our average export contract price that was partially offset by a 49.2% decrease in our average export duty per ton. The decrease in our average realized contract price was due to an overall decrease in crude oil and related commodity prices on international markets in 2009 compared to 2008.

*Liquefied petroleum gas sales*

In 2009, our revenues from the sales of LPG increased by RR 1,877 million, or 29.4%, compared to 2008, primarily due to an increase in volumes sold. In 2009, our total LPG sales volumes increased by 131 thousand tons, or 21.2%, to 749 thousand tons from 618 thousand tons in 2008.

In 2009, we were able to compete with other global LPG producers in the international markets due to the abolishment of Russian export duties on LPG effective until 1 December 2009. As a result, in 2009, our export sales volumes of LPG increased 4.5 times to 405 thousand tons as compared to 2008, which aggregated to 54.1% of our total LPG sales volumes. Our average LPG export price decreased by USD 73.3 per ton, or 14.8%, to USD 422.9 per ton (DAF and CPT, excluding export duties) in 2009 compared to USD 496.2 per ton (DAF, excluding export duties) in 2008. The decrease in our average realized export prices (excluding export duties) was primarily due to a 41.1% decrease in our average contract price which was partially offset by the abolishment of export duties throughout most of 2009.

The remaining volumes of LPG were sold as follows: 44.7% was sold domestically at an average price of RR 8,125 per ton (FCA, excluding VAT) representing a decrease of RR 1,685 per ton, or 17.2%, compared to 2008, and 1.2% was sold to the CIS for an average price of RR 10,694 per ton (DAF) representing a decrease of RR 1,159 per ton, or 9.8%, compared to 2008.

In 2008, we sold 78.5% of our LPG volumes domestically, 14.6% to the export markets and 6.9% to markets in the CIS. The increase in our share of LPG deliveries to export markets from 14.6% in 2008 to 54.1% in 2009 was primarily the result of a decrease in domestic consumption, mainly from the petrochemical industry, and a corresponding sequential reduction in domestic margins.

*Crude oil sales*

In 2009, our revenues from the sales of crude oil decreased by RR 708 million, or 34.7%, compared to 2008, due to a decrease in both our sales volumes and prices.

In 2009, our crude oil volumes available for sale decreased by 72 thousand tons, or 26.7%, to 198 thousand tons from 270 thousand tons in 2008 primarily due to a decrease in crude oil production. In 2009, 65.2% of our crude oil volumes were sold domestically at an average price of RR 6,051 per ton (excluding VAT) representing a decrease of RR 1,830 per ton, or 23.2%, compared to 2008. The decrease in our average realized price was due to the overall decrease in crude oil prices in the domestic market in 2009. The remaining 34.8% of our crude oil volumes were sold to the export markets at an average price of USD 255.1 per ton (DAF, excluding export duties) representing an increase of USD 137.4 per ton, or 116.7%, compared to 2008. The increase in the average realized export price (excluding export duties) was the result of a 5.3% increase in our average export contract price and a 42.0% decrease in our average export duty per ton. The increase in our average realized contract price was due to the fact that in 2008 we sold 100% of our export volumes in the fourth quarter when the average crude oil price on international markets was significantly lower than the average 2009 price.

*Oil products sales*

In 2009, our revenue from the sales of oil products decreased by RR 2,540 million, or 96.5%, compared to 2008, primarily due to a suspension of oil products (naphtha) trading activities on international markets by our foreign trading subsidiary beginning in December 2008.

In 2009, we did not sell oil products (naphtha) to the international markets compared to sales of 93 thousand tons in 2008 for an average contract price of USD 938.6 per ton (DES and FOB).

In 2009, we sold one thousand tons compared to 20 thousand tons in 2008 of oil products (light distillate) produced from our unstable gas condensate to the international market through our foreign trading subsidiary at an average realized price (excluding export duties, FOB Vitino) of USD 299.4 and of USD 149.7 per ton, respectively.

In 2009, our revenues from oil products produced at the Surgutsky refinery decreased to RR 46 million from RR 260 million in 2008. Oil products sales volumes produced from our unstable gas condensate amounted to eight thousand tons in 2009 compared to 37 thousand tons in 2008. Our oil products sales price decreased by RR 1,607 per ton, or 22.9%, to RR 5,419 per ton in 2009 from RR 7,026 per ton in 2008 primarily due to an overall decrease in oil products prices in the domestic market in 2009.

In 2009, our revenues from oil products trading operations sold through our retail stations on the domestic market amounted to RR 36 million compared to RR one million in 2008. In 2009, we sold two thousand tons of oil products (diesel fuel and petrol) for an average price of RR 22,356 per ton through our retail stations. The same operations were insignificant in 2008. In addition, in 2008, we sold nine thousand tons of oil products purchased for resale via our domestic trading operations for an average price of RR 20,794 per ton.

*Sales of polymer and insulation tape*

Our revenues from the sales of polymer and insulation tape decreased by RR 225 million, or 10.7%, to RR 1,873 million in 2009, compared to RR 2,098 million in 2008 mainly due to a decrease in both polymer products production volumes and average realized prices.

Revenues from our sales of BOPP film wrap decreased by RR 61 million, or 4.6%, from RR 1,335 million in 2008 to RR 1,274 million in 2009 due to a decrease in demand on the domestic market. The proportion of BOPP film wrap sales to total sales of polymer and insulation tape increased by 4.4% to 68.0% in 2009 compared to 63.6% in 2008.

Our revenues from pipe insulation product sales decreased by RR 105 million, or 19.9%, from RR 527 million in 2008 to RR 422 million in 2009 mainly due to a decrease in volumes sold. Revenues from polymer pipes sales decreased by RR 55 million, or 26.8%, from RR 205 million in 2008 to RR 150 million in 2009 due to both a decrease in volumes sold and prices. The remaining RR 28 million and RR 30 million in 2009 and 2008, related to sales of other polymer products.

*Other revenues*

Other revenues include geological and geophysical research services, rent, polymer tolling, transportation, handling, storage and other services. In 2009, other revenues increased by RR 80 million, or 7.3%, to RR 1,178 million from RR 1,098 million in 2008. The increase in other revenues was primarily related to the increase in revenues from rent services which accounted for RR 345 million in 2009, compared to RR 111 million in 2008. In addition, our revenues from geological and geophysical research services provided to our associates and third parties increased by RR 34 million, or 4.5%, to RR 798 million in 2009, compared to RR 764 million in 2008.

In 2009, our revenues from transportation, handling and storage services decreased by RR 144 million due to the disposal of our non-core subsidiary OOO “Purovsky Terminal” in December 2008. In addition, our revenues from polymer tolling decreased by RR 33 million. The remaining decrease of RR 11 million in other revenues was composed of various immaterial items.

## Operating expenses

In 2009, our total operating expenses increased by RR 9,214 million, or 19.6%, to RR 56,130 million compared to RR 46,916 million in 2008, largely due to an increase in transportation costs and depreciation, depletion and amortization that was partially offset by a decrease in our purchases of natural gas and liquid hydrocarbons. As a percentage of total operating expenses, our non-controllable expenses, such as transportation and taxes other than income tax, increased by 12.0% in 2009 to 66.0% compared to 54.0% in 2008. Total operating expenses increased as a percentage of total revenues to 62.4% in 2009 compared to 59.2% in 2008, as shown in the table below.

The increase in our operating expenses as a percent of total revenues was primarily due to an increase in our natural gas transportation expense. The increase in natural gas transportation expense was the result of a significant increase in volumes sold to end-customers, primarily due to the reclassification of volumes sold to traders in remote points from ex-field as a result of the negotiated contract terms, and an increase in the tariff for natural gas transportation.

| | **Year ended 31 December:** | | | |
|---|---|---|---|---|
| *millions of Russian roubles* | **2009** | **% of total revenues** | **2008** | **% of total revenues** |
| Transportation expenses | 29,026 | *32.3%* | 18,153 | *22.9%* |
| Taxes other than income tax | 8,042 | *8.9%* | 7,186 | *9.1%* |
| **Subtotal non-controllable expenses** | **37,068** | ***41.2%*** | **25,339** | ***32.0%*** |
| Materials, services and other | 6,259 | *7.0%* | 6,332 | *8.0%* |
| Depreciation, depletion and amortization | 5,588 | *6.2%* | 4,478 | *5.6%* |
| General and administrative expenses | 5,126 | *5.7%* | 5,064 | *6.4%* |
| Purchases of natural gas and liquid hydrocarbons | 1,143 | *1.3%* | 4,665 | *5.9%* |
| Exploration expenses | 566 | *0.6%* | 1,117 | *1.4%* |
| Net impairment expense (reversal) | 125 | *n/m* | 105 | *n/m* |
| Change in natural gas, liquid hydrocarbons, and polymer products and work-in-progress | 255 | *n/m* | (184) | *n/m* |
| **Total operating expenses** | **56,130** | ***62.4%*** | **46,916** | ***59.2%*** |

*Non-controllable expenses*

A significant proportion of our operating expenses are characterized as non-controllable expenses since we are unable to influence the increase in regulated tariffs for transportation of our hydrocarbons or the rates imposed by federal, regional or local tax authorities. In 2009, non-controllable expenses of transportation and taxes other than income tax increased by RR 11,729 million, or 46.3%, to RR 37,068 million from RR 25,339 million in 2008. The change in transportation expenses was primarily due to an increase in the aggregate amount of natural gas volumes delivered to end-customers, including traders in remote points, which were previously recorded as ex-field sales with no responsibility to incur transport related costs, the increase in the natural gas transportation tariff and an increase in liquids export sales volumes. Taxes other than income tax increased primarily due to higher property tax expense. As a percentage of total revenues our non-controllable expenses increased by 9.2% to 41.2% in 2009 compared to 32.0% in 2008.

*Transportation expenses*

In 2009, our total transportation expenses increased by RR 10,873 million, or 59.9%, compared to 2008.

| *millions of Russian roubles* | **Year ended 31 December:** 2009 | 2008 | **Change** % |
|---|---|---|---|
| Natural gas transportation to customers | 20,019 | 11,080 | 80.7% |
| Stable gas condensate, liquefied petroleum gas and oil products transportation by rail | 5,820 | 4,384 | 32.8% |
| Stable gas condensate transported by tankers | 2,675 | 2,168 | 23.4% |
| Unstable gas condensate transportation from the fields to the processing facilities through third party pipelines | 340 | 232 | 46.6% |
| Crude oil transportation to customers | 160 | 123 | 30.1% |
| Other transportation costs | 12 | 166 | (92.8%) |
| **Total transportation expenses** | **29,026** | **18,153** | **59.9%** |

In 2009, our transportation expenses for natural gas increased by RR 8,939 million, or 80.7%, to RR 20,019 million from RR 11,080 million in 2008. The change was mainly due to a 41.9% increase in our sales volumes of natural gas delivered directly to end-customers, including traders in remote points, where the cost of transportation is included in the sales price, as well as increases in the natural gas transportation tariff (see "Transportation tariffs" above). Our average transportation distance for natural gas sold to end-customers fluctuates period-to-period and depends on the location of end-customers and the specific routes of transportation.

Total expenses for transportation by rail increased by RR 1,436 million, or 32.8%, primarily due to higher liquids volumes sold. In 2009, our combined volumes of stable gas condensate, LPG and oil products sold and transported via rail increased by 695 thousand tons, or 31.2%, to 2,923 thousand tons from 2,228 thousand tons in 2008.

Our expense for stable gas condensate transported by rail to export markets increased by RR 498 million, or 19.0% to RR 3,124 million from RR 2,626 million in 2008 due to a 34.0% increase in volumes sold. In 2009, our average transportation rate per ton for stable gas condensate decreased by 11.2% to RR 1,477 from RR 1,664 in 2008, due to the application of a co-efficient of 0.72 to the existing rail tariff for deliveries to export markets from 7 April 2009 until 31 December 2009. In accordance with the FTS announcement, the co-efficient was applied to the existing rail road transportation tariff related to export deliveries of stable gas condensate shipped from the Limbey rail station, located in close proximity to our Purovsky Plant (see "Transportation tariffs" above). The decrease was partially offset by increases to the railroad tariff of 5.0% and 5.7% from 1 January 2009 and from 1 July 2009, respectively.

In 2009, our expense for LPG transported by rail increased by RR 905 million, or 53.1%, primarily due to an increase in volumes sold. In 2009, our expense for LPG transported by rail amounted to RR 2,608 million, of which RR 1,767 million was related to export sales, RR 26 million to CIS sales, and RR 815 million to domestic sales, or RR 4,365 per ton, RR 2,855 per ton, and RR 2,431 per ton, respectively. In 2008, transportation expenses for LPG transported by rail amounted to RR 1,703 million, of which RR 488 million was related to export sales, RR 125 million to CIS sales, and RR 1,090 million to domestic sales, or RR 5,408 per ton, RR 2,935 per ton and RR 2,247 per ton, respectively. Following the formal announcement from the FTS (see "Transportation tariffs" above), we applied a co-efficient of 0.35 to the existing rail tariff for LPG export deliveries at the cross-border points of the Russian Federation for volumes in excess of 90 thousand tons which we reached in the middle of April 2009 and that remained in effect throughout 2009.

In 2009, we incurred RR 75 million of railroad transportation expenses related to the domestic sales of stable gas condensate compared to RR four million in 2008. The transportation rate per ton increased from RR 761 in 2008 to RR 1,378 in 2009 due to an increase in both the average delivery distance and the railroad tariffs.

In 2009, we incurred RR two million of railroad transportation expenses related to the export sales of oil products produced from our unstable gas condensate production compared to RR 41 million in 2008. The transportation rate per ton was RR 1,383 in 2009 compared to RR 2,057 in 2008.
The remaining RR 11 million of transportation expenses by rail in 2009, and RR 10 million in 2008, were related to the transportation of oil products sold on the domestic market and other railroad services not allocated between products.

Total transportation expense for delivery of stable gas condensate by tanker to international markets increased by RR 507 million, or 23.4%, to RR 2,675 million in 2009 from RR 2,168 million in 2008. The change was primarily due to a 34.0% increase in volumes sold that was partially offset by a slight decrease in average freight rates. In 2009, we delivered 66.5% of our stable gas condensate export volumes to United States markets compared to 93.0% in 2008.

*Taxes other than income tax*

| *millions of Russian roubles* | Year ended 31 December: 2009 | 2008 | Change % |
|---|---|---|---|
| Unified natural resources production tax (UPT) | 6,699 | 6,558 | 2.2% |
| Property tax | 1,155 | 670 | 72.4% |
| Other taxes | 188 | 92 | 104.3% |
| Subtotal | 8,042 | 7,320 | 9.9% |
| Less: reversal of provision for additional taxes (UPT) | - | (134) | n/a |
| **Total taxes other than income tax** | **8,042** | **7,186** | **11.9%** |

In 2009, taxes other than income tax increased by RR 856 million, or 11.9%, primarily due to an increase in property tax expense.

In 2009, our UPT for gas condensate and natural gas increased by RR 308 million and RR 265 million, respectively, due to an increase in our production volumes. The decrease in our UPT for crude oil of RR 432 million was due to both a reduction in volumes produced, and a decrease in our average crude oil production tax rate, which is linked to the Urals benchmark crude oil price. Our average UPT rate for crude oil decreased from RR 3,347 per ton in 2008 to RR 2,255 per ton in 2009. The natural gas production tax rate in 2009 and 2008 remained unchanged at RR 147 per mcm.

In 2009, our property tax expense increased by RR 485 million, or 72.4%, to RR 1,155 million from RR 670 million in 2008, primarily due to additions of property, plant and equipment (PPE) at our production subsidiaries.

In 2009, other taxes increased by RR 96 million, or 104.3%, primarily due to the recognition of non-deductible VAT expenses.

*Materials, services and other*

In 2009, our materials, services and other expenses decreased by RR 73 million, or 1.2%, to RR 6,259 million compared to RR 6,332 million in 2008. The main components of this expense were employee compensation and materials and supplies, which comprised 39.3% and 23.2%, respectively, of total materials, services and other expenses in 2009.

| *millions of Russian roubles* | Year ended 31 December: 2009 | 2008 | Change % |
|---|---|---|---|
| Employee compensation | 2,457 | 2,169 | 13.3% |
| Materials and supplies | 1,455 | 1,766 | (17.6%) |
| Tolling and processing fees | 556 | 341 | 63.0% |
| Repair and maintenance services | 396 | 405 | (2.2%) |
| Electricity and fuel | 331 | 308 | 7.5% |
| Fire safety and security expense | 186 | 168 | 10.7% |
| Other | 254 | 454 | (44.1%) |
| **Subtotal materials, services and other** | **5,635** | **5,611** | **0.4%** |
| Operator services expense | 624 | 721 | (13.5%) |
| **Total materials, services and other** | **6,259** | **6,332** | **(1.2%)** |

In 2009, our materials, services and other expenses, excluding operator services expense, increased by RR 24 million, or 0.4%, to RR 5,635 million compared to RR 5,611 million in 2008.

Our employee compensation increased by RR 288 million, or 13.3%, to RR 2,457 million compared to RR 2,169 million in 2008. The increase was primarily due to increases in average salaries and the number of employees. The increase in additional staffing at our subsidiaries, mainly the Purovsky Plant, OOO “NOVATEK-Yurkharovneftegas” and OOO “NOVATEK-Refuelling Complexes”, was due to the significant growth in their respective activities. The increase in employee compensation at our production subsidiaries was partially offset by a decrease in payroll expenses due to the disposal of our non-core subsidiary, OOO “Purovsky Terminal”, in December 2008.

Materials and supplies expense decreased by RR 311 million, or 17.6%, mainly due to the reduction in production of polymers and insulation tape products and the associated decrease in purchases of raw materials, which accounted for RR 260 million, or 83.6%, of the total decrease in materials and supplies expense. In addition, materials and supplies expense decreased by RR 72 million which was mainly related to a reduction in methanol purchases due to a decrease in natural gas production at the East-Tarkosalinskoye and Khancheyskoye fields.

Tolling and processing fees increased by RR 215 million, or 63.0%, primarily due to a 66.9% increase in volumes and a 10.2% increase in third party processing tariffs both related to the de-ethanization of unstable gas condensate produced at the Yurkharovskoye field, which accounted for RR 236 million of the total change in tolling and processing fees. In addition, in 2009, we also incurred RR 25 million in costs related to the preparation of crude oil produced at our East-Tarkosalinskoye field for transportation. The increase was offset by a decrease of RR 46 million in tolling and processing fees at the Surgutsky refinery as a result of lower volumes of unstable gas condensate sent to the refinery.

Electricity and fuel expenses increased by RR 23 million, or 7.5%, from RR 308 million in 2008 to RR 331 million in 2009 primarily due to an increase in energy consumption at the Yurkharovskoye field and the Purovsky Plant resulting from the commencement of operation of new production assets. The increase was partially offset by a decrease in fuel expense at our East-Tarkosalinskoye and Khancheyskoye fields due to a significant decrease in petrol and diesel fuel prices in the domestic market.

Our fire safety and security expenses increased by RR 18 million, or 10.7%, to RR 186 million from RR 168 million in 2008, primarily due to an increase in the service rates of security companies starting from 1 January 2009.

In 2009, operator services expense represented 10.0% of total materials, services and other expenses and refers to the geological and geophysical research provided mainly to our associated companies. In 2009, we provided operator services totaling RR 624 million to our associated companies at the Anomalny, Severo-Russkiy, Zapadno-Tazovskiy, Sredniy Chaselskiy and Yuzhno-Zapolyarniy license areas as compared to RR 713 million in 2008. The corresponding revenues we received from our associates and third parties for operator services provided are shown as other revenues in the consolidated statement of income.

*Depreciation, depletion and amortization*

In 2009, our depreciation, depletion and amortization (“DDA”) expense increased by RR 1,110 million, or 24.8%, compared to 2008. Depreciation and depletion of our oil and gas properties accrued using the “units of production” method increased by RR 615 million, or 15.5%, as a result of an increase in our depletable cost base as well as a 7.5% increase in our hydrocarbon production in barrels of oil equivalent (boe). Straight-line depreciation increased by RR 495 million, or 104.0%, primarily due to the completion of the work performed and the transfer of the related costs for the Purovsky Plant’s second phase expansion in the fourth quarter 2008.

In 2009, our DDA per boe was RR 19.4 compared to DDA per boe of RR 18.1 in 2008, representing a year-on-year increase of 7.2%. The increase in our DDA charge calculated on a boe basis was primarily due to an increase in our depletable cost base as a result of completing the capital expansion program related to the second stage of the second phase of development at the Yurkharovskoye field in October 2009.

Our reserve base used as the denominator in the calculation of the DDA charge under the “units of production” method is only appraised on an annual basis and does not fluctuate during the year, whereas our depletable cost base does change each quarter due to the ongoing capitalization of our costs throughout the year.

*General and administrative expenses*

In 2009, our general and administrative expenses increased by RR 62 million, or 1.2%, to RR 5,126 million compared to RR 5,064 million in 2008. The main components of these expenses were employee compensation, charitable contributions and legal, audit and consulting services, which, on aggregate, comprised 71.7% and 74.0% of total general and administrative expenses in 2009 and 2008, respectively.

| | Year ended 31 December: | | Change |
|---|---|---|---|
| *millions of Russian roubles* | **2009** | **2008** | **%** |
| Employee compensation | 2,840 | 2,940 | (3.4%) |
| Charitable contributions | 533 | 499 | 6.8% |
| Legal, audit, and consulting services | 301 | 309 | (2.6%) |
| Rent expense | 245 | 175 | 40.0% |
| Concession management services | 225 | 182 | 23.6% |
| Business trip expenses | 207 | 216 | (4.2%) |
| Depreciation – administrative buildings | 150 | 103 | 45.6% |
| Fire safety and security expense | 143 | 139 | 2.9% |
| Insurance expense | 90 | 90 | 0.0% |
| Other | 392 | 411 | (4.6%) |
| **Total general and administrative expenses** | **5,126** | **5,064** | **1.2%** |

Our employee compensation decreased by RR 100 million, or 3.4%, to RR 2,840 million as compared to RR 2,940 million in 2008, which was primarily due to a decrease in the accrual of performance-related bonuses during the year, combined with a 1.7% reduction in the number of administrative employees.

In 2009, our charitable contributions increased by RR 34 million, or 6.8%, to RR 533 million compared to RR 499 million in 2008, and were primarily related to our continued support for charities and social programs in the regions where we operate. Charitable contributions will continue to fluctuate period-on-period depending on the funding needs and the implementation schedule of specific programs we support.

Legal, audit, and consulting services expenses decreased by RR 8 million, or 2.6%, to RR 301 million compared to RR 309 million in 2008. The decrease was largely related to savings on information technology system support and maintenance.

In 2009, our rent expense increased by RR 70 million, or 40.0%, primarily due to an increase in rental rates for our Moscow office effective from July 2009.

Concession management services represent administrative expenses incurred by Tharwa Petroleum Company S.A.E (the operator for El Arish concession area located in Egypt). In 2009, our expenses related to concession management services increased by RR 43 million, or 23.6%, compared to 2008 primarily due to the start of exploration activities in this concession area during the second half of 2008.

We remained focused on tight cost controls throughout the year, and as a result, our business trip related expenses decreased by RR 9 million, or 4.2%, from RR 216 million in 2008 to RR 207 million in 2009.

In 2009, other general and administrative expenses decreased by RR 19 million, or 4.6%, compared to 2008. The decrease in these expense items was mainly due to a decrease in advertising expenses by RR 15 million, transportation expenses of administrative nature by RR 13 million and materials expense used for administrative purposes by RR seven million. The decrease was offset by an increase in bank charges by RR 26 million and an increase in repair and maintenance expense by RR 23 million. The remaining decrease of RR 33 million was allocated amongst different expense categories within other general and administrative expenses which, taken individually, increased immaterially.

*Purchases of natural gas and liquid hydrocarbons*

Purchases of natural gas and liquid hydrocarbons decreased by RR 3,522 million, or 75.5%, to RR 1,143 million in 2009, from RR 4,665 million in 2008, primarily due to suspension of trading operations with oil products, namely naphtha, by our foreign trading subsidiary on the international markets. In 2008, our purchases of naphtha amounted to RR 1,886 million.

We also continued to reduce our purchases of natural gas from third parties due to increases in our natural gas production from our own fields. Purchases of natural gas decreased by RR 1,572 million, or 60.6%, from RR 2,593 million in 2008 to RR 1,021 million in 2009, primarily due to a decrease in volumes purchased from third parties that was partially offset by an increase in purchase prices.

*Change in natural gas, liquid hydrocarbons, and polymer products and work-in-progress*

In 2009, we recorded a charge of RR 255 million to change in inventory expense as compared to a reversal of RR 184 million in 2008.

In 2009, we recorded a charge of RR 281 million to change in inventory due to a decrease in our inventory balance of stable gas condensate in transit and storage by 109 thousand tons. In addition, we recorded a charge of RR 82 million and RR 62 million to change in inventory due to a decrease in the inventory balance of polymers and insulation tape products and a decrease in work-in-progress, respectively. During the same period, we recorded a reversal of RR 127 million due to an increase in our inventory balance of natural gas by 372 mmcm, while the remaining reversal of RR 43 million to the change in inventory expense related to changes in our balances of other products.

In 2008, we recorded a reversal of RR 72 million and RR 70 million to change in inventory expense due to an increase in inventory balances of crude oil and of polymers and insulation tape products. We also recorded a reversal of RR 55 million and RR 20 million to change in inventory due to an increase in the cost of our inventory balance of stable gas condensate and an increase in our inventory balance of natural gas, which was offset by a charge of RR 82 million due to a decrease in the cost of naphtha purchased for resale. The remaining reversal of RR 49 million to the change in inventory expense related to a change in other products balances and work-in-progress.

**Other operating income (loss) and net gain (loss) on disposals**

In 2009, we realized other operating loss (net of gain on disposals) of RR 291 million, of which RR 190 million was related to commodity derivative instruments that did not qualify as hedge transactions under IAS 39, *Financial Instruments: Recognition and Measurement* ("IAS 39") and RR 303 million was related to disposal of assets under construction, primarily at our subsidiary JSC "Energy Northern Company". In addition, in 2009, we recognized other income of RR 52 million and RR 63 million due to the disposal of our subsidiary OOO "Purneft" in April 2009 and for penalties from our customers due to non-compliance of their contractual obligations, respectively. The remaining other income of RR 87 million was primarily related to other profit and loss items which, taken individually, increased immaterially.

In 2008, we realized other operating loss of RR 236 million of which, RR 212 million was related to the disposal of our long-term lease with OAO "Gazprom".

**Profit from operations**

As a result of the factors discussed above, our profit from operations increased by RR 1,413 million, or 4.4%, to RR 33,533 million in 2009, compared to RR 32,120 million in 2008. In 2009, our profit from operations as a percentage of total revenues decreased to 37.3% compared to 40.5% in 2008 primarily due to significantly higher transportation expenses as a result of an increase in volumes sold as well as a significant decline in international and domestic benchmark crude oil prices.

**Finance income (expense)**

In 2009, we recorded a net finance expense of RR 831 million versus RR 3,384 million in 2008, which was primarily related to a decrease in our foreign exchange loss due to lower average depreciation of Russian rouble against the US dollar in 2009 compared to 2008.

During the year, our interest expense increased by RR 597 million, or 268.9%, primarily due to an increase in our average borrowings and higher financing rates. In 2009, interest income increased by RR 120 million, or 29.5%, primarily due to the receipt of interest income from loans issued to third parties.

We recorded a net foreign exchange loss of RR 539 million as compared to RR 3,569 million in 2008 due to a 2.9% and 19.7% strengthening of the US dollar against the Russian rouble during 2009 and 2008, respectively, and its effect on our foreign currency denominated borrowings.

### Share of income (loss) of associated companies

In 2009, our proportionate share in the loss of associated companies amounted to RR 202 million compared to a loss of RR 147 million recorded in 2008. The losses recognized by our associated companies in both periods were due to the expensing of geological and geophysical research expenditures under the successful efforts accounting policy.

### Income tax expense

Our overall consolidated effective income tax rates (total income tax expense calculated as a percentage of our reported IFRS profit before income tax) were 20.7% and 19.7% for 2009 and 2008, respectively. Our effective income tax rate, after excluding the effect of foreign subsidiaries, was 21.3% in 2009. Our effective income tax rate, after excluding the change in the statutory income tax rate in 2008 and the effect of foreign subsidiaries, was 24.5% in 2008. In 2009, the Russian statutory income tax rate was 20% as compared to 24% in 2008. The difference between our effective and statutory income tax rates is primarily due to certain non-deductible expenses.

### Profit attributable to shareholders and earnings per share

As a result of the factors discussed above, profit for the year increased by RR 2,795 million, or 12.2%, to RR 25,722 million in 2009 from RR 22,927 million in 2008. The profit attributable to NOVATEK shareholders increased by RR 3,144 million, or 13.7%, to RR 26,043 million in 2009 from RR 22,899 million in 2008.

Our weighted average basic and diluted earnings per share, calculated from the profit attributable to NOVATEK shareholders, increased by RR 1.05 per share, or 13.9%, to RR 8.59 per share in 2009 from RR 7.54 per share in 2008.

## LIQUIDITY AND CAPITAL RESOURCES

The following table shows our net cash flows from operating, investing and financing activities for the years ended 31 December 2009 and 2008:

| | Year ended 31 December: | | Change |
|---|---|---|---|
| *millions of Russian roubles* | 2009 | 2008 | % |
| Net cash provided by operating activities | 36,454 | 31,514 | 15.7% |
| Net cash used in investing activities | (36,025) | (31,886) | 13.0% |
| Net cash provided by (used in) financing activities | (1,006) | 8,143 | n/a |

| *Liquidity ratios* | 31 December 2009 | 31 December 2008 | Change, % |
|---|---|---|---|
| Current ratio | 1.14 | 1.79 | (36.3%) |
| Total debt to equity | 0.33 | 0.27 | 22.2% |
| Long-term debt to long term debt and equity | 0.173 | 0.172 | 0.6% |
| Net debt to total capitalization (1) | 0.17 | 0.12 | 41.7% |

(1) Net debt represents total debt less cash and cash equivalents. Total capitalization represents total debt, total equity and deferred income tax liability.

*Net cash provided by operating activities*

In 2009, our net cash provided by operating activities increased by RR 4,940 million, or 15.7%, to RR 36,454 million compared to RR 31,514 million in 2008. The increase was mainly attributable to lower income tax paid, which was partially offset by a decrease in cash inflow from working capital changes.

*Net cash used in investing activities*

In 2009, our net cash used in investing activities increased by RR 4,139 million, or 13.0%, to RR 36,025 million as compared to the RR 31,886 million spent in 2008. In 2009, we used RR 17,096 million in cash for the purchase of 51% shares of OAO “Yamal LNG”, as well as spending RR 12,569 million for ongoing work at both our Yurkharovskoye field and the Purovsky Plant. In 2008, we spent approximately RR 22,433 million on capital expenditures at our Yurkharovskoye field (first stage of the second phase of development) and the Purovsky Plant (second phase expansion).

*Net cash provided by (used in) financing activities*

In 2009, our repayments of borrowings due throughout the year as well as our payments of dividends exceeded the proceeds we received from long-term and short-term borrowings. In 2008, the majority of our net cash provided by financing activities was related to the proceeds we received from long-term borrowings, which was partially offset by repayment of short-term borrowings and dividends. Our net cash provided by or used in financing activities will vary year-to-year depending on the level of borrowings we receive or the repayment of short- and/or long-term debt.

**Working capital**

Our net working capital position (current assets less current liabilities) at 31 December 2009 decreased from RR 11,259 million at 31 December 2008 to RR 3,274 million at 31 December 2009. The change in our net working capital position was mainly due to an increase in our short-term debt (mostly current portion of long-term debt) and accounts payable and accrued liabilities, as well as a decrease in prepayments and other current assets and prepaid income tax that were partially offset by an increase in trade and other receivables.

Due to the high costs of debt during the first six months of 2009, the Group decided not to undertake significant borrowings in this period, and instead, used existing cash on the balance sheet to fund certain operational activities as well as the acquisition of the “Yamal LNG” equity stake, although bank financing was available to us. Management believes the Group has the ability and the capacity to raise debt financing in both the capital markets and through additional borrowings via financial institutions. The market environment for raising finance through the issuance of debt has shown continued signs of improvement in the second half 2009, and, as a result, the Group has raised long-term debt financing of RR 16,926 million from various international and Russian banks during 2009.

### Capital expenditures

Total capital expenditures on property, plant and equipment for the years ended 31 December 2009 and 2008 are as follows:

| *millions of Russian roubles* | Year ended 31 December: | | Change |
|---|---|---|---|
| | 2009 | 2008 | % |
| Exploration, production and marketing | 17,823 | 30,145 | (40.9%) |
| Polymer production and marketing | 49 | 1,665 | (97.1%) |
| **Total** | **17,872** | **31,810** | **(43.8%)** |

Exploration, production and marketing expenditures represent our investments in exploring for and developing our oil and gas properties. During both reporting periods, the majority of our capital expenditures related to ongoing development and exploration activities at our three core fields and at our Purovsky Plant. In 2009, we spent RR 432 million, RR 2,024 million and RR 11,401 million for further field development at the Khancheyskoye, East-Tarkosalinskoye and Yurkharovskoye fields, respectively, and RR 1,168 million on further construction work at the Purovsky Plant. We were able to successfully reduce our total capital expenditures in 2009 due to our ability to negotiate a reduction in services and equipment costs as compared to the works performed in 2008.

### Debt obligations

At 31 December 2009, the Group had short-term credit facilities as bank overdrafts available for use in the aggregate amount of RR 6,048 million (USD 200 million) on either fixed or variable interest rates subject to the specific type of credit facility.

In addition, the Group has available funds under two credit line facilities with UniCredit Bank up to the maximum amount of RR 3,024 million (USD 100 million) and RR 6,048 million (USD 200 million) until February 2010 and October 2012, respectively. However, total funds that can be withdrawn under these two credit line facilities cannot exceed the combined maximum amount of USD 250 million. Interest rates applicable to these credit line facilities are negotiated on each withdrawal date. In November 2009, the Group withdrew USD 200 million under these facilities as long-term borrowings.

The Group also has available funds under agreement with CALYON RUSBANK Corporate and Investment Bank in amount of USD 100 million until July 2010, with BNP PARIBAS in the amount of USD 100 million until December 2010 with interest rates negotiated at time of each withdrawal and with Gazprombank in the amount of RR 3,894 million until March 2012 with annual interest rate of 13 percent.

Management believes it has sufficient internally generated cash flows as well as access to available external borrowings (both short- and long-term) to fund its capital expenditure program, service its existing debt and meet its current obligations as they become due.

## QUALITATIVE AND QUANTITATIVE DISCLOSURES AND MARKET RISKS

We are exposed to market risk from changes in commodity prices, foreign currency exchange rates and interest rates. We are exposed to commodity price risk as our prices for crude oil and stable gas condensate destined for export sales are linked to international crude oil prices. We are exposed to foreign exchange risk to the extent that a portion of our sales revenues, costs, receivables, loans and debt are denominated in currencies other than Russian roubles. We are subject to market risk from changes in interest rates that may affect the cost of our financing. From time to time we may use derivative instruments, such as commodity forward contracts, commodity price swaps, commodity options, foreign exchange forward contracts, foreign currency options, interest rate swaps and forward rate agreements, to manage these market risks, and we may hold or issue derivative or other financial instruments for trading purposes.

**Foreign currency risk**

Our principal exchange rate risk involves changes in the value of the Russian rouble relative to the US dollar and Euro. As of 31 December 2009, RR 12,846 million, or 34.1%, of our long-term debt was denominated in US dollars (out of RR 37,703 million of our total borrowings at that date). Changes in the value of the Russian rouble relative to the US dollar will impact our foreign currency-denominated costs and expenses and our debt service obligations for foreign currency-denominated borrowings in Russian rouble terms as well as receivables at our foreign subsidiaries. We believe that the risks associated with our foreign currency exposure are mitigated by the fact that a portion of our total revenues, approximately 32.5% in 2009, is denominated in US dollars. As of 31 December 2009, the Russian rouble had depreciated by approximately 2.9% against the US dollar since 1 January 2009.

A hypothetical and instantaneous 10% strengthening in the Russian rouble in relation to the US dollar as of 31 December 2009 would have resulted in an estimated foreign exchange gain of approximately RR 2,667 million on foreign currency denominated borrowings held at that date.

**Commodity risk**

Substantially all of our crude oil, stable gas condensate and LPG export sales are sold under spot contracts. Our export prices are linked to international crude oil prices. External factors such as geopolitical developments, natural disasters and the actions of the Organization of Petroleum Exporting Countries affect crude oil prices and thus our export prices.

The weather is another factor affecting demand for and, therefore, the price of natural gas. Changes in weather conditions from year to year can influence demand for natural gas and to some extent gas condensate and oil products.

From time to time we may employ derivative instruments to mitigate the price risk of our sales activities. In our consolidated financial statements all derivative instruments are recorded at their fair values. Unrealized gains or losses on derivative instruments are recognized within other operating income (loss), unless the underlying arrangement qualifies as a hedge.

**Pipeline access**

We transport substantially all of our natural gas through the Gazprom owned UGSS. Gazprom is responsible for gathering, transporting, dispatching and delivering substantially all natural gas supplies in Russia. Under existing legislation, Gazprom must provide access to the UGSS to all independent suppliers on a non-discriminatory basis provided there is capacity not being used by Gazprom. In practice, however, Gazprom exercises considerable discretion over access to the UGSS because it is the sole owner of information relating to capacity. There can be no assurance that Gazprom will continue to provide us with access to the UGSS, however, we have not been denied access in prior periods.

**Ability to reinvest**

Our business requires significant ongoing capital expenditures in order to grow our production. An extended period of reduced demand for our hydrocarbons available for sale and the corresponding revenues generated from these sales would limit our ability to maintain an adequate level of capital expenditures, which in turn could limit our ability to increase or maintain current levels of production and deliveries of natural gas, gas condensate, crude oil and other associated products; thereby, adversely affecting our financial and operating results.

## Off balance sheet activities

As of 31 December 2009, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which are typically established for the purpose of facilitating off-balance sheet arrangements.