Management's discussion and analysis of financial condition and results of operations

The following report contains a discussion and analysis of the financial condition of OAO LUKOIL as of December 31, 2011 and the results of it's operations for each of the years ended December 31, 2011, 2010 and 2009, and significant factors that may affect its 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 subsidiaries and equity affiliates. 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 were translated into barrels using an average conversion rate of 7.33 barrels per tonne. Translations of cubic meters to cubic feet were made at the rate of 35.31 cubic feet per cubic meter. Translations of barrels of crude oil into barrels of oil equivalent ("BOE") were made at the rate of 1 barrel per BOE and of cubic feet into BOE at the rate of 6 thousand cubic feet per BOE.

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 35 for a discussion of some factors that could cause actual results to differ materially.

Key financial and operational results

	2011	Change to 2010, %	2010	Change to 2009, %	2009
Sales (millions of US dollars)	133,650	27.3	104,956	29.4	81,083
Net income attributable to OAO LUKOIL (millions of US dollars)	10,357	15.0	9,006	28.5	7,011
Adjusted net income attributable to OAO LUKOIL (millions of US dollars)[1]	11,312	25.6	9,006	28.5	7,011
EBITDA (millions of US dollars)	18,606	15.9	16,049	19.1	13,475
Adjusted EBITDA (millions of US dollars)[1]	19,489	21.4	16,049	19.1	13,475
Taxes other than income taxes, excise and export tariffs (millions of US dollars)	(35,135)	26.1	(27,856)	42.6	(19,532)
Earning per share of common stock attributable to OAO LUKOIL (US dollars):					
Basic	13.30	21.4	10.95	32.2	8.28
Diluted	13.04	19.1	10.94	32.1	8.28
Hydrocarbon production by the Group including our share in equity affiliates (thousands of BOE)	780,980	(4.4)	817,335	1.2	807,301
Crude oil production by the Group including our share in equity affiliates (thousands of tonnes)	90,917	(5.3)	95,992	(1.7)	97,615
Gas available for sale produced by the Group including our share in equity affiliates (millions of cubic meters)	18,621	0.4	18,554	24.5	14,898
Refined products produced by the Group including our share in equity affiliates (thousands of tonnes)	62,667	(1.7)	63,770	6.2	60,057
Hydrocarbon proved reserves including our share in equity affiliates (millions of BOE)	17,269	0.1	17,255	(1.4)	17,504

[1] Adjusted for the impairment loss in OOO Narianmarneftegaz (see page 3 for details).

In 2011, our net income was $10,357 million, which is $1,351 million, or 15.0%, more than in 2010. At the same time, our net income for the fourth quarter of 2011 amounted to $1,345 million, which is $841 million, or 38.5%, less than in the fourth quarter of 2010.

The increase in our net income was mainly due to an increase in hydrocarbon prices in 2011, compared to the previous year. At the same time, our results were influenced by an increasing tax burden and the appreciation of the Russian ruble. Moreover, our net income for 2011 was materially affected by impairment loss in OOO Narianmarneftegaz in amount of $955 million net of tax and noncontrolling interest effect, recognized in the fourth quarter of 2011. On the contrary, in 2010, our net income included non-routine gains and losses in the net amount of $132 million gain.

Business overview

The primary activities of OAO LUKOIL and its subsidiaries are oil exploration, production, refining, marketing and distribution. The Company is the ultimate parent entity of a vertically integrated group of companies.

OAO LUKOIL was established in accordance with Presidential Decree 1403, issued on November 17, 1992. Under this decree, on April 5, 1993, the Government of the Russian Federation transferred to the Company 51% of the voting shares of fifteen enterprises. Under Government Resolution 861 issued on September 1, 1995, a further nine enterprises were transferred to the Group during 1995. Since 1995, the Group has carried out a share exchange program to increase its shareholding in each of 24 founding subsidiaries to 100%. From formation, the Group has expanded substantially through consolidation of interests, acquisition of new companies and establishment of new businesses. Now LUKOIL is a global energy company operating through its subsidiaries in 37 countries on four continents.

LUKOIL is one of the world’s largest energy companies in terms of hydrocarbon reserves that amounted to 17.3 billion BOE as of January 1, 2012 and comprised of 13.4 billion barrels of crude oil and 23.2 trillion cubic feet of gas.

Our operations are divided into four main business segments:

- **Exploration and Production** – which includes our exploration, development and production operations relating to crude oil and gas. These activities are primarily located within Russia, with additional activities in Azerbaijan, Kazakhstan, Uzbekistan, the Middle East, South America, Northern and Western Africa and South-East Asia.
- **Refining, Marketing and Distribution** – which includes refining and transport operations, marketing and trading of crude oil, natural gas and refined products.
- **Chemicals** – which includes processing and trading of petrochemical products.
- **Power generation** – which includes generation, transportation and sales of electricity, heat and related services.

Each of our four 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 the “Domestic crude oil and refined products prices” section on page 9, 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, regional market conditions, the cost of crude oil refining and other factors. Accordingly, an analysis of either of these segments on a stand-alone basis could give a misleading impression of those segments’ 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. However, we present the financial data for each in Note 21 “Segment information” to the consolidated financial statements.

Recent developments and outlook

The following has been achieved in 2011:

Exploration and production

- 4 new oil and gas fields were brought into production (2010: 11 oil and gas fields).
- At the end of the year, we commenced gas production within the Gissar project in Uzbekistan, where the annual natural gas production is expected to reach 1.1 billion cubic meters.
- In December, we purchased a 25.1% interest in OOO “Bashneft-Polus”, a subsidiary of OAO “ANK Bashneft” (“Bashneft”), owning license and mineral rights for R.Trebs and A.Titov fields with recoverable oil reserves of 140.1 million tonnes.

Refining

- In April, the Group increased its stake in the joint venture operating the ISAB refining complex ("ISAB") from 49% to 60%.
- In December, the construction of a delayed-coking unit with annual capacity of 1 million tonnes was completed at our Volgograd refinery. This increased refining depth at the refinery to 88%.

Power generation

- In April, a 110 MW combined cycle gas turbine ("CCGT") unit powered by natural gas was put into operation in Astrakhan.

These and other achievements in 2011 are described in detail further in this report.

Changes in the Group structure

In April 2011, LUKOIL and Bashneft signed an agreement to establish a joint venture and to stipulate conditions for the development of two fields named after R. Trebs and A. Titov located in Northern Timan-Pechora region. According to the agreement, in the end of December 2011, the Company purchased a 25.1% interest in OOO "Bashneft-Polus", a Bashneft subsidiary, in favor of which the license and mineral rights for R.Trebs and A.Titov fields were re-issued, for approximately $153 million. In its turn, the joint venture purchased from a Group company 29 exploration wells located in the license area for $60 million. The agreement also envisages the exploitation of the Group's infrastructure, including the oil export terminal in Varandey and the energy centre of the Yuzhnoye Khylchuyu field. The total recoverable oil reserves located within the license areas of R.Trebs and A.Titov fields are 140.1 million tonnes.

In April 2011, the Group acquired an 11% stake in the joint venture operating the ISAB for €241 million (approximately $342 million) and thus increased the Group's ownership in it from 49% to 60%. This was a partial exercise of ERG S.p.A. ("ERG") option to sell its stake in the joint venture, established in 2008. According to the agreement ERG has a put option to sell its stake in full. In January 2012, we were offered to acquire another 20% stake in the refining complex. The transaction is expected to be completed in the second quarter of 2012 in the amount of €400 million (approximately $526 million), except for inventory cost. The transaction is subject to approval by the European regulating authorities.

In January 2010, the Company signed an agreement to develop the West Qurna-2 field located in the south of Iraq. The parties to the agreement are the Iraqi state-owned South Oil Company and the contracting consortium formed by the Iraqi state-owned North Oil Company, the Company and Norway's Statoil ASA. The Company's share in the project is 56.25%. The West Qurna-2 field has recoverable crude oil reserves of about 12.9 billion barrels.

As a part of the expansion of its presence in Kazakhstan, in December 2009, the Group acquired the remaining 46.0% interest in its equity affiliate LUKARCO B.V. ("LUKARCO") for $1.6 billion, thereby increasing the ownership stake to 100%. LUKARCO is a holding company, which owns a 5.0% share in Tengizchevroil, a joint venture which develops the Tengiz and Korolevskoe fields in Kazakhstan, and a 12.5% share in Caspian Pipeline Consortium ("CPC"), which carries Kazakhstani and Russian oil to Novorossiysk marine terminal. Therefore, the Group increased the ownership in Tengizchevroil from 2.7% to 5.0% and the ownership in CPC from 6.75% to 12.5%. The first installment in the amount of $300 million was paid in December 2009. $800 million were paid in December 2010 and the remaining amount – in December 2011.

Impairment of assets in OOO Narianmarneftegaz

In 2005, the Company and ConocoPhillips, within their strategic partnership, established a joined venture based on a Group subsidiary OOO Narianmarneftegaz ("NMNG") to develop oilfields located in Northern Timan-Pechora region of Russia. The Group's share in joint venture is 70%, LUKOIL and ConocoPhillips run NMNG on a 50/50 basis. In 2008, NMNG commenced commercial production at the Yuzhnoye Khylchuyu oilfield, joint venture's major oilfield. As of December 31, 2008, proved reserves of the oilfield were estimated to be approximately 505 million barrels. In 2009 and 2010, the crude oil production from the field amounted to 7.0 and 6.9 million tonnes, respectively. In 2010, the production from the oilfield began to decline due to some unexpected geological reasons and it only reached 3.3 million tonnes in 2011. As of December 31, 2011, crude oil reserves decreased significantly and amounted to approximately 142 million barrels. In 2011, as a result of respective analysis the Company recognized an impairment loss regarding upstream and other assets of NMNG in amount of $1,261 million. An impact on our net income net of ConocoPhillip's share in the impairment loss and deferred tax assets write-off amounted to $955 million and an impact on our EBITDA amounted to $883 million.

Resource base

The table below summarizes the net oil-equivalent proved reserves of consolidated subsidiaries and our share in equity affiliates under SEC standards (until the economic limit of commercial production is reached) that have been derived or extracted from our reserve reports audited by Miller and Lents, Ltd., our independent reservoir engineers, as of January 1, 2012 and 2011.

		Changes in 2011			
(millions of BOE)	January 1, 2012	Production[1]	Extensions, discoveries and changes in structure	Revision of previous estimates	January 1, 2011
Western Siberia	9,711	(439)	307	(18)	9,861
Timan-Pechora	2,550	(134)	97	54	2,533
Ural region	2,169	(100)	22	214	2,033
Volga region	974	(33)	140	22	845
Other in Russia	224	(15)	9	7	223
Outside Russia	1,641	(81)	44	(82)	1,760
Proved oil and gas reserves	**17,269**	**(802)**	**619**	**197**	**17,255**
Probable oil and gas reserves	**8,415**				**8,455**
Possible oil and gas reserves	**3,939**				**3,167**

[1] Gas production shown before own consumption.

The Company's proved reserves as of January 1, 2012 amount to 17,269 million BOE and comprise of 13,403 million barrels of crude oil and 23,196 billion cubic feet of gas.

In 2011, proved reserves growth as a result of geological exploration, production drilling and acquisitions, totaled 619 million BOE. Revision of previous estimates contributed 197 million BOE to the increase.

Significant progress was achieved in 2011 in the preparation and commissioning of a number of new fields of the Company, which allowed the Group to transfer 170 million BOE from the contingent resources category to the category of proved reserves. At the same time, rapid production drop at the Yuzhnoye Khylchuyu oilfield, as compared to the earlier forecasts, led to a decrease in the proved reserves by 147 million BOE.

Operational highlights

Hydrocarbon production

We undertake exploration for, and production of, crude oil and natural gas in Russia and internationally. In Russia our major oil producing subsidiaries are OOO LUKOIL-Western Siberia, OOO LUKOIL-Komi and OOO LUKOIL-Perm. Also we have a consolidated joint venture with ConocoPhillips, OOO Narianmarneftegaz, in the Northern Timan-Pechora region. Exploration and production outside of Russia is performed by our 100% subsidiary LUKOIL-Overseas, that has stakes in PSA's and other projects in Kazakhstan, Azerbaijan, Uzbekistan, Iraq, Saudi Arabia, Columbia, Ghana, Vietnam and Cote d'Ivoire.

The table below summarizes the results of our exploration and production activities.

	2011	2010	2009
	(thousand BOE per day)		
Daily production of hydrocarbons, including the Company's share in equity affiliates, including:	2,140	2,239	2,212
- crude oil	1,840	1,940	1,972
- natural and petroleum gas[1]	300	299	240
	(US dollar per BOE)		
Hydrocarbon extraction expenses	4.71	4.12	3.56
- in Russia	4.70	4.11	3.53
- outside Russia	4.85	4.29	3.99
	(millions of US dollars)		
Hydrocarbon extraction expenses	3,540	3,241	2,787
- in Russia	3,298	3,023	2,592
- outside Russia	242	218	195
Exploration expenses	532	336	218
- in Russia	93	96	71
- outside Russia	439	240	147
Mineral extraction tax	11,594	7,864	5,452
- in Russia	11,502	7,795	5,399
- outside Russia	92	69	53

[1] Gas available for sale (excluding gas produced for our own consumption).

Crude oil production. In 2011, our daily crude oil production decreased to 1,840 thousand barrels, or by 5.2%, compared to 2010. We produced (including the Company's share in equity affiliates) 671.4 million barrels, or 90.9 million tonnes of crude oil.

The following table represents our crude oil production in 2011 and 2010 by major regions.

		Change to 2010			
(thousands of tonnes)	2011	Total, %	Change in structure	Organic change	2010
Western Siberia	49,102	(3.6)	–	(1,832)	50,934
Timan-Pechora	17,547	(17.1)	–	(3,628)	21,175
Ural region	12,805	3.4	–	420	12,385
Volga region	3,203	9.8	–	287	2,916
Other in Russia	1,952	(3.4)	–	(69)	2,021
Crude oil produced in Russia	84,609	(5.4)	–	(4,822)	89,431
Crude oil produced internationally	3,413	(1.4)	–	(47)	3,460
Total crude oil produced by consolidated subsidiaries	**88,022**	**(5.2)**	**–**	**(4,869)**	**92,891**
Our share in crude oil produced by equity affiliates:					
in Russia	357	6.3	–	21	336
outside Russia	2,538	(8.2)	–	(227)	2,765
Total crude oil produced	**90,917**	**(5.3)**	**–**	**(5,075)**	**95,992**

The main oil producing region for the Company is Western Siberia where we produced 55.8% of our crude oil in 2011 (54.8% in 2010 and 55.7% in 2009). In 2011, the Western Siberian producing assets continued to mature resulting in a production decline and water cut increase. The Company undertakes efforts to stabilize production in the region.

The main reason for the production decrease in Timan-Pechora was a decrease in wells' flow rates as a result of the water cut growth and the decrease of recoverable reserves related to reconsideration of the geological model of the Yuzhnoye Khylchuyu oilfield.

In addition to our production, we purchase crude oil in Russia and on international markets. In Russia we primarily purchase crude oil from affiliated producing companies and other producers. Then we either refine or export purchased crude oil. Crude oil purchased on international markets is normally used for trading activities, for supplying our international refineries or for processing at third party refineries.

	2011		2010		2009	
	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)
Crude oil purchases in Russia	4,010	547	2,243	306	4,442	606
Crude oil purchases internationally	151,753	20,703	156,759	21,386	150,258	20,499
Total crude oil purchased	**155,763**	**21,250**	**159,002**	**21,692**	**154,700**	**21,105**

Significant part of our crude oil purchases is for processing. In 2011, we purchased 12,969 thousand tonnes of crude oil to process at our and at third party refineries, compared to 12,516 thousand tonnes in 2010.

Gas production. In 2011, we produced 18,621 million cubic meters of gas available for sale (including our share in equity affiliates), that is approximately on the same level as in 2010.

Our major gas production field is the Nakhodkinskoe field, where we produced 8,273 million cubic meters of natural gas in 2011 (8,146 million cubic meters in 2010). Our international natural gas production decreased by 1.9%.

Refining, marketing and trading

Refining. We own and operate four refineries located in European Russia and three refineries located outside of Russia – in Bulgaria, Ukraine and Romania. Moreover, we have a 60% stake in the ISAB refinery complex in Italy (49% before April 1, 2011) and a 45% interest in the TRN refinery in the Netherlands.

Compared to 2010, production at our consolidated refineries decreased by 3.2%. Russian refineries decreased their production by 0.2%, while international refineries' production decreased by 17.1% mainly as a result of the shutdown of the Odessa refinery. The production of our affiliated refineries ISAB and TRN increased by 5.5% resulting from the increase of Group's share in the ISAB refinery.

We invested, and continue to invest, significant resources in our refineries aiming at taking the leading position in Russia in producing ecological fuel of high quality standards. Thus, in December 2010, we launched a catalytic cracking complex at our refinery in Nizhny Novgorod that enabled us to start production of gasoline fully compliant to the Euro-4 quality standard. Related investments amounted to approximately $1 billion. In December 2011, we completed construction of a delayed-coking unit with annual capacity of 1 million tonnes at our Volgograd refinery increasing refining depth to 88%.

In Russia, LUKOIL holds the leading position in production and sales of European standards motor fuel being ahead of the official terms of their obligatory implementation in the country. At our Russian refineries we produced 8,701, 8,429 and 7,266 thousand tonnes of Euro-4 and -5 diesel fuel and 6,416, 5,373, and 4,746 thousand tonnes of Euro-3, -4 and -5 gasoline in 2011, 2010 and 2009, respectively. We commenced production of Euro-5 gasoline in the end of 2010.

The share of Euro-3 and Euro-4 gasoline exceeds 90% and the share of Euro-4 and Euro-5 diesel exceeds 70% of our total domestic production. We have technological capacity to produce all our gasoline in compliance with the Euro-4 standards. Production of lower quality gasoline is stipulated by the necessity to supply the federal customers. We will be able to increase the share of Euro-4 and Euro-5 diesel to 97% of our total domestic diesel production after the launch of the new fuel hydrorefining unit at Volgograd refinery scheduled for the second half of 2012.

Along with our own production of refined products we can refine crude oil at third party refineries depending on market conditions and other factors. Before 2010, we processed crude oil at third party refineries in Russia, Belarus and Serbia primarily to supply our networks in the Ural region of Russia and in Eastern Europe, as well as for export sales. Starting from 2010, we sell our crude oil to the refineries in Ural region and purchase refined products from them. In the end of 2009, we also ceased crude oil refining in Belarus due to certain amendments in the customs legislation. In the third quarter of 2010, we began refining our crude oil at a third party refinery in Kazakhstan.

The following table summarizes key figures for our refining activities.

	2011	2010	2009
	(millions of US dollars)		
Refining expenses at the Group refineries	1,444	1,121	923
- in Russia	1,112	806	671
- outside Russia	332	315	252
Refining expenses at ISAB and TRN	890	719	543
Refining expenses at third party refineries	7	5	170
Capital expenditures	783	702	828
- in Russia	586	542	520
- outside Russia	197	160	308
	(thousand barrels per day)		
Refinery throughput at the Group refineries	1,073	1,107	1,103
- in Russia	909	908	893
- outside Russia	164	199	210
Refinery throughput at ISAB and TRN(1) (2)	230	222	155
Refinery throughput at third party refineries	5	2	77
Total refinery throughput	**1,308**	**1,331**	**1,335**
	(thousands of tonnes)		
Refined products produced at the Group refineries	51,055	52,762	52,376
- in Russia	43,248	43,346	42,586
- outside Russia	7,807	9,416	9,790
Production of ISAB and TRN(1)	11,612	11,008	7,681
Refined products produced at third party refineries	256	107	3,485
Total refined products produced	**62,923**	**63,877**	**63,542**

(1) Group's share.
(2) Including refined product processed.

Marketing and trading. Our marketing and trading activities mainly include wholesale and bunkering operations in Western Europe, South-East Asia, Central America and retail operations in the USA, Central and Eastern Europe, the Baltic States and other regions. In Russia we purchase refined products on occasion, primarily to manage supply chain bottlenecks.

The Group retails its refined products in 27 countries through nearly 5.7 thousand petrol stations. Most of the stations operate under the LUKOIL brand. Due to the restructuring of our retail network in the USA, the number of petrol stations decreased compared to the beginning of the year (over 6 thousand stations).

The table below summarizes figures for our trading activities.

	2011	2010	2009
	(thousands of tonnes)		
Retail sales	15,249	14,336	14,613
Wholesale sales	87,337	91,020	86,147
Total refined products sales	**102,586**	**105,356**	**100,760**
Refined products purchased in Russia	2,026	1,853	625
Refined products purchased internationally	45,655	45,816	41,445
Total refined products purchased	**47,681**	**47,669**	**42,070**

The decrease in wholesale volumes compared to 2010 was substantially outside of Russia and resulted from the shutdown of the Odessa refinery. Moreover, the increase in retail sales on domestic market and increase in Russian refineries' inventory stock resulted in a decrease in refined products export from Russia.

Exports of crude oil and refined products from Russia. The volumes of crude oil exported from Russia by our subsidiaries are summarized as follows:

	2011		**2010**		**2009**	
	(thousands of barrels)	(thousands of tonnes)	(thousands of barrels)	(thousands of tonnes)	(thousands of barrels)	(thousands of tonnes)
Exports of crude oil using Transneft export routes	215,605	29,414	231,525	31,586	241,890	33,000
Exports of crude oil bypassing Transneft	38,739	5,285	65,999	9,004	66,109	9,019
Total crude oil exports	**254,344**	**34,699**	**297,524**	**40,590**	**307,999**	**42,019**

In 2011, our export of crude oil from Russia decreased by 14.5%, compared to 2010, and we exported 41.0% of our total domestic crude oil production (45.4% in 2010). The reduction of our export was largely caused by a decline in production (mainly from Yuzhnoye Khylchuyu oilfield).

In 2011 and 2010, almost all of the volume of crude oil exported bypassing Transneft was routed through our own export infrastructure.

In 2011, we exported from Russia 24.0 million tonnes of refined products, a decrease of 6.9%, compared to 2010, mostly due to the increase of domestic sales volumes. Primarily, we export from Russia diesel fuel, fuel oil and gasoil. These products account for approximately 89% of our refined products export volumes.

In 2011, our revenue from export of crude oil and refined products from Russia both to Group companies and third parties amounted to $25,022 million and $17,725 million, respectively ($22,178 million for crude oil and $14,088 million for refined products in 2010).

Power generation

In 2011, we continued to develop the new power generation sector of our business as part of our strategic development program. This new sector encompasses all aspects of the power generation business, from generation to transmission and sale of heat and electrical power. Our power generation business sector now includes OOO LUKOIL-Volgogradenergo, OOO LUKOIL-Volgogradteploenergo, OOO LUKOIL-Kubanenergo, OOO LUKOIL-Astrakhanenergo, OOO LUKOIL-Rostovenergo, OOO LUKOIL-Stavropolenergo, OOO LUKOIL-TTK (all spun off from OOO UGK TGK-8), OOO LUKOIL-Ecoenergo (former OOO UGK TGK-8), our own power generating facilities at our oil and gas fields and power generators in Bulgaria, Romania and Ukraine. Our total output of electrical energy was 12.6 billion kW-h in 2011 and 13.2 billion kW-h in 2010. Our total output of heat energy was approximately 13.8 million Gcal in 2011 (15.3 million Gcal in 2010).

In April 2011, we commissioned the CCGT unit with a capacity of 110 MW in Astrakhan. The CCGT unit utilizes natural gas as primary and backup fuel. LUKOIL invested over $150 million in the project.

In 2011, we completed the construction of the CCGT unit with a capacity of 410 MW in Krasnodar. The turbine is in standby mode. The new unit increases the installed electric capacity of power plant in Krasnodar to 1,090 MW.

In 2012, we began construction of another two CCGT units in Astrakhan with a combined capacity of 235 MW. The completion is scheduled for the third quarter of 2013.

Main macroeconomic factors affecting our results of operations

Changes in the price of crude oil and refined products

The price at which we sell crude oil and refined products is the primary driver of the Group's revenues. During 2011, the Brent crude oil price fluctuated between $93 and $126 per barrel and reached its peak of $126.7 in the beginning of April of 2011.

The crude oil price growth that started in December 2010 and continued during the first half of 2011 was caused mainly by speculative factors as a consequence of political instability in the Middle East and Northern Africa. In the third quarter of 2011, crude oil prices stabilized, however financial tensions in Europe and the USA caused some price correction.

Substantially all the crude oil the Group exports is Urals blend. The following table shows the average crude oil and refined product prices in 2011, 2010 and 2009.

	2011	Change to 2010, %	2010	Change to 2009, %	2009
	(in US dollars per barrel, except for figures in percent)				
Brent crude	111.26	39.9	79.50	28.9	61.67
Urals crude (CIF Mediterranean) [(1)]	109.10	39.4	78.29	27.9	61.22
Urals crude (CIF Rotterdam) [(1)]	109.08	39.4	78.26	28.0	61.15
	(in US dollars per metric tonne, except for figures in percent)				
Fuel oil 3.5% (FOB Rotterdam)	609.51	37.8	442.35	28.0	345.72
Diesel fuel 10 ppm (FOB Rotterdam)	958.73	39.3	688.46	28.7	534.84
High-octane gasoline (FOB Rotterdam)	984.12	33.9	735.24	27.0	579.01

Source: Platts.

[(1)] The Company sells crude oil on foreign markets on various delivery terms. Thus, our average realized sale price of oil on international markets differs from the average prices of Urals blend on Mediterranean and Northern Europe markets.

Domestic crude oil and refined products prices

Substantially all crude oil produced in Russia is produced by vertically integrated oil companies such as ours. As a result, most transactions are between affiliated entities within vertically integrated groups. Thus, there is no concept of a benchmark domestic market price for crude oil. The price of crude oil that is produced but not refined or exported by one of the vertically integrated oil companies is 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 competition and economic conditions in those regions.

Domestic prices for refined products are determined to some extent by world market prices, but they are also directly affected by local demand and competition.

The table below represents average domestic wholesale prices of refined products in 2011, 2010 and 2009.

	2011	Change to 2010, %	2010	Change to 2009, %	2009
	(in US dollars per metric tonne, except for figures in percent)				
Fuel oil	318.99	30.1	245.27	51.3	162.12
Diesel fuel	760.53	36.5	557.36	20.5	462.65
High-octane gasoline (Regular)	857.70	20.1	714.26	22.1	584.87
High-octane gasoline (Premium)	897.81	20.8	743.17	16.8	636.24

Source: InfoTEK (excluding VAT).

Changes in the US dollar-ruble exchange rate and inflation

A substantial part of our revenue 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, ruble inflation and movements of exchange rates can significantly affect the results of our operations. In particular, the appreciation of the ruble against the US dollar generally causes our costs to increase in US dollar terms, and vice versa. The devaluation of the purchasing power of the US dollar in the Russian Federation calculated on the basis of the ruble-dollar exchange rates and the level of inflation in Russia was 12.0% in 2011, compared to 2010.

The following table gives data on inflation in Russia and the change in the ruble-dollar exchange rate.

	2011	2010	2009
Ruble inflation (CPI), %	6.1	8.7	8.9
Change of the ruble-dollar exchange rate, %	5.6	0.8	2.9
Average exchange rate for the period (ruble to US dollar)	29.39	30.37	31.72
Exchange rate at the end of the period (ruble to US dollar)	32.20	30.48	30.24

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). In 2011, 2010 and 2009, the tax charge on the operations in Russia was approximately 88%, 85% and 81% of our total tax charge, respectively.

Apart of income tax, fundamental taxes specific to the oil industry in Russia are mineral extraction tax, excise and export tariffs. In addition to above mentioned taxes, we are subject to a number of other taxes in Russia, including social taxes, property tax, VAT and 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 2011, 2010 and 2009, respectively, were 77%, 77% and 75%. In 2011, tax expenses in Russia were about 52% of the domestic and export sales revenue of Russian companies of the Group.

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.

The following table represents average enacted rates for taxes specific to the oil industry in Russia for the respective periods.

		2011[(1)]	Change to 2010, %	2010[(1)]	Change to 2009, %	2009[(1)]
Export tariffs on crude oil	\$/tonne	409.19	49.6	273.55	52.0	179.93
Export tariffs on refined products						
Middle distillates (jet fuel), diesel fuel and gasoils	\$/tonne	274.27	39.5	196.60	47.2	133.54
Light distillates						
gasoline	\$/tonne	341.94	73.9	196.60	47.2	133.54
straight-run gasoline	\$/tonne	333.08	69.4	196.60	47.2	133.54
Liquid fuels (fuel oil)	\$/tonne	208.46	96.8	105.91	47.2	71.93
Mineral extraction tax						
Crude oil	RUR/tonne	4,456.54	44.9	3,075.76	33.6	2,302.85
Natural gas	RUR/1,000 m^3	237.00	61.2	147.00	–	147.00

[(1)] Average values.

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

		2011[(1)]	Change to 2010, %	2010[(1)]	Change to 2009, %	2009[(1)]
Mineral extraction tax						
Crude oil	\$/tonne	151.65	49.7	101.28	39.5	72.59
Natural gas	\$/1,000 m^3	8.06	66.5	4.84	4.5	4.63

[(1)] Average values.

The rates of taxes specific to the oil industry in Russia are linked to international crude oil prices and are changed in line with them. The methods to determine the rates for such taxes are presented below.

Crude oil extraction tax rate. The base rate is 419 rubles per metric tonne extracted and it is adjusted depending on the international market price of Urals blend and the ruble exchange rate. The tax rate is zero when the average Urals blend international market price for a tax period is less than or equal to $15.00 per barrel. Each $1.00 per barrel increase in the international Urals blend price over the threshold ($15.00 per barrel) results in an increase of the tax rate by $1.61 per tonne extracted (or $0.22 per barrel extracted using a conversion factor of 7.33).

The base rate for 2012 and 2013 is currently set at 446 rubles and 470 rubles per metric tonne extracted, respectively. However, the rate may be amended by the authorities later on.

The crude oil extraction tax rate varies depending on the development and depletion of a particular oilfield. The tax rate is zero for extra-heavy crude oil and for crude oil produced in certain regions of Eastern Siberia, the Caspian Sea and the Nenetsky Autonomous District, depending on the period and volume of production.

The Group benefited from the application of zero tax rate to crude oil produced from certain greenfields in the Nenetsky Autonomous District, the major of which was the Yuzhnoye Khylchuyu oilfield. However, in early December 2010, we exceeded the accumulated production limit of 15 million tonnes at this field eligible for the incentive. Thus, starting from December 2010, we pay mineral extraction tax at a regular rate at the Yuzhnoye Khylchuyu oilfield.

The Group also produces crude oil from several greenfields in the Caspian Sea. In 2011, the amount of incentive was relatively insignificant, but we expect it to become sizable as the production volumes grow.

Natural gas extraction tax rate. The mineral extraction tax on natural gas production is calculated using a flat rate. In 2009, the rate per thousand cubic meters of natural gas extracted was 147 rubles. In 2010 and 2011, the rate was 237 rubles. On January 1, 2012, the rate was raised to 251 rubles per thousand cubic meters.

Crude oil export duty rate is calculated on a progressive scale. The rate is zero when the average Urals blend international market price is less than or equal to approximately $15.00 per barrel ($109.50 per metric tonne). If the Urals blend price is between $15.00 and $20.00 per barrel ($146.00 per metric tonne), each $1.00 per barrel increase in the Urals blend price over $15.00 results in an increase of the crude oil export duty rate by $0.35 per barrel exported. If the Urals blend price is between $20.00 and $25.00 per barrel ($182.50 per metric tonne), each $1.00 per barrel increase in the Urals blend price over $20.00 results in an increase of the crude oil export duty rate by $0.45 per barrel exported. Each $1.00 per barrel increase in the Urals blend price over $25.00 per barrel results in an increase of the crude oil export duty rate no more than by $0.65 per barrel exported. Starting from October 1, 2011, the maximum increase of export duty rate is $0.60 per barrel for each $1.00 per barrel increase in the Urals blend price.

The crude oil export duty rate is revised monthly on the basis of the immediately preceding one-month period of crude oil price monitoring.

A special export duty regime is in place for certain greenfields. Effective from December 2010, the list of the oilfields where the reduced rate applies also includes our Yu. Korchagin and V. Filanovsky oilfields located in the Caspian Sea.

Export duty rates on refined products prior to 2011 were set by the Russian government. The rate of export duty depended on internal demand for refined products and international crude oil market conditions. Starting from 2011, export duty rates on crude oil refined products are calculated by multiplying the current export duty rate by a coefficient according to the table below.

	Before October 1st, 2011	**After October, 1st 2011**
Multiplier for:		
Light distillates (except for gasolines), middle distillates (jet fuel), diesel fuel and gasoils	0.670	0.660
Gasolines(1)	0.467	0.900
Liquid fuels (fuel oil)	0.467	0.660
Motor and other oils	0.467	0.660
Other products	0.467	0.660

(1) Starting from May 2011, a coefficient for gasoline export duty rate is set at 0.9.

Crude oil and refined products exported to CIS countries, other than Ukraine, are not subject to export duties.

Excise on refined products. The responsibility to pay excises on refined products in Russia is imposed on refined product producers (except for straight-run gasoline). In other countries where the Group operates, excises are paid either by producers or retailers depending on the local legislation.

Starting from 2011, excise rates on refined products in Russia were increased and tied to the ecological class of fuel. Excise tax rates for 2011, 2010 and 2009 are listed below:

		2011	Change to 2010, %	2010	Change to 2009, %	2009
Gasoline						
Low-octane gasoline not compliant to Euro-3	RUR/tonne	5,995.00	105.1	2,923.00	10.0	2,657.00
High-octane gasoline not compliant to Euro-3	RUR/tonne	5,995.00	50.2	3,992.00	10.0	3,629.00
Euro-3	RUR/tonne	5,672.00	42.1	3,992.00	10.0	3,629.00
Euro-4 and -5	RUR/tonne	5,143.00	28.8	3,992.00	10.0	3,629.00
Diesel fuel						
Below Euro-3	RUR/tonne	2,753.00	131.7	1,188.00	10.0	1,080.00
Euro-3	RUR/tonne	2,485.00	109.2	1,188.00	10.0	1,080.00
Euro-4 and -5	RUR/tonne	2,247.00	89.1	1,188.00	10.0	1,080.00
Motor oils	RUR/tonne	4,681.00	44.2	3,246.10	10.0	2,951.00
Straight-run gasoline	RUR/tonne	6,089.00	41.9	4,290.00	10.0	3,900.00

		2011	Change to 2010, %	2010	Change to 2009, %	2009
Gasoline						
Low-octane gasoline not compliant to Euro-3	$/tonne	204.00	111.9	96.25	14.9	83.76
High-octane gasoline not compliant to Euro-3	$/tonne	204.00	55.2	131.45	14.9	114.40
Euro-3	$/tonne	193.01	46.8	131.45	14.9	114.40
Euro-4 and -5	$/tonne	175.01	33.1	131.45	14.9	114.40
Diesel fuel						
Below Euro-3	$/tonne	93.68	139.5	39.12	14.9	34.04
Euro-3	$/tonne	84.56	116.2	39.12	14.9	34.04
Euro-4 and -5	$/tonne	76.46	95.5	39.12	14.9	34.04
Motor oils	$/tonne	159.29	49.0	106.89	14.9	93.02
Straight-run gasoline	$/tonne	207.20	46.7	141.26	14.9	122.94

Income tax. Starting from January 1, 2009, the Federal income tax rate is 2.0% and the regional income tax rate varies between 13.5% and 18.0%. The Group's foreign operations are subject to taxes at the tax rates applicable to the jurisdictions in which they operate.

Until January 1, 2012, there were no provisions in the taxation legislation of the Russian Federation to permit the Group to reduce taxable profits of a Group company by offsetting tax losses of another Group company against such profits. Tax losses may be fully or partially used to offset taxable profits in the same company in any of the ten years following the year of loss.

Starting from January 1, 2012, if certain conditions are met, taxpayers will be able to pay income tax as a consolidated taxpayers' group ("CTG"). This allows taxpayers to offset taxable losses generated by certain participants of a CTG against taxable profits of other participants of the CTG. During 2012, certain Group companies are going to meet legislation requirements and pay income tax as the CTG.

Losses generated by a taxpayer before joining a CTG are not available for offset against taxable profits of other participants of the CTG. However, if a taxpayer leaves a CTG, such losses again become available for offset against future profits generated by the same taxpayer. The expiration period of the losses is extended to take account of any time spent within a CTG when the losses were unavailable for use.

Transportation of crude oil and refined products in Russia

The main Russian crude oil production regions are remote from the main crude oil and refined products markets. Therefore, access by crude oil production companies to the markets is dependent on the extent of diversification of the transport infrastructure and access to it. As a result, transportation cost is an important macroeconomic factor affecting our net income.

Transportation of crude oil produced in Russia to refineries and export destinations is performed primarily through the trunk oil pipeline system of state-owned OAO AK Transneft or by railway transport.

Transportation of refined products in Russia is performed by railway transport and the pipeline system of OAO AK Transnefteproduct. The Russian railway infrastructure is owned and operated by OAO Russian Railways. Both these companies are state-owned. We transport the major part of our refined products by railway transport.

In Russia, the gas is mostly sold at the wellhead and then transported through the Unified Gas Supply System ("UGSS"). The UGSS is responsible for gathering, transporting, dispatching and delivering substantially all natural gas supplies in Russia and is owned and operated by OAO Gazprom ("Gazprom"). The Federal Service for Tariffs of the Russian Federation regulates natural gas transportation tariffs. We are not able to sell our gas other than through UGSS.

Year ended December 31, 2011, compared to years ended December 31, 2010 and December 31, 2009

The table below presents our consolidated statements of income for the periods indicated.

	2011	2010	2009
	(millions of US dollars)		
Revenues			
Sales (including excise and export tariffs)	133,650	104,956	81,083
Costs and other deductions			
Operating expenses	(9,055)	(8,298)	(7,340)
Cost of purchased crude oil, gas and products	(59,694)	(43,250)	(31,761)
Transportation expenses	(6,121)	(5,608)	(4,830)
Selling, general and administrative expenses	(3,822)	(3,558)	(3,306)
Depreciation, depletion and amortization	(4,473)	(4,154)	(3,937)
Taxes other than income taxes	(12,918)	(8,978)	(6,474)
Excise and export tariffs	(22,217)	(18,878)	(13,058)
Exploration expense	(532)	(336)	(218)
Loss on disposals and impairments of assets	(1,663)	(363)	(381)
Income from operating activities	**13,155**	**11,533**	**9,778**
Interest expense	(694)	(712)	(667)
Interest and dividend income	211	174	134
Equity share in income of affiliates	690	472	351
Currency translation loss	(301)	(122)	(520)
Other non-operating income (expense)	58	125	(13)
Income before income taxes	**13,119**	**11,470**	**9,063**
Current income taxes	(2,678)	(2,104)	(1,922)
Deferred income taxes	(615)	(247)	(72)
Total income tax expense	**(3,293)**	**(2,351)**	**(1,994)**
Net income	**9,826**	**9,119**	**7,069**
Net loss (income) attributable to noncontrolling interests	531	(113)	(58)
Net income attributable to OAO LUKOIL	**10,357**	**9,006**	**7,011**
Earning per share of common stock attributable to OAO LUKOIL (in US dollars):			
Basic	13.30	10.95	8.28
Diluted	13.04	10.94	8.28

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

Sales revenues

Sales breakdown	2011	2010	2009
	(millions of US dollars)		
Crude oil			
Export and sales on international markets other than CIS	30,132	25,251	18,276
Export and sales to CIS	2,390	1,091	1,638
Domestic sales	1,571	956	735
	34,093	**27,298**	**20,649**
Refined products			
Export and sales on international markets			
Wholesale	65,060	50,340	37,716
Retail	11,275	9,678	9,172
Domestic sales			
Wholesale	7,349	5,427	3,820
Retail	7,893	5,501	4,281
	91,577	**70,946**	**54,989**
Petrochemicals			
Export and sales on international markets	1,095	642	574
Domestic sales	914	728	514
	2,009	**1,370**	**1,088**
Gas and gas products			
Export and sales on international markets	1,878	1,565	1,091
Domestic sales	1,001	786	548
	2,879	**2,351**	**1,639**
Domestic sales of energy and related services	**1,472**	**1,416**	**1,087**
Other			
Sales on international markets	880	890	1,030
Domestic sales	740	685	601
	1,620	**1,575**	**1,631**
Total sales	**133,650**	**104,956**	**81,083**

Sales volumes	2011	2010	2009
Crude oil	(thousands of barrels)		
Export and sales on international markets other than CIS	275,696	326,669	305,273
Export and sales to CIS	45,329	23,280	39,106
Domestic sales	32,699	26,637	21,909
	353,724	**376,586**	**366,288**
Crude oil	(thousands of tonnes)		
Export and sales on international markets other than CIS	37,612	44,566	41,647
Export and sales to CIS	6,184	3,176	5,335
Domestic sales	4,461	3,634	2,989
	48,257	**51,376**	**49,971**
Refined products	(thousands of tonnes)		
Export and sales on international markets			
Wholesale	76,313	80,043	76,351
Retail	6,945	7,314	8,397
Domestic sales			
Wholesale	11,024	10,977	9,796
Retail	8,304	7,022	6,216
	102,586	**105,356**	**100,760**
Total sales volume of crude oil and refined products	**150,843**	**156,732**	**150,731**

Realized average sales prices		2011	2010	2009
Average realized price international				
Oil (excluding CIS)	($/barrel)	109.30	77.30	59.87
Oil (CIS)	($/barrel)	52.71	46.84	41.89
Refined products				
Wholesale	($/tonne)	852.55	628.91	493.98
Retail	($/tonne)	1,623.53	1,323.31	1,092.29
Average realized price within Russia				
Oil	($/barrel)	48.06	35.90	33.56
Refined products				
Wholesale	($/tonne)	666.62	494.37	389.92
Retail	($/tonne)	950.51	783.49	688.74

During 2011, our revenues increased by $28,694 million, or by 27.3%, compared to 2010 (in 2010 increased by $23,873 million, or by 29.4%, compared to 2009). Our revenues from crude oil sales increased by $6,795 million, or by 24.9% (in 2010 increased by $6,649 million, or by 32.2%, compared to 2009). Our revenues from sales of refined products increased by $20,631 million, or by 29.1% (in 2010 increased by $15,957 million, or by 29.0%, compared to 2009). In 2011, the increase in sales revenue was due to sharp increase in hydrocarbon prices, compared to 2010.

The appreciation of the ruble against the US dollar also supported our average realized prices in Russia.

Sales of crude oil

2011 vs. 2010

Our total crude oil sales revenues increased by $6,795 million, or by 24.9%, due to growth of crude oil prices. At the same time, due to a decrease of production our sales volumes decreased by 6.1%, or by 3,119 thousand tonnes.

Compared to 2010, we significantly increased crude oil supplies to Belarus, while sales to outside the CIS decreased correspondingly.

In 2011, revenue from export of crude oil from Russia both to the Group companies and third parties amounted to $25,022 million.

2010 vs. 2009

Our total crude oil sales revenues increased by $6,649 million, or by 32.2%, mainly due to growth of crude oil prices. Cease in crude oil refining at third party refineries in Russia and Belarus released crude oil volumes for marketing. As a result, our crude oil sales raised by 2.8% in terms of volumes.

In 2010, revenue from export of crude oil from Russia both to the Group companies and third parties amounted to $22,178 million.

Sales of refined products

2011 vs. 2010

Our revenue from the wholesale of refined products outside of Russia increased by $14,720 million, or by 29.2%, due to an increase in the average realized price by 35.6% in 2011. At the same time, the wholesales volumes decreased by 3,730 thousand tonnes, or by 4.7%, mainly as a result of decrease in export from Russia and the shutdown of the Odessa refinery.

Our revenue from international retail sales increased by $1,597 million, or by 16.5%, also due to an increase in average prices by 22.7%. Retail sales volumes decreased by 369 thousand tonnes, or by 5.0%, following restructuring of our retail network in the USA. At the same time, this was partially compensated by increased retail sales volumes in Europe.

Our revenue from the wholesale of refined products on the domestic market increased by $1,922 million, or by 35.4%, mainly due to an increase in the average realized price by 34.8%. The increase of sales volumes was not significant.

Our revenue from retail sales in Russia increased by $2,392 million, or by 43.5%, due to an increase in prices and sales volumes. Our retail volumes in Russia increased by 18.3% following significant increase of domestic demand.

In 2011, our revenue from the export of refined products from Russia both to Group companies and third parties amounted to $17,725 million.

2010 vs. 2009

In 2010, our revenue from the wholesale of refined products outside of Russia increased by $12,624 million, or by 33.5%, due to increased average realized price by 27.3%. The decrease in output at our refineries in Bulgaria due to overhaul and in Ukraine due to refinery stand-by and termination of processing activities in Russia were almost fully compensated by commencement of crude oil refining at TRN in September 2009. At the same time, expansion of trading activities led to an increase in wholesales volumes by 4.8%.

In 2010, our revenue from international retail sales increased by $506 million, or by 5.5%. Positive effect from the increase of average retail prices by 21.2% was partially offset by 12.9% sales volumes decrease, that reflects restructuring of our retail network in the USA.

In 2010, our revenue from the wholesale of refined products on the domestic market increased by $1,607 million, or by 42.1%, mainly due to an increase in the average realized price by 26.8%. Sales volumes increased by 1,181 thousand tonnes, or by 12.1%. This was primarily due to a decrease in refined products export to Belarus.

In 2010, our revenue from retail sales in Russia increased by $1,220 million, or by 28.5%, due to an increase both in volumes, being a result of higher average daily sales per petrol station, and in prices. In 2010, our retail sales revenue was 50.3% of total refined products sales in Russia (in 2009 – 52.8%).

In 2010, our revenue from export of refined products from Russia both to Group companies and third parties amounted to $14,088 million.

Sales of petrochemical products

2011 vs. 2010

In 2011, our revenue from sales of petrochemical products increased by $639 million, or by 46.6%, mainly as a result of an increase in international sales volumes. In the fourth quarter of 2010, we commenced production at our petrochemical plant Karpatnaftochim Ltd. in Ukraine after modernization and construction of a chlorine and caustic production line. Our realized prices increased by 11.8%.

2010 vs. 2009

In 2010, our revenue from sales of petrochemical products increased by $282 million, or by 25.9%. Outside of Russia, decrease in sales volumes due to decreased refining and trading was compensated by price growth. The growth of domestic sales revenue was largely a result of increase in realized prices and the effect of the real ruble appreciation against the US dollar.

Sales of gas and gas products

2011 vs. 2010

Sales of gas and gas refined products increased by $528 million, or by 22.5%, in 2011. Wholesale gas refined products sales revenue increased by $364 million, or by 43.6%, primarily as a result of an increase in sales prices. Retail gas products revenue increased by $112 million, or by 22.1%, also due to price growth.

Natural gas sales revenue increased by $30 million, or by 3.6%.

2010 vs. 2009

In 2010, sales of gas and gas refined products increased by $712 million, or by 43.4%. Gas refined products sales revenue increased by $424 million, or by 40.8%, primarily as a result of an increase in sales prices. Retail gas product revenue increased up to $506 million, or by 22.2%, due to price growth. Retail revenue represented 37.8% and 44.0% of our total gas product revenue in 2010 and 2009, respectively.

Natural gas sales revenue amounted to $835 million – an increase of 46.2%, compared to 2009. Our domestic natural gas sales revenue significantly increased as a result of increased sales to Gazprom, the major purchaser of our natural gas produced in the Russian Federation. In 2010, we sold 8,146 million cubic meters of natural gas to Gazprom (5,936 million cubic meters in 2009). The average realized price increased by 4.5% to $34.9 per 1,000 cubic meters as a result of the ruble appreciation.

In 2010, natural gas sales revenue outside of Russia increased by $174 million mostly as a result of a revision of sale prices related to the Shakh-Deniz field for 2008-2010 which led to additional revenue of $101 million, recognized in the third quarter of 2010.

Domestic sales of energy and related services

We sell substantially all our energy and related services domestically. International sales are relatively insignificant.

2011 vs. 2010

In 2011, our revenue from sales of electricity, heat and related services increased by $56 million, or by 4.0%. This growth was a result of an increase in tariff rates and the ruble appreciation. At the same time, in the second half 2011, the revenue of our energy segment decreased significantly due to the reduction of resale operations.

2010 vs. 2009

In 2010, our revenue from sales of electricity, heat and related services increased by $329 million, or by 30.3%, as we continued to develop the new power generation segment as part of our strategic development program. The ruble appreciation also contributed to the increase of this revenue.

Sales of other products

Other sales include non-petroleum sales through our retail network, transportation services, rental revenue, crude oil extraction services, and other revenue of our production and marketing companies from sales of goods and services not related to our primary activities.

2011 vs. 2010

In 2011, other sales increased by $45 million, or by 2.9%. The sales of goods and other products from our retail stations increased to $700 million, or by 15.5%. At the same time, transportation services provided to third parties decreased compared to 2010.

2010 vs. 2009

In 2010, our other sales decreased by $56 million, or by 3.4%. A decrease of transportation services provided abroad was partially compensated by higher non-petroleum retail revenue. During 2010, sales of goods and other products from our retail stations amounted to $606 million, an increase of $38 million compared to 2009.

Operating expenses

Operating expenses include the following:

	2011	**2010**	**2009**
		(millions of US dollars)	
Hydrocarbon extraction expenses	3,540	3,241	2,787
Own refining expenses	1,444	1,121	923
Refining expenses at third parties and affiliated refineries	897	724	713
Expenses for crude oil transportation to refineries	1,060	1,048	955
Power generation and distribution expenses	617	654	450
Petrochemical expenses	317	221	127
Other operating expenses	1,180	1,289	1,385
Total operating expenses	**9,055**	**8,298**	**7,340**

The method of allocation of operating expenses above differs from the approach used in preparing the data for Note 21 “Segment information” to our consolidated financial statements. Expenditures in the segment reporting are grouped depending on the segment to which a particular company belongs. Operating expenses for the purposes of this analysis are grouped based on the nature of the costs incurred.

In 2011, our operating expenses increased by $757 million, or by 9.1%, mainly as a result of the ruble appreciation by 12.0%, increased power supply and repair costs and increase in consumption and cost of additives.

Hydrocarbon extraction expenses

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

2011 vs. 2010

In 2011, our extraction expenses increased by $299 million, or by 9.2%. Our average hydrocarbon extraction cost increased from $4.12 per BOE to $4.71 per BOE, or by 14.3%, compared to 2010.

The increase was mainly a result of the real ruble appreciation against the US dollar and increased expenses for power supply, repairs and labor costs.

2010 vs. 2009

In 2010, our extraction expenses increased by $454 million, or by 16.3%. This was due to increase in expenses for power supply, general increase in expenses and the effect of the real ruble appreciation against the US dollar. Our average hydrocarbon extraction cost increased from $3.56 to $4.12 per BOE, or by 15.7%, compared to 2009.

Own refining expenses

2011 vs. 2010

Our own refining expenses increased by $323 million, or by 28.8%, in 2011.

Refining expenses at our domestic refineries increased by 38.0%, or by $306 million. This increase was a result of an increase in consumption and cost of additives, increased power supply costs, higher expenses on repairs and the ruble appreciation against the US dollar.

Refining expenses at our international refineries increased by 5.4%, or by $17 million. Despite the decrease of production volumes at our Bulgarian and Romanian refineries, higher energy costs and overhauls resulted in an overall increase of the refining expenses outside of Russia. We continued to incur operating expenses at our dormant refinery in Odessa although at a significantly lower level than in 2010 as we had to keep production facilities on line.

2010 vs. 2009

In 2010, our refining expenses increased by $198 million, or by 21.5%.

Refining expenses at our domestic refineries increased by 20.1%, or by $135 million, mainly as a result of the real ruble appreciation against the US dollar, increase in power supply costs and higher consumption of additives.

Refining expenses at our international refineries increased by 25.0%, or by $63 million, mainly as a result of increased power supply costs.

Refining expenses at third party and affiliated refineries

Along with our own production of refined products we have the ability to refine crude oil at third party and affiliated refineries both in Russia and abroad.

2011 vs. 2010

In 2011, refining expenses at third party and affiliated refineries increased by $173 million, or by 23.9%. This was due to the increase of our share in ISAB from 49% to 60% since April, 2011, resulting in the increase of our share of costs. Increased energy costs, appreciation of euro to the US dollar and overhauls performed at the ISAB complex in the first quarter of 2011 also contributed to the increase of expenses.

2010 vs. 2009

As opposed to 2009, we did not process crude oil on third party refineries during 2010 in Russia and Belarus. Nevertheless, the commencement of crude oil refining at TRN in late September 2009 almost fully compensated for that. As a result, the overall decrease of throughput at third party and affiliated refineries including refined products processed was 2.8%, compared to 2009. At the same time, in 2010, refining expenses at third party and affiliated refineries increased by 1.5%, compared to 2009, because processing costs at our refineries in Western Europe are higher than at the refineries in Russia or Belarus. Starting from the third quarter of 2010, we also refined crude oil on a third party refinery in Kazakhstan.

Petrochemical expenses

2011 vs. 2010

In 2011, operating expenses of our petrochemical plants increased by $96 million, or by 43.4%, due to an increase in production volumes as a result of the commencement of production at our petrochemical plant Karpatnaftochim Ltd. in Ukraine in the fourth quarter of 2010 after modernization and construction of a chlorine and caustic production line. Additionally, the increased consumption of raw materials due to the changes in product mix and ruble appreciation contributed to the increase of expenses.

2010 vs. 2009

In 2010, operating expenses of our petrochemical plants increased by $94 million, or by 74.0%. Expenses in Russia were impacted by increased production, increased cost of raw materials and ruble appreciation to the US dollar.

Expenses for crude oil transportation to refineries

Expenses for crude oil transportation to refineries include pipeline, railway, freight and other costs related to delivery of the Group's own crude oil to refineries for further processing.

2011 vs. 2010

Expenses for crude oil transportation to refineries in 2011 didn't change significantly. The increase in transportation tariffs compared to 2010 and the effect of ruble appreciation was compensated for by a decrease in volumes of own supply to refineries.

2010 vs. 2009

Expenses for crude oil transportation to refineries increased in 2010 by $93 million, or by 9.7%, due to an increase in transportation tariffs and as a result of a real ruble appreciation in Russia (see Transportation expenses below). Moreover, in 2010, we significantly increased volumes of own crude oil supplies to TRN.

Power generation and distribution expenses

2011 vs. 2010

Power generation and distribution expenses decreased by $37 million, or by 5.7%.

2010 vs. 2009

Power generation and distribution expenses increased by $204 million, or by 45.3%, following expansion of our power generating business and as a result of the real ruble appreciation in Russia.

Other operating expenses

Other operating expenses include expenses of the Group's upstream and downstream enterprises that do not relate to their core activities, namely rendering of transportation and extraction services, operating expenses of our gas processing plants, costs of other services provided and goods sold by our marketing companies, and of non-core businesses of the Group.

2011 vs. 2010

In 2011, other operating expenses decreased by $109 million, or by 8.5%. The decrease was a result of a lower volume of transportation services provided outside of Russia and the decrease of rental activities as a result of the restructuring of our retail network in the USA.

2010 vs. 2009

In 2010, our other operating expenses decreased by $96 million, or by 6.9%, mainly due to decrease of volume of transportation services provided abroad.

Cost of purchased crude oil, gas and products

Cost of purchased crude oil, gas and products includes cost of crude oil and refined products purchased for trading or refining, gas and fuel oil to supply our power generation entities and the result of hedging of international crude oil and refined products sales.

2011 vs. 2010

Cost of purchased crude oil, gas and products increased by $16,444 million in 2011, or by 38.0%, due to an increase in crude oil and refined products prices.

In 2011, we recognized a $657 million expense from hedging, compared to a $232 million expense in 2010.

2010 vs. 2009

In 2010, cost of purchased crude oil, gas and products increased by $11,489 million, or by 36.2%, due to an increase in crude oil and refined products prices and increase in volumes of refined products purchases.

In 2010, we recognized a $232 million expense from hedging, compared to a $781 million expense in 2009.

Transportation expenses

2011 vs. 2010

Our transportation expenses increased by $513 million, or by 9.1%. This increase was primarily related to Russia and resulted from the ruble appreciation, increased tariffs and change in supply directions.

Our actual transportation expenses related to crude oil and refined products deliveries to various export destinations, weighted by volumes transported, changed in 2011, compared to 2010, as follows: crude oil pipeline tariffs increased by 14.1%, railway tariffs for refined products transportation increased by 6.9%, crude oil freight rates decreased by 3.5%, and refined products freight rates decreased by 9.2%.

2010 vs. 2009

In 2010, our transportation expenses increased by $778 million, or by 16.1%. This was primarily due to increase of ruble denominated pipeline and railway transportation tariffs in Russia, which was emphasized by the ruble appreciation.

Our actual transportation expenses related to crude oil and refined products deliveries to various export destinations, weighted by volumes transported, changed in 2010, compared to 2009, as follows: crude oil pipeline tariffs increased by 23.3%, railway tariffs for refined products transportation increased by 21.1%, crude oil freight rates decreased by 7.8%, and refined products freight rates increased by 23.8%.

Selling, general and administrative expenses

Selling, general and administrative expenses include distribution costs, payroll costs (excluding extraction entities' and refineries' production staff costs), insurance costs (except for property insurance related to extraction and refinery equipment), costs of maintenance of social infrastructure, movement in bad debt provision and other expenses.

2011 vs. 2010

Our selling, general and administrative expenses increased by $264 million, or by 7.4%. This increase was driven mainly by higher selling expenses both in Russia and abroad. Expenses in Russia were also affected by the real ruble appreciation. At the same time, the decrease of provisions for bad debts partially offset the adverse effect of the above mentioned factors.

2010 vs. 2009

In 2010, our selling, general and administrative expenses increased by $252 million, or by 7.6%, substantially due to the effect of ruble appreciation on selling, general and administrative expenses in Russia and salary indexation.

Exploration expenses

2011 vs. 2010

Our exploration expense increased by $196 million, or by 58.3%. Dry hole costs amounted to $417 million in 2011, compared to $225 million in 2010.

In 2011, dry hole costs were mostly related to our overseas projects, namely $181 million in Ghana, $149 million in Cote d'Ivoire, $27 million in Vietnam and $17 million in Kazakstan. Dry hole costs in Russia included $28 million and $10 million related to projects in Komi Republic and in Western Siberia, respectively.

2010 vs. 2009

During 2010, exploration expense increased by $118 million, or by 54.1%. Dry hole costs increased by $108 million to $225 million.

In 2010, we charged to expense cost of dry wells in Columbia and Cote d'Ivoire in amount of $112 million and $68 million, respectively. Dry hole write-offs in Russia amounted to $42 million in 2010.

Equity share in income of affiliates

The Group has investments in equity method affiliates and corporate joint ventures. These companies are primarily engaged in crude oil exploration, production, marketing and distribution operations in the Russian Federation, crude oil production and marketing in Kazakhstan and refining operations in Europe. Our largest affiliates are Turgai Petroleum and Tengizchevroil, exploration and production companies operating in Kazakhstan, and ISAB and TRN refineries.

2011 vs. 2010

Our share in income of affiliates increased by $218 million, or by 46.2%, in 2011, mostly due to increase in income of Tengizchevroil.

2010 vs. 2009

At the end of 2009, we increased our share in LUKARCO from 54% to 100%, thus increasing our stake in Tengizchevroil, an exploration and production joint-venture in Kazakhstan, to 5%. Largely as a result of this, our share in income of affiliates increased by $121 million, or by 34.5%.

Taxes other than income taxes

	2011	2010	2009
		(millions of US dollars)	
In Russia			
Mineral extraction taxes	11,502	7,795	5,399
Social security taxes and contributions	480	327	330
Property tax	538	479	438
Other taxes	77	93	92
Total in Russia	**12,597**	**8,694**	**6,259**
International			
Mineral extraction taxes	92	69	53
Social security taxes and contributions	107	102	69
Property tax	35	39	32
Other taxes	87	74	61
Total internationally	**321**	**284**	**215**
Total	**12,918**	**8,978**	**6,474**

2011 vs. 2010

In 2011, taxes other than income taxes increased by 43.9%, or by $3,940 million. This was mainly due to an increase in mineral extraction taxes in Russia as a result of the rise of the tax rate following the increase of international crude oil prices.

In 2011, application of decreased rate for depleted oilfields and zero rate for the fields with extra heavy crude oil and the greenfields led to $1,161 million tax reduction ($1,313 million in 2010). The major oilfield where we benefited from zero extraction tax rate was the Yuzhnoye Khylchuyu field. In early December 2010, accumulated volume of production from this field exceeded the incentive level of 15 million tonnes and since that moment we have been paying extraction tax in full.

The increase in social security taxes and contributions in Russia was due to tax legislation amendments.

2010 vs. 2009

In 2010, taxes other than income taxes increased by $2,504 million, or 38.7%, mainly due to an increase in mineral extraction taxes in Russia. This is explained by an increase in the tax rate following the increase of international crude oil prices.

Application of zero tax rate for crude oil produced in Timan-Pechora and decreased rate for depleted oilfields led to approximately $1,313 million tax reduction (about $961 million in 2009).

Excise and export tariffs

	2011	2010	2009
		(millions of US dollars)	
In Russia			
Excise tax and sales taxes on refined products	1,710	951	763
Crude oil export tariffs	11,714	10,513	6,251
Refined products export tariffs	5,028	3,574	2,306
Total in Russia	**18,452**	**15,038**	**9,320**
International			
Excise tax and sales taxes on refined products	3,445	3,700	3,524
Crude oil export tariffs	319	136	107
Refined products export tariffs	1	4	107
Total internationally	**3,765**	**3,840**	**3,738**
Total	**22,217**	**18,878**	**13,058**

2011 vs. 2010

Export tariffs increased by $2,835 million, or by 19.9%, in 2011. The effect of increase of crude oil and refined products tariff rates was partially compensated for by a decrease in crude oil export volumes by 14.5% and refined products export volumes by 6.9%, compared to 2010.

Starting from 2011, excise rates on refined products in Russia were increased and tied to the ecological class of fuel. Despite the fact that the Company produces high quality ecological motor fuel subject to lower excise rates compared to fuel of lower quality, average excise rates roughly doubled for us compared to 2010.

Starting from December, 2010 the Group applies reduced export duty rate for the crude oil produced from the Yu. Korchagin field in the Caspian Sea, however due to relatively small amount of crude oil export from that field the effect of this incentive on our 2011 and 2010 financial results was insignificant.

2010 vs. 2009

In spite of a decrease in crude oil and refined products export volumes, export tariffs increased by $5,456 million, or by 62.2%, due to an increase in tariff rates in Russia as a result of international crude oil prices growth. The increase in excises in Russia resulted from the ruble appreciation, increase of excise rate and increase in sales volumes.

Other non-operating income (expense)

2011 vs. 2010

In 2011, other non-operating income included the effect of the recalculation of the extraction tax incentive by certain Group companies for prior periods in the total amount of $433 million.

2010 vs. 2009

In 2010, other non-operating income included a $438 million gain related to successful settlement of a corporate dispute between a Group company and a CNPC group company regarding Turgai Petroleum, and a $111 million expense related to provisions accrued in respect of claims to the Group companies by Federal Anti-monopoly Service of the Russian Federation ("FAS of Russia").

Loss on disposals and impairments of assets

2011 vs. 2010

Loss on disposals and impairments of assets for 2011 mainly included an impairment loss related to certain upstream and other assets of NMNG in amount of $1,261 million. For details please refer to "Impairment of assets in OOO Narianmarneftegaz" section on page 3.

Additionally, in 2011, the Company recognized an impairment loss of $175 million for international refining, marketing and distribution assets.

2010 vs. 2009

In 2010, loss on disposals and impairments of assets amounted to $363 million, compared to $381 million in 2009.

As a result of an impairment test performed in December 2010, we recognized an impairment loss of $163 million for certain upstream properties in the Timan-Pechora, Western Siberia and Central European regions of Russia; and an impairment loss of $29 million related to certain our European downstream assets. We also wrote off goodwill related to our Turkish downstream subsidiary in amount of $114 million due to a change in market conditions mostly caused by legislative changes.

Income taxes

2011 vs. 2010

In 2011, our total income tax expense increased by $942 million, or by 40.1%. At the same time, our income before income tax increased by $1,649 million, or by 14.4%.

In 2011, our effective income tax rate was 25.1%, compared to 20.5% in 2010, while the maximum statutory rate for the Russian Federation is 20%.

The high level of the effective income tax rate in 2011 was mostly due to a $1,261 million non-taxable impairment loss in NMNG. For details please refer to "Impairment of assets in OOO Narianmarneftegaz" section on page 3.

2010 vs. 2009

In 2010, our total income tax expense increased by $357 million, or by 17.9%. Income before income tax increased by $2,407 million, or by 26.6%.

In 2010, our effective income tax rate was 20.5%, compared to 22.0% in 2009.

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

	2011	**2010** (millions of US dollars)	**2009**
Net income	**10,357**	**9,006**	**7,011**
Add back:			
Income tax expense	3,293	2,351	1,994
Depreciation and amortization	4,473	4,154	3,937
Interest expense	694	712	667
Interest and dividend income	(211)	(174)	(134)
EBITDA	**18,606**	**16,049**	**13,475**
Impairment loss in NMNG net of noncontrolling interest[1]	883	–	–
Adjusted EBITDA	**19,489**	**16,049**	**13,475**

[1]For details please refer to "Impairment of assets in OOO Narianmarneftegaz" section on page 3.

EBITDA is a non-US GAAP financial measure. EBITDA is defined as net income before interest, taxes and depreciation and amortization. The Company believes that EBITDA provides useful information to investors because it is an indicator of the strength and performance of our business operations, including our ability to finance capital expenditures, acquisitions and other investments and our ability to incur and service debt. While depreciation and amortization are considered as operating costs under US GAAP, these expenses primarily represent the non-cash current period allocation of costs associated with long-lived assets acquired or constructed in prior periods. The EBITDA calculation is commonly used as a basis for some investors, analysts and credit rating agencies to evaluate and compare the periodic and future operating performance and value of companies within the oil and gas industry. EBITDA should not be considered in isolation as an alternative to net income, operating income or any other measure of performance under US GAAP. EBITDA does not include our need to replace our capital equipment over time.

Liquidity and capital resources

	2011	2010	2009
		(millions of US dollars)	
Net cash provided by operating activities	15,514	13,541	8,883
Net cash used in investing activities	(10,773)	(7,296)	(8,551)
Net cash used in by financing activities	(4,263)	(6,146)	(285)

Operating activities

Our primary source of cash flow is funds generated from our operations. During 2011, cash generated from operating activities was $15,514 million, which is 14.6% more than in 2010, mainly due to the increase in sales revenues. On the other hand, our operating cash flows were affected by an increase in working capital by $1,529 million, compared to January 1, 2011.

The increase of working capital was mainly caused by:

- $1,420 million increase in inventory
- $346 million net increase in tax accounts receivable and payable

At the same time, this negative effect was partially offset by a $180 million net decrease in VAT receivable and payable.

Investing activities

The increase in cash used in investing activities mainly resulted from an increase in payments for acquisitions.

In 2011, we made an advance payment of $1,760 million for expected acquisition of certain upstream assets, a final payment of $500 million within the acquisition of LUKARCO, a payment of $342 million for 11% share in ISAB and a payment of $153 million for a 25.1% share in OOO “Bashneft-Polus”.

Capital expenditures increased by $1,653 million, or by 25.1%, compared to 2010.

Financing activities

In 2011, net movements of short-term and long-term debt generated an outflow of $2,004 million, compared to an inflow of $35 million in 2010.

As a result, our indebtedness as at December 31, 2011 amounted to $9,092 million that represents an 18.8% decrease compared to January 1, 2011. Compared to the beginning of the year, our net debt decreased by 28.2% to $6,339 million.

Credit rating

Standard & Poor’s Ratings Services affirmed its long-term corporate credit rating and all debt ratings on the Company at BBB- with stable outlook.

Moody’s affirmed the Company’s long-term corporate family rating and long-term issuer rating of Baa2 with stable outlook.

Fitch Ratings affirmed the Company’s long-term issuer default rating of BBB- with stable outlook.

Analysis of capital expenditures

	2011	2010	2009
	(millions of US dollars)		
Capital expenditures[1]			
Exploration and production			
Russia	5,084	3,911	3,855
International	1,545	997	770
Total exploration and production	6,629	4,908	4,625
Refining, marketing and distribution			
Russia	1,030	944	808
International	324	375	508
Total refining, marketing and distribution	1,354	1,319	1,316
Chemicals			
Russia	55	27	13
International	34	49	100
Total chemicals	89	76	113
Power generation and distribution	196	420	283
Other	224	121	197
Total capital expenditures	**8,492**	**6,844**	**6,534**
Acquisitions of subsidiaries and associates[2]			
Exploration and production			
Russia	252	–	–
International	2,260	922	300
Total exploration and production	2,512	922	300
Refining, marketing and distribution			
Russia	10	7	212
International	342	3	2,069[3]
Total refining, marketing and distribution	352	10	2,281
Power generation and distribution	–	–	10
Other	–	–	1
Less cash acquired	(4)	–	(19)
Total acquisitions	**2,860**	**932**	**2,573**

[1] Including non-cash transactions and prepayments.
[2] Including prepayments related to acquisitions and non-cash transactions.
[3] Including $100 million of non-cash part of consideration for acquisition of TRN.

Our capital expenditures, including non-cash transactions, amounted to $8,492 million, which is 24.1% more than in 2010. Capital expenditures in exploration and production segment increased by $1,721 million, or by 35.1%.

In Russia, we increased the investments in drilling, field development and construction of gas transportation facilities in Western Siberia and petroleum gas utilization program in Western Siberia and Komi Republic. Moreover, our capital expenditures were affected by ruble appreciation.

In our international projects, we significantly increased volumes of exploration drilling in Western Africa, namely Ghana, Cote d'Ivoire and Sierra-Leone. Moreover, we significantly increased investments in our gas production projects in Uzbekistan.

The table below shows our exploration and production capital expenditures in promising new production regions.

	2011	2010	2009
	(millions of US dollars)		
Northern Timan-Pechora	278	285	385
Yamal	372	162	131
Caspian region[1]	555	370	532
Ghana	216	87	73
Cote d'Ivoire	227	92	31
Iraq	203	172	–
Uzbekistan	480	286	201
Total	**2,331**	**1,454**	**1,353**

[1] Russian and international projects.

Contractual obligations, other contingencies and off balance sheet arrangements

Capital commitments and contractual obligations

Under the terms of existing exploration and production license agreements in Russia the Group has to fulfill certain obligations: oil and gas exploration, wells drilling, fields development, etc., and the Group also has commitments to reach a defined level of extraction on the fields. Management believes that the Group’s approved annual capital expenditure budgets fully cover all the requirements of the described license obligations.

Group companies have commitments for capital expenditure contributions in the amount of $406 million related to various production sharing agreements over the next 26 years.

The Company signed a three-year agreement for the years 2010-2012 for drilling services with OOO Eurasia Drilling Company. The volume of these services is based on the Group’s capital construction program, which is re-evaluated on an annual basis. The Group estimates the amount of capital commitment under this agreement for 2012 to be approximately $1,521 million.

The Company signed a strategic agreement for the ongoing provision of construction, engineering and technical services with ZAO Globalstroy-Engineering. The volume of these services is based on the Group’s capital construction program, which is re-evaluated on an annual basis. The Group estimates the amount of capital commitment under this agreement for 2012 to be approximately $225 million.

The Group has a commitment to execute the capital construction program of its power generation segment and under the terms of this program power plants with a total capacity of 890 MW should be constructed. Currently the Group is approving certain amendments to the capital construction program, including its extension by the end of 2014. As of December 31, 2011, the Group estimates the amount of this commitment to be approximately $594 million.

The Group signed a number of agreements for the years 2012-2015 for construction of the offshore platforms in the Caspian Sea. The Group estimates the amount of this capital commitment to be approximately $866 million.

The following table displays our total contractual obligations and other commitments:

(millions of US dollars)	Total	2012	2013	2014	2015	2016	After
On balance sheet							
Short term debt	**148**	148	–	–	–	–	–
Long-term bank loans and borrowings	**1,120**	455	267	130	118	76	74
Long-term non-bank loans and borrowings	**1,532**	40	32	39	21	19	1,381
6.375% Non-convertible US dollar bonds, maturing 2014	**897**	–	–	897	–	–	–
2.625% Convertible US dollar bonds, maturing 2015	**1,412**	–	–	–	1,412	–	–
6.356% Non-convertible US dollar bonds, maturing 2017	**500**	–	–	–	–	–	500
7.250% Non-convertible US dollar bonds, maturing 2019	**596**	–	–	–	–	–	596
6.125% Non-convertible US dollar bonds, maturing 2020	**998**	–	–	–	–	–	998
6.656% Non-convertible US dollar bonds, maturing 2022	**500**	–	–	–	–	–	500
13.35% Russian ruble bonds, maturing 2012	**776**	776	–	–	–	–	–
9.20% Russian ruble bonds, maturing 2012	**311**	311	–	–	–	–	–
7.40% Russian ruble bonds, maturing 2013	**186**	–	186	–	–	–	–
Capital lease obligations	**116**	62	27	27	–	–	–
TOTAL	**9,092**	**1,792**	**512**	**1,093**	**1,551**	**95**	**4,049**
Off balance sheet							
Operating lease obligations	**507**	145	83	74	46	54	105
Capital commitments in PSAs	**406**	258	57	57	2	2	30
Capital commitments of power generating segment	**594**	436	112	46	–	–	–
Obligation under contract with OOO Eurasia Drilling Company	**1,521**	1,521	–	–	–	–	–
Obligation under contract with ZAO Globalstroy-Engineering	**225**	225	–	–	–	–	–
Obligation under contracts for the development of the V. Filanovsky oilfield.	**866**	64	596	191	15	–	–

Litigation and claims

On November 27, 2001, Archangel Diamond Corporation ("ADC"), a Canadian diamond development company, filed a lawsuit in the Denver District Court, Colorado against OAO Arkhangelskgeoldobycha ("AGD"), a Group company, and the Company (together the "Defendants"). ADC alleged that the Defendants interfered with the transfer of a diamond exploration license to Almazny Bereg, a joint venture between ADC and AGD. ADC claimed compensatory damages of $1.2 billion and punitive damages of $3.6 billion. On October 15, 2002, the District Court dismissed the lawsuit for lack of personal jurisdiction. This ruling was upheld by the Colorado Court of Appeals on March 25, 2004. On November 21, 2005, the Colorado Supreme Court affirmed the lower courts' ruling that no specific jurisdiction exists over the Defendants.

By virtue of this finding, AGD (the holder of the diamond exploration license) was dismissed from the lawsuit. The Colorado Supreme Court found, however, that the trial court made a procedural error by failing to hold an evidentiary hearing before making its ruling concerning general jurisdiction regarding the Company and remanded the case to the Colorado Court of Appeals to consider whether the lawsuit should have been dismissed on alternative grounds (i.e., forum non conveniens). The Colorado Court of Appeals declined to dismiss the case based on forum non conveniens and the case was remanded to the District Court. In June 2009, three creditors of ADC filed an Involuntary Bankruptcy Petition putting ADC into bankruptcy. In November 2009, after adding a claim, ADC removed the case from the District Court to the US Bankruptcy Court. On October 28, 2010, the Bankruptcy Court granted the Company's Motion for Remand and Abstention and remanded the case to the Denver District Court. On October 20, 2011, the Denver District Court dismissed all claims in the lawsuit against the Company. ADC has filed a notice of appeal. No briefing schedule has been established. Management does not believe that the ultimate resolution of this matter will have a material adverse effect on the Group's financial condition.

On January 6, 2012, ADC filed a lawsuit in the US District Court for the District of Colorado (federal court) reasserting almost identical claims asserted in the aforementioned lawsuit and dismissed by the Denver District Court (state court) notwithstanding ADC's appeal of the state court's decision. The time within which the Company is required to respond has not expired. The Company plans to seek dismissal of the case and vigorously defend the matter. Management does not believe that the ultimate resolution of this matter will have a material adverse effect on the Group's financial condition.

As of the date the financial statements were available to be issued approximately 100 claims in relation to a violation of the anti-monopoly regulation were initiated against several Group companies in Russia and abroad. The Group companies were accused of violations primarily involving abuse of their dominant market position and execution of coordinated actions in oil products retail markets.

On February 9, 2011, the Federal Anti-monopoly Service of the Russian Federation ("FAS of Russia") filed a case against the three largest Russian oil companies, including the Company, accusing them of abuse of their dominant position in the oil products market. The decision accusing the Company in establishing monopolistically high prices on diesel fuel during the period October 2010 – December 2010 was issued on August 9, 2011. The case in establishing monopolistically high prices on jet fuel was separated into an individual proceeding and its hearing is scheduled for March 20, 2012. On December 28, 2011, FAS of Russia defined fines against the Company and the Group's refinery plants in the amount of $19 million. The decision was not contested and the fines were paid on February 17, 2012. The Group accrued a provision for this amount in the consolidated financial statements as of December 31, 2011.

The Group is involved in cost recovery disputes with the Republic of Kazakhstan. The Group's share of the claim is approximately $295 million. Management is of the view that substantially all of the amounts subject to dispute are in fact recoverable under the Final Production Sharing Agreement. Management believes that the ultimate resolution of the claim will not have a material adverse impact on the Group's operating results or 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

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" to our consolidated financial statements 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.

Business combinations

Purchase price allocation

Accounting for the acquisition of a business requires the allocation of the purchase price to the various assets and liabilities of the acquired business. For most assets and liabilities, purchase price allocation is accomplished by recording the asset or liability at its estimated fair value. The most difficult estimations of individual fair values are those involving property, plant and equipment and identifiable intangible assets. We use all available information to make these fair value determinations and, for major business acquisitions, typically engage an outside appraisal firm to assist in the fair value determination of the acquired long-lived assets. We have, if necessary, up to one year after the acquisition closing date to finish these fair value determinations and finalize the purchase price allocation.

Principles of consolidation

Our consolidated financial statements include the financial position and results of the Company, controlled subsidiaries of which the Company directly or indirectly owns more than 50% of the voting interest, unless minority interest shareholders have substantive participating rights, and variable interest entities where the Group is determined to be the primary beneficiary. Other significant investments in companies of which the Company directly or indirectly owns between 20% and 50% of the voting interest and over which it exercises significant influence but not control, are accounted for using the equity method of accounting. Investments in companies of which the Company directly or indirectly owns more than 50% of the voting interest but where minority interest shareholders have substantive participating rights are accounted for using the equity method of accounting. Undivided interests in oil and gas joint ventures are accounted for using the proportionate consolidation method. Investments in other companies are recorded at cost.

Revenue recognition

Revenues are recognized when title passes to customers at which point the risks and rewards of ownership are assumed by the customer and the price is fixed or determinable. Revenues include excise on petroleum products sales and duties on export sales of crude oil and petroleum products.

Revenues from non-cash sales are recognized at the fair market value of the crude oil and petroleum products sold.

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 (including development dry holes and the Group's share of operators' expenses during the development stage of production sharing and risk service contracts) 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 that individually are relatively small, management exercises judgment and determines a periodic property impairment charge as required that is reported in loss on disposals and impairments of assets.

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. 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

Due to the inherent uncertainties and the necessarily limited nature of reservoir data, estimates of reserves are inherently imprecise, require the application of judgment and are subject to change as additional information becomes available. 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.

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. Proved reserves do not include additional quantities of oil and gas reserves that may result from applying secondary or tertiary recovery techniques not yet tested and determined to be economic. The proved reserves include volumes which are recoverable up to and after license expiry dates. Proved developed reserves are the quantities of proved reserves expected to be recovered through existing wells with existing equipment and operating methods.

Management has included within proved reserves significant quantities which the Group expects to produce after the expiry dates of certain of its current production licenses in the Russian Federation. The Subsoil Law of the Russian Federation states that, upon expiration, a license is subject to renewal at the initiative of the license holder provided that further exploration, appraisal, production or remediation activities are necessary and provided that the license holder has not violated the terms of the license. Since the law applies both to newly issued and old licenses and the Group has currently renewed nearly 50% of its licenses, management believes that licenses will be renewed upon their expiration for the remainder of the economic life of each respective field.

Impairment of long-lived assets

Long-lived assets, such as oil and gas properties (other than unproved properties), other property, plant, and equipment, and purchased intangibles subject to amortization, are assessed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset group may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset group to the estimated undiscounted future cash flows expected to be generated by that group. If the carrying amount of an asset group exceeds its estimated undiscounted future cash flows, an impairment charge is recognized by writing down the carrying amount to the estimated fair value of the asset group, generally determined as discounted future net cash flows. Assets to be disposed of are separately presented in the balance sheet and reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated. The assets and liabilities of a disposed group classified as held for sale are presented separately in the appropriate asset and liability sections of the balance sheet.

Deferred income taxes

Deferred income tax assets and liabilities are recognized in respect of future tax consequences attributable to temporary differences between the carrying amounts of existing assets and liabilities for the purposes of the consolidated financial statements and their respective tax bases and in respect of operating loss and tax credit carryforwards. Deferred income tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to reverse and the assets be recovered and liabilities settled. The effect on deferred income tax assets and liabilities of a change in tax rates is recognized in the consolidated statement of income in the reporting period which includes the enactment date.

The ultimate realization of deferred income tax assets is dependent upon the generation of future taxable income in the reporting periods in which the originating expenditure becomes deductible. In assessing the realizability of deferred income tax assets, management considers whether it is more likely than not that the deferred income tax assets will be realized. In making this assessment, management considers the scheduled reversal of deferred income tax liabilities, projected future taxable income, and tax planning strategies.

An income tax position is recognized only if the uncertain position is more likely than not of being sustained upon examination, based on its technical merits. A recognized income tax position is measured at the largest amount that is greater than 50% likely of being realized. Changes in recognition or measurement are reflected in the period in which the change in judgment occurs.

Asset retirement obligations

Under various laws, contracts, permits and regulations, the Group has legal obligations to remove tangible equipment and restore the land or seabed at the end of operations at production sites. The largest asset retirement obligations of the Group relate to wells and oil and gas production facilities and pipelines. The Group records the fair value of liabilities associated with such obligations when incurred. Estimating the future asset retirement obligations 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

Certain conditions may exist as of balance sheet dates that may result in losses, but the impact of which will only be resolved when one or more future events occur or fail to occur. The Group is required to both determine whether a loss is probable based on judgment and interpretation of laws and regulations and determine whether the loss can be reasonably estimated. If our assessment of a contingency indicates that it is probable that a material loss will arise, and the amount of the liability can be estimated, then the estimated liability is accrued and charged to the consolidated statement of income. If our assessment indicates that a potentially material loss is not probable, but is only reasonably possible, or is probable but cannot be estimated, then the nature of the contingent liability is disclosed in the notes to our consolidated financial statements. Loss contingencies considered remote are generally not disclosed unless they involve guarantees, in which case the nature of the guarantee is disclosed. The Company's management continually monitor known and potential contingent matters and make appropriate charges to the consolidated statement of income when warranted by circumstance.

Use of derivative instruments

The Group's derivative activity is limited to certain petroleum products marketing and trading operations hedging of commodity price risks. Currently this activity involves the use of futures and swaps contracts together with purchase and sale contracts that qualify as derivative instruments. The Group accounts for these activities under the mark-to-market methodology in which the derivatives are revalued each accounting period. Resulting realized and unrealized gains or losses are presented in the consolidated statement of income on a net basis. Unrealized gains and losses are carried as assets or liabilities on the consolidated balance sheet.

Recent accounting pronouncements

In April 2011, the FASB issued Accounting Standards Update ("ASU") No. 2011-02, "*A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*," which amends Topic 310 of the Codification. This ASU provides additional guidance in considering whether a restructuring constitutes a troubled debt restructuring and helps creditors in determining whether a creditor has granted a concession and whether a debtor is experiencing financial difficulties. ASU No. 2011-02 is effective starting from the first interim or annual period beginning on or after June 15, 2011. The Group adopted the requirements of ASU No. 2011-02 starting from the third quarter of 2011. This adoption did not have a material impact on the Group's results of operations, financial position or cash flows and did not require additional disclosures.

In January 2010, the FASB issued ASU No. 2010-06, "*Improving Disclosures about Fair Value Measurements,*" which requires reporting entities to make new disclosures about recurring or nonrecurring fair-value measurements including significant transfers into and out of Level 1 and Level 2 fair-value measurements and to present separately information about purchases, sales, issuances, and settlements on a gross basis in the reconciliation of Level 3 fair-value measurements. This ASU also clarifies existing fair-value measurement disclosure guidance about the level of disaggregation, inputs, and valuation techniques. The Group fully adopted the requirements of ASU No. 2010-06 starting from the first quarter of 2011. This adoption did not have a material impact on the Group's results of operations, financial position or cash flows.

In December 2011, the FASB issued ASU No. 2011-12, "*Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05.*" This ASU defers changes that relate to the presentation to reclassification adjustments out of accumulated other comprehensive income in ASU No. 2011 05, "Presentation of Comprehensive Income," until the FASB is able to reconsider those paragraphs. Entities should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU No. 2011-05. ASU No. 2011-12 is effective at the same time as the ASU No. 2011-05: for public entities for fiscal years, and interim periods within those years, beginning after December 15, 2011 and should be applied retrospectively. The Group will apply the provisions of ASU No. 2011-12 starting from the first quarter of 2012 and does not expect any material impact on its results of operations, financial position or cash flows.

In December 2011, the FASB issued ASU No. 2011-11, "*Disclosures about Offsetting Assets and Liabilities.*" This ASU requires entities to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. The scope includes derivatives, sale and repurchase agreements and reverse sale and repurchase agreements, and securities borrowing and securities lending arrangements. ASU No. 2011-11 is effective for annual reporting periods on or after January 1, 2013, and interim periods within those annual periods, and should be applied retrospectively. The Group is evaluating the effect of the adoption of ASU No. 2011-11 and does not expect any material impact on its results of operations, financial position or cash flows.

In September 2011, the FASB issued ASU No. 2011-08, "*Testing Goodwill for Impairment,*" which allows an entity to use a qualitative approach to test goodwill for impairment. This ASU permits an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount and hence whether it is necessary to perform the two-step goodwill impairment test as required by the provisions of Topic 350 of the Codification. ASU No. 2011-08 is effective for annual and interim goodwill impairment tests performed for the fiscal years beginning after December 15, 2011. The Group will apply the provisions of ASU No. 2011-08 starting from the first quarter of 2012 and does not expect any material impact on its results of operations, financial position or cash flows.

In June 2011, the FASB issued ASU No. 2011-05, "*Presentation of comprehensive income,*" which amends Topic 220 of the Codification. This ASU increases the prominence of other comprehensive income in financial statements. Under this ASU, an entity will have the option to present the components of net income and comprehensive income in either one or two statements. The ASU eliminates the option in US GAAP to present other comprehensive income in the statement of changes in equity. ASU No. 2011-05 is effective for public entities for fiscal years, and interim periods within those years, beginning after December 15, 2011 and should be applied retrospectively. The Group will apply the provisions of ASU No. 2011-05 starting from the first quarter of 2012.

In May 2011, the FASB issued ASU No. 2011-04, "*Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in US GAAP and IFRSs,*" which amends Topic 820 of the Codification. This ASU provides guidance for fair value measurements and disclosure requirements and clarifies the Board's intent about the application of existing fair value measurement requirements. The new standard does not extend the use of fair value but, rather, provides guidance about how fair value should be applied where it already is required or permitted under US GAAP. ASU No. 2011-04 is effective for public entities during interim and annual periods beginning after December 15, 2011 and should be applied prospectively. The Group will apply the provisions of ASU No. 2011-04 starting from the first quarter of 2012 and does not expect any material impact on its results of operations, financial position or cash flows.

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
- 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
- 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.