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

The following represents management's analysis of the financial performance and condition of OAO LUKOIL and significant trends that may affect future performance. It should be read in conjunction with our US GAAP consolidated financial statements and notes and supplemental oil and gas disclosure.

References to "LUKOIL", "the Company", "the Group", "we" or "us" are references to OAO LUKOIL and its consolidated subsidiaries and associates. All dollar amounts are in millions of US dollars, unless otherwise indicated. Tonnes of crude oil produced are translated into barrels using conversion rates characterizing the density of oil from each of our oilfields. Tonnes of crude oil purchased as well as other operational indicators expressed in barrels or barrels per day are translated into barrels using an average conversion rate of 7.33 and billions of cubic feet into millions of oil equivalent barrels using a conversion rate of 0.167.

This report includes forward–looking statements – words such as "believes", "anticipates", "expects", "estimates", "intends", "plans", etc. - that reflect management's current estimates and beliefs, but are not guarantees of future results. Please see "Forward-looking statement" on page 30 for a discussion of some of the factors that could cause actual results to differ materially.

KEY FINANCIAL AND OPERATIONAL RESULTS

	2003	% change to 2003	2002	% change to 2001	2001
Net Income	**3,701**	**100.8%**	1,843	(12.6)%	2,109
Net income excluding cumulative effect of change in accounting principle, gain on sale of share in Azeri, Chirag, Guneshli in 2003, and excluding special items relating to tax claims made by the taxing authorities in respect of income and other taxes and pension adjustments made in 2002 and 2003 *	**2,386**	20.2%	1,985	(5.9)%	2,109
EBITDA	**5,630**	62.3%	3,468	(8.3)%	3,780
Earnings per share of common stock (US dollars)					
Basic earnings	**4.52**	100.0%	2.26	(15.7)%	2.68
Diluted earnings	**4.45**	96.9%	2.26	(15.0)%	2.66
Crude oil production (thousands of tonnes)	**76,072**	6.7%	71,275	1.5%	70,196
Refined products (thousands of tonnes)	**39,233**	0.0%	39,219	14.7%	34,189

*See detailed discussion on page 9.

Net income. In 2003 net income, including the cumulative effect of change in accounting principle, was $3,701 million, which is $1,858 million more than in 2002. Net income excluding the cumulative effect of change in accounting principle was $3,569 million, or $1,726 million higher than in 2002. Net income for 2003 includes a non-taxable gain on sale of our share in the Azeri, Chirag, Guneshli project in the amount of $1,130 million.

Net income for 2002 also includes special items relating to tax claims made by the taxing authorities in respect of income and other taxes amounting to $103 million. The Company agreed to settle these claims without prejudice. Excluding this tax charge and a pension adjustment net income for 2002 would have amounted to $1,985 million compared to $2,109 million in 2001.

SEGMENT INFORMATION

Our operations are divided into three main business segments:

- **Exploration and Production** – which includes our exploration, development and production operations relating to crude oil and natural gas. These activities are primarily located within Russia, with additional activities in Azerbaijan, Kazakhstan, the Middle East, Northern Africa and Colombia

- **Refining, Marketing and Distribution** – which includes marketing and trading of crude oil, natural gas and refined products, and refining and transport operations
- **Chemicals** – which include processing and selling of petrochemical products

Other businesses include banking and finance, construction and other activities. Each of our three main segments is dependent on the other, with a portion of the revenues of one segment being a part of the costs of the other. In particular, our Refining, Marketing and Distribution segment purchases crude oil from our Exploration and Production segment. The prices set for these purchases reflect a combination of factors, including our need for investment capital at different entities in the Exploration and Production segment, the rights of minority shareholders in those entities where minority interests remain and, to a more limited extent, market factors. Accordingly, an analysis of either of these segments on a stand-alone basis could give a misleading impression of that segment's underlying financial position and results of operations. For this reason, we do not analyze either of our main segments separately in the discussion that follows, but we do present the financial data for each in Note 23 to our consolidated financial statements. Due to the prices we set, we believe the profitability of our Exploration and Production segment may be understated and the profits of our Refining, Marketing and Distribution segment may be overstated in that presentation.

RECENT OPERATING DEVELOPMENTS

Our Board of directors approved the Company's development strategy where we set out targets for the next 10 years. According to this development strategy we plan to have 2.2 million barrels of crude oil production per day and 0.569 millions of oil equivalent barrels of natural gas production per day by 2013. This represents a 42% increase in crude oil production from 2002 level and almost a 10 times increase in gas production compared to 2002. We continued to use this strategy as a basis for business activities performed by the Group during 2003 and for our restructuring as discussed below.

Restructuring. In 2003 we continued implementing a restructuring plan designed to improve our operations and maximize shareholder value. The plan included undertaking the following measures in the near term: (i) increase exports of crude oil and refined products; (ii) accelerate the development of our most productive fields; (iii) shut-in low-producing wells; (iv) apply enhanced oil recovery technologies; (v) seek competitive bids for oilfield services; (vi) divest non-core businesses, including certain producing assets where we are not the operator, and reduce headcount; (vii) strengthen performance-related pay; and (viii) streamline our administration.

The following has been achieved to date:

- Our oil and refined products international sales in 2003 increased by 34.8% in terms of volumes while domestic sales volumes decreased by 3.6%, which added $4.0 billion to our revenues;
- 14 new oil fields were put on stream in 2003 (2002: 10 fields), which allowed us to increase production while also shutting in low production wells;
- 2,191 low production wells were shut in (2002: 1,138) and as a result of this measure and despite the real appreciation of the ruble against the US dollar of 20.2% our cost of oil production increased only on 0.4%, or to $2.61 per barrel, compared to $2.60 in 2002;
- We continued to construct our oil and refined products cargo terminal in Vysotsk that will allow us to increase the Company's export capacity. We believe that the first stage of the terminal will be put in operation in the second quarter of 2004. The terminal's initial capacity will reach 2.5-3 million tonnes of crude oil and refined products a year. Through this reloading and distribution terminal we will export light refined products to Western Europe and the United States. It is planned that the full capacity of 10.8 million tonnes will be reached in 2005. The total cost of the project is expected to be around $300 million. Originally we planned to launch the terminal in the fall of 2003, however due to some problems with support infrastructure, such as local railways network and power supply, the completion of the construction was delayed.
- We continue to prepare our drilling division for its sale outside of the Group. At the moment we have created a unified corporate structure of drilling division and separated non-core activities (preparation of workspace for the drilling, wells' development, general purpose transport services, etc.). Professional staff and equipment employed in these non-core activities were transferred to newly established service companies. The Company has received a number of offers for its drilling division, however, these offers did not satisfy the Company with prices and terms of providing the drilling services for the Group. As a result of negotiations with potential investors we understand that the volume of activity and wide geographical location of the LUKOIL-Burenie group limits LUKOIL-Burenie from its sale as a single entity. Currently we continue to negotiate with investors who confirmed their interest to buy the drilling division. LUKOIL plans to sell the non-core businesses of LUKOIL-Burenie at the best possible terms in

order to maximize the value to the Company and its shareholders and, as well, improve efficiency of drilling and other services and reduction of corresponding costs.

- Other achievements are described in detail in other parts of this report.

Divestiture. On December 20, 2002, a Group company entered into a contract with INPEX Corporation, a Japanese company, to sell the Group company's 10% interest in the PSA operated by the Azerbaijan International Operating Company. The purpose of this PSA is to explore and develop the Azeri and Chirag fields and the deep-water portion of the Guneshli field in the Azeri sector of the Caspian Sea. The sale was completed on April 28, 2003 for net $1,337 million cash, resulting in the recognition of a net gain of $1,130 million.

Acquisitions in 2003. In line with our strategy we continued the further consolidation of the Group and acquisition of marketing and distribution companies outside of the Russian Federation:

- In November 2003, the Group acquired the remaining 49% of share capital of OOO Bovel for $49 million. The acquisition increased the Group's ownership stake in OOO Bovel to 100%. OOO Bovel is a Russian oil and gas exploration company operating predominantly within the Timano-Pechora region of Northern Russia.

- In November 2003, the Group acquired the remaining 40% of share capital of Yamalneftegazodobycha for $25 million. The acquisition increased the Group's ownership stake in Yamalneftegazodobycha to 100%. Yamalneftegazodobycha is a Russian oil and gas exploration company with significant proved undeveloped reserves predominantly within the Yamal-Nenetsky Autonomic District of Northern Russia.

- In November 2003, the Group acquired the remaining 40% of share capital of OAO Nakhodkaneftegaz for $45 million. The acquisition increased the Group's ownership stake in OAO Nakhodkaneftegaz to 100%. OAO Nakhodkeneftegaz is a Russian oil and gas exploration company with significant proved undeveloped reserves predominantly within the Yamal-Nenetsky Autonomous District of Northern Russia.

- In October 2003, the Group acquired 79.5% of the share capital of Beopetrol for 117 million EUR. Beopetrol is a marketing and distribution company operating in Serbia. Beopetrol owns and operates over 200 refueling stations and 8 refined product storage facilities. In 2002 Beopetrol's sales reached 390 thousand tonnes, which allows it to control approximately 20% of Serbian retail fuel market. Under the terms of the purchase agreement the Company is required to invest in Beopetrol 85 million EUR over the next three years.

- In September 2003, the Group acquired 100% of the share capital of MV Properties for $121 million. MV Properties is a marketing and distribution company operating in Romania. MV Properties owns and operates 75 refueling stations and 7 refined product storage facilities.

- In August 2003, the Group acquired 25.5% of share capital of AGD in exchange for its 13.6% investment in ZAO Rosshelf and 30% investment in OOO Polar Lights Company. The carrying value of these investments was approximately $40 million. The acquisition increased the Group's ownership stake in AGD to 99.7%. AGD is a Russian oil and gas exploration company operating predominantly within the Timano-Pechora region of Northern Russia. Proved reserves associated with the acquired interest were approximately 337 million barrels.

- In June 2003, the Group acquired the remaining 27% of shares in ZAO LUKOIL-Perm from a related party, which was controlled by certain members of the Group's management, for $398 million, thereby increasing the Group's ownership stake in ZAO LUKOIL-Perm to 100%. The amount of consideration was based on an independent valuation. ZAO LUKOIL-Perm is an exploration and production company operating in European Russia. Proved reserves associated with the acquired interest were approximately 423 million barrels. The Company has reregistered ZAO LUKOIL-Perm as OOO LUKOIL-Perm and merged OOO LUKOIL-Perm with its other subsidiary OOO Permneft in December 2003.

- In June 2003, the Group acquired 39.4% of the outstanding shares in OAO Tebukneft and 55.4% of the outstanding shares in OAO Ukhtaneft, thereby increasing the Group's ownership stake in these companies to 85% and 85.5%, respectively. The Group also acquired 77.4% of outstanding shares in ZAO RKM-Oil. The total cost of the interests acquired in these companies was $134 million. Prior to these acquisitions, OAO Tebukneft and OAO Ukhtaneft were recorded as associated companies using the equity method of accounting. In the second half of 2003, the Group acquired an additional 8.9%

of the outstanding shares in OAO Tebukneft, 12.2% of the remaining share capital in OAO Ukhtaneft and 22.6% of outstanding shares in ZAO RKM-Oil, thereby increasing the Group's ownership stake in these companies to 93.9%, 97.7% and 100%, respectively. The total cost of the interests acquired in these companies was $27 million. OAO Tebukneft, OAO Ukhtaneft and ZAO RKM-Oil are exploration and production companies operating in the Komi Republic of the Russian Federation. The annual oil production of OAO Tebukneft, OAO Ukhtaneft and ZAO RKM-Oil is 1.5 million tonnes. At the time of acquisition in June 2003 OAO Tebukneft, OAO Ukhtaneft and ZAO RKM-Oil had total proved reserves of approximately 242 million barrels.

- In June 2003, the Group acquired an additional 21.5% of OAO Komineft for $63 million, thereby increasing the Group's share in this company to 91.5%. OAO Komineft is an exploration and production company operating mainly in the Komi Republic of the Russian Federation.

- In June 2003, the Group acquired 1.25% of ZAO LUKOIL-AIK for approximately $1 million, thereby increasing the Group's share in this company to 51%. Prior to this acquisition ZAO LUKOIL-AIK was recorded as an associated company using the equity method of accounting. ZAO LUKOIL-AIK is an exploration and production company operating in Western Siberia. During 2003, ZAO LUKOIL-AIK extracted 2.1 million tones of crude oil. At the time of acquisition ZAO LUKOIL-AIK had total proved oil reserves of approximately 171 million barrels.

- In April 2003, the Group acquired 80.8% of OAO Yaregskaya Nefte-Titanovaya Kompaniya ("YaNTK") for $240 million, thereby increasing the Group's share in this company to 98.8%. YaNTK is a company with substantial oil and titanium reserves operating in the Komi Republic of the Russian Federation. YaNTK has total proved oil reserves of approximately 133 million barrels.

Significant restrictions on Beopetrol's activity. Beopetrol carries out its activity within the bounds of significant restrictions imposed by the Serbian government. For example, the country's authorities ban import of refined products into the country. Refined products may be imported only after obtaining the government's permission to do so. This measure is taken in order to protect the state-owned oil refining and marketing companies against competition from foreign companies. Currently, Beopetrol's refueling network can be supplied by either purchasing refined products from third parties in Serbia, or refining the Company's oil at the Serbian state-owned "NIS Refinery". The volume of oil to be refined has to be agreed upon with the refinery beforehand. This situation will remain intact until privatization of the state-owned refinery. The Serbian government also sets upper limits of retail prices on refined products. Retail prices are periodically adjusted for inflation on a straight-line basis.

These restrictions affect the profitability of the Company's operations in Serbia and will continue until they are removed or changed by the Serbian government. However, the Company's plans in Serbia and financial projections indicate that the Company will generate sufficient future cash flows to fully recover its investments.

Acquisition in 2004. On January 26, 2004, a Group company entered into an agreement with ConocoPhillips to purchase 308 gas stations and contracts to supply petroleum products to an additional 471 gas stations in the Northeast of the United States of America for $270 million. The transaction was finalized in May 2004.

Capital commitment. In March 2004, a Group company entered into an agreement for exploration, development and production of non-associated gas and condensate in Saudi Arabia. In respect of this agreement, a Group company has minimum exploration commitments of $215 million over the next 5 years.

CHANGE IN ACCOUNTING PRINCIPLE

Effective January 1, 2003, the Group adopted SFAS No. 143 "Accounting for asset retirement obligations", which resulted in a cumulative-effect adjustment to increase net income by $132 million. The effect of adoption also included an increase of net property, plant and equipment of $330 million, minority interest of $12 million, non-current deferred income tax assets and liabilities of a net $46 million and the establishment of an additional asset retirement obligation of $140 million.

MAIN MACROECONOMIC FACTORS AFFECTING OUR RESULTS OF OPERATIONS

In addition to the factors that may affect the petroleum industry in general, our results of operations are also affected by certain factors specific to operating in the Russian Federation.

The price of crude oil and refined products

The price at which we can sell crude oil and refined products is the primary driver of our revenues. Slow demand due to the global economic slowdown and concern over worldwide production and storage levels contributed to a decline in crude prices beginning from the third quarter of 2001. However, following a decrease of crude oil production as a result of both OPEC decision to maintain oil price between $22-$28 per barrel and due to strikes in some large oil exporting countries led crude prices to rise from the second quarter of 2002. In 2003 crude oil prices were steadily high.

Substantially all of the crude oil that we export is Urals blend. The following table shows the yearly average crude oil export prices for 2001, 2002 and 2003 and refined product prices based on Northern Europe averages:

	2003	% change to 2002	2002	% change to 2001	2001
	(in US Dollars per barrel, except for percentage data)				
Brent crude oil	**28.71**	14.9%	24.98	2.1%	24.46
Urals crude oil (CIF Mediterenean) *	**27.03**	14.1%	23.68	3.0%	22.99
	(in US Dollars per metric tonne, except for percentage data)				
Fuel oil 3.5% (FOB Rotterdam)	**148.37**	15.0%	128.89	16.2%	110.93
Diesel fuel (FOB Rotterdam)	**253.53**	21.4%	208.84	(4.8)%	219.30
High-octane gasoline (FOB Rotterdam)	**296.13**	21.6%	243.62	(1.4)%	247.09

Sources: Platts and Kortes

* The Company sells crude oil on foreign markets on various delivery terms. Thus the average realized sale price of oil on international markets differs from the average price of Urals crude (CIF Mediterranean).

Domestic crude oil prices

Crude oil prices in Russia have remained below world levels primarily due to constraints on the ability of Russian oil companies to export their crude oil, which has led to large regional surpluses in Russia, increased domestic supplies and reduced domestic prices. We also bear Russian transportation costs on all of our export sales and most of our domestic sales. Transportation costs vary widely depending on the origin and destination of the crude oil.

Because substantially all crude oil is produced in Russia by vertically integrated oil companies such as ours, there is no concept of a benchmark domestic market price for crude oil. Most transactions are between affiliated entities with little regard to market considerations. There is also a market within Russia for residual crude oil that is produced but not refined or exported by one of the vertically integrated oil companies. Prices for this oil are generally determined on a transaction-by-transaction basis against a background of world market prices, but with no direct reference or correlation. At any time there may exist significant price differences between regions for similar quality crude oil as a result of the regional imbalances referred to above and competitive and economic conditions in those regions.

Domestic refined product prices

Domestic prices for refined products are determined to some extent by world market prices, but they are also directly affected by local demand, competition and prices imposed on government-directed sales. The portion of our domestic refined product sales in 2003 was 20.8% (2002: 24.4%) of total tonnes sold, but 15.6% of our total sales revenue (2002: 18.8%).

Access to markets

The Russian Government places restrictions on access to the Transneft crude oil export pipeline network, which limits our ability to export via this method. The principal reasons for this are:

- a need to ensure that sufficient oil remains in Russia to meet domestic requirements, including supplies to various government controlled or strategically important institutions across the Russian Federation; and
- capacity constraints of the crude oil pipeline network.

Access to the crude oil export pipeline network is allocated quarterly, based on recent volumes produced and delivered through the pipeline and proposed export destinations, and allocations are typically in the region of 30% of production. Additional access to international markets bypassing Transneft export routes is obtained through rail transport or by tankers. In 2003 the Company exported 7.1% of oil produced (5,367 thousand tones) by means other than Transneft, including through its own export infrastructure. By these methods we were able to export crude oil produced in Yamal-Nenetsky Autonomous District and Kaliningrad Region.

During 2003 the total volume of production sold to international markets increased by 34.8% compared to 2002.

Up to 2003 the Government gave companies the ability to increase export pipeline allocations under arrangements whereby oil companies provided crude oil or refined products to organisations participating in government construction and improvement projects in return for additional export pipeline access. Beginning from 2003 such arrangements were ceased.

The U.S. dollar-ruble exchange rate and inflation

A substantial part of our revenues are either denominated in US dollars or are correlated to some extent with US dollar crude oil prices, while most of our costs in the Russian Federation are settled in Russian rubles. Therefore, the movements of the ruble inflation and exchange rates can significantly affect the results of our operations. In particular, our operating margins are generally adversely affected by the real appreciation of the ruble against the US dollar, because this will generally cause our costs to increase in real terms relative to our revenues. It should be noted that in contrast to previous periods, during 2003 this process was exacerbated by the fact that inflation was accompanied by an increase (rather than a decline) in the exchange rate of the ruble to the US dollar.

The following table gives data on inflation in Russia, the nominal change in the ruble–dollar exchange rate, and the level of real appreciation.

	2003	2002	2001
Ruble inflation (CPI)	12.0%	15.1%	18.8%
Nominal devaluation (RUR v. U.S.$)	(7.3)%	5.5%	7.0%
Real appreciation (RUR v. U.S.$)	20.2%	9.1%	11.0%
Average exchange rate for the period (ruble to US dollar)	30.69	31.35	29.17
Exchange rate at the end of the period (ruble to US dollar)	29.45	31.78	30.14

Tax burden

Given the relative size of our activities in Russia, our tax profile is largely determined by the taxes payable in Russia (based on records maintained under Russian legislation – not US GAAP). For 2003, 2002 and 2001 the tax charge on the Russian part of our operations was more than 80% of our total tax charge.

In addition to profits tax, we are subject to a number of other taxes in Russia, many of which are based on revenue or volumetric measures. Taxes to which we are subject include:

- extraction tax;
- excise and export tariffs;
- property tax;
- social taxes;
- sales tax and VAT;
- other local and regional taxes

The effective rates of total taxes and tariffs (total taxes, including income taxes, taxes other than on income and excise and export tariffs, divided by income before taxes and tariffs) for 2003, 2002 and 2001, respectively, were 64%, 72% and 60%.

The measures that we use for tax planning and management strategies have been based on our understanding of tax legislation existing at the time of implementation of these measures. We are subject to tax authority audits on an ongoing basis, as is normal in the Russian environment, and, at times, the authorities have attempted to impose significant additional taxes on us. We believe that we have adequately met and provided for tax liabilities based on our interpretation of existing tax legislation. However, the relevant authorities may have differing interpretations and the effects could be significant.

		2003 *	% change to 2002	2002 *	% change to 2001	2001 *
Export tariffs on crude oil	$/tonne	30.40	59.3%	19.08	(27.3)%	26.25
Export tariffs on oil products						
Light distillates (gasoline), middle distillates (jet fuel), diesel fuel and gasoils	$/tonne	27.36	(3.7)%	28.40	(18.7)%	34.94
Liquid fuels (fuel oil)	$/tonne	27.36	91.3%	14.30	(35.2)%	22.06
Excise on oil products						
High-octane gasoline	RUR/tonne	3,000.00	44.8%	2,072.00	12.0%	1,850.00
Low-octane gasoline	RUR/tonne	2,190.00	44.8%	1,512.00	12.0%	1,350.00
Diesel fuel	RUR/tonne	890.00	44.5%	616.00	12.0%	550.00
Motor oils	RUR/tonne	2,440.00	45.2%	1,680.00	12.0%	1,500.00
Mineral extraction tax	RUR/tonne	801.44	20.1%	667.12	–	n/a **

* average values
** unified mineral extraction tax was introduced in January 1, 2002, and replaces royalty tax, mineral replacement tax and excise on crude oil sales (see also "Taxes other than income taxes" and "Excise and export tariffs" on page 16)

The rates of several taxes increased significantly compared to 2002. For instance, the average rate of export tariffs on crude oil increased by 59.3% compared to 2002 and amounted to $30.40 per tonne. At the same time the export tariffs on gasoline, jet fuel, diesel fuel and gasoils decreased by 3.7%. The export tariff on fuel oil increased by 91.3%. Excises on oil products increased by 44.8%.

The mineral extraction tax rate increased by 20.1% compared to 2002 due to growth of international oil prices.

The mineral extraction tax rate is determined as follows. The base rate is set at 340 Rubles ($11.5 using the year end exchange rate) per metric tonne extracted and is adjusted with reference to the international market price of the Urals blend and the Ruble exchange rate. The tax rate is zero when the average Urals international market price for a tax period is less than or equal to $8.00 per barrel. Each $1.00 per barrel increase in the international Urals price over the stated limit ($8.00 per barrel) effectively results in an increase of the tax rate by $1.35 per tonne extracted (or 18.41 cents per barrel extracted using a conversion factor of 7.33).

Crude oil and refined products export duties also depend on the international market price of the Urals blend. The duties' rates are zero when the average Urals international market price is less than or equal to approximately $15.00 per barrel ($109.50 per metric tonne). If the Urals price is in a layer between $15.00 and $25.00 per barrel ($182.50 per metric tonne), each $1.00 per barrel increase in the Urals price over the layer's lower bound results in an increase of the crude oil export duty rate by $0.35 per barrel exported. If the Urals price is above $25.00 per barrel, each $1.00 dollar per barrel increase in the Urals price over this limit results in the increase of the crude oil export duty rate by $0.40 per barrel exported.

Effective from January 1, 2003, the maximum export duty rates on export of refined products shall not exceed 90% of the crude oil export duty rate stated for the respective period. Crude oil and refined products exported to CIS countries, other than Ukraine, are not subject to export duties.

Recent amendments to Russian tax legislation

Effective from January 1, 2004, the mineral extraction tax base rate is set at 347 Rubles per metric tonne extracted, or 2.0% higher than in 2003. Hence, each $1.00 per barrel increase in the international Urals price over the stated limit ($8.00 per barrel) will effectively result in an increase of the tax rate by $1.38 per tonne extracted (or 18.79 cents per barrel extracted using a conversion factor of 7.33).

If the Urals blend price in 2004 remains on the same level as in 2003, the increase of the mineral extraction tax base rate by 2.0% will result in increase of our the mineral extraction tax expenses by approximately $40 million.

Effective from January 1, 2004, excise tax rates in Russia were increased by approximately 12% and set at the following level:

		Effective from January 1, 2004
Excise on oil products		
High-octane gasoline	RUR/tonne	3,360.00
Low-octane gasoline	RUR/tonne	2,460.00
Diesel fuel	RUR/tonne	1,000.00
Motor oils	RUR/tonne	2,732.00

RESULTS OF OPERATIONS

The table below details certain income and expense items from our consolidated statements of income for the periods indicated. All items are presented in millions of US dollars, except for earnings per share data and the items expressed as a percentage of revenues.

	2003		2002		2001	
Revenues						
Sales (including excise and export tariffs)	22,118	99.2%	15,334	99.3%	13,426	99.0%
Equity share in income of affiliates	181	0.8%	115	0.7%	136	1.0%
Total revenues	**22,299**	**100.0%**	**15,449**	**100.0%**	**13,562**	**100.0%**
Costs and other deductions						
Operating expenses	(2,546)	(11.4)%	(2,403)	(15.6)%	(2,584)	(19.1)%
Costs of purchased crude oil and petroleum products	(5,909)	(26.5)%	(2,693)	(17.4)%	(2,087)	(15.4)%
Transportation expenses	(2,052)	(9.2)%	(1,414)	(9.2)%	(919)	(6.8)%
Selling, general and administrative expenses	(1,800)	(8.1)%	(1,313)	(8.5)%	(1,375)	(10.1)%
Depreciation, depletion and amortization	(920)	(4.1)%	(824)	(5.3)%	(886)	(6.5)%
Taxes other than income taxes	(2,456)	(11.0)%	(1,972)	(12.8)%	(1,010)	(7.4)%
Excise and export tariffs	(2,954)	(13.3)%	(1,996)	(12.9)%	(1,456)	(10.7)%
Exploration expense	(136)	(0.6)%	(89)	(0.6)%	(144)	(1.1)%
Gain from sale of interest in Azeri, Chirag, Guneshli	1,130	5.1%	–	–	–	–
Loss on disposal and impairment of assets	(69)	(0.3)%	(83)	(0.5)%	(153)	(1.1)%
Income from operating activities	**4,587**	**20.6%**	**2,662**	**17.2%**	**2,948**	**21.7%**
Interest expense	(273)	(1.2)%	(222)	(1.4)%	(257)	(1.9)%
Interest and dividend income	139	0.6%	160	1.0%	146	1.1%
Currency translation gain (loss)	148	0.7%	40	0.3%	(33)	(0.2)%
Other non-operating income	11	0.0%	11	0.1%	31	0.2%
Minority interest	(36)	(0.2)%	(69)	(0.5)%	(52)	(0.4)%
Income before income taxes	**4,576**	**20.5%**	**2,582**	**16.7%**	**2,783**	**20.5%**
Current income taxes	(939)	(4.2)%	(834)	(5.4)%	(861)	(6.3)%
Deferred income tax benefit	(68)	(0.3)%	95	0.6%	187	1.4%
Total income tax expense	**(1,007)**	**(4.5)%**	**(739)**	**(4.8)%**	**(674)**	**(4.9)%**
Income before cumulative effect of change in accounting principle	**3,569**	**16.0%**	**1,843**	**11.9%**	**2,109**	**15.6%**
Cumulative effect of change in accounting principle, net of tax	**132**	**0.6%**	**–**	**–**	**–**	**–**
Net income	**3,701**	**16.6%**	**1,843**	**11.9%**	**2,109**	**15.6%**
Basic earnings per share of common stock (in USD)	4.52		2.26		2.68	
Diluted earnings per share of common stock (in USD)	4.45		2.26		2.66	
Exclusion of special items:						
Cumulative effect of change in accounting principle, net of tax	(132)	(0.6)%	–	–	–	–
Gain from sale of interest in Azeri Chirag Guneshli	(1,130)	(5.1)%	–	–	–	–
Charges for settlement of tax claims	–	–	103	0.7%	–	–
Pension curtailment	(53)	(0.2)%	39	0.3%	–	–
Net income excluding special items	**2,386**	**10.7%**	**1,985**	**12.9%**	**2,109**	**15.6%**

The analysis of the main financial indicators of the financial statements is provided below.

Special items. Our effective income tax rate in 2002 increased as a result of settlement of claims with tax authorities in respect to income tax and other tax relief received in 2001. The Company agreed to settle these claims without prejudice and recorded a provision of $103 million in 2002. Management does not expect any further claims from tax authorities related to tax relief received in prior periods.

During 2002 we recorded a total pension expense of $82 million, including $39 million related to adjustments of pension liabilities as a result of revision of some underlying actuarial assumptions.

In December 2003 we took the decision to replace the Group's existing defined benefit pension plan with a new plan. The new plan is principally a defined contribution plan. This resulted in the recognition of a curtailment gain of $53 million.

Net income for 2003 includes the non-taxable gain from sale of interest in the Azeri, Chirag, Guneshli project of $1,130 million.

Year ended December 31, 2003 compared to year ended December 31, 2002

Sales revenues

Sales breakdown	**2003**		**2002**	
	(millions of US dollars)			
Crude oil				
Export and sales on international markets other than CIS..........	6,411	29.0%	4,171	27.2%
Export and sales to CIS..	433	2.0%	165	1.1%
Domestic sales	374	1.7%	469	3.1%
	7,218	**32.7%**	**4,805**	**31.4%**
Oil products				
Export and sales on international markets..................................	9,480	42.9%	6,225	40.6%
Domestic sales	3,450	15.6%	2,883	18.8%
	12,930	**58.5%**	**9,108**	**59.4%**
Petrochemicals				
Export and sales on international markets..................................	671	3.0%	392	2.6%
Domestic sales	251	1.1%	134	0.9%
	922	**4.1%**	**526**	**3.4%**
Other	**1,048**	**4.7%**	**895**	**5.8%**
Total sales	**22,118**	**100.0%**	**15,334**	**100.0%**

Sales volumes	**2003**		**2002**	
	(thousands of barrels)			
Crude oil				
Export and sales on international markets other than CIS..........	246,889		183,826	
Export and sales to CIS..	29,826		13,722	
Domestic sales	43,826		56,618	
Crude oil	(thousands of tonnes)			
Export and sales on international markets other than CIS..........	33,682	34.3%	25,079	31.1%
Export and sales to CIS..	4,069	4.1%	1,872	2.3%
Domestic sales	5,979	6.1%	7,724	9.6%
	43,730	**44.5%**	**34,675**	**43.0%**
Oil products	(thousands of tonnes)			
Export and sales on international markets..................................	33,995	34.7%	26,284	32.6%
Domestic sales	20,473	20.8%	19,727	24.4%
	54,468	**55.5%**	**46,011**	**57.0%**
Total sales volume of crude oil and refined products...........	**98,198**	**100.0%**	**80,686**	**100.0%**

Realized average sales prices

	2003		**2002**	
	($/barrel)	($/tonne)	($/barrel)	($/tonne)
Average realized price international				
Oil (excluding CIS)..	25.97	190.35	22.69	166.33
Oil (CIS)...	14.50	106.25	12.00	87.97
Refined products		278.87		236.85
Average realized price within Russia				
Oil	8.53	62.54	8.28	60.72
Refined products		168.50		146.14

In 2003 sales revenue increased by $6,784 million, or 44.2%, compared to 2002.

The total volume of crude oil and refined products sold amounted to 98.2 million tonnes, which is 21.7% more than in 2002. Our revenues from crude oil sales increased by $2,413 million, or 50.2%. Our sales of refined products increased by $3,822 million, or 42.0%.

Sales of crude oil and refined products on the international market, including the CIS, accounted for 73.1% of total sales in 2003, compared to 66.0% in 2002.

The increase in sales was principally due to the following:

- increase in crude oil prices and refined products prices compared to 2002 (e.g. price increase on Urals crude (CIF Med) on international markets was 14.1%, light distillates – more than 20.0%, fuel oil – 15.0%)
- increase in volumes exported from Russia (export of crude oil increased by 24.5%; export of refined products decreased by 1.1% due to growth of own consumption)
- increase in total volume of oil production to 76.1 million tonnes
- increase in marketing activities

Increase in export and refining due to reduction in sales of crude oil on the domestic market

In 2003 the Company increased volumes exported by domestic producers by 53.7 million barrels as compared to 2002. In particular this change was caused by a decrease of sales of crude oil on the domestic market compared to the previous year by 12.8 million barrels, or 22.6%.

Production volumes of refined products remained the same compared to 2002 at 39.2 million tonnes. Information about production of refined products in the Russian Federation and internationally is presented below:

	2003	% change to 2002	2002
	(thousands of tonnes)		
Russian Federation	**32,444**	0.4%	32,325
International	**6,789**	(1.5)%	6,894
	39,233	0.0%	39,219

The increase in export sales, along with an increase in the average realized export price of crude oil on international markets (other than CIS) from $22.69 per barrel in 2002 to $25.97 per barrel in 2003 as well as an increase in the average realized price on CIS markets from $12.00 per barrel to $14.50 per barrel, allowed us to obtain an additional $1.2 billion in revenues.

Change in share of refined products in total sales volumes

Sales of refined products made up 55.5% of our total sales compared to 57.0% in 2002.

The average realized price on refined products outside Russia increased by $42.02 per tonne, or 17.7%. Volumes of refined products sold outside Russia increased by 7,711 thousand tonnes, or 29.3%. As a result our revenues from sales of refined products outside Russia increased by $3,255 million, or 52.3%.

The Company's revenues from refined product sales outside Russia in 2003 include revenues from retail sales of $2,323 million. Refined products sold at retail amounted to 3,926 thousand tonnes; the average realized price was $591.78 per tonne.

The average realized price on refined products sold within Russia increased by $22.36 per tonne, or 15.3%. Domestic refined products sales increased by 746 thousand tonnes, or 3.8%. As a result our revenues from sales of refined products on the domestic market increased by $567 million, or 19.7%.

The Company's revenues from refined product sales on the domestic market in 2003 include revenues from retail sales of $787 million. Refined products sold at retail amounted to 2,315 thousand tonnes; the average realized price was $340.08 per tonne.

Increase in total volume of production

In line with our long term strategy we increased our total daily oil production (including the Company's share in equity associates, but excluding our share in Azeri, Chirag, Guneshli in 2002) by 5.5% and produced 591,966 thousand barrels (80,232 thousand tonnes).

	2003	2002	Change, %
Daily production of crude oil, including Company's share in equity associates (thousand barrels per day)	**1,622**	1,545	5.0%
Daily production of crude oil, including Company's share in equity associates, but excluding our share in Azeri, Chirag, Guneshli (thousand barrels per day)	**1,622**	1,538	5.5%
Daily production of gas, including Company's share in Equity associates (million of cubic feet per day)	**364**	345	5.5%
Company's refineries thourghput (thousand barrels per day) *	**845**	842	0.4%

* including refining at OAO LUKOIL-Nizhegorodnefteorgsyntez in 2002.

The main oil production region of the Company remains Western Siberia. In the oil fields of Western Siberia the Company produced 67.4% of its total production of crude oil in 2003 (66.8% in 2002). The increased production in Western Siberia of 7.7% is a result of both acquisitions by the Group of new oil producing companies (primarily additional interest in LUKOIL-AIK), and improvement and optimization of oil production methods. The organic growth of the oil production resulted from these improvements was 3.8%. The increase of production in the Komi Republic of 12.0% primarily resulted from the consolidation of our oil production companies (see section "Acquisitions in 2003" on page 4). Commencement of oil production in new oil fields in Yamal-Nenetsky Autonomous District led to an increase of oil production in this region of Russia more than 1.9 times compared to 2002.

	2003	% change to 2002	2002
	(thousands of tonnes)		(thousands of tonnes)
Western Siberia	**51,244**	7.7%	47,577
Komi Republic	**8,626**	12.0%	7,700
Ural region	**9,949**	1.0%	9,850
Volga region	**2,977**	(1.3)%	3,016
Timano-Pechora (Yamal-Nenetsky Autonomous District)	**956**	93.4%	494
Other in Russia	**1,240**	3.7%	1,196
Crude oil production in Russia	**74,992**	7.4%	69,833
Crude oil produced internationally	**1,080**	(25.1)%	1,442
	76,072	6.7%	71,275

Attributes of 2003 production growth	**2003**
	(thousands of tonnes)
2002 crude oil production.	**71,275**
Effect of changes in the Group's structure	**2,295**
Organic growth of production	**2,502**
2003 crude oil production	**76,072**

Increase in sales of petrochemical products

Revenues from sales of petrochemical products increased by $396 million, or 75.3%, mainly as a result of an increase in sales volumes due to the acquisition of the LUKOR petrochemical plant in the third quarter of 2002 and an increase in average realized prices in 2003 compared to 2002. The increase in the output of petrochemical products at LUKOR in 2003 led to a revenue increase from sales of petrochemical products of $70 million.

Increase in sales of other products

Other sales increased by $153 million or 17.2% as a result of sales of other products produced by the Company, and also increased activity in providing services to third parties such as transportation and construction.

Increase in marketing activities

In line with our strategy, during 2003 the Group continued penetration into new international markets and development of the LUKOIL brand name around the world. We significantly expanded our marketing activities in developed markets. In particular, the Group commenced marketing and trading on different markets in Western Europe, South-East Asia, Northern and Central America. The total volume of refined products, which were purchased from third parties for resale, was 7.4 million tonnes or $1,533 million.

In addition, the Group purchased refined products in the USA in order to supply its retail sales chain. Total volume of refined products purchased in this activity from third parties during 2003 was 3.1 million tonnes or $1,068 million.

Increase in the equity share in income of affiliates

Our share in the income of affiliates was $181 million. This is $66 million higher than in the previous reporting period. This increase was mainly resulted from significant profits generated by our exploration and production affiliates in 2003 as result of the growth of international markets prices for crude oil.

Operating expenses

Operating expenses include the following types of costs:

	2003	2002
	(millions of US dollars)	
Extraction expenses	1,458	1,355
Refining expenses	479	417
Processing costs at associated refineries	–	131
Petrochemical expenses	149	115
Other operating expenses	460	385
Total operating expenses	**2,546**	**2,403**
Costs of purchased crude oil and petroleum products	**5,909**	**2,693**

Compared to 2002, operating expenses increased by $143 million, or 6.0%. Costs of purchased crude oil and petroleum products increased by $3,216 million, or 119.4%, compared to 2002 primarily as a result of increase in volumes of crude oil and petroleum products purchased for resale.

During the preparation of the annual financial statements for the period ended December 31, 2003, the Company enhanced its accounting information gathering and processing procedures. It allowed us to classify certain revenues and expenses arising out of transactions with third parties more punctually than was done in the interim financial statements. Changes in classification we made do not have an effect on net income or income from operating activities of the Company for either the whole period ended December 31, 2003, or for any interim period. These changes have an effect on presentation of other revenues and other operating expenses in the financial statements.

The following table summarizes our oil production and refining data, and also data on purchased oil and oil products.

	2003		2002	
	(thousands barrels)	(thousands tonnes)	(thousands barrels)	(thousands tonnes)
Crude oil produced by consolidated subsidiaries	560,869	76,072	522,446	71,275
Crude oil purchased	93,714	12,785	60,736	8,286
Gas produced	20,708		19,873	
Refined products produced at Group refineries.....................		39,233		33,652
Refined products produced at associated refinery (LUKOIL-Nizhegorodnefteorgsintez)		–		5,567
Refined products purchased		15,795		7,399

Our extraction expenses include expenditures related to current and overhaul repairs of extraction equipment, labor costs, expenses of artificial stimulation of reservoirs, fuel and electricity costs and other similar costs.

Expenses of the Company's production enterprises related to the sale of services and goods (such as electricity, heat, etc.) that do not relate to core activities have been excluded from extraction expenses and are included in other operating costs.

Despite a 20.2% real ruble appreciation during the 2003, our **average extraction cost per barrel** increased slightly from $2.60 to $2.61 per barrel (average extraction cost calculated using an average tonnes to barrels conversion rate of 7.33). The increase in total extraction expenses resulted from an increase in volumes of oil produced by our subsidiaries from 71.3 million tonnes 2002 to 76.1 million tonnes in 2003. Total extraction expenses rose by $103 million, or 7.6%, as compared to the previous year.

Refining expenses at our refineries increased by $62 million, or 14.9%, in 2003 compared to 2003. This was primarily a result of refining expenses at the LUKOIL-Nizhegorodnefteorgsintez refinery being included in the Company's total refining expenses starting from August 2002, when it became a consolidated subsidiary. Prior to this period processing fees at LUKOIL-Nizhegorodnefteorgsintez were accounted for as processing costs at an associated refinery. Expenses of LUKOIL-Nizhegorodnefteorgsintez in 2003 were $66 million, while in the same period of the previous year these expenses amounted to $18 million.

In addition, refining expenses of our international refineries increased by 9.2%, or $12 million. This was primarily caused by an appreciation in the exchange rate of Bulgarian lev to the US dollars. The exchange rate of Bulgarian lev is pegged to the Euro and as such is appreciated in line with the Euro-US dollar movement in 2003 (20.3%).

Operating expenses of petrochemical companies increased by $34 million, or 29.6%, compared to 2002. The increase resulted from the acquisition of the LUKOR petrochemical plant in the third quarter of 2002. The operating expenses of the LUKOR refinery for the first half of 2003 were $30 million.

Other operating expenses include the costs of other services provided and goods not related to primary activities (such as electricity, heat, etc.) sold by our production companies, and operating expenses of other non-core businesses of the Group. Other operating expenses also include costs associated with the delivery of crude oil from the Group's exploration and production entities to the Group's refineries, as well as the amount of the change in crude oil and refined products inventory at the Group's marketing entities. Other operating expenses increased by $75 million, or 19.5%, as compared to 2002 in particular as a result of increase in other sales, increase in delivery costs and change in crude oil and refined products inventory during 2003.

Other operating expenses also include pension expense (income). During 2002 we recorded a pension expense of $82 million as a part of other operating expenses. As a result of revision of underlying actuarial assumptions regarding our pension liabilities and curtailment gain in 2003, we recorded an income of $6 million to other operating expense from reduction of such liabilities.

Costs of purchased crude oil and petroleum products increased by $3,216 million, or 119.4%, in comparison with the prior period primarily due to a significant increase in volumes purchased (crude oil by 33.0 million barrels, refined products by 8.4 million tonnes) and an increase in purchase prices.

Transportation expenses

The increase in the total volume of sales and the change in their structure led to an increase in transportation expenses. However, the main factor in the increase of $638 million, or 45.1%, in these expenses compared to 2002 was the increase in the transportation tariffs and increase of transportation of crude oil and oil products by sea, railway and river transport.

During 2003, transportation tariffs increased as follows: pipeline transport – 19.0%, sea shipping – 50.5% (weighted average by volumes transported to different locations), railway transport – 20.2%. At the same time the volume of goods transported by sea tankers decreased by 3%.

Selling, general and administrative expenses

Our other selling, general and administrative expenses increased by $487 million, or 37.1%, in comparison with 2002. The above-mentioned expenses include general business expenses, payroll costs (excluding extraction entities' and refineries' production staff cost), insurance costs, costs of maintenance of social infrastructure, movement in bad debt provision and other expenses.

The increase in other selling, general and administrative expenses was primarily a result of 20.2% real appreciation of the ruble during 2003. Also, the Company accrued compensation to management of approximately $26 million in relation to a stock appreciation rights compensation program. In addition, the movement in bad debt provision had an effect on selling, general and administrative expenses for the periods under consideration. For the year 2002 our bad debt provision decreased by $12 million thus decreasing general expenses, while for the year 2003 our bad debt provision increased by $79 million.

Depreciation, depletion and amortization

Depreciation, depletion and amortization expenses include depletion of assets fundamental to production, depreciation of other productive and non-productive assets and certain intangible assets and provision for abandonment and site restoration costs during 2002. Our depreciation, depletion and amortization expenses increased by $96 million, or 11.7%, in comparison to 2002. This increase is a result of implementation by the Company the capital expenditure program and corresponding growth of depreciable assets, but this increase is partly compensated by upward revisions of the Company's proved reserves and, consequently, an increase in estimated useful economic life of fixed assets.

Taxes other than income taxes

Taxes other than income taxes include extraction tax, road user's tax, property tax and social taxes.

	2003		**2002**	
	in Russia	**International**	**in Russia**	**International**
	(millions of US dollars)			
Extraction tax	1,966	–	1,472	–
Social security taxes and contributions	235	21	191	7
Road taxes	–	–	126	–
Property tax	123	16	89	12
Other taxes	59	36	48	27
	2,383	**73**	**1,926**	**46**
Total		**2,456**		**1,972**

The increase in taxes other than income taxes resulted primarily from a $494 million increase in mineral extraction tax, which is linked to international crude oil prices. The $58 million increase in social taxes and contributions was compensated by the abolition of road taxes from January 1, 2003.

Excise and export tariffs

Our excise and export tariffs include duties on sales of refined products and export tariffs on export of crude oil and refined products. Excise and export tariffs increased by $958 million, or 48.0%, compared to the previous reporting period. The increase in export tariff expenses resulted from the increase in export tariff rates and also an increase in volumes exported. The increase in international excise taxes on refined products resulted from an increase in excise taxes and fuel sales taxes and from an increase in volumes of products sold across our international group as well as the increase in our refining.

Effective January 1, 2003, domestic tax legislation was amended in terms of payment of excises on refined products. Starting January 1, 2003, excises are paid by our marketing companies if they sell refined products to the end customer. If refined products are sold to another retailer or a wholesaler, the seller is not subject to excise if certain conditions set by legislation are met. During 2003 domestic excise rates rose by more than 44.8% as compared to 2002.

	2003		2002	
	in Russia	International	in Russia	International
	(millions of US dollars)			
Excise tax and sales taxes on refined products	449	1,106	387	811
Export tariffs	1,392	7	796	2
	1,841	**1,113**	**1,183**	**813**
Total		**2,954**		**1,996**

Exploration expenses

The costs we incur in our exploratory drilling efforts are capitalized to the extent that our exploration efforts are successful and otherwise are charged to expenses of the current period. During 2003, the amount charged to exploration expense increased in comparison to 2002 by $47 million.

Loss on disposal and impairment of assets

Loss on disposal and impairment of assets in 2003 was $69 million (excluding gain on sale of interest in Azeri, Chirag, Guneshli) compared to $83 million in 2002.

Interest expense

Interest expense in 2003 increased by $51 million, or 23.0%, compared to 2002 primarily due to an increase in the Group's level of debt, including balances of customers' deposits at the Group's banks. As of December 31, 2002, the Group's total debt was $4,193 million, including customers' deposits of $755 million. By December 31, 2003, the Group's total debt increased to $4,811 million, including customers' deposits of $1,007 million. Also, in 2003 1% convertible US Dollar bonds with carrying value of $455 million as of December 31, 2002, have matured.

Income taxes

Our total income tax expense increased by $268 million, or 36.3%, compared to 2002 while our income before income tax increased by $1,994 million, or 77.2% (excluding gain on sale of interest in Azeri, Chirag, Guneshli, by $864 million, or 33.5%).

Our effective tax rate in 2003, excluding the effect of gain on sale of interest in Azeri, Chirag, Guneshli, was 29.2% (in 2002 it was 28.6%), which is higher than the maximum statutory rate for the Russian Federation (24%). This is attributable to the fact that some costs incurred during the year were not tax deductible or only deductible to a certain limit.

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

	2003	2002
	(millions of US dollars)	
Income before income taxes	**4,576**	**2,582**
Add back:		
Depreciation and amortization	920	824
Interest expense	273	222
Interest and dividend income	(139)	(160)
EBITDA	**5,630**	**3,468**

Year ended December 31, 2002 compared to year ended December 31, 2001

Sales revenues

Sales breakdown	**2002**		**2001**	
	(millions of US dollars)			
Crude oil				
Export and sales on international markets	4,336	28.3%	3,951	29.4%
Domestic sales	469	3.1%	992	7.4%
	4,805	**31.4%**	**4,943**	**36.8%**
Oil products				
Export and sales on international markets	6,225	40.6%	4,690	34.9%
Domestic sales	2,883	18.8%	2,595	19.3%
	9,108	**59.4%**	**7,285**	**54.2%**
Petrochemicals				
Export and sales on international markets	392	2.6%	334	2.5%
Domestic sales	134	0.9%	159	1.2%
	526	**3.4%**	**493**	**3.7%**
Other	**895**	**5.8%**	**705**	**5.3%**
Total sales	**15,334**	**100.0%**	**13,426**	**100.0%**

Sales volumes	**2002**		**2001**	
	(thousands of barrels)			
Crude oil				
Export and sales on international markets	197,548		187,024	
Domestic sales	56,618		91,582	
Crude oil	(thousands of tonnes)			
Export and sales on international markets	26,951	33.4%	25,515	33.2%
Domestic sales	7,724	9.6%	12,494	16.2%
	34,675	**43.0%**	**38,009**	**49.4%**
Oil products	(thousands of tonnes)			
Export and sales on international markets	26,284	32.6%	20,725	26.9%
Domestic sales	19,727	24.4%	18,281	23.7%
	46,011	**57.0%**	**39,006**	**50.6%**
Total sales volume of crude oil and refined products	**80,686**	**100.0%**	**77,015**	**100.0%**

Realized average sales prices

	2002		**2001**	
	($/barrel)	($/tonne)	($/barrel)	($/tonne)
Average realized price international				
Oil	21.95	160.88	21.13	154.85
Refined products		236.85		226.30
Average realized price within Russia				
Oil	8.28	60.72	10.83	79.40
Refined products		146.14		141.95

Our sales increased by $1,908 million, or 14.2%, from 2001 to 2002, primarily as a result of change in sales mix and increased volumes. Our revenues from sales of crude oil decreased by $138 million, or 2.8%, and our sales of refined products increased by $1,823 million, or 25.0%. The total volume of crude oil and refined products sold reached 80.7 million tonnes, that is 4.8% more than for the same period of 2001.

The proportion of our sales volumes represented by refined products was 57.0% compared to 50.6% in the 2001. This is the result of the Company's strategy to increase the share of exports in the total volume of sales, which was realized mainly through an increase of refined products exports. The proportion of our international sales volumes, including both crude oil and refined products, reached 66.0% in 2002 compared to 60.0% in 2001.

The increase in our sales was principally due to the following

International crude oil
Revenues from our crude oil sales outside Russia increased by $385 million, or 9.7% as a result of two factors: a) an increase in the average realized prices from $21.13 per barrel in 2001 to $21.95 per barrel in 2002, or 3.9%, which resulted from the increase in the price of Urals blend; b) an increase in sales volumes of 10.5 million barrels, or 5.6%.

Domestic crude oil
Our revenues from crude oil sales on the domestic market decreased by $523 million, or 52.7%, as a result of decreases in prices and volumes. The average realized price decreased by $2.55 per barrel, or 23.5%, to $8.28 per barrel in 2002. Volumes of domestic crude oil sales decreased by 35.0 million barrels, or 38.2%. This change primarily resulted from an increase in refining volumes, including processing at Nizhegorodnefteorgsintez, and from an increase in export volumes.

International refined products
Our revenues from sales of refined products outside Russia increased by $1,535 million, or 32.7%. This was a result of an increase in volumes sold of 5.6 million tonnes, or 26.8%. The average realized prices on refined products increased slightly by $10.55 per tonne, or 4.7%.

Domestic refined products
Our revenues from sales of refined products on the domestic market increased by $288 million, or 11.1%. Volumes of domestic refined products sales increased by 1.4 million tonnes, or 7.9%. The average realized price on refined products sold within Russia increased by $4.19 per tonne, or 2.9%.

Petrochemicals
Sales of Petrochemicals increased by $33 million, or 6.7%, basically due to a reallocation of sales from the domestic to international market with a corresponding increase in average price and processing at the newly acquired LUKOR petrochemical refinery.

Other sales
Other sales increased by $190 million or 27.0% as a result of increased activity of providing services to third parties such as transportation, construction and consumer goods.

Equity share in income of affiliates
Our equity share in income of affiliates accounted for using the equity method was $115 million. This was $21 million, or 15.4%, less than in the previous period. In general, this change was caused by obtaining control over certain affiliate companies in the second half of 2001, while before that these companies were accounted for using the equity method.

Operating expenses

	2002	**2001**
	(millions of US dollars)	
Extraction expenses	1,355	1,411
Refining expenses	417	426
Processing costs on the affiliated refinery	131	109
Petrochemical expenses	115	82
Other operating expenses	385	556
Total operating expenses	**2,403**	**2,584**
Costs of purchased crude oil and petroleum products	**2,693**	**2,087**

Operating expenses, consisting primarily of direct operating and labor costs associated with our exploration and production and refining, marketing and distribution activities, have decreased by $181 million, or 7%, primarily as a result of our corporate cost saving program. Costs of purchased crude oil and petroleum products have increased on $606 million, or 29%, in comparison with the same period of 2001 primarily as a result of the increase in volumes of crude oil and petroleum products purchased for resale.

The following table summarizes our production and purchases data:

	2002 (thousands barrels)	2002 (thousands tonnes)	2001 (thousands barrels)	2001 (thousands tonnes)
Crude oil produced by consolidated subsidiaries	522,446	71,275	514,540	70,196
Crude oil purchased	60,736	8,286	52,250	7,128
Gas produced	19,873		17,535	
Refined products produced at Group's refineries		33,652		29,366
Refined products produced at affiliated refinery (Nizhegorodnefteorgsintez)		5,567		4,823
Refined products purchased		7,399		7,059

Our extraction expenses decreased by $56 million, or 4.0%. At the same time average extraction costs per barrel decreased from $2.74 per barrel in 2001 to $2.60 per barrel in 2002. The decrease in the average extraction costs per barrel resulted from our cost reduction policy, primarily from shutting-in low-producing wells and from increasing oil flows as a result of using artificial stimulation and other technologies.

The volume of oil extracted by our subsidiaries in 2002 was 71.3 million tonnes (522 million barrels), while in 2001 it was 70.2 million tonnes (515 million barrels). Average daily production in 2002 reached 1,431 thousand barrels per day, which is 1.4% more than in the same period of 2001 (average daily production for that period was 1,411 mbbls per day).

Our extraction expenses include expenditures related to current repairs of extraction equipment, labor costs, expenses of artificial stimulation of reservoirs, fuel and electricity costs and other similar costs. Other operating expenses of our oil production companies are excluded from extraction expenses. These other operating expenses are related to sale of other services and goods (such as electricity, heat, etc.) and are included in other operating costs.

Refining expenses at our refineries decreased by $9 million, or 2.1%, from 2001 to 2002. This was primarily caused by the closure of the Petrotel SA refinery in July 2001. The decrease in our refining expenses due to the closure of Petrotel SA was partially offset by an increase in refining expenses of Nizhegorodnefteorgsintez refinery. Operating expenses of Nizhegorodnefteorgsintez were included in our refining expenses starting from July 2002, when it became a consolidated subsidiary.

Our processing costs at the affiliated refinery (Nizhegorodnefteorgsintez) increased by $22 million, or 20%, in comparison with 2001. The increase in processing costs was caused by an increase of volumes processed by 0.7 million tonnes, or 15%. During 2002 total processed volumes at Nizhegorodnefteorgsintez increased to 10.3 million tonnes, or by 113% in comparison with 2001. Nizhegorodnefteorgsintez became a consolidated subsidiary in July 2002.

Other operating expenses include costs of other services provided and goods sold (such as electricity, heat, etc.) by our production companies and operating expenses of other non-core businesses, costs associated with the delivery of crude oil from the Group's exploration and production entities to the Group's refineries, as well as the amount of the change in crude oil and refined products inventory at the Group's marketing entities. Other operating expenses also include pension related expense (income). Reduction of other expenses in the amount of $171 million was caused by a decrease in other operating activities and divestments of certain non-core businesses.

Costs of purchased crude oil and petroleum products increased by $606 million, or 29%, in comparison with the prior period primarily due to a significant increase in volumes purchased (crude oil by 8.5 million barrels, refined products by 0.34 million tonnes) and a slight increase in prices.

Transportation expenses

Our transportation expenses increased by $495 million, or 53.9%, in comparison with 2001. The increase in transportation expenses was principally caused by an increase of all transport tariffs, the increase in sales volumes described above and a change in product mix – increase in volume of refined products sold as a percentage of total volume sold.

Selling, general and administrative expenses

Our other selling, general and administrative expenses decreased by $62 million, or 4.5%, in comparison with 2001. The above-mentioned expenses include general business expenses, payroll costs (excluding extraction entities' and refineries' production staff cost), insurance costs, costs of maintenance of social infrastructure and other expenses.

The decrease was attributable to a reduction in 2002 of $141 million in costs relating to achieving certain tax efficiencies, which are no longer available to the Company. This was offset by an increase of $79 million, or on 6%, resulting primarily from an increase in selling expenses related to the growth in the international wholesale and retail business (more than 20%).

Depreciation, depletion and amortization

Depreciation, depletion and amortization expenses include depletion of assets fundamental to production, depreciation of other productive and non-productive assets, amortization of goodwill (for 2001 only) and intangible assets and provision for abandonment and site restoration costs. Our depreciation, depletion and amortization expenses decreased by $62 million, or 7.0%, in comparison to the prior period. This decrease resulted from our discontinuance of amortization of goodwill during 2002 and also due to a decrease in applied depletion rates resulting from revisions of the Company's proved reserves and revisions of future abandonment and site restoration costs of our productive oil and gas assets.

Taxes other than income taxes

Taxes other than income taxes include extraction tax, road user's tax, property tax and social taxes. Beginning January 1, 2002 some taxes, including royalty tax, mineral replacement tax and excise on crude oil sales, were canceled and replaced with a unified extraction tax. This unified extraction tax led to an increase of these expenses by $737 million (including the effect of excise tax on sale of crude oil, discussed below), or 100%, in comparison to the same period in 2001. Other taxes increased by $52 million.

	2002		2001	
	Russian	International	Russian	International
	(millions of US dollars)			
Extraction tax	1,472	–	–	–
MRT	–	–	215	–
Royalty	–	–	347	–
Social security taxes and contributions	191	7	197	4
Road taxes	126	–	100	–
Property taxes	89	12	72	11
Other taxes	48	27	35	29
	1,926	**46**	**966**	**44**
Total		**1,972**		**1,010**

Excise and export tariffs

Our excise and export tariffs include duties on the sale of refined products and export duties on the export of crude oil and refined products. Excise and export tariffs increased by $540 million, or 37%, compared to the prior period (or, excluding the effect of excise tax on sale of crude oil, $713 million, or 55.6%). The increase in the total amount of excise and export tariffs expense resulted mainly from an increase in excise tax rates and volumes of petroleum products and the elimination of certain excise concessions previously available to the Company. The increase in international excise taxes on refined products resulted from an increase in excise taxes and fuel sales taxes and from an increase in volumes of products sold across our international group as well as the increase in our refining.

	2002		2001	
	Russian	International	Russian	International
	(millions of US dollars)			
Excise tax and sales taxes on refined products	387	811	176	276
Excise tax on sale of crude oil	–	–	173	–
Export duties	796	2	831	–
	1,183	**813**	**1,180**	**276**
Total		**1,996**		**1,456**

Exploration expenses

The costs we incur in our exploratory drilling efforts are capitalized to the extent that our exploration efforts are successful and otherwise are charged to expense. During 2002, the amount charged to exploration expense decreased in comparison with the prior period by $55 million, primarily due to higher level of successful drilling.

Loss on disposal and impairment of assets

Loss on disposal and impairment of assets in 2002 was $83 million compared to $153 million in 2001. The change of $70 million, or 45.8%, was due to impairment of goodwill relating to Petrotel and other investments recorded in 2001.

Interest expense

Interest expense decreased by $35 million, or 13.6%, compared to 2001 primarily due to a decrease in interest rates. The weighted-average interest rate on short-term borrowings from third parties was 6.0% per annum and 6.7% per annum as of December 31, 2002 and 2001, respectively. The weighted-average interest rate on long-term loans and borrowings from third parties was 5.58%, and 6.32% per annum as of December 31, 2002 and 2001, respectively.

Interest and dividend income

Interest and dividend income increased primarily due to an increase in cash balances and investments held.

Currency translation gain (loss)

During 2002, we recorded a currency translation gain of $40 million compared to a currency translation loss of $33 million in 2001. During 2002 we were in a net liability position for our Russian rouble denominated monetary assets, which resulted in a currency translation gain.

Income taxes

Our total income tax expense in 2002 increased by $65 million or 9.6% compare to 2001 while our income before income tax decreased by $201 million.

Our effective tax rate in 2002 was 28.6%. This rate was higher than the 24% maximum statutory rate for the Russian Federation primarily because the Company was no longer able to use certain tax incentives and concessions that were previously available, but no longer allowed in 2002 by changed tax legislation. Also, some costs incurred during the year were not tax deductible or were only deductible to a certain limit, thus increasing the effective tax rate.

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

	2002	2001
	(millions of US dollars)	
Income before income taxes	**2,582**	**2,783**
Add back:		
Depreciation and amortization	824	886
Interest expense	222	257
Interest and dividend income	(160)	(146)
EBITDA	**3,468**	**3,780**

LIQUIDITY AND CAPITAL RESOURCES

	2003	2002	2001
	(millions of US dollars)		
Net cash provided by operating activities	2,936	2,396	2,673
Net cash used in investing activities	(2,792)	(2,390)	(3,061)
Net cash provided by financing activities	(4)	96	471
Net debt	3,376	2,941	2,258
Current ratio	1.50	1.35	1.48
Total debt to equity	28%	30%	28%
Long term debt to long term debt and equity	12%	11%	14%
Total net debt to cash flow from operations	1.15	1.23	0.84

Sources of Capital

Our primary source of cash flow is funds generated from our operations. In 2003 cash generated by operating activities was $2,936 million, an increase of $540 million from $2,396 million recorded in 2002 and of $263 million from the $2,673 million in 2001. Higher cash from operating activities was primarily due to growth of international oil prices and, consequently, growth of net income of the Company.

In 2003 the Company spent $4,106 million on capital investments, acquisitions of interests in other companies and other investments. These acquisitions were largely financed from sale proceeds of $1,337 million received on sale of the Company's share in PSA the Azeri, Chirag, Guneshli PSA.

Net cash used in investing activities amounted to $2,792 million in 2003, an increase of $402 million from the $2,390 million in 2002 and a decrease of $269 million from the $3,061 million in 2001.

In 2003 cash provided from financing activities included $1,445 million from the issuance of long-term debt and $220 million from short-term borrowings. Cash utilized by financing activities in 2003 included $1,124 million of debt repayments, $467 million of dividends paid on common shares and $368 million used for purchases of treasury stock. In 2003 net cash provided by financing activities decreased by $100 million compared to 2002.

The Company made payments of $467 million, $423 million and $244 million for dividends on common stock and preferred stock in 2003, 2002 and 2001, respectively.

As of December 31, 2003 our outstanding long-term debt amounted to $2,803 million, including amounts due within one year, compared to $2,698 as of December 31, 2002. The annual maturities of our total long-term debt are $411 million in 2004, $415 million in 2005, $484 million in 2006, $686 million in 2007, $265 million in 2008 and $542 million thereafter. As of December 31, 2003, the Company also had obligations under short-term borrowings, excluding current portion of long-term debt, and customer deposits and other borrowings of banking subsidiaries of $1,001 million and $1,007 million, respectively, compared with $740 million and $755 million as of December 31, 2002.

As of December 31, 2003 the Company had available unutilized credit facilities with a number of banks in the amount of $371 million. Interest rates on these facilities vary and are based on LIBOR.

The Company has sufficient borrowing capacity to meet unanticipated cash requirements, and even during the periods of low commodity prices and narrow margins for refined products, it would have the flexibility to increase borrowings and/or modify capital spending plans to continue paying the common stock dividend and to maintain the Company's high-quality debt ratings.

Credit rating

The Company has a credit rating of BB (RUAA) by Standard and Poor's, which is one grade below the Russian country credit rating of BB+ (RUAAA). Our bonds issued in 2002 are also rated BB.

In 2003 Moody's rated the Company at Ba2, which is two grades below the Russian country rating of Baa3.

Analysis of capital expenditures

	2003	2002	2001
	(millions of US dollars)		
Exploration and production			
- Russia	1,537	1,078	1,543
- International	247	333	246
Total exploration and production	1,784	1,411	1,789
Refining, marketing and distribution			
- Russia	960	683	645
- International	274	110	183
Total refining, marketing and distribution	1,234	793	828
Total capital expenditures	**3,018**	**2,204**	**2,617**
Acquisitions of subsidiaries			
Exploration and production			
- Russia	989	67	467
- International	–	–	–
Total exploration and production	989	67	467
Refining, marketing and distribution			
- Russia	23	53	35
- International	257	57	59
Total refining, marketing and distribution	280	110	94
Less cash acquired	**(44)**	**(4)**	**(62)**
Total	**1,225**	**173**	**499**

According to our strategy to increase crude oil production by 40% up to 2013, which will be achieved from new provinces, we have started exploring and developing these areas during the last three years. The table below shows our historical capital expenditures included into exploration and production expenditures above on new promising oil regions.

Exploration and production	2003	2002	2001
	(millions of US dollars)		
Timano-Pechora	363	338	373
Caspian region	118	46	94

2004 Capital Expenditures Program

The Company estimates 2004 capital expenditures will be $2,919 million (on the assumption that the exchange rate of ruble to US dollars will be the same as in 2003), which is about 2.3% higher than capital expenditures in 2003. About $2,004 million, or 69% of the total, is budgeted for exploration and production activities, with $273 million of that outside of Russia. Exploration and production expenditures will target the most promising exploratory prospects in Caspian region and major development projects in Timano-Pechora region, as well on the maintenance and increase of production on existing fields in the other regions. Refining, marketing and distribution capital spending is estimated to be $914 million, with $182 million of that outside of Russia. Refining, marketing and distribution expenditures in Russia will be allocated to upgrading our refineries and selling facilities, and also on launching of our export terminal in Vysotsk. International refining, marketing and distribution capital spending will target refineries in Bulgaria, Ukraine and Romania. Also we will develop our distribution infrastructure in these countries and the others.

The Company believes that, based on its current expectation for commodity prices for 2004 (by forecasts of international investment banks the average price for Brent crude oil, which is traded with a premium to Urals crude oil, will exceed $28.00 per barrel in 2004), its capital expenditures program will be funded by operating activities and, to the extent required, available lines of credit. In the event of significantly lower cash flow the Company is able to defer certain of its capital spending program without penalty.

GUARANTEES, OFF-BALANCE-SHEET ARRANGEMENTS AND CONTRACTUAL OBLIGATIONS, AND OTHER CONTINGENCIES

Financial Guarantees

		Commitment Expiration by Period					
Millions of dollars	**Total**	**2004**	**2005**	**2006**	**2007**	**2008**	**After**
Guarantees of equity affiliate's debt	718	13	70	25	25	12	573
Guarantees of third party's debt	63	25	22	16	–	–	–

As of December 31, 2003 the Company provided guarantees of $718 million for loans of equity investees and $63 million for third parties. There are no amounts being carried as liabilities for the Company's obligations under these guarantees. Guarantees issued in regard to equity investees primarily relate to borrowings for capital projects or general corporate purposes. These guarantees were undertaken to enhance the credit standing of the affiliated operations and to achieve lower interest rates. Under the terms of guarantees, the Company would be required to perform should an affiliate be in default of its loans, generally for the full amount disclosed. There are no provisions for recourse to third parties, and no assets are held as collateral for the obligations of affiliates. One of the guarantees is secured by the shares of an affiliated company held by the Group, the carrying amount of which was approximately $8 million as of December 31, 2003. No collateral secures other guarantees. See Note 19, "Financial guarantees."

Capital commitments and contractual obligations

The Company and its subsidiaries have significant capital commitments in respect to development of oil and gas fields in Russia. These commitments are regulated by law and described in the individual license agreements. Also we have long term lease obligations for retail outlets in US.

The following table displays our total on and off balance sheet contractual obligations:

		Payments Due by Period					
Millions of dollars	**Total**	**2004**	**2005**	**2006**	**2007**	**2008**	**After**
On balance sheet:							
Short term debt	1,001	1,001	–	–	–	–	–
Long-term bank loans and borrowings	1,604	367	276	361	251	218	131
Long-term non-bank loans and borrowings	711	27	119	106	52	31	376
3.5% Convertible US dollar bonds	366	–	–	–	366	–	–
Other bonds	7	1	3	–	–	–	3
Capital lease obligations	115	16	17	17	17	16	32
TOTAL	**3,804**	**1,412**	**415**	**484**	**686**	**265**	**542**
Off balance sheet							
Operating lease obligations	808	68	67	67	66	66	474
Capital commitment in Neftohim Burgas refinery (Bulgaria)	41	41	–	–	–	–	–
Capital commitment in Petrotel refinery (Romania)	60	60	–	–	–	–	–
Capital commitment in Beopetrol (Serbia)	106	86	17	3	–	–	–
Capital commitments in PSAs	421	170	123	45	17	10	56
Capital commitments under oil and gas license agreements in Russia	2,004	298	302	338	504	517	45
TOTAL	**3,440**	**723**	**509**	**453**	**587**	**593**	**575**

Litigation

On November 27, 2001, Archangel Diamond Corporation ("ADC"), a Canadian diamond development company, filed a lawsuit in the district court of Denver, Colorado, against AGD, a Group company, and the Company (together the "Defendants") claiming compensation for damage allegedly caused by the Defendants relating to Almazny Bereg, a joint venture between AGD and ADC. ADC claims, among other things, that the Defendants interfered with the transfer of a diamond exploration license which was subject to an agreement between ADC and AGD. The total damages claimed by ADC are $4.8 billion, including compensatory damages of $1.2 billion and punitive damages of $3.6 billion. On October 15, 2002, the District Court of Denver, Colorado dismissed ADC's action against the Defendants based on lack of jurisdiction. On November 22, 2002, the Denver District Court denied ADC's request for reconsideration of the Court's October 15th order dismissing the case. ADC subsequently filed an appeal on November 27, 2002 with the Court of Appeals in the State of Colorado. On March 25, 2004, the Court of Appeals in the State of Colorado upheld the October 15, 2002 decision. ADC filed a petition for rehearing on April 7, 2004 requesting that the Court of Appeals in the State of Colorado reconsider its March 25, 2004 ruling. ADC's petition for rehearing is currently pending. The Company does not believe that the ultimate resolution of this matter will have a material adverse effect on its financial condition.

The Group is involved in various other claims and legal proceedings arising in the normal course of business. While these claims may seek substantial damages against the Group and are subject to uncertainty inherent in any litigation, management does not believe that the ultimate resolution of such matters will have a material adverse impact on the Group's operating results or financial condition.

Other matters

During July 2001, the Group temporarily shut down operations of the Petrotel SA refinery due to the economic conditions in Romania. The refinery remains closed as of the date of these consolidated financial statements. In 2002 the management of the Company has completed and approved the results of a feasibility study and investment program to upgrade the Petrotel SA refinery and resume operations during 2004. The Group has been implementing the investment program and upgrade of the refinery during 2003. However, if management ultimately decides to abandon the refinery, the Group may be exposed to losses on the carrying value of property, plant and equipment of up to approximately $60 million.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

Interest rate risk

We are exposed to changes in interest rates, primarily associated with our variable rate short-term and long-term borrowings. We do not utilize any interest rate swaps or other derivatives to hedge against the risk of changes in interest rates on our variable rate debt. Utilizing the actual interest rates in effect and the balance of our variable rate debt as of December 31, 2003 and assuming a 10% change in interest rates and no change in the balance of debt outstanding, the potential effect on annual interest expense would not be material to our results of operations.

Foreign currency risk

The countries in which our principal operations are located have been subject to hyperinflation and during the last 10 years the local currency has been subject to large devaluations. As a result we are subject to the risk that the local currency may suffer future devaluation that may subject us to losses, depending on our net monetary asset position. We currently do not use any formal hedging arrangements to minimize the effect of these potential losses. Additionally, because we have operations in a number of other countries we are required to conduct business in a variety of foreign currencies and, as a result, we are subject to foreign exchange rate risk on cash flows related to sales, expenses, financing and investment transactions. The impacts of fluctuations in foreign currency exchange rates on our geographically diverse operations are varied. We recognized net foreign currency translation gains (losses) of $148 million, $40 million and $(33) million for the years ended December 31, 2003, 2002 and 2001, respectively

Appreciation of ruble against US dollar in 2003 had a negative impact on our operating profit and cash flows since it lead to an increase of our costs in dollar terms and a decrease of amount of the export cash revenue in the ruble terms. As mentioned above, a substantial part of our revenue is denominated in US dollars or, to some extent, bound to the oil prices quoted in US dollars, while a significant part of our costs is ruble denominated. Should the ruble appreciation against US dollars in 2004 be at a level of 10% (on the base of the forecasts of the Ministry of Economic Development as well as assumptions underlying the state budget) our operating profit will decrease by $160 million and net cash flows by $400 million (taking into account that other macroeconomic factors will remain constant).

An appreciation in the exchange rate of Bulgarian lev to US dollars may also have negative impact on our operating profit and cash flows. In 2003 the exchange rate of Bulgarian lev appreciated against the US dollar by 20.3%. However, taking into account the volume of our operations in Bulgaria as compared to Russia the total impact would not exceed $10 million.

Commodity instruments

We make limited use of commodity instruments in our operations. The use of such instruments relates to limited marketing and trading of petroleum products outside of our physical crude oil and products businesses and hedging of commodity price risks. This includes the use of futures and swap contracts together with purchase and sale contracts that qualify as derivative instruments. The Company maintains a system of controls over these marketing and trading activities that includes policies covering the authorization, reporting and monitoring of derivative activity. We do not believe our derivative activities pose material credit or market risks to our operations, financial condition or liquidity. We recognized a net loss of $37 million during 2003 ($5 million in 2002) associated with such activities. The fair value of derivative contracts outstanding and recorded on the consolidated balance sheet as of December 31, 2003 was a net payable of $1 million ($6 million in 2002). The derivative activity during 2001 was negligible.

CRITICAL ACCOUNTING POLICIES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to select appropriate accounting policies and to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. See Note 2, "Summary of significant accounting policies," for descriptions of the Company's major accounting policies. Certain of these accounting policies involve judgments and uncertainties to such an extent that there is a reasonable likelihood that materially different amounts would have been reported under different conditions, or if different assumptions had been used.

Successful Efforts Accounting for Oil and Gas Activities

Accounting for oil and gas activities is subject to special accounting rules that are unique to the oil and gas industry. Property acquisitions, successful exploratory wells, all development costs and support equipment and facilities are capitalized. Artificial stimulation and well work-over costs are included in operating expenses as incurred.

Property Acquisition Costs

For individually significant undeveloped properties, management periodically performs impairment test based on exploration and drilling efforts to date. For undeveloped properties acquisition costs that individually are relatively small, management exercises judgment and determines a periodic property impairment charge as required that is reported in exploration expense.

Exploratory Costs

For exploratory wells, drilling costs are temporarily capitalized, or "suspended", on the balance sheet, pending a judgmental determination of whether potentially economic oil and gas reserves have been discovered by the drilling effort. If a judgment is made that the well did not encounter potentially economic oil and gas quantities, the well costs are expensed as a dry hole and are reported in exploration expense. Exploratory wells that are judged to have discovered potentially economic quantities of oil and gas and that are in areas where a major capital expenditure would be required before production could begin, remain capitalized on the balance sheet as long as additional exploratory appraisal work is under way or firmly planned. Unlike license acquisition costs, there is no periodic impairment assessment of suspended exploratory well costs. Management continuously monitors the results of the additional appraisal drilling and seismic work and expenses the suspended well costs as dry holes when it judges that the potential field does not warrant further exploratory efforts in the near term.

Other exploratory expenditures, including geological and geophysical costs are expensed as incurred.

Proved Oil and Gas Reserves

Proved oil and gas reserves are the estimated quantities of crude oil, natural gas liquids including condensate and natural gas that geological and engineering data demonstrate with reasonable certainty can be recovered in future years from known reservoirs under existing economic and operating conditions. Reserves are considered proved if they can be produced economically as demonstrated by either actual production or conclusive formation tests. Reserves which must be produced through the application of enhanced recovery techniques are included in the proved category only after successful testing by a pilot project or operation of an installed program in the same reservoir that provides support for the engineering analysis on which the project was based. Proved developed reserves are expected to be produced through existing wells and with existing facilities and operating methods.

The estimates are made using all available geological and reservoir data as well as historical production data. Estimates are reviewed and revised as appropriate. Revisions occur as a result of changes in prices, costs, fiscal regimes, reservoir performance or a change in the Company's plans.

The Group has included within proved reserves quantities, which the Group expects to produce after the expiry dates of its current production licenses. These licenses expire between 2011 and 2026, with the most significant expiring between 2011 and 2014. We believe the licenses will be extended to produce subsequent to their current expiry dates. The Group is in the process of extending all of its production licenses in the Russian Federation. The Group has already extended a portion of these licenses and expects to extend the remaining licenses for indefinite periods. To date there have been no unsuccessful license renewal applications.

Impairment Of Long-Lived Assets

Long-lived assets used in operations are assessed for impairment whenever changes in facts and circumstances indicate a possible significant deterioration in the future cash flows expected to be generated by an asset group. If, upon review, the sum of the undiscounted pretax cash flows is less than the carrying value of the asset group, the carrying value is written down to estimated fair value. Individual assets are grouped for impairment purposes based on a judgmental assessment of the lowest level for which there are identifiable cash flows that are largely independent of the cash flows of other groups of assets. Because there usually is a lack of quoted market prices for long-lived assets, the fair value usually is based on the present values of expected future cash flows using discount rates commensurate with the risks involved in the asset group. The expected future cash flows used for impairment reviews and related fair value calculations are based on judgmental assessments of future production volumes, prices and costs, considering all available information at the date of review.

Site Restoration and Abandonment Costs

Under various laws, contracts, permits and regulations, the Company has legal obligations to remove tangible equipment and restore the land or seabed at the end of operations at production sites. The largest site restoration and abandonment obligations of the Company relate to wells and oil and gas production facilities and pipelines. In accordance with SFAS No. 143, *"Accounting for Asset Retirement Obligations"*, the Company records the fair value of liabilities associated with such obligations when incurred. See Note 2 of the financial statements which describes the Company's adoption of SFAS No. 143 effective January 1, 2003. Estimating the future site restoration and abandonment costs necessary for this accounting calculation involves significant estimates and judgments by management. Most of these obligations are many years in the future and the contracts and regulations often have vague descriptions of what removal practices and criteria will have to be met when the removal event actually occurs. Asset removal technologies and costs are constantly changing, as well as political, environmental, safety and public relations considerations.

Contingencies

The Company is required to both determine whether a loss is probable based on judgment and interpretation of laws and regulations and determine that the loss can be reasonably estimated. When the loss is determined it is charged to net income. The Company's management must continually monitor known and potential contingent matters and make appropriate provisions by charges to net income when warranted by circumstance.

Defined Benefit Pension Plan

Determination of the projected benefit obligations for the Company's defined benefit pension plan is important to the recorded amounts for such obligations on the balance sheet and to the amount of benefit expense in the income statement. This also impacts the required Company contributions into the plans. The actuarial determination of projected benefit obligations and Company contribution requirements involves judgment about uncertain future events, including estimated retirement dates, salary levels at retirement, mortality rates, lump-sum election rates and rates of return on plan assets. Due to the specialized nature of these calculations, the Company engages outside actuarial firms to assist in the determination of these projected benefit obligations. Ultimately, the Company will be required to fund all promised benefits under pension benefit plans not funded by plan assets or investment returns, but the judgmental assumptions used in the actuarial calculations significantly affect periodic financial statements and funding patterns over time. Benefit expense is particularly sensitive to the discount rate and return on plan assets assumptions

New Accounting Pronouncements

In January 2003, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 46 "Consolidation of Variable Interest Entities", which was ammended in December 2003 when FASB Interpretation No. 46 (revised in December 2003) "Consolidation of Variable Interest Entities" ("FIN 46 R") was issued. FIN 46 R addresses when a business enterprise should consolidate another entity in which it has a controlling financial interest through means other than voting interests. The provisions of FIN 46 R must be applied for variable interest entities commonly referred to as "special purpose entities" by December 31, 2003. For all other variable interest entities, implementation is required by March 31, 2004.

The Group is currently reviewing its existing financial arrangements to identify any that may qualify as variable interest entities. There is a reasonable possibility that certain joint ventures in which the Group has an interest might be variable interest entities. The variable interests arise primarily because of certain guarantees extended by the Group to the joint ventures, which are disclosed in Note 19 to the consolidated financial statements. However, the Group does not expect any significant impact on net income if it is required to consolidate any of these possible variable interest entities because the Group's share of net income in these entities is already included in the Group's consolidated statements of income. The potential increase to the Group's assets and liabilities is also not expected to be significant.

FORWARD-LOOKING STATEMENTS

Certain statements in this document are not historical facts and are "forward-looking." We may from time to time make written or oral forward-looking statements in reports to shareholders and in other communications. Examples of such forward-looking statements include, but are not limited to:

- *statements of our plans, objectives or goals, including those related to products or services;*
- *statements of future economic performance; and*
- *statements of assumptions underlying such statements.*

Forward looking statements that may be made by us from time to time (but that are not included in this document) may also include projections or expectations of revenues, income (or loss), earnings (or loss) per share, dividends, capital structure or other financial items or ratios. Words such as "believes," "anticipates," "expects," "estimates," "intends" and "plans" and similar expressions are intended to identify forward-looking statements but are not the exclusive means of identifying such statements. By their very nature, forward-looking statements involve inherent risks and uncertainties, both general and specific, and risks exist that the predictions, forecasts, projections and other forward-looking statements will not be achieved. You should be aware that a number of important factors could cause actual results to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward-looking statements.

These factors include:
- *inflation, interest rate and exchange rate fluctuations;*
- *the price of oil;*
- *the effects of, and changes in, Russian government policy;*
- *the effects of competition in the geographic and business areas in which we conduct operations;*
- *the effects of changes in laws, regulations, taxation or accounting standards or practices;*
- *our ability to increase market share for our products and control expenses;*
- *acquisitions or divestitures;*
- *technological changes; and*
- *our success at managing the risks of the aforementioned factors.*

This list of important factors is not exhaustive. When relying on forward-looking statements, you should carefully consider the foregoing factors and other uncertainties and events, especially in light of the political, economic, social and legal environment in which we operate. Such forward-looking statements speak only as of the date on which they are made, and, subject to any continuing obligations under the Listing Rules of the U.K. Listing Authority, we do not undertake any obligation to update or revise any of them, whether as a result of new information, future events or otherwise. We do not make any representation, warranty or prediction that the results anticipated by such forward-looking statements will be achieved, and such forward-looking statements represent, in each case, only one of many possible scenarios and should not be viewed as the most likely or standard scenario.