

## 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 September 30, 2012 and the results of its operations for the three and nine month periods ended September 30, 2012 and 2011, and significant factors that may affect its future performance. It should be read in conjunction with our interim US GAAP consolidated financial statements and notes thereto.

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 and natural gas liquids produced are translated into barrels using conversion rates characterizing the density of crude oil from each of our oilfields and actual density of liquids produced at our gas processing plants. 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 – 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.*

### Key financial and operational results

	3 <sup>rd</sup> quarter of		Change,	9 months of		Change,
	2012	2011	%	2012	2011	%
Sales (millions of US dollars) .....	35,494	34,563	2.7	103,152	99,101	4.1
Net income attributable to OAO LUKOIL (millions of US dollars).....	3,509	2,244	56.4	8,316	9,012	(7.7)
EBITDA (millions of US dollars).....	5,441	4,628	17.6	14,249	15,316	(7.0)
Taxes other than income taxes, excise and export tariffs (millions of US dollars) .....	(8,900)	(9,570)	(7.0)	(27,506)	(26,330)	4.5
Earning per share of common stock attributable to OAO LUKOIL (US dollars):						
Basic .....	4.65	2.88	61.4	10.91	11.55	(5.6)
Diluted .....	4.55	2.83	60.6	10.68	11.31	(5.6)
Hydrocarbon production by the Group including our share in equity affiliates (thousands of BOE).....	198,889	196,247	1.3	593,941	592,042	0.3
Daily hydrocarbon production by the Group including our share in equity affiliates (thousands of BOE per day).....	2,162	2,133	1.4	2,168	2,169	0.0
Crude oil and natural gas liquids produced by the Group including our share in equity affiliates (thousands of barrels) .....	170,566	171,086	(0.3)	507,016	513,675	(1.3)
Gas available for sale produced by the Group including our share in equity affiliates (millions of cubic meters).....	4,813	4,276	12.6	14,771	13,317	10.9
Refined products produced by the Group including our share in equity affiliates (thousands of tonnes).....	16,204	16,115	0.6	46,899	46,960	(0.1)

During the nine months of 2012, our net income was \$8,316 million, which is \$696 million, or 7.7%, less than in the same period of 2011. At the same time, our net income for the third quarter of 2012 amounted to \$3,509 million, which is \$1,265 million, or 56.4%, more than in the third quarter of 2011. Our net income was influenced mainly by export tariffs and mineral extraction tax rates and by hydrocarbon prices.

## 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 38 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 7, 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 20 “Segment information” to the interim consolidated financial statements.

## Changes in the Group structure

In January 2012, the Group was offered to acquire a 20% stake in the joint venture operating the ISAB refining complex (“ISAB”). The transaction was approved by European regulatory authorities and was completed in September 2012 in amount of €485 million (approximately \$609 million). The Group’s ownership in ISAB increased from 60% to 80% and the Group obtained control over this joint venture. This transaction was a partial exercise of ERG S.p.A. option to sell in full its stake in the joint venture established in 2008. In April 2011, within this option, the Group acquired an 11% stake in the joint venture for €241 million (approximately \$342 million).

In August 2012, the Group acquired ConocoPhillips’ investment in OOO “Narianmarneftegas” (“NMNG”) and certain related assets for \$604 million. ConocoPhillips group owned 30% interest in NMNG. The acquisition increased the Group’s total ownership interest in NMNG to 100%.

## 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. 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, Egypt, Ghana, Cote d'Ivoire and Vietnam.

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

	3 <sup>rd</sup> quarter of		9 months of	
	2012	2011	2012	2011
	(thousand BOE per day)			
Daily production of hydrocarbons, including the Company's share in equity affiliates, including: .....	2,162	2,133	2,168	2,169
- crude oil and natural gas liquids <sup>(1)</sup> .....	1,854	1,860	1,851	1,882
- natural gas <sup>(2)</sup> .....	308	273	317	287
	(US dollar per BOE)			
Hydrocarbon extraction expenses.....	5.05	5.05	4.92	4.99
- in Russia .....	5.05	5.04	4.94	5.01
- outside Russia .....	5.09	5.24	4.74	4.67
	(millions of US dollars)			
Hydrocarbon extraction expenses.....	971	955	2,821	2,842
- in Russia .....	900	894	2,611	2,671
- outside Russia .....	71	61	210	171
Exploration expenses.....	52	196	199	309
- in Russia .....	17	18	109	73
- outside Russia .....	35	178	90	236
Mineral extraction tax .....	2,992	3,122	9,264	8,779
- in Russia .....	2,967	3,094	9,193	8,706
- outside Russia .....	25	28	71	73

<sup>(1)</sup> Natural gas liquids produced at the Group gas processing plants.

<sup>(2)</sup> Gas available for sale (excluding gas produced for our own consumption and including petroleum gas sold to third parties).

**Crude oil production.** In the nine months of 2012, we produced 67.2 million tonnes (496.6 million barrels) of crude oil compared to 68.3 million tonnes (504.2 million barrels) in the same period of 2011 (including the Company's share in equity affiliates).

The following table represents our crude oil production in the nine months of 2012 and 2011 by major regions.

(thousands of tonnes)	Change to 2011				
	9 months of 2012	Total, %	Change in structure	Organic change	9 months of 2011
Western Siberia.....	36,893	0.4	–	137	36,756
Timan-Pechora.....	11,745	(12.8)	–	(1,722)	13,467
Ural region .....	10,036	5.4	–	516	9,520
Volga region .....	2,640	11.8	–	278	2,362
Other in Russia.....	1,418	(3.3)	–	(49)	1,467
Crude oil produced in Russia .....	62,732	(1.3)	–	(840)	63,572
Crude oil produced internationally.....	2,517	(1.4)	(37)	–	2,554
<b>Total crude oil produced by consolidated subsidiaries .....</b>	<b>65,249</b>	<b>(1.3)</b>	<b>(37)</b>	<b>(840)</b>	<b>66,126</b>
<b>Our share in crude oil produced by equity affiliates:</b>					
in Russia .....	288	8.7	–	23	265
outside Russia .....	1,710	(10.0)	–	(189)	1,899
<b>Total crude oil produced .....</b>	<b>67,247</b>	<b>(1.5)</b>	<b>(37)</b>	<b>(1,006)</b>	<b>68,290</b>

The main oil producing region for the Company is Western Siberia where we produced 56.5% of our crude oil in the nine months of 2012 (55.6% in the nine months of 2011). Since the second half of 2011, the Company managed to stabilize crude oil production in the region that had been declining for several preceding years.

The continuing trend of increasing water cut at our Yuzhnoye Khylychuyu oilfield was the main reason for the production decrease in Russia.

The structural decrease of our international production was a result of sale of 10% of our share in Karachaganak Petroleum Operating consortium (“KPO”), an upstream project in Kazakhstan, to a state-owned KazMunayGaz in the end of the second quarter of 2012.

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.

	3 <sup>rd</sup> quarter of			
	2012	2012	2011	2011
	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)
Crude oil purchases in Russia .....	462	63	1,122	153
Crude oil purchases internationally .....	31,409	4,285	47,095	6,425
<b>Total crude oil purchased .....</b>	<b>31,871</b>	<b>4,348</b>	<b>48,217</b>	<b>6,578</b>

	9 months of			
	2012	2012	2011	2011
	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)
Crude oil purchases in Russia .....	1,767	241	2,016	275
Crude oil purchases internationally .....	87,997	12,005	110,668	15,098
<b>Total crude oil purchased .....</b>	<b>89,764</b>	<b>12,246</b>	<b>112,684</b>	<b>15,373</b>

Significant part of our crude oil purchases is for processing. In the nine months of 2012, we purchased 8,995 thousand tonnes of crude oil to process at our and at third party refineries, compared to 9,823 thousand tonnes in the nine months of 2011. The decrease was due to higher volumes of own supply. Our purchases for trading also decreased compared to the nine months of 2011.

**Production of gas and natural gas liquids.** In the nine months of 2012, we produced 14,771 million cubic meters (86.9 million BOE) of gas available for sale (including our share in equity affiliates), that is 10.9% more than in the nine months of 2011.

Our major gas production field is the Nakhodkinskoe field, where we produced 5,942 million cubic meters of natural gas in the nine months of 2012 (6,192 million cubic meters in the nine months of 2011). Our international gas production increased by 36.1%, mostly due to growth of our production in Uzbekistan. We produced 754 million cubic meters of gas from the Gissar field (commercial production commenced in December 2011), and increased production from the Khauzak field by 570 million cubic meters, or by 30.2%.

In the nine months of 2012, the output of natural gas liquids at the Group gas processing plants in Western Siberia, Ural and Volgograd regions of Russia was 10.4 million BOE, compared to 9.5 million BOE in the nine months of 2011.

### 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 45% interest in the Zeeland Refinery in the Netherlands.

In September 2012, we increased our interest up to 80% and obtained control over ISAB, in which we previously held 60% (49% before April 2011). Therefore, starting from September 2012, ISAB became our consolidated subsidiary rather than an equity affiliate.

Compared to the nine months of 2011, the total volume of refined products produced by the Group (including our share in equity affiliates production) remained on roughly the same level. Due to scheduled overhauls, production volumes of our Russian refineries decreased by 3.2%. Production of our international refineries increased by 16.3% as a result of the increase of our share in ISAB.

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. Starting from July 1, 2012, all the gasoline and most of diesel fuel produced by the Group in Russia comply with Euro-5 standards.

Along with our own production of refined products we can refine crude oil at third party refineries depending on market conditions and other factors. In 2011, we began processing our crude oil at a third party refinery in Kazakhstan. In 2012, we restarted processing operations in Belarus.

The following table summarizes key figures for our refining activities.

	3 <sup>rd</sup> quarter of		9 months of	
	2012	2011	2012	2011
	(millions of US dollars)			
Refining expenses at the Group refineries.....	430	375	1,108	1,048
- in Russia .....	310	307	838	821
- outside Russia <sup>(1)</sup> .....	120	68	270	227
Refining expenses at ISAB and Zeeland Refinery <sup>(2)</sup> .....	166	226	645	648
Refining expenses at third party refineries .....	28	2	75	7
Capital expenditures.....	345	225	905	524
- in Russia .....	279	193	581	407
- outside Russia .....	66	32	324	117
	(thousands of barrels per day)			
Refinery throughput at the Group refineries .....	1,153	1,084	1,069	1,078
- in Russia .....	889	912	879	912
- outside Russia <sup>(1)</sup> .....	264	172	190	166
Refinery throughput at ISAB and Zeeland Refinery <sup>(2) (3)</sup> .....	192	247	233	230
Refinery throughput at third party refineries .....	55	6	55	7
<b>Total refinery throughput .....</b>	<b>1,404</b>	<b>1,337</b>	<b>1,357</b>	<b>1,315</b>
	(thousands of tonnes)			
Refined products produced at the Group refineries.....	13,808	12,962	38,169	38,247
- in Russia .....	10,674	10,934	31,370	32,401
- outside Russia <sup>(1)</sup> .....	3,134	2,028	6,799	5,846
Production of ISAB and Zeeland Refinery <sup>(2)</sup> .....	2,396	3,153	8,730	8,713
Refined products produced at third party refineries .....	684	72	1,919	241
<b>Total refined products produced .....</b>	<b>16,888</b>	<b>16,187</b>	<b>48,818</b>	<b>47,201</b>

<sup>(1)</sup> Including 80% share of ISAB for September 2012.

<sup>(2)</sup> Including 60% share of ISAB from April 2011 to August 2012 (49% share of ISAB before April 2011) and 49% share of Zeeland Refinery.

<sup>(3)</sup> 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 26 countries through nearly 5.6 thousand petrol stations. Most of the stations operate under the LUKOIL brand.

The table below summarizes figures for our trading activities.

	3 <sup>rd</sup> quarter of		9 months of	
	2012	2011	2012	2011
	(thousands of tonnes)			
Retail sales .....	4,103	4,204	11,371	11,152
Wholesale sales .....	24,874	21,932	71,809	65,257
<b>Total refined products sales .....</b>	<b>28,977</b>	<b>26,136</b>	<b>83,180</b>	<b>76,409</b>
Refined products purchased in Russia.....	385	643	1,136	1,539
Refined products purchased internationally .....	13,530	10,295	38,956	32,755
<b>Total refined products purchased.....</b>	<b>13,915</b>	<b>10,938</b>	<b>40,092</b>	<b>34,294</b>

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

	3 <sup>rd</sup> quarter of			
	2012		2011	
	(thousands of barrels)	(thousands of tonnes)	(thousands of barrels)	(thousands of tonnes)
Exports of crude oil using Transneft export routes .....	57,196	7,803	54,059	7,375
Exports of crude oil bypassing Transneft.....	8,569	1,169	9,917	1,353
<b>Total crude oil exports .....</b>	<b>65,765</b>	<b>8,972</b>	<b>63,976</b>	<b>8,728</b>

	9 months of			
	2012		2011	
	(thousands of barrels)	(thousands of tonnes)	(thousands of barrels)	(thousands of tonnes)
Exports of crude oil using Transneft export routes .....	178,501	24,352	158,556	21,631
Exports of crude oil bypassing Transneft.....	19,945	2,721	31,145	4,249
<b>Total crude oil exports .....</b>	<b>198,446</b>	<b>27,073</b>	<b>189,701</b>	<b>25,880</b>

In the nine months of 2012, our export of crude oil from Russia increased by 4.6%, compared to the same period of 2011, and we exported 43.2% of our total domestic crude oil production (40.7% in the nine months of 2011).

Almost all the volume of crude oil exported bypassing Transneft was routed through our own export infrastructure. The reduction of export through our own export infrastructure was mainly caused by a decrease in production from Yuzhnoye Khylychuyu oilfield (1,010 thousand tonnes in the nine months of 2012 compared to 2,794 thousand tonnes in the nine months of 2011).

In the nine months of 2012, we exported from Russia 16.9 million tonnes of refined products, a decrease of 9.4%, compared to the respective period of 2011. Primarily, we export from Russia diesel fuel, fuel oil and gasoil. These products account for approximately 88% of our refined products export volumes.

The decrease in refined products export and increase in the export of crude oil were both a result of a decrease in throughput at our refineries in Nizhny Novgorod and Ukhta due to scheduled overhauls in the second and third quarters of 2012, respectively.

In the nine months of 2012, our revenue from export of crude oil and refined products from Russia both to Group companies and third parties amounted to \$19,696 million and \$12,695 million, respectively (\$18,607 million for crude oil and \$13,887 million for refined products in the nine months of 2011).

## 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 the nine months of 2012, the Brent crude oil price fluctuated between \$88 and \$128 per barrel and reached its peak of \$128.18 in the beginning of March. During the third quarter of 2012, average crude oil prices increased by 1.1% compared to the second quarter of 2012, quarter-end Brent price amounted to \$111.00 per barrel.

Substantially all the crude oil the Group exports is Urals blend. The following table shows the average crude oil and refined product prices in the respective periods of 2012 and 2011.

	3 <sup>rd</sup> quarter of 2012	2011	Change, %	9 months of 2012	2011	Change, %
(in US dollars per barrel, except for figures in percent)						
Brent crude.....	109.50	113.41	(3.4)	112.21	111.89	0.3
Urals crude (CIF Mediterranean) <sup>(1)</sup> .....	109.13	111.43	(2.1)	111.09	109.24	1.7
Urals crude (CIF Rotterdam) <sup>(1)</sup> .....	108.69	111.52	(2.5)	110.71	109.22	1.4
(in US dollars per metric tonne, except for figures in percent)						
Fuel oil 3.5% (FOB Rotterdam).....	621.25	630.62	(1.5)	644.98	604.56	6.7
Diesel fuel 10 ppm (FOB Rotterdam) .....	977.17	967.33	1.0	977.74	953.94	2.5
High-octane gasoline (FOB Rotterdam).....	1,062.57	1,026.87	3.5	1,051.97	1,001.82	5.0

Source: Platts.

<sup>(1)</sup> 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 the respective periods of 2012 and 2011.

	3 <sup>rd</sup> quarter of 2012	2011	Change, %	9 months of 2012	2011	Change, %
(in US dollars per metric tonne, except for figures in percent)						
Fuel oil.....	295.22	333.73	(11.5)	293.89	321.90	(8.7)
Diesel fuel.....	753.05	700.23	7.5	777.91	740.35	5.1
High-octane gasoline (Regular) .....	807.77	929.99	(13.1)	801.01	870.58	(8.0)
High-octane gasoline (Premium) .....	879.26	977.89	(10.1)	858.84	911.30	(5.8)

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 appreciation 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 3.3% in the nine months of 2012, compared to the nine months of 2011.

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

	3 <sup>rd</sup> quarter of		9 months of	
	2012	2011	2012	2011
Ruble inflation (CPI), % .....	1.9	(0.3)	5.2	4.7
Change of the ruble-dollar exchange rate, % .....	5.8	(13.5)	4.0	(4.6)
Average exchange rate for the period (ruble to US dollar) .....	32.01	29.05	31.10	28.77
Exchange rate at the end of the period (ruble to US dollar) .....	30.92	31.88	30.92	31.88

### Tax burden

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

		3 <sup>rd</sup> quarter of		Change, %
		2012 <sup>(1)</sup>	2011 <sup>(1)</sup>	
Export tariffs on crude oil .....	\$/tonne	366.27	442.45	(17.2)
Export tariffs on refined products				
Middle distillates (jet fuel), diesel fuel and gasoils .....	\$/tonne	241.70	296.42	(18.5)
Light distillates				
gasoline .....	\$/tonne	329.63	398.18	(17.2)
straight-run gasoline .....	\$/tonne	329.63	398.18	(17.2)
Liquid fuels (fuel oil) .....	\$/tonne	241.70	206.59	17.0
Mineral extraction tax				
Crude oil .....	RUR/tonne	5,146.30	4,544.85	13.2
Natural gas .....	RUR/1,000 m <sup>3</sup>	251.00	237.00	5.9

<sup>(1)</sup> Average values.

		9 months of		Change, %
		2012 <sup>(1)</sup>	2011 <sup>(1)</sup>	
Export tariffs on crude oil .....	\$/tonne	403.30	411.01	(1.9)
Export tariffs on refined products				
Middle distillates (jet fuel), diesel fuel and gasoils .....	\$/tonne	266.14	276.91	(3.9)
Light distillates				
gasoline .....	\$/tonne	362.95	334.72	8.4
straight-run gasoline .....	\$/tonne	362.95	322.87	12.4
Liquid fuels (fuel oil) .....	\$/tonne	266.14	188.92	40.9
Mineral extraction tax				
Crude oil .....	RUR/tonne	5,085.65	4,368.40	16.4
Natural gas .....	RUR/1,000 m <sup>3</sup>	251.00	237.00	5.9

<sup>(1)</sup> Average values.

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

		3 <sup>rd</sup> quarter of		Change, %
		2012 <sup>(1)</sup>	2011 <sup>(1)</sup>	
Mineral extraction tax				
Crude oil .....	\$/tonne	160.79	156.47	2.8
Natural gas .....	\$/1,000 m <sup>3</sup>	7.84	8.16	(3.9)

<sup>(1)</sup> Average values.

		9 months of		Change, %
		2012 <sup>(1)</sup>	2011 <sup>(1)</sup>	
Mineral extraction tax				
Crude oil .....	\$/tonne	163.53	151.86	7.7
Natural gas .....	\$/1,000 m <sup>3</sup>	8.07	8.24	(2.1)

<sup>(1)</sup> 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 446 rubles per metric tonne extracted (419 rubles in 2011) 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 2013 is currently set at 470 rubles per metric tonne extracted. 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 produces crude oil in the Caspian Sea. In the nine months of 2012, the amount of incentive was relatively insignificant, but we expect it to increase 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 2011, the rate was 237 rubles per thousand cubic meters. 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 refined products are calculated by multiplying the current crude oil export duty rate by a coefficient according to the table below.

	<b>Before October 1, 2011</b>	<b>After October 1, 2011</b>
Multiplier for:		
Light distillates (except for gasolines), middle distillates (jet fuel), diesel fuel and gasoils .....	0.670	0.660
Gasolines <sup>(1)</sup> .....	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

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

**Crude oil and refined products exported to the member countries of the Custom Union – Belarus and Kazakhstan,** 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). Only domestic sales volumes are subject to excises.

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 the respective periods of 2012 and 2011 are listed below:

		3 <sup>rd</sup> quarter of		Change, %
		2012	2011	
<b>Gasoline</b>				
Below Euro-3.....	RUR/tonne	8,225.00	5,995.00	37.2
Euro-3 .....	RUR/tonne	7,882.00	5,672.00	39.0
Euro-4 .....	RUR/tonne	6,822.00	5,143.00	32.6
Euro-5 .....	RUR/tonne	5,143.00	5,143.00	—
<b>Diesel fuel</b>				
Below Euro-3.....	RUR/tonne	4,300.00	2,753.00	56.2
Euro-3 .....	RUR/tonne	4,300.00	2,485.00	73.0
Euro-4 .....	RUR/tonne	3,562.00	2,247.00	58.5
Euro-5 .....	RUR/tonne	2,962.00	2,247.00	31.8
Motor oils.....	RUR/tonne	6,072.00	4,681.00	29.7
Straight-run gasoline .....	RUR/tonne	7,824.00	6,089.00	28.5

		3 <sup>rd</sup> quarter of		Change, %
		2012	2011	
<b>Gasoline</b>				
Below Euro-3.....	\$/tonne	256.97	206.40	24.5
Euro-3 .....	\$/tonne	246.26	195.28	26.1
Euro-4 .....	\$/tonne	213.14	177.06	20.4
Euro-5 .....	\$/tonne	160.68	177.06	(9.3)
<b>Diesel fuel</b>				
Below Euro-3.....	\$/tonne	134.34	94.78	41.7
Euro-3 .....	\$/tonne	134.34	85.55	57.0
Euro-4 .....	\$/tonne	111.29	77.36	43.9
Euro-5 .....	\$/tonne	92.54	77.36	19.6
Motor oils.....	\$/tonne	189.71	161.16	17.7
Straight-run gasoline .....	\$/tonne	244.45	209.63	16.6

		9 months of		Change, %
		2012	2011	
<b>Gasoline</b>				
Below Euro-3.....	RUR/tonne	7,892.88	5,995.00	31.7
Euro-3 .....	RUR/tonne	7,549.88	5,672.00	33.1
Euro-4 .....	RUR/tonne	6,822.00	5,143.00	32.6
Euro-5 .....	RUR/tonne	6,258.25	5,143.00	21.7
<b>Diesel fuel</b>				
Below Euro-3.....	RUR/tonne	4,165.82	2,753.00	51.3
Euro-3 .....	RUR/tonne	3,977.18	2,485.00	60.0
Euro-4 .....	RUR/tonne	3,562.00	2,247.00	58.5
Euro-5 .....	RUR/tonne	3,360.54	2,247.00	49.6
Motor oils.....	RUR/tonne	6,072.00	4,681.00	29.7
Straight-run gasoline .....	RUR/tonne	7,824.00	6,089.00	28.5

		9 months of		Change, %
		2012	2011	
<b>Gasoline</b>				
Below Euro-3.....	\$/tonne	253.80	208.40	21.8
Euro-3 .....	\$/tonne	242.77	197.17	23.1
Euro-4 .....	\$/tonne	219.37	178.79	22.7
Euro-5 .....	\$/tonne	201.24	178.79	12.6
<b>Diesel fuel</b>				
Below Euro-3.....	\$/tonne	133.96	95.70	40.0
Euro-3 .....	\$/tonne	127.89	86.39	48.0
Euro-4 .....	\$/tonne	114.54	78.11	46.6
Euro-5 .....	\$/tonne	108.06	78.11	38.3
Motor oils.....	\$/tonne	195.25	162.72	20.0
Straight-run gasoline .....	\$/tonne	251.59	211.67	18.9

**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 could 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 are 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. Certain Group companies met the legislative requirements and pay income tax as a CTG starting from the first quarter of 2012.

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.

## Three and nine months ended September 30, 2012, compared to three and nine months ended September 30, 2011

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

	3 <sup>rd</sup> quarter of		9 months of	
	2012	2011	2012	2011
	(millions of US dollars)			
<b>Revenues</b>				
Sales (including excise and export tariffs) .....	35,494	34,563	103,152	99,101
<b>Costs and other deductions</b>				
Operating expenses .....	(2,349)	(2,280)	(6,891)	(6,858)
Cost of purchased crude oil, gas and products .....	(16,343)	(15,051)	(47,127)	(43,058)
Transportation expenses .....	(1,523)	(1,604)	(4,625)	(4,677)
Selling, general and administrative expenses .....	(904)	(1,043)	(2,665)	(2,845)
Depreciation, depletion and amortization .....	(1,309)	(1,137)	(3,581)	(3,345)
Taxes other than income taxes .....	(3,309)	(3,442)	(10,248)	(9,811)
Excise and export tariffs .....	(5,591)	(6,128)	(17,258)	(16,519)
Exploration expense .....	(52)	(196)	(199)	(309)
(Loss) gain on disposals and impairments of assets .....	(29)	(11)	137	(171)
<b>Income from operating activities .....</b>	<b>4,085</b>	<b>3,671</b>	<b>10,695</b>	<b>11,508</b>
Interest expense .....	(109)	(182)	(430)	(532)
Interest and dividend income .....	62	53	194	144
Equity share in income of affiliates .....	64	168	408	510
Currency translation loss .....	(97)	(154)	(493)	(312)
Other non-operating income (expense) .....	41	(48)	(26)	287
<b>Income before income taxes .....</b>	<b>4,046</b>	<b>3,508</b>	<b>10,348</b>	<b>11,605</b>
Current income taxes .....	(613)	(1,091)	(2,205)	(2,071)
Deferred income taxes .....	37	(27)	89	(500)
<b>Total income tax expense .....</b>	<b>(576)</b>	<b>(1,118)</b>	<b>(2,116)</b>	<b>(2,571)</b>
<b>Net income .....</b>	<b>3,470</b>	<b>2,390</b>	<b>8,232</b>	<b>9,034</b>
Net loss (income) attributable to noncontrolling interests .....	39	(146)	84	(22)
<b>Net income attributable to OAO LUKOIL .....</b>	<b>3,509</b>	<b>2,244</b>	<b>8,316</b>	<b>9,012</b>
Earning per share of common stock attributable to OAO LUKOIL (in US dollars):				
Basic .....	4.65	2.88	10.91	11.55
Diluted .....	4.55	2.83	10.68	11.31

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

## Sales revenues

Sales breakdown	3 <sup>rd</sup> quarter of		9 months of	
	2012	2011	2012	2011
	(millions of US dollars)			
Crude oil				
Export and sales on international markets other than CIS .....	6,265	8,056	18,948	21,827
Export and sales to CIS.....	395	654	1,243	1,885
Domestic sales .....	446	366	1,093	1,209
	<b>7,106</b>	<b>9,076</b>	<b>21,284</b>	<b>24,921</b>
Refined products				
Export and sales on international markets				
Wholesale.....	19,075	16,160	55,957	48,426
Retail.....	2,867	3,055	7,973	8,489
Domestic sales				
Wholesale.....	2,303	2,033	5,854	5,530
Retail.....	2,249	2,324	6,276	5,694
	<b>26,494</b>	<b>23,572</b>	<b>76,060</b>	<b>68,139</b>
Petrochemicals				
Export and sales on international markets .....	232	277	776	849
Domestic sales .....	73	241	191	744
	<b>305</b>	<b>518</b>	<b>967</b>	<b>1,593</b>
Gas and gas products				
Export and sales on international markets .....	565	475	1,781	1,356
Domestic sales .....	276	261	789	732
	<b>841</b>	<b>736</b>	<b>2,570</b>	<b>2,088</b>
Sales of energy and related services.....	<b>296</b>	<b>229</b>	<b>983</b>	<b>1,137</b>
Other				
Sales on international markets .....	238	243	659	666
Domestic sales .....	214	189	629	557
	<b>452</b>	<b>432</b>	<b>1,288</b>	<b>1,223</b>
<b>Total sales .....</b>	<b>35,494</b>	<b>34,563</b>	<b>103,152</b>	<b>99,101</b>

Sales volumes	3 <sup>rd</sup> quarter of		9 months of	
	2012	2011	2012	2011
Crude oil	(thousands of barrels)			
Export and sales on international markets other than CIS .....	57,745	71,871	172,306	199,743
Export and sales to CIS.....	7,103	12,608	23,903	35,507
Domestic sales .....	8,356	7,858	21,763	25,047
	<b>73,204</b>	<b>92,337</b>	<b>217,972</b>	<b>260,297</b>
Crude oil	(thousands of tonnes)			
Export and sales on international markets other than CIS .....	7,878	9,805	23,507	27,250
Export and sales to CIS.....	969	1,720	3,261	4,844
Domestic sales .....	1,140	1,072	2,969	3,417
	<b>9,987</b>	<b>12,597</b>	<b>29,737</b>	<b>35,511</b>
Refined products	(thousands of tonnes)			
Export and sales on international markets				
Wholesale.....	21,541	18,859	63,304	56,926
Retail.....	1,765	1,840	4,908	5,181
Domestic sales				
Wholesale.....	3,333	3,073	8,505	8,331
Retail.....	2,338	2,364	6,463	5,971
	<b>28,977</b>	<b>26,136</b>	<b>83,180</b>	<b>76,409</b>
<b>Total sales volume of crude oil and refined products.....</b>	<b>38,964</b>	<b>38,733</b>	<b>112,917</b>	<b>111,920</b>

Realized average sales prices	3 <sup>rd</sup> quarter of		9 months of		
	2012	2011	2012	2011	
Average realized price international					
Oil (excluding CIS) .....	(\$/barrel)	108.52	112.09	109.97	109.28
Oil (CIS) .....	(\$/barrel)	55.49	51.96	51.99	53.10
Refined products					
Wholesale .....	(\$/tonne)	885.54	856.90	883.94	850.69
Retail.....	(\$/tonne)	1,624.55	1,660.38	1,624.60	1,638.55
Average realized price within Russia					
Oil.....	(\$/barrel)	53.32	46.67	50.21	48.28
Refined products					
Wholesale .....	(\$/tonne)	690.96	661.60	688.25	663.73
Retail.....	(\$/tonne)	962.37	982.81	971.17	953.57

During the third quarter of 2012, our revenues increased by \$931 million, or by 2.7%, compared to the same period of 2011, crude oil sales decreased by \$1,970 million, or by 21.7%, refined products sales increased by \$2,922 million, or by 12.4%.

During the nine months of 2012, our revenues increased by \$4,051 million, or by 4.1%, compared to the same period of 2011. Our revenues from crude oil sales decreased by \$3,637 million, or by 14.6%. Our revenues from sales of refined products increased by \$7,921 million, or by 11.6%.

#### *Sales of crude oil*

Compared to the respective periods of 2011, our total crude oil sales revenues decreased by \$1,970 million, or by 21.7%, in the third quarter of 2012 as a result of the decrease in sales volumes and prices and by \$3,637 million, or by 14.6%, in the nine months of 2012 as a result of decreased sales volumes.

Our sales volumes decreased by 20.7%, or by 2,610 thousand tonnes, in the third quarter of 2012 and by 16.3%, or by 5,774 thousand tonnes, in the nine months of 2012, because of lower scale of trading operations and decrease in production.

During the third quarter and the nine months of 2012, our revenue from crude oil export from Russia both to the Group companies and third parties amounted to \$6,504 million and \$19,696 million, respectively.

#### *Sales of refined products*

Compared to the same periods of 2011, our revenue from the wholesale of refined products outside of Russia increased by \$2,915 million, or by 18.0%, in the third quarter of 2012 as a result of an increase in sales volumes by 14.2% and prices by 3.3%, and increased by \$7,531 million, or by 15.6%, in the nine months of 2012 due to an increase in sales volumes by 11.2% and prices by 3.9%.

Our revenue from international retail sales decreased by \$188 million, or by 6.2%, in the third quarter of 2012 and by \$516 million, or by 6.1%, in the nine months of 2012 due to a decrease in average prices by 2.2% and sales volumes by 4.1% in the third quarter of 2012, and due to a decrease in sales volumes by 5.3% in the nine months of 2012. Retail sales volumes decreased by 75 thousand tonnes in the third quarter of 2012 and by 273 thousand tonnes in the nine months of 2012, mainly as a result of restructuring of our retail network in the USA.

Our revenue from the wholesale of refined products on the domestic market increased by \$270 million, or by 13.3%, in the third quarter of 2012 and increased by \$324 million, or by 5.9%, in the nine months of 2012. Our average realized price increased by 4.4% and by 3.7%, respectively. Our sales volumes also increased by 8.5% in the third quarter of 2012 and by 2.1% in the nine months of 2012.

Our revenue from retail sales in Russia decreased by \$75 million, or by 3.2%, in the third quarter of 2012 and increased by \$582 million, or by 10.2%, in the nine months of 2012. Domestic retail sales volumes decreased by 1.1% in the third quarter of 2012 and increased by 8.2% in the nine months of 2012 resulting from the increase in domestic demand for motor fuels. Average retail prices in Russia decreased by 2.1%, compared to the third quarter of 2011, and increased by 1.8%, compared to the nine months of 2011.

In the third quarter and the nine months of 2012, our revenue from export of refined products from Russia both to Group companies and third parties amounted to \$3,906 million and \$12,695 million, respectively.

### *Sales of petrochemical products*

In the third quarter of 2012, our revenue from sales of petrochemical products decreased by \$213 million, or by 41.1%, and in the nine months of 2012, our revenue decreased by \$626 million, or by 39.3%, mainly as a consequence of a fire on our petrochemical plant in Stavropol, Russia in December 2011. Domestic sales volumes dropped by 71.1% in the third quarter of 2012 and by 73.9% in the nine months of 2012. International sales volumes decreased by 15.2% in the third quarter and by 3.1% the nine months of 2012. The decrease of international sales was due to maintenance works at our petrochemical plant Karpatnaftochim Ltd. in Ukraine. Our international realized prices decreased by 0.6% in the third quarter of 2012 and by 4.7% in the nine months of 2012.

### *Sales of gas and gas products*

Sales of gas and gas refined products increased by \$105 million, or by 14.3%, in the third quarter of 2012 and by \$482 million, or by 23.1%, in the nine months of 2012.

Gas products wholesales revenue decreased by \$16 million, or by 5.0% in the third quarter of 2012 and increased by \$101 million, or by 11.5%, in the nine months of 2012. Average realized wholesale prices for gas products decreased by 15.6% in the third quarter of 2012 and by 5.4% in the nine months of 2012, while sales volumes increased by 12.5% and 17.8%, respectively.

Retail gas products revenue remained flat to the third quarter of 2011 and decreased by \$11 million, or by 2.4%, compared to the nine months of 2011 because of price factor.

Natural gas sales revenue increased by \$101 million, or by 51.7%, in the third quarter of 2012 and by \$348 million, or by 57.6%, in the nine months of 2012. This revenue increased both domestically and internationally. At the domestic market, this was mainly a result of the increase of sales price to Gazprom by 30.8%. The main reason for the rise of revenue outside of Russia was the increase of both sales volumes and prices in Uzbekistan.

### *Domestic sales of energy and related services*

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

Our revenue from sales of electricity, heat and related services increased by \$67 million, or by 29.3%, in the third quarter of 2012 and decreased by \$154 million, or by 13.5%, in the nine months of 2012. These changes in revenue were a result of changes in volume of resale operations as a result of alteration of scheme of electricity supplies to our subsidiaries.

### *Sales of other products*

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

In the third quarter of 2012, other sales increased by \$20 million, or by 4.6%, and in the nine months of 2012, other sales increased by \$65 million, or by 5.3%. Other sales include \$22 million of ISAB refining services revenue for September 2012.

## **Operating expenses**

Operating expenses include the following:

	3 <sup>rd</sup> quarter of		9 months of	
	2012	2011	2012	2011
	(millions of US dollars)			
Hydrocarbon extraction expenses .....	971	955	2,821	2,842
Own refining expenses .....	430	375	1,108	1,048
Refining expenses at third parties and affiliated refineries.....	194	228	720	655
Cost of processing operations at ISAB.....	16	–	16	–
Expenses for crude oil transportation to refineries .....	325	267	914	807
Power generation and distribution expenses .....	146	108	463	477
Petrochemical expenses .....	72	89	230	250
Other operating expenses .....	195	258	619	779
<b>Total operating expenses .....</b>	<b>2,349</b>	<b>2,280</b>	<b>6,891</b>	<b>6,858</b>

The method of allocation of operating expenses above differs from the approach used in preparing the data for Note 20 “Segment information” to our interim 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.

Our operating expenses increased by \$69 million, or by 3.0%, in the third quarter of 2012 and by \$33 million, or by 0.5%, in the nine months of 2012.

#### *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, cost of extraction of natural gas liquids, property insurance of extraction equipment and other similar costs.

In the third quarter of 2012, our extraction expenses increased by \$16 million, or by 1.7%, and in the nine months of 2012, our extraction expenses decreased by \$21 million, or by 0.7%. Increase in labor costs, repairs and artificial stimulation of reservoirs was compensated for by devaluation of ruble against the US dollar. Our average hydrocarbon extraction expenses remained at the same level of \$5.05 per BOE as in the third quarter of 2011, but decreased from \$4.99 per BOE in the nine months of 2011 to \$4.92 per BOE the nine months of 2012, or by 1.4%.

#### *Own refining expense*

Our own refining expenses increased by \$55 million, or by 14.7%, in the third quarter of 2012, and by \$60 million, or by 5.7%, in the nine months of 2011.

Refining expenses at our domestic refineries remained nearly flat to the third quarter of 2011, and in the nine months of 2012 increased by \$17 million, or by 2.1%. The increase of expenses due to higher consumption and cost of additives was compensated for by the ruble devaluation and lower energy cost.

Refining expenses at our international refineries increased by 76.5%, or by \$52 million, in the third quarter of 2012 and by 18.9%, or by \$43 million, in the nine months of 2012. The increase was mainly due to obtaining control over ISAB in September 2012 (see *Refining, marketing and trading* section for details).

#### *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.

In the third quarter and the nine months of 2012, refining expenses at third party and affiliated refineries decreased by 14.9% and increased by 9.9%, respectively. The decrease to the third quarter of 2011 was due to obtaining control over ISAB in September 2012 (see *Refining, marketing and trading* section for details). The increase compared to the nine months of 2011 was due to crude oil processing at third party refineries in Belorussia since the beginning of 2012.

#### *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.

In the third quarter of 2012, expenses for crude oil transportation to refineries increased by \$58 million, or by 21.7%, while in the nine months of 2012 they increased by \$107 million, or by 13.3%. The increase was largely due to supplies of our crude oil to the refineries in Belorussia, where we commenced crude oil processing in the first quarter of 2012.

#### *Petrochemical expenses*

In the third quarter of 2012, operating expenses of our petrochemical plants decreased by \$17 million, or by 19.1%, compared to the third quarter of 2011, and in the nine months of 2012, these expenses decreased by \$20 million, or by 8.0%, compared to the nine months of 2011. Despite the sharp decrease in production as a result of the fire that destroyed the ethylene production unit at our plant in Stavropol, Russia, operating expenses of the plant didn’t decrease significantly due to overhauls at other plant units. The effect of the increased production at Group’s other petrochemical plants was partially compensated by the devaluation of local currencies against the US dollar.



### *Power generation and distribution expenses*

Power generation and distribution expenses increased by \$38 million, or by 35.2%, in the third quarter of 2012 and decreased by \$14 million, or by 2.9%, in the nine months of 2012. These changes in expenses were a result of changes in volume of resale operations as a result of alteration of scheme of electricity supplies to our subsidiaries.

### *Other operating expenses*

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

In the third quarter of 2012, other operating expenses decreased by \$63 million, or by 24.4%, and in the nine months of 2012, other operating expenses decreased by \$160 million, or by 20.5%.

### **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.

Cost of purchased crude oil, gas and products increased by \$1,292 million in the third quarter of 2012, or by 8.6%, compared to the same period of 2011, and increased by \$4,069 million, or by 9.5%, in the nine months of 2012, driven by the movements in refined product prices and changes in trading volumes.

In the third quarter of 2012, we recognized a \$534 million loss from hedging, compared to a \$220 million gain in the third quarter of 2011. At the same time, in the nine months of 2012, we recognized a \$452 million loss from hedging, compared to a loss of \$422 million in the nine month of 2011.

### **Transportation expenses**

Our transportation expenses decreased by \$81 million, or by 5.0%, compared to the third quarter of 2011, and by \$52 million, or 1.1%, compared to the nine months of 2011. The decrease in 2012 was due to commencement of crude oil processing in Belorussia instead of export sales to our Belorussian customers as it was in 2011. Consequently, associated costs in 2012 were included in operating expenses (see *Expenses for crude oil transportation to refineries*). The devaluation of ruble and euro against the US dollar also contributed to the decrease in transportation expenses.

Our actual transportation expenses related to crude oil and refined products deliveries to various export destinations, weighted by volumes transported, changed to the nine months of 2011 as follows: crude oil pipeline tariffs increased by 3.1%, railway tariffs for refined products transportation decreased by 6.6%, crude oil freight rates decreased by 1.4%, and refined products freight rates decreased by 3.7%.

### **Selling, general and administrative expenses**

Selling, general and administrative expenses include 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.

Our selling, general and administrative expenses decreased by \$139 million, or by 13.3%, in the third quarter of 2012 and by \$180 million, or by 6.3%, in the nine months of 2012. In Russia, the main reason for this was the effect of the ruble devaluation on our expenses. Our expenses outside of Russia were influenced by decrease of payroll costs and selling expenses in the third quarter of 2012.

## 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 Zeeland Refinery. Starting from September 2012, we do not include the results of ISAB in equity share in income of affiliates (see *Refining, marketing and trading* section for details).

Compared to the respective periods of 2011, our share in income of affiliates decreased by \$104 million, or by 61.9%, in the third quarter of 2012 and by \$102 million, or by 20.0%, in the nine months of 2012. The main reason for this decrease was additional excess profit tax for prior periods accrued by Turgai Petroleum in the third quarter of 2012.

## Taxes other than income taxes

	3 <sup>rd</sup> quarter of		9 months of	
	2012	2011	2012	2011
	(millions of US dollars)			
<b>In Russia</b>				
Mineral extraction taxes .....	2,967	3,094	9,193	8,706
Social security taxes and contributions .....	114	112	397	410
Property tax .....	128	137	379	406
Other taxes .....	20	23	59	60
<b>Total in Russia .....</b>	<b>3,229</b>	<b>3,366</b>	<b>10,028</b>	<b>9,582</b>
<b>International</b>				
Mineral extraction taxes .....	25	28	71	73
Social security taxes and contributions .....	28	25	77	76
Property tax .....	5	5	16	29
Other taxes .....	22	18	56	51
<b>Total internationally .....</b>	<b>80</b>	<b>76</b>	<b>220</b>	<b>229</b>
<b>Total .....</b>	<b>3,309</b>	<b>3,442</b>	<b>10,248</b>	<b>9,811</b>

In the third quarter of 2012, taxes other than income taxes decreased by 3.9%, or by \$133 million, compared to the third quarter of 2011. Compared to the nine months of 2011, they increased by 4.5%, or by \$437 million. This was mainly due to growth of mineral extraction taxes in Russia driven by the increase in tax rate. At the same time, mineral extraction tax expenses in the third quarter of 2012 were lower than in the same period of 2011 due to the effect of changes of this tax included in inventory balances.

Application of decreased rate for depleted oilfields and zero rate for greenfields in the third quarter of 2012 led to \$385 million tax reduction (\$301 million in the third quarter of 2011). In the nine months of 2012, application of decreased rate for depleted oilfields led to \$1,100 million tax reduction (\$867 million in the nine months of 2011). Of these amounts, \$44 million and \$82 million refer to production from the Yu. Korchagin field on the Caspian seashore in the third quarter and nine months of 2012, respectively.

## Excise and export tariffs

	3 <sup>rd</sup> quarter of		9 months of	
	2012	2011	2012	2011
	(millions of US dollars)			
<b>In Russia</b>				
Excise tax on refined products .....	456	458	1,471	1,282
Crude oil export tariffs .....	2,713	3,302	8,883	8,630
Refined products export tariffs .....	1,318	1,337	3,996	3,738
<b>Total in Russia .....</b>	<b>4,487</b>	<b>5,097</b>	<b>14,350</b>	<b>13,650</b>
<b>International</b>				
Excise tax and sales taxes on refined products .....	918	945	2,403	2,624
Crude oil export tariffs .....	66	85	218	244
Refined products export tariffs .....	120	1	287	1
<b>Total internationally .....</b>	<b>1,104</b>	<b>1,031</b>	<b>2,908</b>	<b>2,869</b>
<b>Total .....</b>	<b>5,591</b>	<b>6,128</b>	<b>17,258</b>	<b>16,519</b>

Export tariffs decreased by \$508 million, or by 10.8%, in the third quarter of 2012 and increased by \$771 million, or by 6.1%, in the nine months of 2012.

Export duty rate for crude oil and refined products in Russia depends on the international Urals blend price. As the rate is set monthly based on crude oil price for preceding one-month period, that results in a one-month gap between changes in crude oil price and the rate. Thus, in the third quarter of 2012, the rates decreased while crude oil prices had already turned upwards. Compared to the second quarter of 2012, Urals blend price increased by 2.2%, and crude oil export duty rate decreased by 17.3%.

The decrease in excise tax expense outside of Russia to the respective periods of 2011 was a result of lower volume of sales subject to excises as well as of the devaluation of euro and local currencies against the US dollar. In Russia, the increase of excise expense to the nine months of 2011 was driven mainly by the growth of excise rates.

Although the excise rates for motor fuels except for Euro-5 gasoline increased compared to the third quarter of 2011, the increase of the share of Euro-5 motor fuels in our production in Russia let us keep our excise expenses in the third quarter of 2012 on the same level as in the respective period of 2011. In the third quarter of 2012, all the gasoline produced by the Group in Russia was compliant with Euro-5 ecological class, while in the third quarter of 2011 the share of Euro-5 gasoline was insignificant.

### **Exploration expenses**

Our exploration expenses decreased by \$144 million, or by 73.5%, during the third quarter of 2012 and by \$110 million, or by 35.6%, during the nine months of 2012. Dry hole costs amounted to \$3 million in the third quarter of 2012 and \$90 million in the nine months of 2012. In the third quarter and the nine months of 2011, dry hole costs amounted to \$165 million and \$215 million, respectively.

There were no sizeable write-offs in the third quarter of 2012. In the second quarter of 2012, we charged to expense the cost of an exploratory well in Volga region of Russia totaling \$50 million.

In the first half of 2011, we charged to expense the cost of an exploratory well in the Komi Republic of Russia in the amount of \$28 million and in Kazakhstan in the amount of \$17 million, and in the third quarter of 2011, we charged to expense \$161 million of costs related to two exploratory wells in Ghana.

### **Gain (loss) on disposals and impairments of assets**

In the second quarter of 2012, the Group recognized a gain of \$178 million from sale of 10% of its share in KPO to a state-owned KazMunayGaz. The tax effect of the deal amounted to \$148 million of the income tax expense.

### **Other non-operating (expense) income**

In the third quarter of 2012, the Group recognized a \$73 million gain on preliminary revaluation of our share in ISAB within the acquisition of additional 20% share in September 2012.

Other non-operating income included the effect of the recalculation of the extraction tax incentive by certain Group companies for prior periods in total amount of \$433 million in the first half of 2011.

### **Income taxes**

In the third quarter of 2012, our total income tax expense decreased by \$542 million, or by 48.5%, compared to the third quarter of 2011. At the same time, our income before income tax increased by \$538 million, or by 15.3%.

In the nine months of 2012, our total income tax expense decreased by \$455 million, or by 17.7%, compared to the nine months of 2011, while our income before income tax decreased by \$1,257 million, or by 10.8%.

In the third quarter of 2012, our effective income tax rate was 14.2%, compared to 31.9% in the third quarter of 2011. The maximum statutory rate in Russia is 20%. The deviations of the effective income tax rates from the maximum statutory rate were mainly due to currency translation losses and gains reported by Russian subsidiaries, that decreased and increased taxable income in the respective periods.

In the nine months of 2012, our effective income tax rate was 20.4%, compared to 22.2% in the nine months of 2011.

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

	3 <sup>rd</sup> quarter of		9 months of	
	2012	2011	2012	2011
	(millions of US dollars)			
<b>Net income</b> .....	<b>3,509</b>	<b>2,244</b>	<b>8,316</b>	<b>9,012</b>
Add back:				
Income tax expense.....	576	1,118	2,116	2,571
Depreciation and amortization .....	1,309	1,137	3,581	3,345
Interest expense.....	109	182	430	532
Interest and dividend income .....	(62)	(53)	(194)	(144)
<b>EBITDA</b> .....	<b>5,441</b>	<b>4,628</b>	<b>14,249</b>	<b>15,316</b>

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

	9 months of	
	2012	2011
	(millions of US dollars)	
Net cash provided by operating activities.....	12,861	13,299
Net cash used in investing activities.....	(8,472)	(7,620)
Net cash used in financing activities.....	(4,755)	(3,398)

### Operating activities

Our primary source of cash flow is funds generated from our operations. During the nine months of 2012, cash generated from operating activities was \$12,861 million, which is 3.3% less than in the same period of 2011. At the same time, our cash flow from operating activity was supported by a decrease in working capital by \$685 million, compared to January 1, 2012.

The decrease in working capital was mainly caused by:

- \$461 million net decrease in trade accounts receivable and payable
- \$108 million net decrease in VAT accounts receivable and payable
- \$511 million net decrease in taxes receivable and payable
- \$317 million net decrease in other assets and liabilities

At the same time, this was partially offset by a \$712 million increase in inventories.

### Investing activities

In the nine months of 2012, the Group acquired additional 20% share in ISAB for approximately \$609 million.

In the nine months of 2011, we made an advance payment of \$1,778 million for expected acquisitions of certain upstream assets. In the second quarter of 2012, \$1,760 million from this amount was used for purchase of equity linked notes. Also, in the nine months of 2011, we paid \$342 million for 11% share in ISAB.

Capital expenditures increased by \$2,480 million, or by 44.4%, compared to the nine months of 2011.

### Financing activities

In the nine months of 2012, net movements of short-term and long-term debt generated an outflow of \$1,375 million, compared to an outflow of \$1,393 million in the nine months of 2011.

In the first quarter of 2012, we purchased Company's stock worth \$128 million and in the second quarter of 2012, we spent \$740 million for purchase of equity-linked notes.

## Analysis of capital expenditures

	3 <sup>rd</sup> quarter of		9 months of	
	2012	2011	2012	2011
	(millions of US dollars)			
<b>Capital expenditures<sup>(1)</sup></b>				
Exploration and production				
Russia.....	1,581	1,146	5,100	3,581
International.....	443	419	1,239	908
Total exploration and production.....	2,024	1,565	6,339	4,489
Refining, marketing and distribution				
Russia.....	411	293	857	667
International.....	95	61	390	185
Total refining, marketing and distribution.....	506	354	1,247	852
Chemicals				
Russia.....	24	14	47	33
International.....	5	7	16	16
Total chemicals.....	29	21	63	49
Power generation and distribution.....	88	39	312	117
Other.....	80	55	179	141
<b>Total capital expenditures.....</b>	<b>2,727</b>	<b>2,034</b>	<b>8,140</b>	<b>5,648</b>
<b>Acquisitions of subsidiaries and associates<sup>(2)</sup></b>				
Exploration and production				
Russia.....	–	–	52	18
International.....	–	–	22	1,760
Total exploration and production.....	–	–	74	1,778
Refining, marketing and distribution				
Russia.....	–	–	22	10
International.....	610	–	645	342
Total refining, marketing and distribution.....	610	–	667	352
Power generation and distribution.....	–	–	–	–
Other.....	–	–	–	–
Less cash acquired.....	(3)	–	(19)	–
<b>Total acquisitions.....</b>	<b>607</b>	<b>–</b>	<b>722</b>	<b>2,130</b>

<sup>(1)</sup> Including non-cash transactions and prepayments.

<sup>(2)</sup> Including prepayments related to acquisitions and non-cash transactions.

Our capital expenditures, including non-cash transactions, amounted to \$8,140 million, which is 44.1% more than in the nine months of 2011.

Capital expenditures in exploration and production segment increased by \$1,850 million, or by 41.2%. In Russia, the rise was due to development of the V. Filanovsky oilfield on the Caspian seashore and increased production drilling in Western Siberia. Internationally, we increased investments in developing our projects in Iraq and Uzbekistan.

The increase in our refining, marketing and distribution capital expenditures outside of Russia was mainly due to construction of a heavy residue processing complex at our Bulgarian refinery. In Russia, we invested in construction of catalytic cracking unit and in extension of reservoir park at our Nizhny Novgorod refinery.

Capital expenditures in power generation sector increased as a result of fulfilling of our investment program, namely construction of 235 MW combined cycle gas turbine in Astrakhan with a completion scheduled for the third quarter of 2013.

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

	3 <sup>rd</sup> quarter of		9 months of	
	2012	2011	2012	2011
	(millions of US dollars)			
Yamal.....	85	64	402	260
Caspian region <sup>(1)</sup> .....	251	106	1,080	325
Ghana.....	4	130	13	177
Cote d'Ivoire.....	9	16	33	28
Iraq.....	233	53	604	128
Uzbekistan.....	89	91	335	293
<b>Total.....</b>	<b>671</b>	<b>460</b>	<b>2,467</b>	<b>1,211</b>

<sup>(1)</sup> Russian and international projects.