# 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 interim consolidated financial statements and notes thereto.

References to "LUKOIL", "the Group", "the Company", "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.

**Forward-looking statements**

This report contains forward-looking statements. Words such as "believes", "anticipates", "expects", "estimates", "intends", "plans", etc. reflect management's current estimates and beliefs, but are not guarantees of future results.

**Financial highlights**

| | **9 months of 2004** | 9 months of 2003 | % change | **3rd quarter of 2004** | 3rd quarter of 2003 | % change |
|---|---|---|---|---|---|---|
| Sales (including excise and export tariffs) | **24,217** | 16,136 | 50.1% | **9,740** | 5,994 | 62.5% |
| **Net Income** | **3,095** | 3,065 | 1.0% | **1,399** | 701 | 99.6% |
| Net income excluding cumulative effect of change in accounting principle and gain from sale of share in Azeri, Chirag, Guneshli | **3,095** | 1,803 | 71.7% | **1,399** | 701 | 99.6% |
| EBITDA | **5,220** | 4,434 | 17.7% | **2,255** | 1,256 | 79.5% |
| Earnings per share of common stock (US dollars) | | | | | | |
| Basic earnings | **3.79** | 3.74 | 1.3% | **1.71** | 0.85 | 101.2% |
| Diluted earnings | **3.73** | 3.68 | 1.4% | **1.69** | 0.84 | 101.2% |
| Crude oil production by consolidated subsidiaries (thousands of tonnes) | **61,407** | 56,065 | 9.5% | **20,855** | 19,773 | 5.5% |
| Refined products produced at Group refineries (thousands of tonnes) | **30,425** | 29,410 | 3.5% | **10,703** | 10,347 | 3.4% |

During the nine-month period ended September 30, 2004 net income was $3,095 million, which is $1,292 million more than in the same period of 2003 (excluding the cumulative effect of change in accounting principle and gain from sale of our share in Azeri, Chirag, Guneshli in amount of $1,262 million).

The increase in net income resulted from favorable price conditions in the nine-month period ended September 30, 2004 and improved cost control. However, an increased tax burden, appreciation of the ruble against the US dollar and an increase in transportation costs have restrained growth of our profitability. These restraining factors as well as other drivers impacting the results of our operations are considered below in detail.

**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 trading 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. As a result of certain factors considered in section "Domestic crude oil prices" on page 4, benchmarking crude oil market prices in Russia cannot be determined with certainty. Therefore, the prices set for inter-segment purchases of crude oil reflect a combination of market factors, primarily international crude oil market prices, transportation costs and need for investment resources at Group's oil producing companies. 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 18 to our interim consolidated financial statements.

**Recent developments**

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.

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

In June 2004, we entered into an agreement for exploration, development and production of non-associated gas in Uzbekistan. In respect of this agreement, the Company has minimum exploration commitments of $16 million over next 3 years. The amount of recoverable reserves agreed upon under the terms of the contract is 250 bcm.

In June 2004, we put into operation the first stage of our reloading and distribution terminal in Vysotsk. The terminal's initial capacity is 4.7 million tonnes of crude oil and refined products a year. Through this terminal we will export light refined products to Western Europe and the United States. It is planned that the full capacity of approximately 12.0 million tonnes will be reached in 2005.

In June 2004, the Company made a decision to sell its 99% interest in Petrocommerce Bank for $214 million. The first phase of the transaction representing the sale of 78% of the Group's ownership interest for $169 million was completed on September 22, 2004. The second phase in which the Group will sell its remaining 21% of ownership interest in the Bank for $45 million will be completed by the end of June 2007. The decision to sell the shares was made pursuant to the Strategic Development Program of OAO LUKOIL with a view of increasing the investment attractiveness of the Company through divestiture of non-core assets from the Group.

In October 2004, we put into operation Petrotel-LUKOIL S.A., our Romanian refinery, after modernization. The Company invested $120.7 million in the refinery reconstruction. The annual throughput will reach 2.4 million tonnes.

In November 2004, we signed a sale and purchase agreement in respect of our 100% ownership in OOO LUKOIL-Burenie, our drilling company, for $69 million. The terms of the contract require signing a five-year contract for drilling services to be provided to the Group and revising the terms of Group financing previously provided to LUKOIL-Burenie. The transaction is expected to be completed by the end of December 2004. This sale is another part of our Strategic Development Program designed to improve our operations and maximize shareholder value.

**Consolidation of the Group**

By the end of 2003 we completed the restructuring of the Group's oil producing assets in the Perm region. ZAO "LUKOIL-Perm", our 100% subsidiary, merged with OOO "LUKOIL-Permneft", also a 100% subsidiary. Furthermore, oil producing assets of ZAO "LUKOIL-Perm" located in Western Siberia and the Komi Republic were transferred to the Group's companies operating in the respective regions. Thus, we created a single oil extraction company operating in the Perm region, namely OOO "LUKOIL-Perm". Within the bounds of this restructuring process we took certain measures, which allowed us to:

- optimize organizational structure
- dispose from the Group certain service companies and non-core businesses
- decrease general and administrative expenses
- introduce standardized organizational structure and management functions

During our optimization of the organizational structure we decreased the number of employees by more than 1,000. The consolidation of our oil producing assets will allow us to further increase our labour productivity and production output.

## Main macroeconomic factors affecting our results of operations

### Change in 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. During 2003 crude oil prices were steadily high due to recommenced growth of the world economy (3.7% in 2003) and increased worldwide crude oil consumption (in 2003 worldwide crude oil consumption was 78.5 million barrels a day, or 1.9% more than in 2002). In 2004, due to the robust growth in demand in the USA and China, which had not been fully anticipated, certain geopolitical tensions, refining and distribution bottlenecks in some major consuming regions, crude oil prices rapidly escalated and in September reached their historical records (OPEC Reference basket) in absolute terms. In responding to this and in order to ensure market stability, OPEC decided to increase daily level of production up to 27.0 million barrels a day from November 2004. However, based on OPEC's data, actual daily production in September already reached 27.9 million barrels a day excluding Iraq (or 30.1 million barrels a day including Iraq) – near to OPEC's full capacity. This situation can be viewed as an indicator that crude oil prices will remain steadily high in a medium-term perspective.

Substantially all of the crude oil that we sell for export is Urals blend. The following table shows the average crude oil export prices for respective periods of 2003 and 2004 and refined product prices based on Northern Europe averages:

| | **9 months of 2004** | 9 months of 2003 | Change % | **3rd quarter 2004** | 3rd quarter 2003 | Change % |
|---|---|---|---|---|---|---|
| | (in US dollars per bbl, except for figures in percent) | | | | | |
| Brent crude | **36.35** | 28.62 | 27.0% | **41.54** | 28.38 | 46.4% |
| Urals crude (CIF Mediterranean)* | **33.02** | 26.71 | 23.6% | **37.41** | 27.05 | 38.3% |
| | (in US dollars per metric tonne, except for figures in percent) | | | | | |
| Fuel oil 3.5% (FOB Rotterdam) | **152.25** | 150.19 | 1.4% | **161.47** | 153.42 | 5.2% |
| Diesel fuel (FOB Rotterdam) | **321.38** | 251.18 | 27.9% | **376.82** | 235.58 | 60.0% |
| High-octane gasoline (FOB Rotterdam) | **393.03** | 299.41 | 31.3% | **435.97** | 302.80 | 44.0% |

Source: Platts

* 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. 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 within vertically integrated groups. 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 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 is 17.8% (the nine months ended September 30, 2003: 21.4%) of total tonnes sold, but represents 13.4% of our total sales revenue (the nine months ended September 30, 2003: 16.0%). In general, retail prices on refined products in Russia are comparable to those in the USA. For example, in the nine months ended September 30, 2004 the average retail price on regular gasoline in the USA was about 49 cents per liter, an increase of 15% as compared to the same period of 2003. In central regions of European Russia the average retail price on gasoline of the same quality (95 octane) in the nine months ended September 30, 2004 was 45 cents per liter, an increase of 23% as compared to the same period of 2003.

**Changes in the US dollar-ruble exchange rate and inflation**

A substantial part of our revenues is either denominated in US dollars or is 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 ruble inflation and exchange rates can significantly affect the results of our operations. In particular, our operating margins are generally adversely affected by real appreciation of the ruble against the US dollar, because this will generally cause our costs to increase in US dollar terms relative to our revenues. It should be noted that during 2003 and the first quarter of 2004 the exchange rate of the ruble to the US dollar was constantly increasing, rather than declining like in periods prior to 2003. However, in April-August of 2004 the ruble tended to devaluate against 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.

| | **9 months of 2004** | 9 months of 2003 | **3rd quarter 2004** | 3rd quarter 2003 |
|---|---|---|---|---|
| Ruble inflation (CPI) | 8.1% | 8.6% | 1.7% | 0.6% |
| Nominal appreciation/(devaluation) of the exchange rate (ruble to US dollar) | 0.8% | 3.7% | (0.7)% | (0.9)% |
| Real appreciation/(devaluation) of the exchange rate (ruble to US dollar) | 8.9% | 12.7% | 1.0% | (0.3)% |
| Average exchange rate for the period (ruble to US dollar) | 28.91 | 30.99 | 29.17 | 30.43 |
| Exchange rate at the end of the period (ruble to US dollar) | – | – | 29.22 | 30.61 |

**Change in tax rates and export tariffs**

| | | **9 months * of 2004** | 9 months * of 2003 | Change % |
|---|---|---|---|---|
| Export tariffs on crude oil | $/tonne | 43.61 | 29.58 | 47.4% |
| Export tariffs on refined products | $/tonne | 33.73 | 26.62 | 26.7% |
| Excise on refined products | | | | |
| High-octane gasoline | RUR/tonne | 3,360 | 3,000 | 12.0% |
| Low-octane gasoline | RUR/tonne | 2,460 | 2,190 | 12.3% |
| Diesel fuel | RUR/tonne | 1,000 | 890 | 12.4% |
| Motor oils | RUR/tonne | 2,732 | 2,440 | 12.0% |
| Mineral extraction tax | RUR/tonne | 1,009.50 | 798.95 | 26.4% |

* average values

| | | **3rd quarter 2004 *** | **3rd quarter 2003 *** | Change % |
|---|---|---|---|---|
| Export tariffs on crude oil | $/tonne | 60.36 | 25.67 | 135.1% |
| Export tariffs on refined products | $/tonne | 39.90 | 23.11 | 72.7% |
| Excise on refined products | | | | |
| High-octane gasoline | RUR/tonne | 3,360 | 3,000 | 12.0% |
| Low-octane gasoline | RUR/tonne | 2,460 | 2,190 | 12.3% |
| Diesel fuel | RUR/tonne | 1,000 | 890 | 12.4% |
| Motor oils | RUR/tonne | 2,732 | 2,440 | 12.0% |
| Mineral extraction tax | RUR/tonne | 1,195.63 | 791.49 | 51.1% |

* average values

During the nine months ended September 30, 2004 our tax burden rose significantly compared to the same period of the previous year. Average crude oil export tariffs increased by 47.4% compared to same period of 2003, but surged by 135.1% comparing the third quarters of 2004 with 2003. Approximately 83% of the quarterly increase related to growth of crude oil prices, remaining 52% resulting from changes in the duty rate calculations effective June 2004 (see page 7). Export tariffs on gasoline, kerosene, jet fuel, diesel fuel, fuel oil and gasoils increased by 26.7%. Excise on refined products increased by approximately 12%.

The mineral extraction tax rate increased by 26.4% compared to the nine months of 2003. This resulted from an increase of the Urals crude price, increase of the base rate up to 347 Rubles per metric tonne extracted and as a different spread of crude oil prices over the nine months of 2004 as compared to the same period of 2003.

The mineral extraction tax rate is determined as follows. The base rate is set at 347 Rubles per metric tonne extracted (effective from January 1, 2004; prior to this the base rate was 340 rubles) and is adjusted depending on 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 $1.38 per tonne extracted (or 18.79 cents per barrel extracted using a conversion factor of 7.33).

Crude oil export duties also depend on the international market price of the Urals blend. Before June 2004 the duty rates have been calculated as follows (for a new method of the duty rate calculations enacted from June 2004 see "Recent amendments to Russian tax legislation" below). The 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 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.

Export duty rates on export of refined products are set by the Russian government. Effective from January 2004 the upper bound for refined products export duties limited to 90% of the crude oil export duty was abolished. Crude oil and refined products exported to CIS countries, other than Ukraine, are not subject to export duties.

Tax rates set in rubles and translated at the average exchange rates for respective periods are as follows:

| | **9 months of 2004 *** | 9 months of 2003 * | Change % | **3rd quarter 2004 *** | 3rd quarter 2003 * | Change % |
|---|---|---|---|---|---|---|
| | (in USD dollars per tonne) | | | | | |
| Excise on refined products | | | | | | |
| High-octane gasoline | 116.22 | 96.81 | 20.0% | 115.18 | 98.57 | 16.9% |
| Low-octane gasoline | 85.09 | 70.67 | 20.4% | 84.33 | 71.96 | 17.2% |
| Diesel fuel | 34.59 | 28.72 | 20.4% | 34.28 | 29.24 | 17.2% |
| Motor oils | 94.49 | 78.74 | 20.0% | 93.65 | 80.17 | 16.8% |
| Mineral extraction tax | 34.92 | 25.81 | 35.5% | 40.99 | 26.01 | 57.6% |

* average values

**Recent amendments to Russian tax legislation**

Effective from January 1, 2005 the formula underlying the mineral extraction tax calculation will be adjusted - the base rate is to be set at 419 Rubles per metric tonne extracted (instead of 400 Rubles as planned before) and the lower non-taxable threshold is to be increased up to $9.00 per barrel. As a result each $1.00 per barrel increase in the international Urals price over the threshold ($9.00 per barrel) will effectively result in an increase of the tax rate by $1.61 per tonne extracted (or 21.90 cents per barrel extracted using a conversion factor of 7.33). If the Urals blend price in 2005 will be between $22 – 28 per barrel the mineral extraction tax will increase by 7.6 – 10.8% as a result of the amendment.

Effective from June 2004 the Russian government reconsidered crude oil export duty rates. A three-layer progressive scale was introduced. If the Urals price is in a layer between $15.00 ($109.50 per metric tonne) and $20.00 per barrel ($146.00 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 in a layer between $20.00 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 $0.45 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 $0.65 per barrel exported. If the Urals blend price is between $22 – 28 per barrel the crude oil export duties will increase by 8.2 – 26.6% as a result of the amendment.

## Operational highlights

### Oil production

In line with our long term strategy we increased our total daily oil production (including the Company's share in equity associates) by 8.2% and produced 474.5 million barrels (64.1 million tonnes) in the period ended September 30, 2004.

| | **9 months of 2004** | **9 months of 2003** | Change, % |
|---|---|---|---|
| Daily production, including Company's share in Equity associates (thousand barrels per day) | **1,732** | 1,601 | 8.2% |
| Refinery throughput (thousand barrels per day) | **863** | 842 | 2.5% |

| | **3rd quarter of 2004** | **3rd quarter of 2003** | Change, % |
|---|---|---|---|
| Daily production, including Company's share in Equity associates (thousand barrels per day) | **1,753** | 1,635 | 7.2% |
| Refinery throughput (thousand barrels per day) | **898** | 868 | 3.5% |

The main oil production region of the Company remains Western Siberia. In the oil fields of Western Siberia the Company produced 67.6% of its total production of crude oil in the nine months ended September 30, 2004 (67.3% in 2003). The increase of production in Western Siberia by 10.1% is a result of both acquisitions in 2003 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 oil production resulting from these improvements was 6.2%. The increase of production in the Komi Republic by 14.3% primarily resulted from the consolidation of our oil production companies – acquisitions of additional interests in OAO Tebukneft, OAO Ukhtaneft and ZAO RKM-Oil in 2003. The organic growth of the oil production in the Komi Republic was 1.8%. Commencement of oil production in new oil fields in the Nenetsky Autonomous District led to an increase of oil production in this region of Russia more than 1.5 times compared to 2003. In the third quarter of 2004 we started commercial production at Kravtsovskoye (D-6), a Baltic offshore field. It is expected that 70 thousand tonnes of crude oil will be produced during 2004 from this field, and yearly crude oil production will reach 600 thousand tonnes by 2007. The total organic growth of the oil production was 5.5% compared to the nine-month period of 2003.

The following table represents our production by major regions excluding our share in equity associates:

| (thousands of tonnes) | **9 months of 2004** | Change to 2003 Total % | Change to 2003 Change in structure | Change to 2003 Organic growth | **9 months of 2003** |
|---|---|---|---|---|---|
| Western Siberia | **41,539** | 10.1% | 1,464 | 2,333 | 37,742 |
| Komi Republic | **7,153** | 14.3% | 784 | 110 | 6,259 |
| Ural region | **7,496** | 0.7% | – | 51 | 7,445 |
| Volga region | **2,223** | (0.4)% | – | (8) | 2,231 |
| Timano-Pechora (Nenetsky Autonomous District) | **1,065** | 55.5% | – | 380 | 685 |
| Other in Russia | **994** | 8.5% | 29 | 49 | 916 |
| **Crude oil production in Russia** | **60,470** | 9.4% | 2,277 | 2,915 | 55,278 |
| **Crude oil produced internationally** | **937** | 19.1% | – | 150 | 787 |
| **Total crude oil produced** | **61,407** | 9.5% | 2,277 | 3,065 | 56,065 |

In addition to our production, we purchase crude oil from third parties in Russia and on international markets. In Russia we primarily purchase crude oil from associated producing companies and other producers, including vertically integrated companies that lack refining capacity or are unable to export their crude oil. We may either refine or export purchased crude oil. Crude oil purchased on international markets is used mostly for marketing activities and, on certain occasions, for supplying our overseas refineries.

| | 9 months of | | | |
|---|---|---|---|---|
| | 2004 | | 2003 | |
| | (thousand of barrels) | (thousand of tonnes) | (thousand of barrels) | (thousand of tonnes) |
| Crude oil purchases in Russia | 16,866 | 2,301 | 29,034 | 3,961 |
| Crude oil purchases internationally | 51,677 | 7,050 | 41,774 | 5,699 |
| **Total crude oil purchased** | **68,543** | **9,351** | **70,808** | **9,660** |

| | 3rd quarter of | | | |
|---|---|---|---|---|
| | 2004 | | 2003 | |
| | (thousand of barrels) | (thousand of tonnes) | (thousand of barrels) | (thousand of tonnes) |
| Crude oil purchases in Russia | 6,377 | 870 | 5,307 | 724 |
| Crude oil purchases internationally | 18,039 | 2,461 | 14,059 | 1,918 |
| **Total crude oil purchased** | **24,416** | **3,331** | **19,366** | **2,642** |

The volume of crude oil purchased in Russia in the nine months of 2004 was 2,301 thousand tonnes, a 1,660 thousand tonnes decrease compared to the same period of 2003. The decrease occurred because in the first half of 2003 most of our purchases of crude oil in Russia were from associate companies, which later became fully consolidated subsidiaries. The volume of crude oil purchased internationally increased by 1,351 thousand tonnes, or by 23.7%, as a result of an increase in our marketing activity.

### Refining and marketing

We operate four refineries located in European Russia and three refineries located overseas – in Bulgaria, Ukraine and Romania. Our Romanian refinery, Petrotel-LUKOIL S.A., had been undergoing significant upgrades until October 2004. In October 2004, we put Petrotel into operation (see page 2).

Production of refined products in the nine months of 2004 increased by 3.5% as compared to the same period of 2003. Russian refineries increased production by 4.6%.

In 2004 we continued to expand our marketing activities in Western Europe, South-East Asia, Northern and Central America. Our marketing activities mainly include wholesale and bunkering operations in Western Europe and South-East Asia. The total volume of refined products, purchased in this activity from third parties, was 9,872 thousand tonnes or $2,637 million (6,268 thousand tonnes or $1,347 million in the nine months of 2003).

In addition, the Group purchases refined products to supply our retail networks in the USA, Baltic states and some other regions. The total volume of refined products purchased in this activity from third parties during the nine months of 2004 was 4,608 thousand tonnes or $2,155 million (3,125 thousand tonnes or $1,157 million in the nine months of 2003).

In Russia we purchase refined products on occasion, primarily to manage supply chain bottlenecks.

The following table represents volumes of refined products produced and purchased:

| | 9 months of 2004 (thousand of tonnes) | 9 months of 2003 (thousand of tonnes) |
|---|---|---|
| Refined products produced at the Group refineries in Russia | 25,194 | 24,089 |
| Refined products produced at the Group refineries outside of Russia | 5,231 | 5,321 |
| **Total refined products produced** | **30,425** | **29,410** |
| Refined products purchased in Russia | 1,536 | 887 |
| Refined products purchased internationally | 14,636 | 10,026 |
| **Total refined products purchased** | **16,172** | **10,913** |

| | 3rd quarter of 2004 (thousand of tonnes) | 3rd quarter of 2003 (thousand of tonnes) |
|---|---|---|
| Refined products produced at the Group refineries in Russia | 8,699 | 8,282 |
| Refined products produced at the Group refineries outside of Russia | 2,004 | 2,065 |
| **Total refined products produced** | **10,703** | **10,347** |
| Refined products purchased in Russia | 645 | 269 |
| Refined products purchased internationally | 5,145 | 4,187 |
| **Total refined products purchased** | **5,790** | **4,456** |

### Export of crude oil and refined products from Russia

Access to the Transneft crude oil export pipeline network is allocated quarterly, based on recent volumes produced and delivered through the pipeline and proposed export destinations. The Russian Government places restrictions on access to the Transneft export network, which limits our ability to export via this method because of a need to ensure that sufficient oil remains in Russia to meet domestic requirements and capacity constraints of the crude oil pipeline network.

At the same time additional access to international markets bypassing Transneft export routes is obtained through rail transport or by tankers. Moreover, in the second quarter of 2004 we put into operation the first stage of our Vysotsk terminal and loaded the first tankers with crude oil. In the nine months of 2004 the Company exported 8.2% of crude oil produced (5,012 thousand tonnes) by means other than Transneft, including through our own export infrastructure. By these methods we were able to export crude oil produced in the Nenetsky Autonomous District and the Kaliningrad Region.

| | 9 months of 2004 | | 9 months of 2003 | |
|---|---|---|---|---|
| | (thousand of barrels) | (thousand of tonnes) | (thousand of barrels) | (thousand of tonnes) |
| Export of crude oil using Transneft export routs | 217,063 | 29,613 | 173,024 | 23,605 |
| Export of crude oil bypassing Transneft | 36,738 | 5,012 | 30,068 | 4,102 |
| **Total crude oil export** | **253,801** | **34,625** | **203,092** | **27,707** |

| | 3rd quarter of 2004 | | 3rd quarter of 2003 | |
|---|---|---|---|---|
| | (thousand of barrels) | (thousand of tonnes) | (thousand of barrels) | (thousand of tonnes) |
| Export of crude oil using Transneft export routs | 73,102 | 9,973 | 58,442 | 7,973 |
| Export of crude oil bypassing Transneft | 12,967 | 1,769 | 11,757 | 1,604 |
| **Total crude oil export** | **86,069** | **11,742** | **70,199** | **9,577** |

In March 2004 capacity of the Baltic Pipeline System was increased up to 42 million tonnes of crude oil a year. This allowed us to increase the volume of crude oil exported via Primorsk terminal in the nine months of 2004 by more than 3 times as compared to the same period of the previous year. In the period ended September 30, 2004 we exported via Primorsk 6.3 million tonnes of crude oil.

An increase in production of refined products in the nine months of 2004 coupled with flat domestic sales and increased purchases of refined products in Russia allowed us to increase our export of refined products by 7.3% as compared to the same period of the previous year, or up to 11 million tonnes.

## Nine months ended September 30, 2004 compared to the nine months ended September 30, 2003

The table below details certain income and expense items from our consolidated statements of income for the periods indicated.

| | 9 months of | | | |
|---|---|---|---|---|
| | 2004 | | 2003 | |
| **Revenues** | | | | |
| Sales (including excise and export tariffs) | 24,217 | 99.1% | 16,136 | 99.2% |
| Equity share in income of affiliates | 214 | 0.9% | 138 | 0.8% |
| **Total revenues** | **24,431** | **100.0%** | **16,274** | **100.0%** |
| **Costs and other deductions** | | | | |
| Operating expenses | (2,101) | (8.6)% | (2,054) | (12.6)% |
| Cost of purchased crude oil, petroleum and chemical products | (7,335) | (30.0)% | (4,300) | (26.4)% |
| Transportation expenses | (2,080) | (8.5)% | (1,483) | (9.1)% |
| Selling, general and administrative expenses | (1,445) | (5.9)% | (1,231) | (7.6)% |
| Depreciation, depletion and amortization | (806) | (3.3)% | (685) | (4.2)% |
| Taxes other than income taxes | (2,515) | (10.3)% | (1,776) | (10.9)% |
| Excise and export tariffs | (3,412) | (14.0)% | (2,105) | (12.9)% |
| Exploration expense | (125) | (0.5)% | (77) | (0.5)% |
| Gain from sale of interest in Azeri, Chirag, Guneshli | – | – | 1,130 | 6.9 % |
| Loss on disposal and impairment of assets | (168) | (0.7)% | (67) | (0.4)% |
| **Income from operating activities** | **4,444** | **18.2%** | **3,626** | **22.3%** |
| Interest expense | (220) | (0.9)% | (214) | (1.3)% |
| Interest and dividend income | 145 | 0.6 % | 99 | 0.6 % |
| Currency translation gain | 12 | 0.0 % | 123 | 0.7 % |
| Other non-operating income | 15 | 0.1 % | 31 | 0.2 % |
| Minority interest | (57) | (0.2)% | (31) | (0.2)% |
| **Income before income taxes** | **4,339** | **17.8%** | **3,634** | **22.3%** |
| Current income taxes | (1,266) | (5.2)% | (686) | (4.2)% |
| Deferred income taxes | 22 | 0.1 % | (15) | (0.1)% |
| **Total income tax expense** | **(1,244)** | **(5.1)%** | **(701)** | **(4.3)%** |
| **Income before cumulative effect of change in accounting principle** | **3, 095** | **12.7%** | **2,933** | **18.0%** |
| Cumulative effect of change in accounting principle, net of tax | – | – | 132 | 0.8% |
| **Net income** | **3, 095** | **12.7%** | **3,065** | **18.8%** |
| Per share of common stock (in US dollars): | | | | |
| **Income before cumulative effect of change in accounting principle** | | | | |
| Basic | 3.79 | | 3.58 | |
| Diluted | 3.73 | | 3.52 | |
| **Net income** | | | | |
| Basic | 3.79 | | 3.74 | |
| Diluted | 3.73 | | 3.68 | |

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

## Sales revenues

| Sales breakdown | 9 months of 2004 | | 2003 | |
|---|---|---|---|---|
| | (millions of US dollars) | | | |
| Crude oil | | | | |
| Export and sales on international markets other than CIS | 7,643 | 31.6% | 4,513 | 28.0% |
| Export and sales to CIS | 475 | 2.0% | 336 | 2.1% |
| Domestic sales | 139 | 0.6% | 288 | 1.7% |
| | **8,257** | **34.2%** | **5,137** | **31.8%** |
| Refined products | | | | |
| Export and sales on international markets | | | | |
| Wholesale | 8,046 | 33.2% | 5,235 | 32.5% |
| Retail | 2,741 | 11.3% | 1,635 | 10.1% |
| Domestic sales | | | | |
| Wholesale | 2,362 | 9.8% | 1,965 | 12.2% |
| Retail | 890 | 3.7% | 616 | 3.8% |
| | **14,039** | **58.0%** | **9,451** | **58.6%** |
| Petrochemicals | | | | |
| Export and sales on international markets | 688 | 2.8% | 522 | 3.2% |
| Domestic sales | 240 | 1.0% | 143 | 0.9% |
| | **928** | **3.8%** | **665** | **4.1%** |
| Other | **993** | **4.0%** | **883** | **5.5%** |
| **Total sales** | **24,217** | **100.0%** | **16,136** | **100.0%** |

| Sales volumes | 9 months of 2004 | | 2003 | |
|---|---|---|---|---|
| | (thousands of barrels) | | | |
| Crude oil | | | | |
| Export and sales on international markets other than CIS | 234,780 | | 174,799 | |
| Export and sales to CIS | 24,314 | | 24,138 | |
| Domestic sales | 9,514 | | 36,320 | |
| Crude oil | (thousands of tonnes) | | | |
| Export and sales on international markets other than CIS | 32,030 | 39.1% | 23,847 | 32.9% |
| Export and sales to CIS | 3,317 | 4.1% | 3,293 | 4.5% |
| Domestic sales | 1,298 | 1.6% | 4,955 | 6.9% |
| | **36,645** | **44.8%** | **32,095** | **44.3%** |
| Refined products | (thousands of tonnes) | | | |
| Export and sales on international markets | | | | |
| Wholesale | 26,660 | 32.6% | 22,124 | 30.5% |
| Retail | 3,910 | 4.8% | 2,787 | 3.8% |
| Domestic sales | | | | |
| Wholesale | 12,510 | 15.3% | 13,638 | 18.8% |
| Retail | 2,061 | 2.5% | 1,886 | 2.6% |
| | **45,141** | **55.2%** | **40,435** | **55.7%** |
| **Total sales volume of crude oil and refined products** | **81,786** | **100.0%** | **72,530** | **100.0%** |

| Realized average sales prices | 9 months of 2004 | | 2003 | |
|---|---|---|---|---|
| | ($/barrel) | ($/tonne) | ($/barrel) | ($/tonne) |
| Average realized price international | | | | |
| Oil (excluding CIS) | 32.55 | 238.61 | 25.82 | 189.24 |
| Oil (CIS) | 19.55 | 143.29 | 13.91 | 101.99 |
| Refined products | | | | |
| Wholesale | | 301.83 | | 236.59 |
| Retail | | 700.98 | | 586.76 |
| Average realized price within Russia | | | | |
| Oil | 14.64 | 107.31 | 7.92 | 58.02 |
| Refined products | | | | |
| Wholesale | | 188.80 | | 144.06 |
| Retail | | 431.73 | | 326.87 |

During the nine months ended September 30, 2004 sales revenues increased by $8,081 million, or 50.1%, compared to the same period of 2003.

The total volume of crude oil and refined products sold amounted 81.8 million tonnes, which is 12.8% more than that sold in the same period of 2003. Our revenues from crude oil sales increased by $3,120 million, or 60.7%. Our sales of refined products increased by $4,588 million, or 48.5%.

Sales of crude oil and refined products on the international market, including the CIS, accounted for 80.6% of total sales volume in the nine months ended September 30, 2004 compared to 71.8% in the same period of 2003.

***The increase in sales was principally due to the following:***

- favorable price conditions: international crude oil market prices were at a ten-year high (see "Change in the price of crude oil and refined products" on page 4)
- increase in total volume of crude oil production (see "Oil production" on page 8)
- increase in marketing activities (see page 9)
- decrease of crude oil sales in Russia and increase in volumes exported on international markets (see "Export of crude oil and refined products from Russia" on page 10)

*Sales of crude oil*

During the period ended September 30, 2004 the Company decreased its sales of crude oil on the domestic market compared to the same period in the previous year by 3,657 thousand tonnes, or 73.8%. This change was caused by an increase in volumes exported by the Company's domestic producers.

During the period ended September 30, 2004 we increased exports of crude oil on international markets by the Company's domestic producers by 6,918 thousand tonnes. 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 $25.82 to $32.55 per barrel, allowed us to obtain an additional $1,648 million in revenues.

*Sales of refined products*

Sales of refined products made up 58.0% of our total sales revenues (55.2% in terms of volumes sold) compared to 58.6% in the same period of 2003 (55.7% in terms of volumes).

The average realized wholesale price on refined products outside of Russia increased by $65.24 per tonne, or 27.6%. Volumes of refined products sold outside of Russia increased by 4,536 thousand tonnes, or 20.5% (see also "Refining and marketing" on page 9). As a result, our revenues from wholesale of refined products outside of Russia increased by $2,811 million, or 53.7%.

In the period ended September 30, 2004 we increased retail sales of refined products outside of Russia by 1,123 thousand tonnes, or by 40.3% as compared to the same period of 2003. The increase was a result of continuing development of the existing retail chains in other regions and structural changes in the retail network we operate. In particular, we acquired Beopetrol in Serbia and the retail network in the USA. As of September 30, 2004 we operated 3,044 refueling stations outside of Russia compared to 2,285 as of September 30, 2003. Retail sales primarily include sales of gasoline, diesel oil and other refined products (heating oil, lubricants, etc.). Average retail prices increased up to $700.98 per tonne, or by 19.5%. As a result, our revenues from retail sales increased by $1,106 million, or 67.6%. Revenue from retail sales was 25.4% of total sales of refined products outside of Russia in the nine months ended September 30, 2004.

Wholesale of refined products within Russia in the nine months ended September 30, 2004 decreased by 1,128 thousand tonnes, or 8.3%, as compared to the same period in 2003. The decrease was caused by an increase in retail sales and increase in export of refined products. It was compensated by an increase of the average domestic realized price on refined products of $44.74 per tonne, or 31.1%. As a result, our revenues from wholesale of refined products on the domestic market increased by $397 million, or 20.2%.

Retail sales within Russia in the nine months ended September 30, 2004 increased by 175 thousand tonnes, or 9.3%, as compared to the same period of 2003. Average retail prices increased up to $431.73 per tonne, or by 32.1%. As a result, our revenues from retail sales increased by $274 million, or 44.5%. Revenue from retail sales was 27.4% of total sales of refined products in Russia in the nine months ended

September 30, 2004. As of September 30, 2004 we operated 1,227 refueling stations in Russia as compared to 1,223 as of September 30, 2003.

*Sales of petrochemical products*

Revenues from sales of petrochemical products increased by $263 million, or 39.5%, during the nine months ended September 30, 2004. This was mainly due to an increase of production volume up to 1,567 thousand tonnes, or by 5.4%, compared to the same period of 2003, and an increase in average realized prices.

*Sales of other products*

Other sales increased by $110 million, or 12.5%, as a result of sales of other products produced by the Company, and also increased activity in providing other services to third parties.

*Equity share in income of affiliates*

Our share in the income of affiliates in the nine-month period of 2004 increased by $76 million, or 55.1%, compared to the same period of 2003, primarily due to an increase in the net income of ZAO Turgay-Petroleum. ZAO Turgay-Petroleum, our 50% interest affiliate company, is a partner in the Turgay Petroleum joint venture developing the Kumkol field in Kazakhstan. The Group share in the net income of ZAO Turgay-Petroleum in the period ended September 30, 2004 amounted $94 million that represents an increase of $67 million as compared to the same period of 2003.

**Operating expenses**

Operating expenses include the following types of costs:

| | 9 months of | |
|---|---|---|
| | **2004** | **2003** |
| | (millions of US dollars) | |
| Extraction expenses | 1,145 | 1,076 |
| Refining expenses | 386 | 361 |
| Petrochemical expenses | 132 | 108 |
| Other operating expenses | 438 | 509 |
| **Total operating expenses** | **2,101** | **2,054** |
| **Cost of purchased crude oil, petroleum and chemical products** | **7,335** | **4,300** |

Compared to the same period of 2003, operating expenses increased by $47 million, or 2.3%.

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.

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 16.8% real ruble appreciation during the twelve-month period ended September 30, 2004 (including 8.9% real ruble appreciation during the nine months ended September 30, 2004), our average extraction cost per barrel decreased from $2.60 to $2.54 per barrel, or 2.4%. The decrease was caused by an increase in an average daily oil flow per well from 9.58 tonnes a day in the nine months ended September 30, 2003 to 10.65 tonnes a day in the nine months ended September 30, 2004, or 11.2%, and restructuring of our oil producing assets in the Perm region. The increase in total extraction expenses resulted from an increase in volumes of oil produced by our subsidiaries from 56.1 million tonnes during the nine months ended September 30, 2003 to 61.4 million tonnes during the nine months ended September 30, 2004. Thus, total extraction expenses rose by $69 million, or 6.4%, compared to the respective period of 2003.

**Refining expenses at our refineries** increased by $25 million, or 6.9%, in the nine-month period ended September 30, 2004 compared to the same period of 2003.

Refining expenses of our domestic refineries increased by 12.9%, or $32 million. This was primarily caused by an appreciation in the exchange rate of the ruble to the US dollar.

Refining expenses of our international refineries decreased by 6.2%, or $7 million. This was primarily caused by a larger amount of an overhaul and maintenance expenses incurred in the nine months ended September 30, 2003 as compared to the same period of 2004.

**Operating expenses of petrochemical companies** increased by $24 million, or 22.2%, compared to the same period of 2003, as result of an appreciation in the exchange rate of the ruble to the US dollar and an increase of volumes produced.

**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 decreased by $71 million, or 13.9%, as compared to the same period of 2003 primarily as a result of change in crude oil and refined products inventory in the period ended September 30, 2004.

**Cost of purchased crude oil, petroleum and chemical products** increased by $3,035 million, or 70.6%, compared to the prior period due to a significant increase in volumes of refined products purchased by 5,259 thousand tonnes and growth of market prices on crude oil and petroleum products.

**Transportation expenses**

The increase in the total volume of sales led to an increase in transportation expenses. However, the main factor in the increase of $597 million (40.3%) in these expenses compared to the period ended September 30, 2003 was the increase in the transportation tariffs.

During the twelve month period ended September 30, 2004, transportation tariffs increased as follows: pipeline transport – 39.8%, sea shipping – 32.8% (weighted average by volumes transported to different locations), railway transport – 21.4%.

**Selling, general and administrative expenses**

Our selling, general and administrative expenses increased by $214 million, or 17.4%, compared to the same period of 2003. 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 selling, general and administrative expenses was primarily caused by 16.8% real appreciation of the ruble during the twelve months period ended September 30, 2004. Also, the Company accrued compensation to management of $55 million in relation to the share-based compensation program, $26 million in the same period of 2003. In addition, movement in the bad debt provision had an effect on selling, general and administrative expenses for the periods under consideration. In the nine months ended September 30, 2004 the bad debt provision increased by $14 million, thus increasing general expenses, while for the same period of 2003 the bad debt provision increased by $30 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. Our depreciation, depletion and amortization expenses increased by $121 million, or 17.7%, in comparison to the same period of 2003. The increase is a result of the Company's capital expenditure program and corresponding growth of depreciable assets. 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 mineral extraction tax, property tax and social taxes.

| | 9 months of | | | |
|---|---|---|---|---|
| | 2004 | | 2003 | |
| | in Russia | International | in Russia | International |
| | (millions of US dollars) | | | |
| Mineral extraction tax | 2,130 | – | 1,420 | – |
| Social security taxes and contributions | 242 | 17 | 181 | 16 |
| Property tax | 59 | 14 | 86 | 12 |
| Other taxes | 31 | 22 | 32 | 29 |
| | **2,462** | **53** | **1,719** | **57** |
| **Total** | | **2,515** | | **1,776** |

The increase in taxes other than income taxes resulted primarily from a $710 million increase in mineral extraction tax, which is linked to international crude oil prices (see "Change in tax rates and export tariffs" on page 5). Social taxes and contributions in Russia increased by $61 million, or 33.7%, as compared to the same period of 2003. Based on the current legislation we recalculated domestic property tax for 2002 and 2003 years that resulted in $36 million decrease in property tax charge for the nine months of 2004.

**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 $1,307 million, or 62.1%, compared to the previous reporting period. The increase in export tariff expenses resulted from an increase in export tariff rates (see "Change in tax rates and export tariffs" on page 5) 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, primarily in the USA.

| | 9 months of | | | |
|---|---|---|---|---|
| | 2004 | | 2003 | |
| | in Russia | International | in Russia | International |
| | (millions of US dollars) | | | |
| Excise tax and sales taxes on refined products | 391 | 1,259 | 306 | 787 |
| Export tariffs | 1,752 | 10 | 1,007 | 5 |
| | **2,143** | **1,269** | **1,313** | **792** |
| **Total** | | **3,412** | | **2,105** |

**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 the nine months ended September 30, 2004 the amount charged to exploration expense increased in comparison with the same period of 2003 by $48 million, or by 62.3%.

**Loss on disposal and impairment of assets**

Loss on disposal and impairment of assets in the period ended September 30, 2004 was $168 million compared to $67 million in the same period of 2003. In the second quarter of 2004 we recognized an impairment loss of $35 million in relation to our decision to sell our ownership interest in OAO Bank Petrocommerce. In the third quarter of 2004 we recognized an impairment loss of $70 million in relation to our decision to sell our ownership interest in OOO LUKOIL-Burenie. For details please refer to Note 8 "Assets held for sale and disposition" of the consolidated financial statements.

**Interest expense**

Interest expense in the period ended September 30, 2004 slightly increased by $6 million as compared to the same period of 2003.

As of September 30, 2003, the Group's total debt was $3,946 million, including customer deposits placed in banking subsidiaries of $847 million. By September 30, 2004, the Group's total debt increased to $3,921 million, considering the total debt does not include customer deposits placed in banking subsidiaries as the Group sold its ownership in Bank Petrocommerce in the third quarter of 2004.

**Income taxes**

Our total income tax expense increased by $543 million, or 77.5%, compared to the same period of 2003 while our income before income tax increased by $705 million, or 19.4% (excluding gain on sale of interest in Azeri, Chirag, Guneshli, our income before income tax increased by $1,835 million, or 73.3%).

Our effective tax rate in the period ended September 30, 2004 was 28.7% (in the same period of 2003 it was 28.0%, excluding the effect of gain on sale of interest in Azeri, Chirag, Guneshli), 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 period are not tax deductible or only deductible to a certain limit. Moreover, despite the impairment losses recorded in the consolidated financial statements, the disposals of OAO Bank Petrocommerce and OOO LUKOIL-Burenie result in a taxable gain under Russian tax legislation. In the period ended September 30, 2004 income tax expense includes $28 million related to the disposal, thus increasing our effective tax rate.

## Liquidity and capital resources

| | 9 months of 2004 | 2003 |
|---|---|---|
| | (million US dollars) | |
| Net cash provided by operating activities | 2,870 | 2,269 |
| Net cash used in investing activities | (2,679) | (1,915) |
| Net cash used in financing activities | (74) | (236) |
| Net debt | 2,361 | 2,558 |
| | | |
| Current ratio | 1.76 | 1.32 |
| Total debt to equity | 20% | 23% |
| Long term debt to long term debt and equity | 11% | 8% |

Our primary source of cash flow is funds generated from our operations. In the period ended September 30, 2004 cash generated by operating activities was $2,870 million, an increase of $601 million from $2,269 million recorded in the same period of 2003. In the period ended September 30, 2004 cash inflow from operating activity was impacted by the following factors:

- increase in revenue
- increase in amount of income tax paid
- increase in volume of export sales and, consequently, prepayment of custom fees, export duties and transportation tariffs.

In the period ended September 30, 2004 the Company spent $2,679 million on capital investments, acquisitions of interests in other companies and other investments. Capital expenditures during the period ended September 30, 2004 amounted to $2,242 million ($2,087 million in the same period of 2003). In the period ended September 30, 2003 net cash used in investing activities includes proceeds received from the sale of our share in Azeri, Chirag, Guneshli of $1,337 million.

In the period ended September 30, 2004 cash flows related to financing activities included $944 million from the issuance of long-term debt. Cash used in financing activities during the period ended September 30, 2004 included $628 million of debt repayments and $352 million used for purchases of treasury stock.

**Analysis of capital expenditures ***

| | 9 months of 2004 | 2003 |
|---|---|---|
| | (millions of US dollars) | |
| Exploration and production | | |
| Russia | 1,374 | 1,106 |
| International | 87 | 218 |
| Total exploration and production | 1,461 | 1,324 |
| Refining, marketing and distribution | | |
| Russia | 581 | 673 |
| International | 259 | 182 |
| Total refining, marketing and distribution | 840 | 855 |
| **Total capital expenditures** | **2,301** | **2,179** |
| | | |
| **Acquisitions of subsidiaries **** | | |
| Exploration and production | | |
| Russia | – | 876 |
| International | – | – |
| Total exploration and production | – | 876 |
| Refining, marketing and distribution | | |
| Russia | 6 | 24 |
| International | 289 | 148 |
| Total refining, marketing and distribution | 295 | 172 |
| **Less cash acquired** | **–** | **(40)** |
| **Total** | **295** | **1,008** |

* Including non-cash transactions

** Including prepayments related to acquisitions of subsidiaries and minority shareholding interest

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

| | 9 months of 2004 | 9 months of 2003 |
|---|---|---|
| **Income before income taxes** | **4,339** | **3,634** |
| Add back: | | |
| Depreciation and amortization | 806 | 685 |
| Interest expense | 220 | 214 |
| Interest and dividend income | (145) | (99) |
| **EBITDA** | **5,220** | **4,434** |

## Three months ended September 30, 2004 compared to three months ended September 30, 2003

The table below details certain income and expense items from our consolidated statements of income for the periods indicated.

| | 3rd quarter of | | | |
|---|---|---|---|---|
| | **2004** | | **2003** | |
| **Revenues** | | | | |
| Sales (including excise and export tariffs) | 9,740 | 99.2% | 5,994 | 99.2% |
| Equity share in income of affiliates | 82 | 0.8% | 47 | 0.8% |
| **Total revenues** | **9,822** | **100.0%** | **6,041** | **100.0%** |
| **Costs and other deductions** | | | | |
| Operating expenses | (767) | (7.8)% | (693) | (11.5)% |
| Cost of purchased crude oil, petroleum and chemical products | (3,007) | (30.7)% | (1,635) | (27.1)% |
| Transportation expenses | (697) | (7.1)% | (544) | (9.0)% |
| Selling, general and administrative expenses | (523) | (5.3)% | (473) | (7.8)% |
| Depreciation, depletion and amortization | (292) | (3.0)% | (230) | (3.8)% |
| Taxes other than income taxes | (957) | (9.7)% | (636) | (10.5)% |
| Excise and export tariffs | (1,465) | (14.9)% | (776) | (12.8)% |
| Exploration expense | (38) | (0.4)% | (23) | (0.4)% |
| (Loss) gain on disposal and impairment of assets | (97) | (1.0)% | 1 | 0.0% |
| **Income from operating activities** | **1,979** | **20.1%** | **1,032** | **17.1%** |
| Interest expense | (77) | (0.8)% | (74) | (1.2)% |
| Interest and dividend income | 46 | 0.5 % | 36 | 0.6 % |
| Currency translation (loss) gain | (7) | (0.1)% | 39 | 0.6 % |
| Other non-operating income (expense) | 11 | 0.1 % | (33) | (0.5)% |
| Minority interest | (20) | (0.2)% | (12) | (0.2)% |
| **Income before income taxes** | **1,932** | **19.6%** | **988** | **16.4%** |
| Current income taxes | (554) | (5.6)% | (286) | (4.8)% |
| Deferred income taxes | 21 | 0.2 % | (1) | (0.0)% |
| **Total income tax expense** | **(533)** | **(5.4)%** | **(287)** | **(4.8)%** |
| **Net income** | **1,399** | **14.2%** | **701** | **11.6%** |
| Per share of common stock (in US dollars): | | | | |
| **Net income** | | | | |
| Basic | 1.71 | | 0.85 | |
| Diluted | 1.69 | | 0.84 | |

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

## Sales revenues

| Sales breakdown | 3rd quarter of 2004 | | 2003 | |
|---|---|---|---|---|
| | (millions of US dollars) | | | |
| Crude oil | | | | |
| Export and sales on international markets other than CIS | 3,073 | 31.6% | 1,657 | 27.6% |
| Export and sales to CIS | 177 | 1.8% | 86 | 1.4% |
| Domestic sales | 38 | 0.4% | 137 | 2.3% |
| | **3,288** | **33.8%** | **1,880** | **31.3%** |
| Refined products | | | | |
| Export and sales on international markets | | | | |
| Wholesale | 3,211 | 32.9% | 1,925 | 32.1% |
| Retail | 1,253 | 12.9% | 587 | 9.8% |
| Domestic sales | | | | |
| Wholesale | 947 | 9.7% | 732 | 12.2% |
| Retail | 375 | 3.9% | 267 | 4.5% |
| | **5,786** | **59.4%** | **3,511** | **58.6%** |
| Petrochemicals | | | | |
| Export and sales on international markets | 237 | 2.4% | 208 | 3.5% |
| Domestic sales | 86 | 0.9% | 59 | 1.0% |
| | **323** | **3.3%** | **267** | **4.5%** |
| Other | **343** | **3.5%** | **336** | **5.6%** |
| **Total sales** | **9,740** | **100.0%** | **5,994** | **100.0%** |

| Sales volumes | 3rd quarter of 2004 | | 2003 | |
|---|---|---|---|---|
| | (thousands of barrels) | | | |
| Crude oil | | | | |
| Export and sales on international markets other than CIS | 81,583 | | 61,491 | |
| Export and sales to CIS | 7,411 | | 5,432 | |
| Domestic sales | 1,964 | | 11,735 | |
| Crude oil | (thousands of tonnes) | | | |
| Export and sales on international markets other than CIS | 11,130 | 38.9% | 8,389 | 33.3% |
| Export and sales to CIS | 1,011 | 3.5% | 741 | 2.9% |
| Domestic sales | 268 | 0.9% | 1,601 | 6.3% |
| | **12,409** | **43.3%** | **10,731** | **42.5%** |
| Refined products | (thousands of tonnes) | | | |
| Export and sales on international markets | | | | |
| Wholesale | 9,860 | 34.5% | 8,555 | 33.9% |
| Retail | 1,709 | 6.0% | 987 | 3.9% |
| Domestic sales | | | | |
| Wholesale | 3,851 | 13.4% | 4,162 | 16.6% |
| Retail | 791 | 2.8% | 786 | 3.1% |
| | **16,211** | **56.7%** | **14,490** | **57.5%** |
| **Total sales volume of crude oil and refined products** | **28,620** | **100.0%** | **25,221** | **100.0%** |

| Realized average sales prices | 3rd quarter of 2004 | | 2003 | |
|---|---|---|---|---|
| | ($/barrel) | ($/tonne) | ($/barrel) | ($/tonne) |
| Average realized price international | | | | |
| Oil (excluding CIS) | 37.67 | 276.13 | 26.95 | 197.55 |
| Oil (CIS) | 23.86 | 174.86 | 15.75 | 115.44 |
| Refined products | | | | |
| Wholesale | | 325.75 | | 224.93 |
| Retail | | 732.96 | | 594.89 |
| Average realized price within Russia | | | | |
| Oil | 19.50 | 142.94 | 11.63 | 85.28 |
| Refined products | | | | |
| Wholesale | | 245.61 | | 175.88 |
| Retail | | 474.61 | | 339.84 |

In the third quarter of 2004, sales revenues increased by $3,746 million or 62.5% compared to the third quarter of 2003.

The total volume of crude oil and refined products sold reached 28.6 million tonnes, which is 13.5% more than for the same period of 2003. Our revenues from sales of crude oil increased by $1,408 million, or 74.9%. Our sales of refined products increased by $2,275 million, or 64.8%.

Sales of crude oil and refined products on the international market, including the CIS, accounted for 82.8% of total sale volume in the third quarter of 2004, compared to 74.0% in the third quarter of 2003.

***The increase in sales was principally due to the following:***

- favorable price conditions: international crude oil market price was at a ten-year high (see "Change in the price of crude oil and refined products" on page 4)
- increase in total volume of crude oil production (see "Oil production" on page 8)
- increase in marketing activities (see page 9)
- decrease of crude oil sales in Russia and increase in volumes exported on international markets (see "Export of crude oil and refined products from Russia" on page 10)

*Sales of crude oil*

In the third quarter of 2004 the Company decreased its sales of crude oil on the domestic market compared to the same period in the previous year by 1,333 thousand tonnes, or 83.3%. This change was caused by an increase in volumes exported by the Company's domestic producers.

In the third quarter of 2004 we increased exports of crude oil on international markets (other than CIS) by the Company's domestic producers by 2,165 thousand tonnes in the third quarter of 2004. The increase of the export sales, along with an increase in the average realized export price of crude oil on international markets (other than CIS) from $26.95 to $37.67 per barrel, allowed us to obtain an additional $570 million in revenues.

In the third quarter of 2004 our export sales on CIS markets increased by 270 thousand tonnes, or 36.4%, as compared to the same period of 2003.

*Sales of refined products*

Sales of refined products made up 59.4% of our total sales revenues (56.7% in terms of volumes sold) compared to 58.6% in the same period of 2003 (57.5% in terms of volumes).

The average realized wholesale price on refined products outside of Russia increased by $100.82 per tonne, or 44.8%. Volumes of refined products sold outside of Russia increased by 1,305 thousand tonnes, or 15.3% (see also "Refining and marketing" on page 9). As a result, our revenues from wholesale of refined products outside of Russia increased by $1,286 million, or 66.8%.

In the third quarter of 2004 we increased retail sales of refined products outside of Russia by 722 thousand tonnes, or 73.1%, as compared to the same period of 2003. The increase was a result of structural changes in the retail network we operate, in particular we acquired Beopetrol in Serbia, and continued development in other regions. Moreover, the results of the third quarter of 2004 include sales made through the USA retail network acquired from ConocoPhillips in May 2004. Retail sales primarily include sales of gasoline, diesel oil and other refined products (heating oil, lubricants, etc.). Average retail prices increased up to $732.96 per tonne, or by 23.2%. As a result, our revenues from retail sales increased by $666 million, or 113.3%. Revenue from retail sales was 28.1% of total sales of refined products outside of Russia in the third quarter of 2004.

Wholesale of refined products within Russia in the third quarter of 2004 decreased by 311 thousand tonnes, or 7.5%, as compared to the same period in 2003. The decrease was caused by an increase in export of refined products. The average domestic realized price on refined products increased by $69.73 per tonne, or 39.6%. As a result, our revenues from wholesale of refined products on the domestic market increased by $215 million, or 29.4%.

Retail sales within Russia in the third quarter of 2004 increased by 5 thousand tonnes, or 0.7%, as compared to the same period of 2003. Average retail prices increased up to $474.61 per tonne, or by

39.7%. As a result, our revenues from retail sales increased by $108 million, or 40.4%. Revenue from retail sales was 28.4% of total sales of refined products in Russia in the third quarter of 2004.

*Sales of petrochemical products*

Revenues from sales of petrochemical products increased by $56 million, or 21.0%, as result of an increase in average realized prices in the quarter ended September 30, 2004 compared to the same period of 2003. However, production volume decreased by 10.3% to 485 thousand tonnes in the third quarter of 2004. The production volume decreased due to planned overhaul, activities that took place in the third quarter of 2004 on the Group's petrochemical plants.

*Sales of other products*

Other sales increased by $7 million, or 2.1%, as a result of sales of other products produced by the Company, and also increased activity in providing other services to third parties.

*Equity share in income of affiliates*

Our share in the income of affiliates was $82 million. This was $35 million more than in the same period of 2003, primarily due to an increase in the net income of ZAO Turgay-Petroleum. The Group share in the net income of ZAO Turgay-Petroleum totaled $45 million in the third quarter of 2004 that represents an increase of $31 million as compared to the third quarter of 2003.

**Operating expenses**

Operating expenses include the following types of costs:

| | 3rd quarter of 2004 | 3rd quarter of 2003 |
|---|---|---|
| | (millions of US dollars) | |
| Extraction expenses | 393 | 382 |
| Refining expenses | 133 | 123 |
| Petrochemical expenses | 43 | 40 |
| Other operating expenses | 198 | 148 |
| **Total operating expenses** | **767** | **693** |
| **Cost of purchased crude oil, petroleum and chemical products** | **3,007** | **1,635** |

Compared to the same period of 2003, operating expenses increased by $74 million, or 10.7%.

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.

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 16.8% real ruble appreciation during the twelve month period ended September 30, 2004 (including 1.0% real ruble appreciation during the third quarter of 2004), our average extraction cost per barrel decreased from $2.63 to $2.57 per barrel, or 2.3%. The decrease was caused by an increase in an average daily oil flow per well from 9.88 tonnes a day in the third quarter of 2003 to 10.81 tonnes a day in the third quarter of 2004, or 9.4%, and restructuring of our oil producing assets in the Perm region. The increase in total extraction expenses resulted from an increase in volumes of oil produced by our subsidiaries from 19.8 million tonnes during the third quarter of 2003 to 20.9 million tonnes during the same period of 2004. Thus, the total extraction expenses rose by $11 million, or 2.9%, as compared to the respective period of 2003.

**Refining expenses at our refineries** increased by $10 million, or 8.1%, comparing the third quarter of 2003 with the same period of 2004.

Refining expenses of our domestic refineries increased by 14.0%, or $12 million. This was primarily caused by an appreciation in the exchange rate of the ruble to the US dollar.

Refining expenses of our international refineries decreased by 5.4%, or $2 million. This was primarily caused by a larger amount of an overhaul and maintenance expenses incurred in the third quarter of 2003 as compared to the same period of 2004.

**Operating expenses of petrochemical companies** increased by $4 million, or 10.0%, compared to the same period of 2003. This is a result of an appreciation in the exchange rate of the ruble to the US dollar, which was compensated by a decrease of volume produced due to planned overhaul, activities that took place in the third quarter of 2004.

**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 $50 million, or 33.8%, as compared to the same period of 2003 primarily as a result of change in crude oil and refined products inventory in the third quarter of 2004.

**Cost of purchased crude oil, petroleum and chemical products** increased by $1,372 million, or 83.9%, compared to the prior period primarily due to a significant increase in volumes of refined products purchased and growth of market prices on crude oil and petroleum products.

**Transportation expenses**

The increase in the total volume of sales led to an increase in transportation expenses. However, the main factor in the increase of $153 million (28.1%) in these expenses compared to the period ended September 30, 2003 was the increase in the transportation tariffs.

**Selling, general and administrative expenses**

Our other selling, general and administrative expenses increased in the third quarter of 2004 by $50 million, or 10.6%, compared to the same period of 2003. 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 caused by 16.8% real appreciation of the ruble during the twelve months period ended September 30, 2004. It was compensated by a movement in the bad debt provision. In the third quarter of 2004 the bad debt provision decreased by $13 million, thus decreasing general expenses, while for the same period of 2003 the bad debt provision increased by $18 million. Also, in the third quarter of 2004 the Company accrued compensation to management of $24 million in relation to the share-based compensation program, while in the same period of 2003 compensation to management decreased on $4 million due to movement in the market price of our shares.

**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. Our depreciation, depletion and amortization expenses increased by $62 million, or 27.0%, in comparison to the same period of 2003. The increase is a result of the Company's capital expenditure program and corresponding growth of depreciable assets. 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 mineral extraction tax, property tax and social taxes.

| | 3rd quarter of | | | |
|---|---|---|---|---|
| | 2004 | | 2003 | |
| | in Russia | International | in Russia | International |
| | (millions of US dollars) | | | |
| Mineral extraction tax | 855 | – | 514 | – |
| Social security taxes and contributions | 81 | 4 | 51 | 6 |
| Property tax | (2) | 5 | 35 | 4 |
| Other taxes | 5 | 9 | 12 | 14 |
| | **939** | **18** | **612** | **24** |
| **Total** | | **957** | | **636** |

The increase in taxes other than income taxes resulted primarily from a $341 million increase in mineral extraction tax, which is linked to international crude oil prices (see “Change in tax rates and export tariffs” on page 5). Based on the current legislation we recalculated domestic property tax for 2002 and 2003 years that resulted in $36 million decrease in property tax charge in the third quarter of 2004.

### 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 $689 million, or 88.8%, compared to the previous reporting period. The increase in export tariff expenses resulted from the increase in export tariff rates (see “Change in tax rates and export tariffs” on page 5) and also the 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, primarily in the USA.

| | 3rd quarter of | | | |
|---|---|---|---|---|
| | 2004 | | 2003 | |
| | in Russia | International | in Russia | International |
| | (millions of US dollars) | | | |
| Excise tax and sales taxes on refined products | 142 | 503 | 116 | 325 |
| Export tariffs | 816 | 4 | 334 | 1 |
| | **958** | **507** | **450** | **326** |
| **Total** | | **1,465** | | **776** |

### 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 the third quarter of 2004 the amount charged to exploration expense increased in comparison with the same period of 2003 by $15 million, or 65.2%.

### Loss on disposal and impairment of assets

Loss on disposal and impairment of assets in the third quarter of 2004 was $97 million compared to a gain $1 million in the same period of 2003. In the third quarter of 2004 we recognized an impairment loss of $70 million in relation to our decision to sell our ownership interest in OOO LUKOIL-Burenie. For details please refer to Note 8 “Assets held for sale and disposition” of the consolidated financial statements.

### Interest expense

Interest expense in the third quarter of 2004 slightly increased by $3 million as compared to the same period of 2003.

### Income taxes

Our total income tax expense in the third quarter of 2004 increased by $246 million, or 85.7%, compared to the same period of 2003 while our income before income tax increased by $944 million, or 95.5%.

Our effective tax rate in the third quarter of 2004 was 27.6% (in the same period of 2003 it was 29.0%), 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 are not tax deductible or only deductible to a certain limit. Moreover, despite the impairment loss recorded in the consolidated financial statements, the disposal of OOO LUKOIL-Burenie results in a taxable gain under Russian tax legislation. In the third quarter of 2004 income tax expense includes $11 million related to the disposal, thus increasing our effective tax rate.

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

| | 3rd quarter of 2004 | 3rd quarter of 2003 |
|---|---|---|
| **Income before income taxes** | **1,932** | **988** |
| Add back: | | |
| Depreciation and amortization | 292 | 230 |
| Interest expense | 77 | 74 |
| Interest and dividend income | (46) | (36) |
| **EBITDA** | **2,255** | **1,256** |