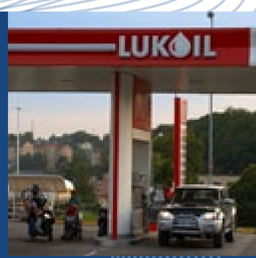
# LUKOIL

ANNUAL REPORT

# 2008




always moving forward

# Address to shareholders

Dear Shareholders,

LUKOIL had a challenging year in 2008. Oil price growth in the first half of the year was unprecedented by duration and scale, but was followed by a collapse of prices in the second half. Despite this, LUKOIL achieved strong financial indicators and high levels of operating efficiency, increasing production and refining of hydrocarbons. The second half of the year and the beginning of 2009 presented another test of strength for the Company. Once again, LUKOIL has responded well and is meeting the new challenges successfully.

Net income of the Company in the reporting year was $9,144 million, and return on average capital employed was 17.4%. Free cash flow was at a record level of $3,775 million, which is a considerable achievement in view of large capital expenditures by the Company during the year to support production at mature fields and develop new fields, implement a program of refinery modernization, expand the filling station network, and broaden the scale of its operations.

**Valery GRAYFER**
Chairman of the Board of Directors of LUKOIL

Despite unfavourable economic conditions in the second half of the year and the crisis on oil markets, accrued operating and investment potential enabled the Company to pursue implementation of its development strategy. LUKOIL does not intend to interrupt its investment cycle and is launching key projects, which will ensure consistent and rapid development of the Company and increase of its shareholder value in the future. In 2008 LUKOIL began production at the Yuzhnaya Khylchuya field, one of the largest in Timan-Pechora, and continued rapid expansion of refining capacities and filling stations network.

The average price for Urals during the reporting year was 37% higher than in 2007 at $94.8 per barrel, despite the price collapse in the second half of the year. Refining margins in Russia were also at a high level, which had a favourable effect on profitability of our refineries. Thus, price environment had a positive impact on Company business results in 2008 as a whole.

A positive factor in the second half of 2008 was reduction in the tax burden on oil companies in Russia. The base price for calculation of mineral extraction tax was increased and a number of remissions on that tax were introduced effective from 2009. The method of calculation of export tariffs was changed at the end of 2008, and further tax remissions are also being discussed. These introductions will have substantial positive impact on the Company's operating cash flow and will create an additional incentive for investment in promising projects.

The Company also had to face a number of challenges in 2008. As well as the unprecedented fall in oil prices, there was a major increase of financing costs in the course of the year. However, a well-designed financial policy ensures that LUKOIL's financial position remains strong, and the Company has no difficulties with debt repayment and financing its activities from available sources of capital.

In the Exploration & Production segment the Company made every effort to raise levels of highly profitable production in new regions and to keep production levels steady in traditional regions. LUKOIL also remained dedicated to its strategic goal of growing the resource base to achieve consistent long-term growth.

Appraisal of hydrocarbon reserves in 2008 was in a context of dramatic downturn on global commodities markets. Significant decline of oil prices resulted in reclassification of a part of reserves from "proved reserves" to "resources". However, these reserves were not scheduled for development in the near future and their reclassification does not affect current plans of the Company. LUKOIL expects most of the declassified reserves to return to the "proved" category when prices for oil recover.

LUKOIL achieved growth of hydrocarbon production in 2008 despite difficulty of maintaining stable production levels in traditional regions. This was made possible by investments in development, which the Company had carried out earlier. Average daily production of marketable hydrocarbons by the Group increased by almost 1% in 2008 to 2.19 million boe. In particular, the Company increased marketable gas production as part of international projects by one and a half times, mainly thanks to the Kandym – Khauzak – Shady project in Uzbekistan.

Maintaining steady growth of production presented a tough challenge for the Company in 2008. However commissioning of the Yuzhnaya Khylchuya field, which is the Group's biggest field in Timan-Pechora, enabled substantial compensation of natural decline of oil production in Western Siberia. Launch of production at the Yuzhnaya Khylchuya field was a major event for the Company and marked a new stage in cooperation with our American partner, ConocoPhillips, which has a 30% stake in the project. The field will approach planned production level in 2009, supporting the Company's strategic goal of increasing production in new regions.

Another important contribution to LUKOIL's hydrocarbon production growth was from gas production as part of the Kandym – Khauzak – Shady project in Uzbekistan. The Khauzak area was brought into commercial production in November 2007 and reached planned levels of production in the reporting year. The Company also continued rapid development of other projects in the international E&P segment. In particular, the Group acquired SNG Holdings Ltd., which owns 100% of the PSA for fields in South-West Gissar and Ustyurt region in the Republic of Uzbekistan. LUKOIL also signed an agreement with PDVSA for joint study of the Junin-3 block in Venezuela. Overall hydrocarbon production in international projects rose by nearly a quarter in 2008, despite the sale of a 50% stake in Caspian Investments Resources Ltd. in April 2007.

**Vagit ALEKPEROV**
President of LUKOIL

We are confident that LUKOIL will be able to increase production of hydrocarbons in the future thanks to its strong resource potential, rapid development of production in new regions, and implementation of the Company's gas program unless other price shocks occur.

Company efforts in the Refining & Marketing segment were focused mainly on modernization of capacities, increase in refinery throughputs, improvements in product quality and industrial safety, optimization of logistics and development of the marketing network. Total refinery throughputs at Group refineries and at the ISAB refining complex rose by nearly 8% to a record level of 56.3 million tonnes.

The main event in the Refining & Marketing segment in 2008 was creation, together with ERG S.p.A., of a joint venture to manage the ISAB refining complex in Italy. LUKOIL's stake in the JV is 49% and may be increased in the future. ISAB is a large, high-tech oil refining complex with daily refining capacity of 320,000 barrels (16 million tonnes per year) and Nelson Complexity Index of 9.3. Participation in the joint venture will create a synergy effect for the Group through deliveries of oil for refining and sale of petroleum products on European markets.

The Company continued rapid modernization of its refineries in Russia and abroad in order to raise refining efficiency and product quality. The Odessa Refinery was recommissioned after completion of a three-year modernization. Ongoing modernization of refineries increased the share of high-octane gasoline in total gasoline production to over 90% and the share of environmentally friendly diesel fuel in total diesel output approached 70%. The Company also increased output of motor fuels, which meet European environmental standards.

LUKOIL significantly expanded its marketing network in 2008, helping to bring Company products to end-users worldwide. LUKOIL acquired the company Akpet, which operates nearly 700 filling stations in Turkey. A number of Russian filling station networks were also acquired. The Company's retail network was expanded by nearly 11% in the course of the year and we placed special emphasis on efficiency of the marketing business and optimization of the filling station network. Average daily sales per filling station were 7.3 tonnes.

A new business sector – Power Generation – was added to the Company structure in 2008. LUKOIL's core asset in the new sector is UGK TGK-8 (TGK-8), which owns power stations in Astrakhan, Volgograd and Rostov regions, Krasnodar and Stavropol territories, and the Republic of Dagestan, with overall capacity of 3.6 GW. Acquisition of TGK-8 should ensure efficient prices for the Company's gas as well as major synergy effect from uninterrupted deliveries of natural gas to TGK-8 from LUKOIL fields located in the Northern Caspian and Astrakhan Region.

LUKOIL has put emphasis on social responsibility over many years. We give top priority to people's health and quality of life, prevention of negative impact on the environment and sustainable use of natural resources. LUKOIL successfully completed its Program of Environmental Protection for the period of 2004–2008, which included more than 300 environmental protection measures at a total cost of about $1.2 billion. We have also developed an environmental program for the period from 2009 to 2013.

We recognize primary importance and value of our employees, whose work and professionalism play a major role in enabling the Company to look into the future with confidence, despite the current difficult situation in the world economy. We therefore continue to pursue a responsible personnel policy in all our operating spheres.

Despite global economic difficulties and low price levels on oil markets, the Company continues to fulfil its commitment to shareholders of maintaining dividend payment levels no lower than 15% of net income. On April 23, 2009 the Board of Directors recommended the General Meeting of Shareholders to approve dividends of 50 roubles ($1.5 as of the date of the Board of Directors meeting) per share for 2008, which is 19% more than for 2007. Dividend yield will be at its highest level in the last 4 years at 2.8%.

The Company share price declined by 63.2% in 2008 due to the crisis on world financial markets. However, the price of Company shares fell less than key Russian market indices. Market value of Company shares has now returned to its 2005 level and that is not an adequate reflection of LUKOIL's shareholder value, which increased in recent years, thanks not only to oil price rises but also to improvements in efficiency of the Company business. We believe that the market will reassess Company value more fairly after the acute stage of the world economic crisis has been overcome.

The Group is taking effective measures in 2009 to maintain positive cash flow and shareholder value, despite the negative environment on international markets. Rouble depreciation will have favourable impact on our cash flows in 2009, since most of Company spending is in Russia, while a significant part of revenues is nominated in foreign currencies. LUKOIL has designed and is implementing a range of measures to raise business efficiency, optimize cooperation with suppliers and sub-contractors, reduce and optimize capital expenditures and operating costs, and improve financial discipline. The Company's financial situation remains strong thanks to a low credit burden and successful capital management policy. We are also maintaining full financing of new projects, which will provide medium-term production growth. We are planning to launch production at the Yu. Korchagin field in the Northern Caspian as early as in 2009. Our goal this year is to secure a steady rate of Company development while maintaining stability and ensuring positive cash flows in any oil price scenario.

We believe that, with the support of its shareholders, LUKOIL will rise confidently above the period of crisis in the world economy, achieving sustainable growth and will continue to excel in the future increasing its shareholder value.

Chairman of the Board of Directors of LUKOIL — Valery Grayfer

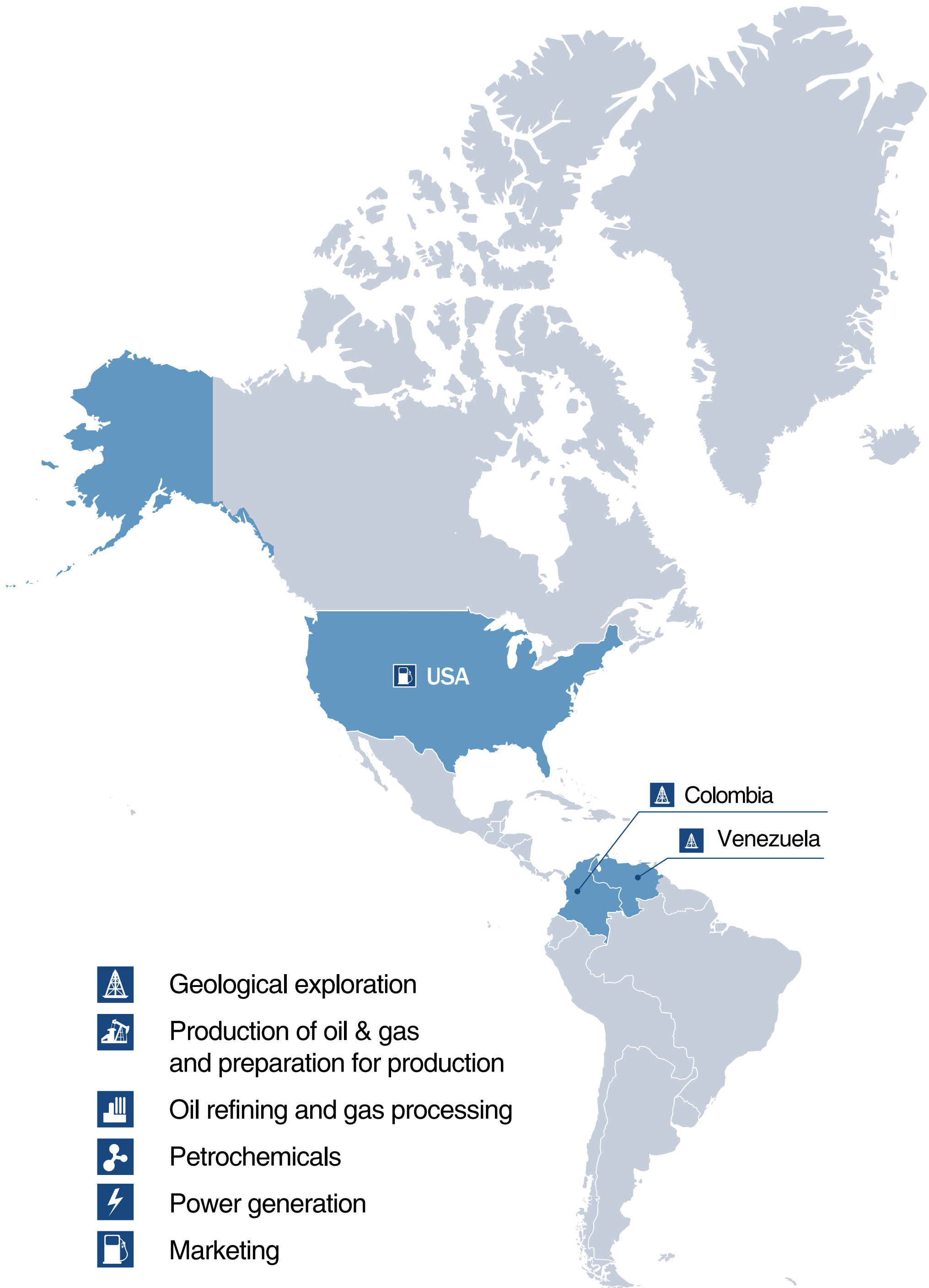
President of LUKOIL — Vagit Alekperov

# Main Operating and Financial Indicators

| | 2008 | 2007 | Growth, % |
|---|---|---|---|
| **Main financial indicators** | | | |
| Sales, $ million | 107,680 | 81,891 | +31.5% |
| EBITDA, $ million | 15,552 | 15,388 | +1.1% |
| Operating income, $ million | 13,709 | 13,071 | +4.9% |
| Income before income taxes, $ million | 12,366 | 13,018 | -5.0% |
| Net income, $ million | 9,144 | 9,511 | -3.9% |
| Basic EPS, $ | 10.88 | 11.48 | -5.2% |
| ROACE, % | 17.4 | 22.2 | |
| Capital expenditures, $ million | 10,589 | 9,372 | +13.0% |
| Investments (acquisition of subsidiaries and minority stakes), $ million | 5,398 | 1,566 | +244.7% |
| Share price (end of year), $ | 32.00 | 87.00 | -63.2% |
| Dividend per share, roubles | 50 | 42 | +19.0% |
| **Main operating indicators** | | | |
| Oil reserves, million barrels | 14,458 | 15,715 | -8.0% |
| Gas reserves, billion cubic feet | 29,253 | 27,921 | +4.8% |
| Hydrocarbon reserves, million boe | 19,334 | 20,369 | -5.1% |
| Crude oil production, million barrels | 702.9 | 713.0 | -1.4% |
| Production of marketable natural gas, million cubic meters | 12,671 | 9,652 | +31.3% |
| Production of marketable associated gas, million cubic meters | 4,349 | 4,303 | +1.1% |
| Production of marketable hydrocarbons, thousand boe per day | 2,194 | 2,178 | +0.7% |
| Throughputs at own refineries and at ISAB, million tonnes | 56.28 | 52.16 | +7.9% |
| Throughputs at third-party refineries, million tonnes | 5.48 | 4.61 | +18.9% |
| Gas processing, million cubic meters | 3,249 | 3,317 | -2.1% |
| Production of petrochemicals, million tonnes | 1.46 | 2.04 | -28.4% |
| Crude oil exports, million tonnes | 39.30 | 42.15 | -6.8% |
| Petroleum product exports, million tonnes | 25.8 | 25.1 | +2.6% |
| Crude oil sales, million tonnes | 39.54 | 41.01 | -3.6% |
| Wholesale sales of petroleum products, million tonnes | 80.98 | 78.10 | +3.7% |
| Retail sales of petroleum products, million tonnes | 14.16 | 12.76 | +11.0% |
| Number of filling stations (owned, leased and franchises) | 6,748 | 6,090 | +10.8% |
| Average number of employees, thousand | 152.5 | 151.4 | +0.7% |

Hydrocarbon reserves and production data include Group share in equity affiliates.

## LUKOIL is One of the Major International Vertically Integrated Energy Companies




Geological exploration

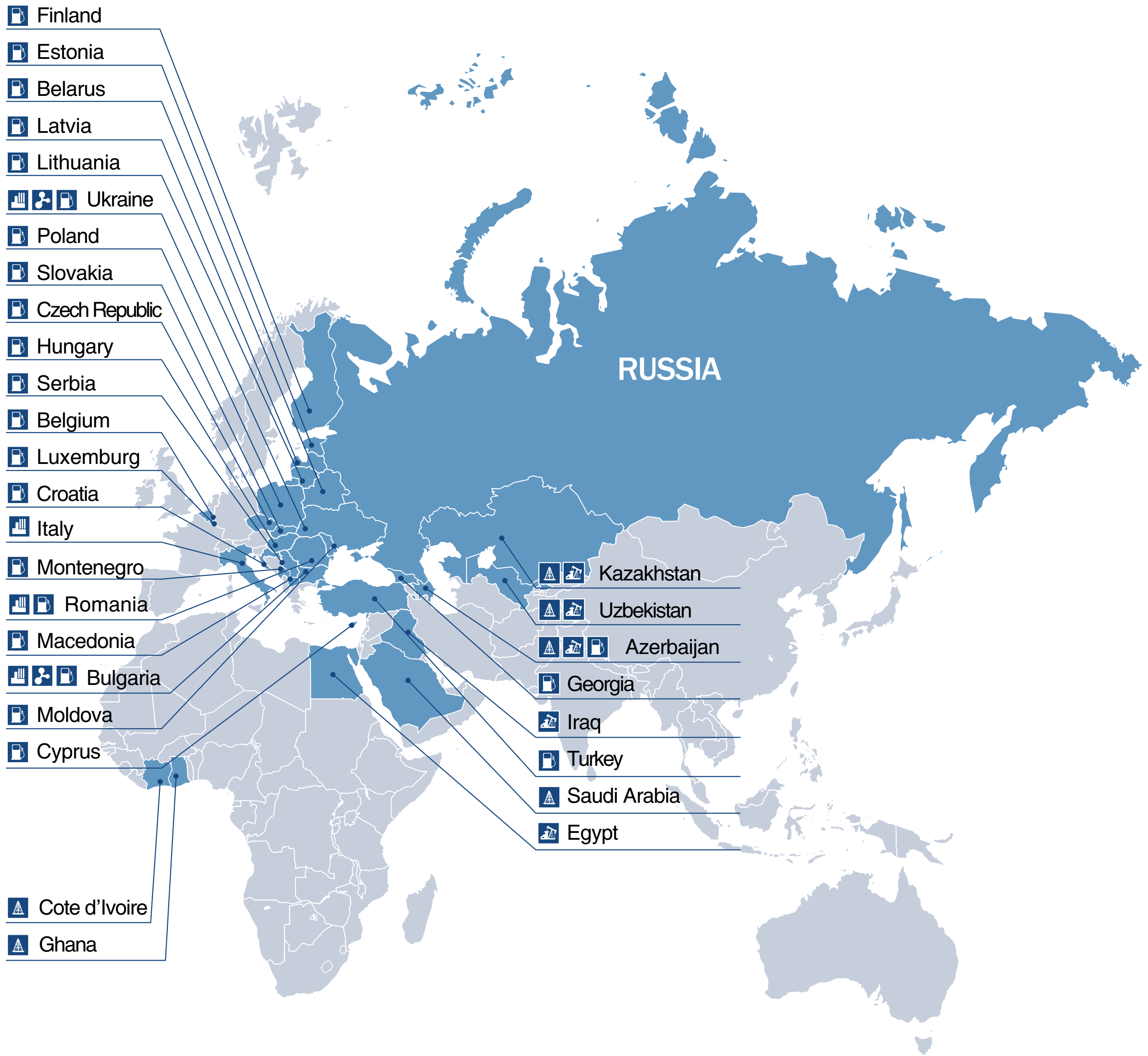
Production of oil & gas and preparation for production

Oil refining and gas processing

Petrochemicals

Power generation

Marketing



# Events in 2008

## January

LUKOIL signs a five-year agreement on strategic cooperation with Severstal-Auto. Provisions of the agreement include supply of LUKOIL branded oils & lubricants to plants of Severstal-Auto for upkeep of machinery, first filling of new automobiles and after-sales service. The parties also intend to work together on development of new oils & lubricants and other petroleum products and products of gas processing.

## March

LUKOIL Group signs an agreement for acquisition of 64.31% of UGK TGK-8 (TGK-8) for $2.1 billion. The transaction was completed in May 2008. During the period from May to December 2008 the Group acquired a further stake in TGK-8 for $1.1 billion, increasing the total Group stake in the company to 95.53%. TGK-8 is one of the biggest gas consumers in the Southern Federal District of Russia with annual consumption of about 6 billion cubic meters. The company has power stations in Astrakhan, Volgograd and Rostov Regions, Krasnodar and Stavropol Territories, and the Republic of Dagestan of Russia, with total capacity of 3.6 GW. The acquisition is a part of LUKOIL's strategy for development of its power generation business.

LUKOIL Group acquires SNG Holdings Ltd., which owns 100% of the PSA for fields in South-West Gissar and Ustyurt region in the Republic of Uzbekistan. Forecast annual production at the fields is about 4 billion cubic meters of gas and more than 300,000 tonnes of oil and gas condensate. Value of the deal is $578 million (including advance payment made in 2007). The acquisition agreement envisaged two further conditional payments of $100 million each. These additional payment conditions were fulfilled during 2008 and the Group settled liabilities under the agreement in full.

## April

The Group's motor fuel brand, EKTO, wins the silver prize in the automotive category of the Brand of the Year/EFFIE 2007 awards. LUKOIL launched premium fuels for the Russian market under the EKTO brand in 2006, offering consumers motor gasoline and diesel fuel with cleansing qualities, which improve engine functioning and reduce harmful emissions. Technical features of EKTO fuels comply with Euro-3 and Euro-4 standards.

LUKOIL Group acquires 95.53% of UGK TGK-8.

LUKOIL Group recommissions the Odessa refinery after completion of an upgrade, which began in 2005. Over three years the Company rebuilt the Refinery's vacuum distillation unit, increasing its annual capacity from 2.4 to 2.8 million tonnes and the atmospheric unit was rebuilt for visbreaking. The hydrotreatment complex and various other facilities were modernized. The Refinery is now capable of producing motor gasoline to Euro-3 standards and diesel fuel to Euro-4 standards, as well as jet fuel, bitumen and liquefied gas.

LUKOIL Group recommissions the Odessa refinery after completion of an upgrade, which began in 2005.

## May

TsentrCaspneftegaz, a joint venture between LUKOIL and Gazprom, discovers a large oil, gas and condensate field at the Tsentralnaya structure in the Caspian Sea. The structure is located in Russian sector of the northern part of the Sea. The field was discovered by the first prospecting well and testing gave a commercial gushing flow of low-sulphur oil. The Agreement (and Protocol to the same Agreement) between Russia and Kazakhstan on demarcation of the seabed in the northern part of the Caspian Sea for purposes of mineral use gives the Russian Federation rights of mineral use at the Tsentralnaya structure. However, the Agreement also stipulates that, in case of discovery of commercial reserves, development is to be carried out by Russia and Kazakhstan on parity basis.

## June

LUKOIL Group commissions a stationary, ice-resistant loading sea wharf at the Varandey oil loading terminal. The terminal is located on the coast of the Barents Sea in the Nenets Autonomous District. Annual capacity at Varandey is up to 12 million tonnes of oil (240,000 barrels per day). The terminal is used for year-round deliveries of oil produced by the Company in Timan-Pechora, primarily at the Yuzhnaya Khylchuya field.

LUKOIL Group commissions a stationary, ice-resistant loading sea wharf at the Varandey oil loading terminal.

LUKOIL reaches agreement with a syndicate of international banks on provision to the Company of a $1-billion credit for settlement of the remainder of a credit taken in 2005 in order to finance purchase of Nelson Resources. The unsecured syndicated credit consists of two tranches. The first credit tranche of $300 million is for a period of three years at LIBOR +0.85% and the second $700-million tranche is for five years at LIBOR +0.95%. The new facility improves structure of the Group's debt portfolio while leaving the overall debt level almost unchanged.

LUKOIL and ERG S.p.A. sign an agreement on creation of a joint venture for management of the ISAB oil refining complex on the island of Sicily in Italy. The Company owns 49% of the new joint venture and the stake may be increased in the future. Final value of the deal is 1.45 billion euros (about $1.83 billion). The Group completed the transaction in December 2008, paying 600 million euros (about $762 million). The rest of the sum was paid ahead of schedule in February 2009. Each of the partners delivers oil for refining and sells petroleum products in accordance with its stake in the JV. ISAB consists of two oil refineries joined by a system of oil pipelines and integrated in a single operating complex with annual capacity of 16 million tonnes, as well as three sea wharfs, and a tank battery with capacity of 3.7 million cubic meters. The JV also owns a power station with capacity of 99 MW and other infrastructure facilities.

LUKOIL and ERG S.p.A. sign an agreement on creation of a joint venture for management of the ISAB oil refining complex on the island of Sicily in Italy.

The Annual General Meeting of Shareholders is held, at which the LUKOIL Annual Report for 2007 and annual financial statements are approved. Shareholders approve payment of dividends for 2007 at 42 roubles per ordinary share (compared with 38 roubles for 2006). The AGM also confirms amounts of remuneration and compensation of costs to members of the Board of Directors and Internal Audit Commission, elects members of the BoD and Internal Audit Commission, and approves transactions with interest.

## July

LUKOIL is acclaimed the best European oil & gas company for quality of investor relations by Institutional Investor magazine based on results of a survey of buy-side analysts (portfolio managers responsible for investment decisions) at 500 companies.

LUKOIL signs up to the United Nations Global Compact, which is a voluntary initiative aimed at supporting sustainable development and enhancing social responsibility on the part of business. The Global Compact is based on requirements for public accounting and transparency, as well as commitment on the part of business, trade unions and society to organization of specific joint programs for sustainable development. The Company has already issued two Sustainability Reports, using the main international standards, GRI and AA1000. The reports are for the periods of 2003–2004 and 2005–2006.

LUKOIL and National oil company of Venezuela PDVSA sign an agreement on joint study of the Junin-3 block in Venezuela. The work will be carried out in order to assess a project for production of extra heavy crude oil, refining of the crude in Venezuela and subsequent export. Spending on the study will be financed equally by the parties. The agreement is for a period of two years, with a possibility for extension. The previous agreement on the Junin-3 block was signed by the Company and PDVSA in 2005 for a period of three years. Commitments under that agreement for quantitative appraisal and certification of reserves of extra heavy oil have been carried out in full.

LUKOIL signs an agreement on acquisition of 100% of shares in the Turkish company Akpet. The transaction was completed in November 2008 for a total amount of $555 million. The parties agreed that payment for the acquisition will be made in several interest-free instalments. Payment of the first tranche of $250 million was made in November 2008, and the second and third tranches are to be paid no later than April 30 and October 30, 2009, respectively. The assets being acquired consist of 689 filling stations, 8 petroleum product terminals with overall capacity of 300,000 cubic meters, 5 storage facilities for liquefied hydrocarbon gas, 3 aircraft refuelling complexes, and a plant for production and packaging of motor oils and lubricants.

LUKOIL signs an agreement on acquisition of 100% of shares in the Turkish company Akpet.

## August

LUKOIL and ConocoPhillips start commercial production at the Yuzhnaya Khylchuya field. Test production at the field began at the end of June 2008. Construction of the second stage of the field was completed in December 2008. The field is being developed by Naryanmarneftegaz, the joint venture between LUKOIL (70%) and ConocoPhillips (30%). Yuzhnaya Khylchuya is one of the biggest fields in the north of Timan-Pechora, with proved reserves exceeding 500 million barrels of oil. Quality of oil from the field is superior to that of Urals export blend. The annual production target is 7.5 million tonnes (about 150,000 barrels per day).

## September

LUKOIL commissions a unit for visbreaking of vacuum residue with annual capacity of 2.4 million tonnes at the Nizhny Novgorod Refinery. The unit enables substantial improvement in profitability of the Refinery thanks to reduction in output of heating oil by 930,000 tonnes per year and increase in output of vacuum gas oil by 860,000 tonnes per year. Implementation of the project increases refining depth and raises operating efficiency at the Refinery.

Seven top managers of LUKOIL Group are included in a rating of the 1,000 most professional managers in Russia. More than 400 experts helped to compile the rating, which identifies Russia's most professional managers, leaders in their sectors and fields of specialization.

## October

LUKOIL Group is a prize winner in the annual competition 'Russian Corporate Donor 2008'. The Company wins the nomination for 'Best Joint Program by Business, Non-profit Organizations and Regional (Local) Government'. Also the Company's program for support of the Children's Football League reached the short list in the nomination, 'Best Program for Improvement of the Social Climate – Support for the Family'. Competition judges also placed LUKOIL in top position in a rating of companies by total amounts spent on charity.

LUKOIL Group takes 8th position among oil & gas companies in Europe, the Middle East and Africa, and 11th position worldwide in Platts ranking of the Top 250 Global Energy Companies for 2008. Companies were assessed by four main indicators: assets, revenue, net income and return on capital employed. LUKOIL took 6th and 11th positions in the Platts ranking for 2007, 6th and 15th positions in 2006, and 9th and 16th positions in 2005.

## November

LUKOIL signs an Agreement with St. Petersburg on cooperation in 2008–2012. The document calls for cooperation in meeting the needs of the city for main types of high-quality petroleum products, including gasoline and diesel fuel which comply with the Euro-3 and Euro-4 European standards, construction of new, environmentally safe filling stations in the city, and development of joint socio-economic programs. As part of the Agreement, the St. Petersburg Government will assist the Company in preparation of necessary enabling documentation for construction and commissioning of the new facilities, and concerning environmental and industrial safety issues.

LUKOIL signs a memorandum of mutual understanding with the Argentinean companies ENARSA S.A. and POBATER S.A.

## December

LUKOIL signs a memorandum of mutual understanding with the Argentinean companies ENARSA S.A. and POBATER S.A. The document envisages possibility of petroleum product deliveries (of fuel oil and/or diesel fuel) to ENARSA using infrastructure of POBATER for fuel storage. The memorandum is for three years and may be extended.

LUKOIL acquires 100% of the companies Association GRAND and MEGA OIL M. Assets of the companies include 181 filling stations in Moscow and Moscow Region, as well as in Pskov, Kaluga, Novgorod and other regions. The stations have total annual sales in excess of 300,000 tonnes. Average daily sales per filling station in Moscow and Moscow Region are 9.6 tonnes. The value of the deal is $493 million (including advance payment made in 2007).

LUKOIL wins the annual contest ‘For strong corporate policy in the sphere of information disclosure’ held by Interfax and AK&M agencies, authorized by the Russian Federal Financial Markets Service (FSFR). The competition panel chose the winner based on fullness and timeliness of international financial reporting in accordance with international standards, disclosure of information about beneficiaries, and simultaneity of disclosure for Russian and international investors.

LUKOIL

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2008

# Exploration & Production

Strategy

- Creating potential for long-term Company growth through reserve replacement in traditional production regions and through accelerated development of new production regions in Russia and abroad.
- Improving efficiency of geological exploration work by careful selection of projects and use of the latest technologies.
- Steady increase in hydrocarbon production in the medium term.
- Improving production indicators and efficient control over lifting costs by application of the latest technologies, and by optimization of the well stock and field development systems.
- Using financial criteria to assess projects and business results, and to optimize the asset portfolio.

Development of the Exploration & Production business segment and raising its operating and financial efficiency remained priority tasks for LUKOIL Group in 2008.

Net income in the E&P segment was $4,234 million. Production of marketable hydrocarbons grew by 1.0% in 2008 to 803 million boe. Average daily production was 2.194 million boe (1.921 million barrels of oil, and marketable gas production representing 273,000 boe).

One of the most important events in 2008 was launch of commercial production at the Yuzhnaya Khylchuya field, the Company's largest field in Timan-Pechora. The planned annual oil production at the field is 7.5 million tonnes (about 150,000 barrels per day). We also commissioned the unique Varandey terminal, which enables year-round deliveries of crude oil from Yuzhnaya Khylchuya to the international market, maintaining high-quality of the oil. Launch of production at the field was another milestone in the development of broad cooperation with ConocoPhillips, which develops the field jointly with LUKOIL.

Strong financial results in the E&P segment were achieved thanks to the favourable price environment in the first half of 2008, improvement in production efficiency, expansion of business scale, use of modern technologies, optimization of corporate structure and logistics, and acquisition of new, highly efficient assets.

There was negative impact on Company financial results in 2008 from collapse of oil prices in the second half of the year, high tax burden in Russia, and strengthening of the rouble in real terms, which led to growth in hydrocarbon lifting and transportation costs. Results were also negatively affected by production decrease at fields in Western Siberia. This was mainly due to natural change in recoverable reserves structure, as well as limitations in supply of electricity to LUKOIL fields in that region. The Company intends to reduce negative impact of these factors by application of new enhanced oil recovery technologies and construction of the Company's own power generating capacities.

## Price and Tax Environment

### Crude Oil Market

There was a sharp correction in the oil price in 2008, following the steady growth of the previous seven years. In the course of half a year the price fell from a record high to a four-year low amid the crisis in the world economy. Main factors behind oil price growth in the first half of the year were weakening of the dollar to other main currencies, OPEC's policy of limiting supply, slower rates of production growth by independent producers, and significant growth of demand from countries in the Asia-Pacific region (particularly China, ahead of the Olympic Games) and the Persian Gulf. Price growth was supported by political instability in production regions, capital transfer from financial markets to commodities as a result of the financial crisis, and behaviour of speculators. As a result, prices for oil reached a historical peak in July 2008, when the Brent price approached $145 per barrel. However, oil prices fell dramatically in the second half of the year as the world economy entered the crisis. There was a marked decline in demand for oil, particularly in the USA, and commercial stocks of oil and petroleum products rose, which had major negative impact on the oil market. Brent prices had fallen to $36.5 per barrel by the end of the year as a result.

Despite the abrupt decline of prices in the second half of the year, the average price for Brent crude in 2008 was $97.3 per barrel, which is 34.4% more than in 2007.

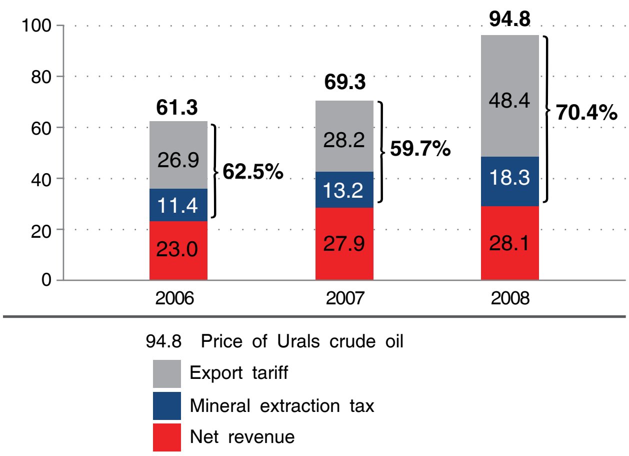
During 2008 LUKOIL produced more than 94% of its oil in Russia, so the price of Russia's Urals export blend had direct impact on the Company's financial results. Due to lack of a quality bank in the Transneft pipeline system, oil of any quality delivered through that system is sold at the Urals price, so that Urals is the Company's main crude export. LUKOIL exported over 8% of its oil by-passing the Transneft system in 2008, and value of these deliveries was based on factual quality of the oil, meaning a premium to Urals price in most cases.

Urals price rose by 36.9% compared with 2007 to average $94.8 per barrel. Reduction of the price differential between Urals and Brent was due to several factors: lowering of Russian oil exports to Europe as the domestic market became more attractive; domestic oil production decline; and overcoming of the imbalance on international markets for light and dark oil products. Reduction of the differential in prices for Brent and Urals oil is positive for the Company, and provided additional revenue of $0.6 per barrel in 2008.

The Company pays mineral extraction tax on its crude production inside Russia. Mineral extraction tax on oil grew by 38.5% in dollar terms in 2008 and the average tax rate for the year was $18.3 per barrel. The mineral extraction tax rate grew faster than Urals price because the tax uses a progressive scale.

The Company pays export tariffs on crude oil exports from Russia calculated using a progressive scale based on Urals prices. Export tariffs on crude oil rose by 71.8% in 2008 and the average rate for the year was $48.4 per barrel. The rate of export tariff growth considerably exceeded growth rates of the Urals price in 2008 due to a time lag in calculation of export tariff levels (under Russian law the export tariff level for the coming two months was calculated in 2008 based on the average oil price for the previous two months). This led to a situation where oil exports were loss-making

Revenue structure of a Russian crude oil exporter
$ per barrel




The Russian Government took a number of steps in 2008 to lower the tax burden on the Russian oil industry. This will help to stabilize the domestic fuel market, stimulate greater investment in new fields and, in the longer term, will help to prevent decline of Russian oil production.

Specifically, it was decided to change over to a new system for calculating the oil export tariff from December 1, 2008. The new system sets a new level of tariffs each month based on monitoring of prices from the 15th day of each calendar month to the 14th day of the next month, inclusive. Rates are set from the 1st day of each calendar month after the end of the monitoring period. So the tariff in December is calculated using the average price for Russian oil from October 15th until November 14th. (Previously export tariffs were reviewed once every two months based on two-monthly monitoring of Russian Urals crude prices on the international market).

Amendments to the mineral extraction tax were also approved and came into force from 2009. The amendments change the untaxed minimum oil price from $9 to $15 per barrel and make it no longer necessary to use direct accounting of oil production volumes in order to obtain tax remissions at fields with high-viscosity oil.

The amendments also offer mineral extraction tax holidays to companies, which explore and produce hydrocarbons at offshore fields. (The tax holidays last 10 years for companies, which only produce hydrocarbons, and 15 years for companies involved in both exploration and production). The tax holiday ends when cumulative production reaches 35 million tonnes. In addition, the amendments envisage seven-year tax holidays for companies, which carry out hydrocarbon exploration and production on the Yamal Peninsula and in Timan-Pechora.

At the end of the year the President of Russia signed a law, which lowers the income tax rate from 24% to 20% for all companies, regardless of their sphere of business. This will undoubtedly have positive impact on business of the Company.

in the fourth quarter. At the end of the year the Russian Government changed the system for calculation of export tariffs, significantly reducing the time lag and making the mechanism more efficient and timely (see insert).

The Urals price for a Russian exporter in 2008 net of tax (the price on the international market minus export tariffs and mineral extraction tax) was $28.1 per barrel, which is only 0.8% more than in 2007. The share of mineral extraction tax and export tariffs in the average price of oil for the year rose to a record level of 70.4% (the average for the previous three years was 58.4%).

LUKOIL pays taxes in international projects based on production sharing agreements (PSAs) and concession agreements. For example, in Egypt the only significant tax, which the Company pays, is income tax paid as a share of production. The tax rate is progressive and depends on oil prices. In Kazakhstan the Company pays income tax at a fixed rate in cash form. But Kazakh PSAs also require payment of a share of profit production (the size of the share depends on a project's internal rate of return), while other Kazakh projects require payment of royalties and tax on super profits. So tax scale in all the Company's Kazakh projects is progressive. The Government of Kazakhstan introduced export tariff on crude oil in May 2008. The tariff was increased from $109.9 to $204 per tonne between May and December 2008, which affected almost all LUKOIL businesses in the country. Provisions of the new Tax Code came into force in Kazakhstan from January 1, 2009, and have significant impact on Company projects. The provisions include introduction of a rent tax on exported oil when prices are higher than $40 per barrel (replacing export tariffs), a new mineral extraction tax to replace the royalty system, lower corporation tax on income of organizations, and a change in the method for calculating taxation of super profits of companies.

Tax payments as part of international projects increased due to oil price growth in 2008.

## Gas Market

LUKOIL produces most of its gas inside Russia, and as part of the Kandym – Khauzak – Shady project in Uzbekistan, the Karachaganak project in Kazakhstan, and the Shakh Deniz project in Azerbaijan. Most of gas production growth in 2008 was due to launch of the Khauzak-Shady area at the end of 2007. Marketable gas produced in Russia is sold to Gazprom and directly to Russian consumers. The Company cannot export the gas, which it produces, since Gazprom has a monopoly on gas exports and owns the gas transport system. Natural gas produced at the Khauzak–Shady area is sold at an official price, determined by an agreement between Russia and Uzbekistan. Natural gas produced as part of the Karachaganak project is supplied to the Orenburg Gas-processing Plant. Gas produced at the Shakh Deniz field is supplied to the domestic market in Azerbaijan and also via the Southern Caucasus pipeline to Georgia and Turkey, where it is sold at market prices.

The price environment on the natural gas market inside Russia was quite favourable in 2008: gas prices grew steadily in accordance with government policy. Sale prices to Gazprom and its affiliates, which take more than 70% of the Company's Russian gas supplies, rose from $41.1 to $44.9 per 1,000 cubic meters. The average weighted price for gas supplies to other customers rose by 22% to $53.3 per 1,000 cubic meters.

The Company pays mineral extraction tax on its gas production in Russia. The tax rate in 2008 remained at 147 roubles per 1,000 cubic meters, unchanged from 2007. However, the rate increased by 2.9% in dollars due to nominal strengthening of the rouble.

During 2008 the Company rapidly increased natural gas production under PSA terms as part of the Kandym – Khauzak – Shady project in Uzbekistan. From January 1, 2008, the sale price for this gas was $130 per 1,000 cubic meters, and it rose to $160 per 1,000 cubic meters from July 1, 2008. Royalty is paid on production at a rate of 30% as part of the agreement. LUKOIL also has a seven-year holiday from income tax (which began after the start of production), at the end of which income tax will also be payable at a preferential rate. The Uzbek Government share in profit oil varies depending on the project's internal rate of return for LUKOIL Group, so the actual tax scale is progressive.

Taxation in the Karachaganak project in Kazakhstan is in accordance with the PSA terms (see "Price and Tax Environment, Oil Market" on page 14).

Under terms of the PSA in Azerbaijan, LUKOIL is exempt from payment of taxes in cash on production and export of gas. The only significant tax paid by the Company is income tax at a fixed rate (the tax is withheld as a share of production).

## Inflation and Exchange Rate

LUKOIL Group produces most of its hydrocarbons inside Russia, so a significant part of Company costs are in roubles and change in value of the rouble against the dollar, both nominal and real (taking account of inflation), changes the level of Company costs in dollars. Real strengthening of the rouble against the dollar in 2008 was 17.4% y-o-y and was the main reason for growth of the Company's hydrocarbon lifting costs in Russia. These costs grew by 15.8%, from $3.55 to $4.11 per boe, representing a decrease in real terms. This shows the Company's success in controlling costs through optimization of production and application of modern technologies.

Real appreciation of the rouble was also one of the main factors behind 6.6% growth of capital expenditures in the E&P segment in Russia. Excluding the effect of real strengthening of the rouble, the Company's capital expenditures in Russia decreased in 2008.

Capital expenditures as part of international projects grew faster than in Russia due to increased scale of Company operations abroad: they rose by 23.5% in 2008. However LUKOIL succeeded in limiting growth of hydrocarbon lifting costs outside Russia to 3.8%.

The Group's total lifting costs rose by 15.1% in 2008, from $3.58 to $4.12 per boe. Capital expenditures in the E&P segment rose by 8.6% to $7.89 billion.

The exchange rate of the dollar to the rouble grew substantially in the second half of 2008 due to the global economic crisis and decline of oil prices and this process has continued during 2009. The exchange rate development and close cooperation with suppliers and sub-contractors will enable the Company to win appreciable cost reductions in dollar terms.

## Acquisition of Assets

The Company continued energetic expansion of its resource potential and production capacity in 2008 through acquisition of highly-efficient assets. Spending on restructuring and acquisition of new assets in the E&P segment totalled $361 million in 2008.

LUKOIL's biggest acquisition in 2008 was SNG Holdings Ltd., which has a 100% share in the PSA for fields in South-West Gissar and Ustyurt region in the Republic of Uzbekistan. The other party to the PSA is the National holding company, Uzbekneftegaz, acting as an authorized representative of the Uzbek Government. The PSA was signed on January 23, 2007 and came in force on April 23, 2007. Duration of the agreement is 36 years. Forecast annual production at the fields is about 4 billion cubic meters of gas and over 300,000 tonnes of oil and gas condensate. In accordance with the PSA, a license has been issued for five years, permitting geological exploration, including prospecting and appraisal work at the Karaumbetovsky and Shumanaisky investment blocks in Central Ustyurt (Kara-Kalpak) and additional exploration of the South-West Gissar contract territory. Gas from the South-West Gissar fields will be processed at the Shurtan gas-chemical complex, from where dry gas will be delivered for export via the Gazprom trunk pipeline network, the Central Asia – Centre pipeline and the Bukhara – Urals pipeline. Crude oil produced at the fields will be delivered via a terminal at Shurtan to the Bukhara and Fergana oil refineries. Value of the deal is $578 million (including advance payment made in 2007). The acquisition agreement envisaged two additional conditional payments of $100 million each, the first to be made when the agreed level of proved and possible hydrocarbon reserves is confirmed by an independent oil engineering company; and the second to be made when an agreed development program is confirmed by government bodies of Uzbekistan and an agreed minimum oil production level is achieved. During 2008, all conditions for both additional payments were met and a Group company completely settled LUKOIL's obligations under the agreement.

## Major Discoveries

A joint venture between LUKOIL and Gazprom, TsentrCaspneftegaz, discovered a large oil, gas and condensate field at the Tsentralnaya structure in the Caspian Sea. The structure is located in the Russian sector of the northern part of the Sea. The field was discovered by the first prospecting well, and testing gave a commercial gushing flow of low-sulphur oil at a daily rate of 700 barrels and 70,500 cubic meters of daily gas production. The Agreement (and Protocol to the same Agreement) between Russia and Kazakhstan on demarcation of the seabed in the northern part of the Caspian Sea for purposes of mineral use gives the Russian Federation rights of mineral use at the Tsentralnaya structure. However, the Agreement also stipulates that, in case of discovery of commercial reserves, development is to be carried out by Russia and Kazakhstan on parity basis. 3D seismic work began in the fourth quarter of 2008 and is due to be completed in 2009. Possible and probable liquids reserves at the structure are estimated at 736 million barrels (the Company's share is 368 million barrels) and gas reserves at 2.5 trillion cubic feet (the Company share is 1.2 trillion cubic feet).

## Optimization of Corporate Structure and Consolidation

LUKOIL continued to optimize its corporate structure in 2008, aiming to improve efficiency of business management at its subsidiaries and to reduce administrative expenses.

Khantymansiyskneftegazgeologiya and Paitykh Oil were merged into LUKOIL-Western Siberia.

LUKOIL-Nizhnevolzhskneft was reorganized through separation of LUKOIL-Volgogradneftegaz. Development activity of LUKOIL-Nizhnevolzhskneft is now entirely focused on the Northern Caspian fields.

The Company pursued consolidation and optimization of its asset structure in Timan-Pechora during the accounting year. KomiTEK, LUKOIL-UGPZ, SeverTEK, Ukhtaneft and Tebukneft were merged into LUKOIL-Komi.

## Asset Sales

LUKOIL completed the sale of a 15% stake in the D-222 project (Azerbaijan) to GDF Suez (France) in 2008.

# Licensing

The main tasks for the Company as regards licensing inside Russia are: to obtain new licenses for mineral resource exploitation; to extend the terms of licenses up to full field depletion; to secure reissue of licenses to reflect reorganization of subsidiary companies; and to change and add to conditions of use of mineral resources. The Company was successful in all these tasks during 2008.

There were 423 licenses on the balance sheets of LUKOIL Group companies at the end of 2008, of which 386 carried production rights and 37 were for geological exploration, including prospecting and field assessment.

The Company obtained 16 new licenses for use of mineral resources in 2008, of which one license was based on proof of a field discovery (the Ulyanovskoye field in Volgograd Region), and 14 licenses with production rights (in Western Siberia, Timan-Pechora, and Perm Territory) were obtained as a result of auctions and contests. Spending to acquire these licenses was $12 million. One license was obtained on the basis of an application to carry out geological studies in the offshore Baltic Sea.

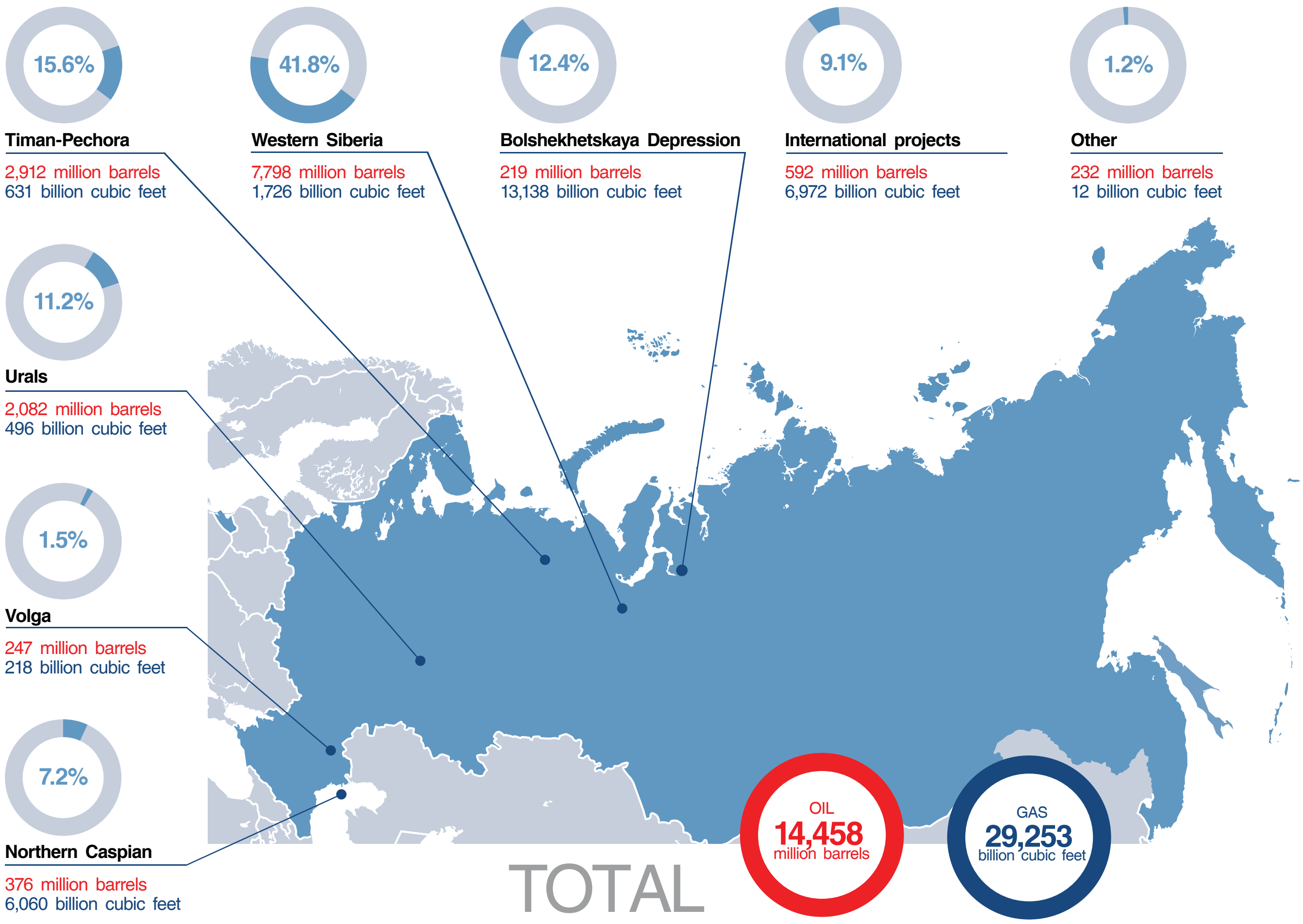
LUKOIL surrendered 6 licenses for geological studies due to their expiry or on the initiative of Group companies.

A total of 79 licenses for use of mineral resources were reissued during 2008 in connection with ongoing optimization of corporate structure of LUKOIL Group (including 55 licenses, which were reissued from LUKOIL-Nizhnevolzhskneft in favour of LUKOIL-Volgogradneftegaz).

The Group registered 23 additions to licenses in 2008 in order to extend their period of validity. Work also continued on amendments and additions to current license agreements. A total of 51 additions were made concerning rescheduling of development launches at fields, changes to geological exploration programs, clarification of borders of license areas, confirmation of ownership rights to production from license areas, and clarifications concerning obligations to achieve specific production levels in accordance with project documentation, as well as other issues.

# Oil and Gas **Reserves**

## ■ Proved Oil & Gas Reserves of LUKOIL Group by Regions

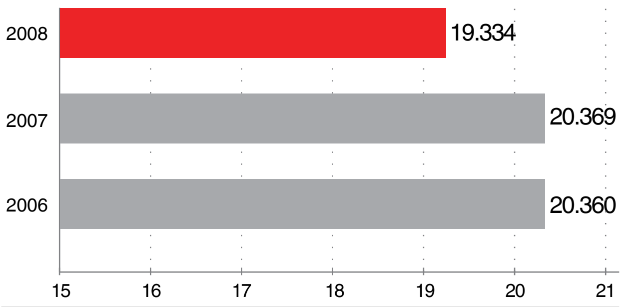



% – share in proved hydrocarbon reserves

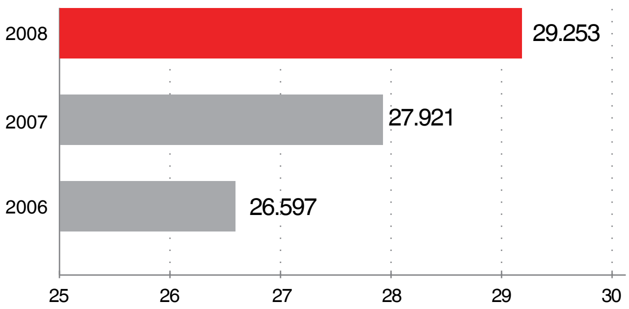
Reserve replacement is fundamental to long-term, sustainable development of the Company. LUKOIL Group carries out extensive geological exploration work in Russia and abroad in order to increase its reserves as well as maintaining constant monitoring of new projects and assets, which could represent acquisition targets.

The Company's proved reserves as of January 1, 2009 were 19.334 billion boe, consisting of 14.458 billion barrels of oil and 29.253 trillion cubic feet of gas. Proved hydrocarbon reserves of LUKOIL Group declined by 5.1% in 2008. The decline including production was 1.1%. The decline of oil reserves including production was 3.5%, while gas reserves increased by 7.2%.

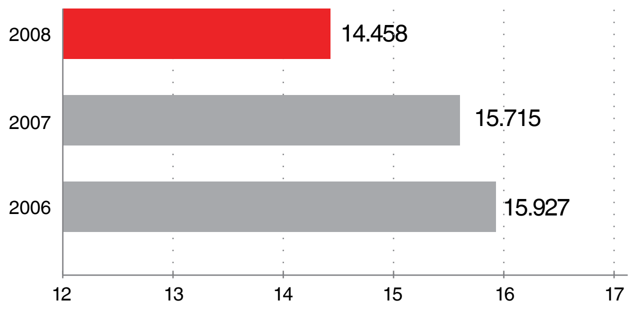
Proved hydrocarbon reserves, billion boe




Proved gas reserves, trillion cubic feet




Proved oil reserves, billion barrels




## Oil & Gas Reserves of LUKOIL Group

| January 1, 2009 | Oil, million barrels | Gas, billion cubic feet | Hydrocarbons, million boe |
|---|---|---|---|
| Proved reserves | 14,458 | 29,253 | 19,334 |
| of which: | | | |
| developed | 9,170 | 7,919 | 10,490 |
| undeveloped | 5,288 | 21,334 | 8,844 |
| Probable reserves | 8,083 | 22,103 | 11,767 |
| Possible reserves | 3,333 | 11,694 | 5,282 |

Appraisal of hydrocarbon reserves in 2008 was in the context of major worsening of the situation on global commodities markets. The Urals oil price on the appraisal date was $34.8 per barrel compared with $93.7 per barrel a year earlier. Fall of oil prices by 2.7 times had impact on economic feasibility of developing a part of Company reserves, so that 1.1 billion boe of reserves were transferred from proved reserves to resources. However, the Company did not intend to develop these reserves in the near future and their transfer has no impact on current plans of the Company. LUKOIL expects most of the reserves, which have lost their proved status for economic reasons, to be reclassified as proved when oil prices recover.

Reduction of reserves due to revisions and ongoing production was partly compensated by organic growth and growth due to acquisitions.

Growth of proved hydrocarbon reserves in 2008 due to geological exploration work and new data obtained in the course of production drilling was 601 million boe (529 million barrels of oil and 435 billion cubic feet of gas). So organic growth of hydrocarbon reserves compensated about 74% of production (75% for oil and 63% for gas). Most of the organic growth of proved oil reserves was obtained in Western Siberia (73% of the total) and Timan-Pechora (12% of the total). Most of organic growth in proved gas reserves was obtained in the Yamal-Nenets Autonomous District (47% of the total) and in two international projects, Kandym – Khauzak – Shady and Shakh Deniz (27% of the total).

Acquisition of 100% of the PSA for fields in South-West Gissar and the Ustyurt region in Uzbekistan increased proved reserves of the Company by 250 million boe.

LUKOIL remains one of the leading Russian and international companies by proved hydrocarbon reserves. The ratio of proved hydrocarbon reserves to production is 24 years (21 years for oil and 43 years for gas).

The greater part of the Company's proved reserves of oil are in Western Siberia, Timan-Pechora and the Urals region. The greater part of proved gas reserves are in the Bolshekhetskaya Depression, Uzbekistan and the Caspian region. 54% of Company proved reserves are under development (63% of oil reserves and 27% of gas reserves). This reserve structure reflects large potential of the Company to increase production in the medium term, particularly production of gas.

Most of the Company's proved hydrocarbon reserves are conventional. Only about 4% of the total represent high-viscosity oil and 8% are at offshore fields. This reserve structure enables the Company to ensure efficient control of development costs and to bring new fields into production rapidly.

# Geological Exploration

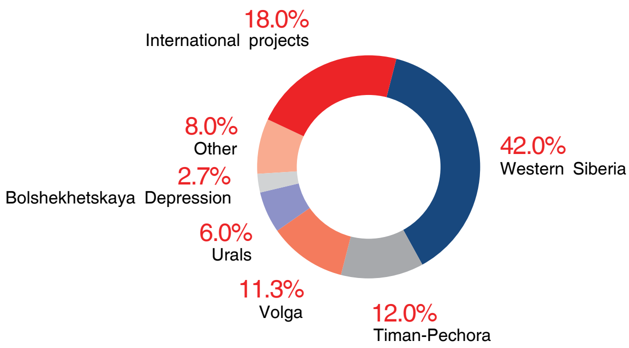
The chief objective of LUKOIL's geological exploration work is to replace production with new commercial reserves of hydrocarbons and to prepare reserves for rapid launch and expansion of production in promising regions (Timan-Pechora, the Northern Caspian and the Bolshekhetskaya Depression). The Company maximizes efficiency of its geological exploration work by use of the latest technologies.

Most of the Company's geological oil & gas exploration work in 2008 was concentrated in Western Siberia, Perm Territory, Volgograd Region, Timan-Pechora, and the offshore Caspian.

During 2008 the Company carried out 6,266 km of 2D seismic and 2,973 km$^2$ of 3D seismic in order to locate and detail geological structures and to prepare for drilling of prospecting and exploration wells at promising sites. In recent years the Company has improved quality of its seismic exploration work and speeded up processing and interpretation of data, mainly thanks to use of the latest IT solutions. High quality of seismic

## Main Geological Exploration Regions of LUKOIL Group

Exploration drilling by regions (2008)




exploration has improved the success rate of exploration drilling in the Group to a level above 70% in the last five years.

Geoelectric exploration totalled 3,603 km in 2008. Vertical seismic profiling, which details the geological structure around a drilled well, was carried out at 15 wells. Total exploration drilling in 2008 was 150,400 meters with efficiency of 929 tonnes of reference fuel per meter drilled. LUKOIL drilled up 51 prospecting and exploration wells in 2008, of which 31 were productive. The success rate of prospecting and exploration drilling was 61%.

LUKOIL discovered eight new fields in 2008: Vinnikovskoye (Perm Territory), Nirmalinskoye (Nenets Autonomous District), Severo-Alexeyevskoye and Avilovskoye (Volgograd Region), Zapadno-Rakushechnoye and Tsentralnoye (offshore Caspian), Long-Yuganskoye (Yamal-Nenets Autonomous District), Vostochno-Druzhbinskoye (Tatarstan). LUKSAR, a JV between LUKOIL and Saudi Aramco, discovered a hydrocarbon deposit (gas and condensate) at the central part of Block A in Saudi Arabia. The results which have been obtained require further study. The Company also found 18 new deposits at previously discovered fields.

Commercial recoverable reserves under Russian classification discovered by the Group in Russia in 2008 through geological exploration amounted to 125 million tonnes of reference fuel. Growth of proved reserves under international classification as a result of geological exploration and additional information obtained during production drilling was 601 million boe.

Spending by LUKOIL Group on geological exploration work totalled $679 million in 2008.

Most growth of liquid hydrocarbon reserves as a result of geological exploration work was obtained in the offshore Caspian, Western Siberia, Timan-Pechora and Perm Territory. Most of the growth in gas reserves was in the offshore Caspian and Western Siberia, as well as in foreign projects in Uzbekistan and Kazakhstan.

## Russia

Exploration drilling in Russia in 2008 totalled 123,600 meters, 2D seismic exploration was 4,724 km and 3D seismic was 2,779 km$^2$. Geological exploration spending in Russia was $322 million.

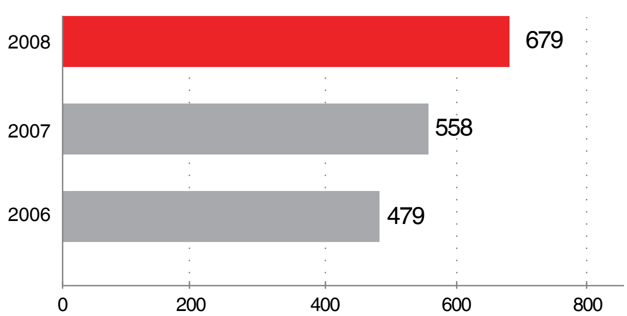
### Western Siberia

#### Khanty-Mansiysk Autonomous District

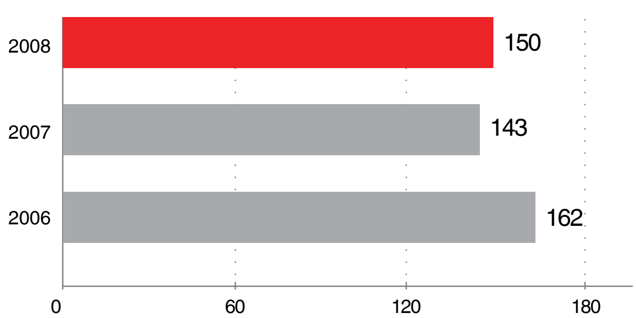
The Khanty-Mansiysk Autonomous District is the main oil production base of LUKOIL Group. The chief aim of geological exploration work there is replacement of reserves in order to maintain the Group's current production levels in the region. Although reserves in the region have been extensively explored, geological exploration work there is highly efficient and successful.

Exploration drilling in the region totalled 63,000 meters in 2008 and 20 wells were drilled, of which 14 were productive. The success rate of exploration drilling was 70%. The Company carried out 260 km of 2D seismic work at the Berezovsky-24 license area in order to locate structures and prepare for deep drilling. 3D seismic in the region totalled 1,610 km$^2$. Most of the work was carried out at peripheral areas of large fields in order to define outlines of oil & gas presence and predict oil saturation depths preparatory to production drilling. 3D seismic work and exploration drilling led to growth of reserves at the Pokachevskoye, Severo-Kochevskoye, Zapadno-Pokamasovskoye and Nong-Yeganskoye fields. 5 new deposits were found at previously discovered fields in the region during 2008. Proved oil reserves in the region

Exploration costs, $ million




Exploration drilling, thousand meters



declined by 4.6% (including production). However reserves grew substantially at some of the fields.

Testing of a well at the Severo-Pokamasovskoye field gave a gushing oil flow at a daily rate of 500 barrels per day from jurassic sediments. Proved reserves at the field were increased by 300,000 barrels.

Testing of exploration wells at the Nivagalskoye, Tevlinsko-Russkinskoye and Shaimskoye fields gave oil flows of 130, 180, and 170 barrels per day, respectively.

Drilling of well №6 was completed at the small Aprelskoye field and daily flow of 200 barrels of water-free oil was obtained. Proved reserves at the field were increased by nearly 50% as a result. Work continued on re-entry, retesting and intensification of inflows from previously drilled prospecting and exploration wells at the Aprelsky, Bolshoy, Olkhovsky and Sredne-Nazymsky license areas. Daily oil inflows of 100–200 barrels were obtained.

### Yamal-Nenets Autonomous District

LUKOIL is developing gas reserves at the Bolshekhetskaya Depression in Yamal-Nenets Autonomous District as part of its program for accelerated production of gas. The Company is also working at the Severo-Gubkinskoye, Prisklonovoye, Yuzhno-Tarasovskoye oil, gas and condensate fields, as well as the Urabor-Yakhinsky and Vansko-Namyssky areas.

The Company carried out 7,000 meters of exploration drilling in the region during 2008.

Testing of previously drilled exploration wells and 3D seismic work led to increase of reserves of condensate and free gas at the Yuzhno-Messoyakhskoye field by 12% or 55 million boe.

An exploration well was drilled at the Pyakyakhinskoye field and 11 tests were carried out on structures in lower and upper cretaceous strata. The tests gave daily inflows of oil (up to 300 barrels), gas (up to 178,000 cubic meters) and condensate (up to 100 barrels). An exploration well was also completed at the Severo-Khalmerpayutinskoye field.

Work was completed to resolve complications during drilling of a prospecting well at the Khalmerpayutinskoye field, and the well is being prepared for testing.

The Company carried out 300 km of electric exploration work in 2008 at the Khalmerpayutinsky and Pyakyakhinsky license areas. Processing of the results is now being completed.

As of the end of 2008 proved gas reserves at Company fields in the Bolshekhetskaya Depression were 13.1 trillion cubic feet (45% of LUKOIL's proved gas reserves).

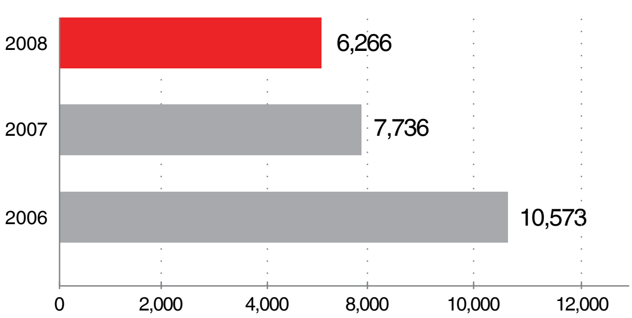
The Group's geological exploration work in the region extended beyond the Bolshekhetskaya Depression in 2008. Prospecting well №95 at the Long-Yugansky license area gave a flow of oil, leading to discovery of the Long-Yuganskoye field. The Company carried out 400 km of 2D seismic work at the Lenzitsky license area.

## Timan-Pechora

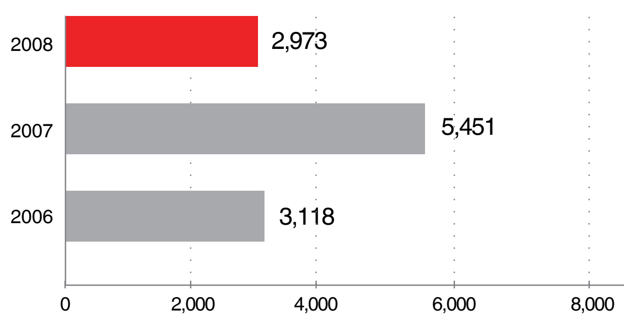
Timan-Pechora (Nenets Autonomous District and the Komi Republic) is a promising oil producing region for the Company. The region is little studied and has high potential for new discoveries. The Company carried out extensive geological exploration work in Timan-Pechora during 2008. 2D seismic totalled 510 km. Nine structures will be prepared for deep drilling in 2009 based on the results of this seismic work, including the Severo-Bayandyskaya, Vostochno-Lambeishorskaya, and Yuzhno-Bayandyskaya structures. 589 km² of 3D seismic was carried out at the Bayandyskoye, Usinskoye, Aresskoye, Yuzhno-Kyrtaelskoye and Oshskoye fields in order to clarify geological deposit models, and at the Zapadno-Kyrtaelskaya and Khoromaginskaya areas to clarify structural formations before drilling of prospecting wells.

Exploration drilling totalled 18,000 meters, and geological exploration work in the region during 2008 led to discovery of a new field and four deposits at previously discovered

2D seismic, km




3D seismic, km²



fields. Most of the oil reserve growth, including production, was at the Bayandyskoye, Kyrtaelskoye and Lekkerskoye fields (by 8%, 26% and 42%, respectively).

In the Komi Republic the Company carried out geological exploration work at the Denisovskaya and Izhma-Pechorskaya Depressions and at the Kolvinsky Rise. Drilling of eight wells was completed and four of them were productive.

Drilling of exploration well №2 at the Bayandyskoye field (discovered in 2007) was completed. Well testing gave oil inflow with maximum daily rate of 1,400 barrels. Testing of well №5 gave inflow of oil with high gas content at a daily rate of 2,700 barrels, confirming presence of oil & gas in upper devonian carbonate deposits of the Verkhnebayandysky Dome.

Drilling of well №16 at the Shchelyayurskoye field gave a gushing flow of oil at a daily rate of 800 barrels.

A well at the Makaryel-Nizevaya zone of the Izhma-Pechorskaya Depression did not find any new reserves, and the well was closed down for geological reasons.

Work resumed in the Nenets Autonomous District on testing of Nirmalinskaya well №1. Inflow of oil at a daily rate of 600 barrels was obtained, leading to discovery of the Nirmalinskoye field with C1+C2 reserves (Russian classification) of 200,000 tonnes.

Drilling was completed at Oshskaya prospecting well №27. Testing of starooskol sediments was carried out during drilling and inflow of oil at a daily rate of 1,900 barrels was obtained.

Operations in 2008 by Naryanmarneftegaz (the joint venture between LUKOIL and ConocoPhillips) included completion of secondary testing at wells №63 and 65 in the Zapadno-Lekeyaginskoye field in order to determine production potential of lower devonian deposits. Severo-Saremboiskaya well №40 was re-entered and oil inflow at maximum daily rate of 700 barrels was obtained following hydrochloric treatment.

## Urals region

The Urals is a traditional production region for the Company, and reserves in the region have been extensively explored. Total 493 km$^2$ of 3D seismic exploration was carried out in the region in 2008, as a result of which three structures (Simonyatskaya, Lisyinskaya and Severo-Bugrovskaya) were prepared for deep drilling. Exploration drilling totalled 9,000 meters during the year. Exploration drilling work for discovery of new fields and increase in reserves was mainly carried out adjacent to formations where commercial oil & gas reserves had already been found.

Testing of wells drilled at the Kharitonovskaya structure gave commercial inflows of oil at maximum daily rate of 500 barrels, as a result of which the Vinnikovskoye field was discovered.

8 new deposits were found at previously discovered fields.

## Volga (onshore)

The Volga is also a traditional hydrocarbon production region for LUKOIL. Geology of the region has been extensively studied. Total 2,360 km of 2D seismic was carried out here (in Volgograd and Astrakhan Regions) during 2008 in order to prepare for deep drilling. Exploration drilling totalled 11,000 meters. Four structures were prepared for deep prospecting drilling in 2008, and 13 new structures were located and will be examined in more detail.

Two fields were discovered as a result of work carried out in 2008.

Reserves of the Severo-Alexeyevskoye oil, gas and condensate field, discovered in 2007 at the Levoberezhnaya structure, were booked on the Company balance sheet in 2008. Probable reserves at the field at the end of 2008 were 2.5 million barrels of oil and 6.3 billion cubic feet of gas. Also the LUKOIL equity affiliate, Volgodeminoil, discovered the Avilovskoye field in Volgograd Region. The Group share in proved reserves at the field at the end of 2008 was 104,000 barrels of oil and 1.6 billion cubic feet of gas.

Drilling of exploration well №2 continued at the giant Tsentralno-Astrakhanskoye gas and condensate field (part of the Poimenny license area in Astrakhan Region) in order to clarify field structure and transfer reserves to commercial categories. Drilling (including drilling of a sidetrack) totalled 5,913 meters and the crust of a productive bashkirian horizon was penetrated at a depth of 4,242 meters. The well is to be tested in the second quarter of 2009. As of the start of 2009 probable and possible reserves at the Tsentralno-Astrakhanskoye field were estimated at 10.0 trillion cubic feet of gas and 1.2 billion barrels of condensate, which is comparable with reserves at the Karachaganak field in Kazakhstan. Gas at the Tsentralno-Astrakhanskoye field contains very high levels of hydrogen sulphide. However, this problem can be solved by application of modern technologies, as shown by Gazprom during development of the adjacent Astrakhanskoye field. The Tsentralno-Astrakhanskoye field will be one of the main sources for increase of gas production by the Company after 2012.

Construction of Danilovskiye wells №3 and №4 at the Yuzhno-Boldyrevskaya and Severo-Stanovaya structures (Berezovsky license area) was completed in 2008. A small inflow of oil and water was obtained at well №3, which was mothballed. Well №4 was closed down without a production string being lowered into the well due to absence of collectors in upper devonian sediments. Drilling of Olkhovskaya well №7 at the Stepnoye field was begun in December.

Increase of oil reserves in the region was achieved by transfer of reserves to the proved category at the Rechnoye field and as a result of discovery of the Severo-Alexeyevskoye and Avilovskoye fields.

In the Republic of Tatarstan a prospecting well at the Vostochno-Druzhbinskoye elevation in the Menzelinsky license area discovered a new field and inflow of oil was obtained at a daily rate of 100 barrels.

A total of 470 km of 2D seismic was carried out at the Agryzsky and Menzelinsky license areas in order to clarify their structures and prepare for deep drilling.

## Northern Caspian

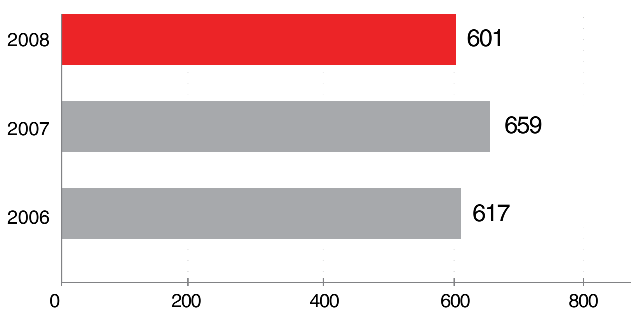
The Northern Caspian is one of the key regions for increase of oil & gas production by LUKOIL in the medium term and the Company pays special attention to development of resource potential in the region.

Most of the Company's geological exploration work in the offshore Caspian was focused on geological structure of hydrocarbon fields in the Severny, Tsentralno-Kaspiysky and Vostochno-Rakushechny license areas.

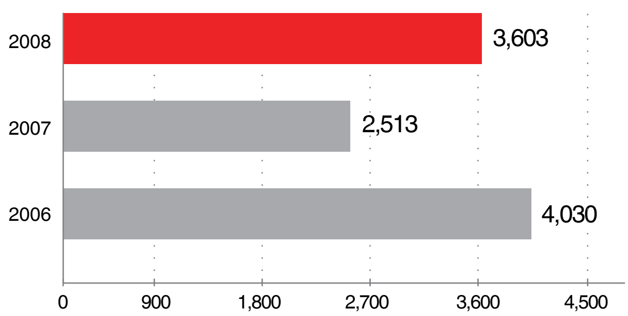
There was a modest increase in hydrocarbon reserves at the V.Filanovsky field thanks to drilling in 2007 of exploration well №6 and execution of 3D seismic work in 2007–2008.

The Caspian Oil Company, in which LUKOIL owns 49.89% (another 49.89% is owned by Rosneft and remaining shares belong to Gazprom), drilled the first Zapadno-Rakushechnaya prospecting well to a depth of 1,500 meters. The well found

Hydrocarbon reserve extensions and discoveries, million boe




Geoelectrics, km



commercial oil & gas presence in neocomian and aptian layers of the lower cretaceous. Testing of these formations gave commercial oil inflows. A new field was thus discovered with probable and possible reserves of 64 million barrels of oil and 33 billion cubic feet of gas (the Company's share is 32 million barrels and 16 billion cubic feet, respectively).

TsentrCaspneftegaz, in which LUKOIL owns a 50% stake (50% is owned by Gazprom), completed drilling of a 2,758-meter prospecting well at the Tsentralnaya structure. Testing gave oil inflow at a daily rate of 700 barrels and gas inflow of 70,500 cubic meters. An oil, gas and condensate field has thus been discovered with probable and possible liquid hydrocarbon reserves of 736 million barrels (the Company's share is 368 million barrels) and 2.5 trillion cubic feet of gas (the Company's share is 1.2 trillion cubic feet). 3D seismic exploration began in the fourth quarter of 2008 and is due for completion in 2009. The Agreement (and Protocol to the same Agreement) between Russia and Kazakhstan on demarcation of the seabed in the northern part of the Caspian Sea for purposes of mineral use gives the Russian Federation rights of mineral use at the Tsentralnaya structure. However, the Agreement also stipulates that, in case of discovery of commercial reserves, development is to be carried out by Russia and Kazakhstan on parity basis.

### Azov Sea

Priazovneft, in which LUKOIL Group has a 42.5% stake (42.5% is owned by Rosneft and 15% belongs to the State Property Fund of Krasnodar Territory), completed drilling of a prospecting well at the Gelendzhikskaya structure. Well depth at the end of the year was 3,180 meters. The well was closed down without testing due to absence of deposits in chokrakian horizons, as established by geophysical studies. The Group's share in 2D seismic work carried out in 2008 was 260 km. In 2007 Priazovneft discovered the Novoye field in the offshore Azov Sea, giving the first proof of high potential of the offshore Azov.

### Kaliningrad Region

LUKOIL carried out geological work in 2008 in Kaliningrad Region both onshore and in the offshore Baltic Sea.

Total 254 km of 2D seismic work was completed onshore and 210 km was carried out on the shelf of the Baltic Sea during 2008. As a result three onshore structures and one offshore structure (D6 Yuzhnaya) have been prepared for deep drilling.

Exploration drilling totalled 6,000 meters. Dubrovskaya №1 and Pravdinskaya №1 prospecting wells were drilled. No oil deposits were found and the wells were closed down for geological reasons.

Increase in oil reserves by 80,000 barrels was obtained at the Domnovskoye field as a result of prospecting drilling carried out in 2007.

## International Projects

In accordance with LUKOIL's strategy for intensive development of its international business in the E&P segment, the main task of geological exploration by the Company outside Russia is to prepare the resource base for rapid launch of production. Exploration drilling in international projects in which LUKOIL participates was 26,800 meters in 2008. The Group's share of 2D seismic work in international projects in 2008 totalled 1,542 km and 3D work was 194 km$^2$. Spending on geological exploration outside Russia was $357 million.

LUKOIL was involved in 15 geological exploration projects outside Russia in 2008: in Azerbaijan, Colombia, Kazakhstan, Saudi Arabia, Uzbekistan, Venezuela, Cote d'Ivoire and Ghana.

LUKOIL constantly monitors opportunities for participation in new, promising international projects.

LUKOIL's biggest acquisition in 2008 was the company SNG Holdings Ltd., which holds 100% of the PSA for fields in South-West Gissar and Ustyurt region in the Republic of Uzbekistan. According to the PSA conditions, a license for geological exploration, including prospecting and appraisal work at the Karaumbetovsky and Shumanaisky investment blocks in Central Ustyurt and additional exploration at the South-West Gissar contract territory, has been issued for five years (see "Acquisitions of Assets" on page 17).

In 2008 the Company completed a deal with Vanco Energy for acquisition of a stake in the Cape Three Points Deep Water project (Republic of Ghana) and obtained extension of the project exploration period up to the end of April 2009 (an agreement was reached in April 2009 to extend the project exploration period by 3 years with possibility of 2 further extensions of 1 year each). Location of the first prospecting well has been approved and drilling is to begin in the second quarter of 2009.

LUKSAR, a JV between LUKOIL and Saudi Aramco, discovered a hydrocarbon deposit (gas and condensate) at the central part of Block A in Saudi Arabia in 2008. The results which have been obtained require further study. Another four wells were drilled up, but were closed down without testing due to absence of promising oil & gas deposits. Selection of technologies for successful commercialization of project reserves was completed.

A certificate was prepared for the Western structure of block CI-205 in Cote d'Ivoire. Location of the first prospecting well was approved.

Seismic data collected in 2007 at blocks CI-401 and CI-101 were processed.

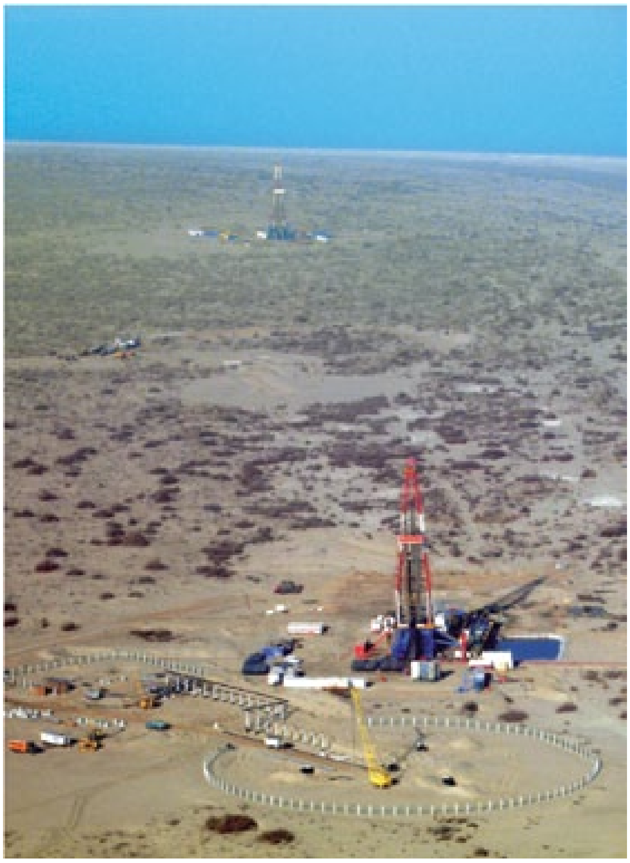
Drilling of the Lengupa-1 well at the Condor project in Colombia was completed. Signs of hydrocarbon presence (luminescence) were detected during its construction and there were inflows of water with signs of oil. However, commercial inflows of oil were not obtained and the well was closed down. 3D seismic work also began and is due for completion in 2009.

Appraisal of oil reserves was carried out at the Medina field (discovered in 2006) through reinterpretation of drilling data and testing of the Guavio-1 well.

A first exploration well was drilled as part of the Atash project in the Kazakh sector of the Caspian Sea, but no hydrocarbon deposits were found and the well was closed down. Drilling of the well helped to establish geological structure of the area.

Research and development work was carried out on basin modelling as part of the Tyub-Karagan project and a formation model of the current structure layout of Tyub-Karagan was constructed. At the end of 2008 a supplement to the PSA was signed for exploration work in 2009–2010.

Seismic data for the South Zhambai and South Zaburunye blocks were reinterpreted, enabling clarification of the seismic-geological model, and previously discovered structures were confirmed. The North Edil structure was identified as the prime target for deep drilling and location of the first exploration well with planned depth of 1,850 meters was approved.



In Uzbekistan total 1,142 meters of 2D seismic were carried out at the Kungrad block (part of the Kandym – Khauzak – Shady project). Based on interpretation of the data, a decision will be taken in mid-2009 on whether to extend the exploration period at Kungrad.

Total 87 km$^2$ of 3D seismic was carried out in 2008 at the South Kyzylbairak field as part of the South-West Gissar project, acquired in the accounting year. Processing and interpretation of 3D seismic data and geological modelling were completed. This work determined the structural-tectonic model of the South Kyzylbairak field, structural maps of the main reflection horizons were prepared and promising locations were identified. Structural maps and provisional geological models enabled adjustment of wellhead locations and drilling trajectory of slant production wells at the field.

Calibration, reprocessing and reinterpretation of 250 km of seismic materials from past years were carried out at the Ustyurt license territory, as a result of which changes were proposed to mapping of 2D seismic project profiles at the Shumanaisky and Karaumbetovsky license blocks, taking account of newly defined geological structure of the block territories. The work will be completed in 2009.

The Investment Consortium, which is carrying out the Aral project in the Uzbek sector of the Aral Sea (LUKOIL's stake is 20%), completed 2,005 km of 2D seismic work. Interpretation of 2D seismic data for the western and central parts of the contract territory is now being completed. Preliminary results of data interpretation suggest several promising structures for oil & gas finds: the Western Aral, Umid and Northern Umid.

Drilling of a second prospecting well was completed in the D-222 project (part of the Yalama-Samur structure, located in the Caspian Sea). LUKOIL carried out drilling at a sea depth of 665 meters, which represents a record for the Company. The well was closed down due to lack of promising oil & gas presence. Research and development work on analysis of geological and geophysical materials at the Yalama-Samur structure was also completed.

A two-year agreement was signed for joint study and analysis of possible business approaches for development of the license block in the Junin-3 project in Venezuela.

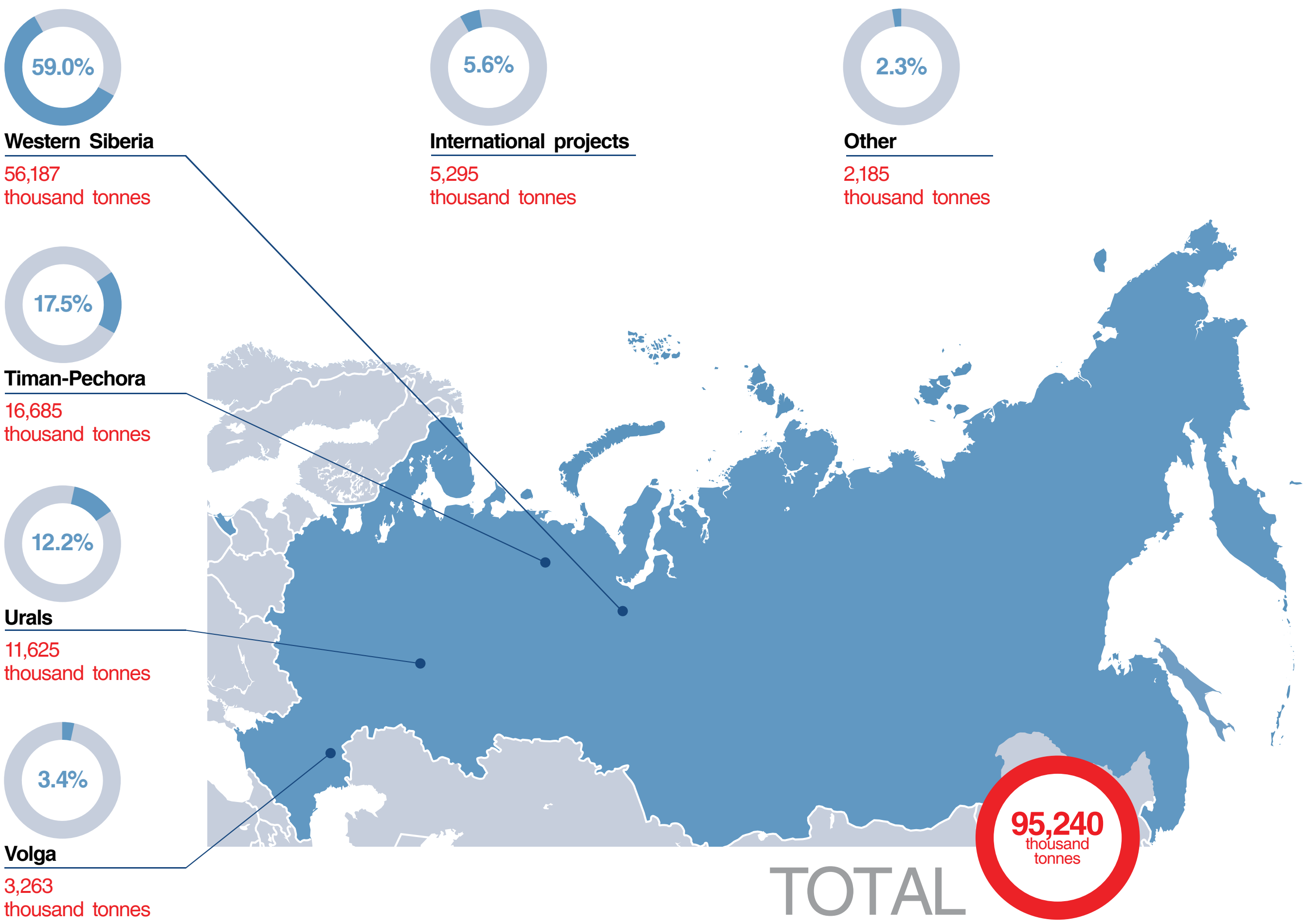
LUKOIL, Rosneft, Gazprom, Surgutneftegaz, and TNK-BP created a JV, National Oil Consortium, on parity basis in 2008. The purpose of the Consortium is to carry out operations in the oil & gas sector in Latin America. The Russian and Venezuelan governments agreed to support creation of a joint venture between the Consortium and the Venezuelan company PDVSA for work at the Junin-6 block. The Consortium is also considering participation in oil & gas projects in Cuba and Nicaragua.

# Oil Field Development and Production

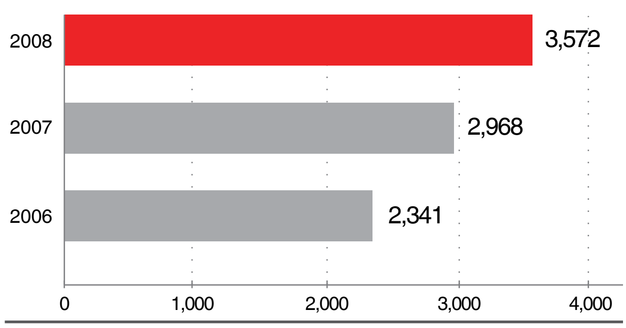
Total crude oil production by LUKOIL Group in 2008 (including share of production by equity affiliates) was 95.240 million tonnes (1.921 million barrels per day), which is 1.5% less than in 2007.

The main reason for decline of oil production by LUKOIL Group in 2008 was lower output from fields in Western Siberia, due primarily to objective changes in the structure of recoverable reserves and limited power supplies by

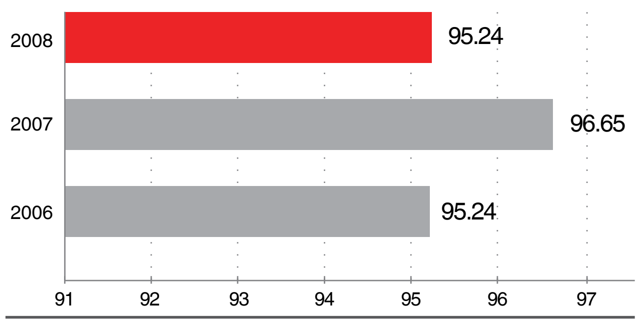
## LUKOIL Group Oil Production by Regions



**Oil production drilling, thousand meters**




**Oil production, million tonnes**




electricity companies to oil fields in the region. The Company intends to reduce negative impact of these factors on production in Western Siberia by use of the latest enhanced production technologies and construction of its own power generating capacities.

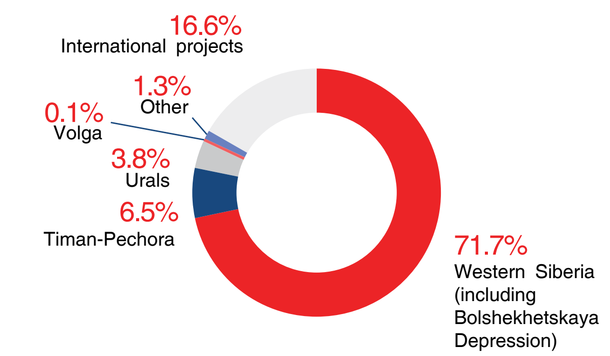
LUKOIL continued intensive work in 2008 on construction and commissioning of new fields as part of its strategic development program. In the middle of 2008 LUKOIL launched production at the Yuzhnaya Khylchuya field, which is the Company's largest field in Timan-Pechora.

The Company paid much attention in the accounting year to preparation and installation of facilities as part of field development in the Northern Caspian. Strict control by the Company and a precise work schedule will enable commissioning in 2009 of the Yu. Korchagin oil, gas and condensate field, the first of a whole group of fields in the Russian sector of the offshore Caspian.

The Company continued work to improve field development efficiency and reduce development costs through implementation of its Complex program for optimization of development and oil production in 2006–2008. LUKOIL production companies implemented a range of measures to achieve crude oil production targets for 2008 as part of the Program, increasing well productivity and oil recovery rates. Development costs during the year were $7.288 billion.

LUKOIL subsidiaries and equity affiliates produced hydrocarbons at 370 fields during 2008. 11 new fields were brought into development during the year: Yuzhnaya Khylchuya, Yareyuskoye, Yuzhno-Yuryakhinskoye, Bayandyskoye (Timan-Pechora), Novomostovskoye, Zapadno-Tugrovskoye (Western Siberia), Severo-Alexeyevskoye, Vostochno-Druzhbinskoye (Volga), Abramovskoye, Tartinskoye and Sagrinskoye (Urals). Oil production at 17 fields grew in the reporting period by more than 50,000 tonnes in comparison with the previous year. The largest increases in oil production (by more than 200,000 tonnes) were achieved at 4 fields, which gave overall growth of the Group's annual production by more than 1 million tonnes. These were the Kechimovskoye and Nivagalskoye fields in Western Siberia, and the Kyrtayelskoye and Pashshorskoye fields in Timan-Pechora.

**Production drilling by regions (2008)**




The Company had 29,420 production wells as of January 1, 2009, of which 25,110 were actually in use, and the number of water injection wells was 9,550, of which 7,050 were under pressure. The number of production wells was 3.3% higher than in 2007, due to increased amounts of production drilling. The share of idle wells fell by comparison with the end of 2007 and stood at 14.6% of the total. Average daily oil flow from wells in projects with Company participation was 14.2 tonnes, which is a little lower than in 2007 due to objective changes in the structure of recoverable reserves.

Production drilling in 2008 was 3.572 million meters, which is 20% more than in 2007. There was an increase in the share of international projects in total production drilling, which reflected rapid field development as part of the Kandym – Khauzak – Shady project in Uzbekistan, the Kumkol, KarakudukMunai and Kazakhoil Aktobe projects in Kazakhstan, and the Meleiha project in Egypt. A total of 1,510 new production wells were commissioned, including 112 horizontal wells. Drilling of horizontal wells is highly efficient and the Company plans to increase their numbers in the medium term. Average daily flow from new wells at projects, in which the Group is participating, was 43.4 tonnes, including average flow of 58.4 tonnes from horizontal wells. Despite the fact that commissioning of new production wells increased by more than 25% in 2008, average flow from new wells exceeded the rate achieved in 2007: flow from new wells was higher than in 2007 by

5.6 tonnes per day, or 14.8%. This result reflects improvement in the quality of geological and hydrodynamic models, and extensive application of such models for planning of production drilling, as well as continued work to improve well-completion technologies and initial and secondary drilling-in of productive formations.

The Company increased drilling of sidetracks by almost 1.5 times in 2008 compared with the previous year, while maintaining efficiency of this drilling technique. A total of 260 wells with sidetracks were drilled, and they gave average increase of daily flow by 18.1 tonnes. Growth of flow rates at some fields was significantly higher than the Company's average. In particular, reconstruction of three wells by drilling of sidetracks at the Kyrtayelskoye field in Timan-Pechora gave an average increase of oil daily flow by 91 tonnes, adding 30,000 tonnes of production during the year.

A total of 576 new injection wells (including 13 steam-injection wells) were put under pressure to optimize field development systems and maintain reservoir pressure. Injection wells pumped 488 million cubic meters of water into productive formations, which is 7.5% more than in 2007. The Company was successful in restricting growth of the water cut, thanks to measures to limit volumes of associated water extraction and unproductive pumping at fields in Russia: the water cut rose by 1.3 percentage points in 2008, compared with average 1.5 percentage points growth in the last five years. However, volumes of water injection to maintain reservoir pressure were lower than planned due to electricity supply interruptions at some of the Western Siberian fields. The Company is addressing this problem by installation of small-scale generating facilities at its fields (see "Power Generation" on page 59). The Company plans further improvement of its systems for maintaining reservoir pressure at fields currently under development.

Steps were taken in 2008 to increase well productivity. A total of 1,231 operations were carried out to optimize functioning of mechanized wells, and 95 wells were transferred to mechanized production. The Company continued to make extensive use of enhanced oil recovery techniques at oilfields. A total of 5,376 operations were carried out on productive formations using physical, chemical, hydrodynamic and heat techniques (see "Exploration and Production Technologies" on page 78). Additional oil production in Russia from application of enhanced oil recovery methods was 23 million tonnes, representing almost 26% of total Russian production by the Group.

## Russia

Crude oil production by LUKOIL Group in Russia in 2008 was 89.945 million tonnes, of which 89.646 million tonnes were produced by subsidiaries. Russian production was down by 1.3% compared with 2007.

Subsidiaries and equity affiliates of LUKOIL produced hydrocarbons at 343 fields in Russia during 2008. Production drilling was 2.981 million meters, which is 12.9% more than in 2007. The number of production wells at the end of 2008 was 28,100, of which 23,960 were actually in use. A total of 1,183 new wells were commissioned during 2008.

Western Siberia accounted for 62.5% of oil production by LUKOIL Group in Russia. Production in the region was somewhat lower than in 2007 at 56.19 million tonnes. A shortage of electric power led to technological losses and made it impossible to pump sufficient volumes of water to maintain reservoir pressure. Limited supply of electricity forced the Company to downsize its program of geological interventions: the least technically and financially efficient

The first stage of construction at the Yuzhnaya Khylchuya field was completed in June 2008, and commercial production at the field began in August. The first stage consists of 32 production wells, an oil treatment unit with annual capacity of 3.8 million tonnes, an oil desulphurization unit, and a tank farm with overall capacity of 40,000 cubic meters. An external pumping station was also built, as well as the Yareyu – Yuzhnaya Khylchuya high-pressure gas pipeline, and a gas treatment unit with annual throughput capacity of 370 million cubic meters, together with other facilities.

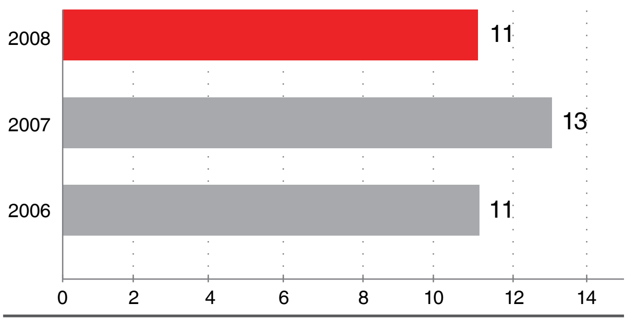
In December 2008 the Company completed construction of the second stage of the Yuzhnaya Khylchuya field, increasing annual capacity of the oil treatment unit by 3.8 million tonnes. A high-pressure compressor station was also installed, as well as facilities for sulphur recycling and storage.

Proved oil reserves at Yuzhnaya Khylchuya exceed 500 million barrels. The annual production target is 7.5 million tonnes (about 150,000 barrels per day). Oil production in 2008 was over 1.5 million tonnes (nearly 60,000 barrels per day).

Oil produced at the field is transported by pipeline to the Varandey oil export terminal on the Barents Sea, which has annual handling capacity of 12 million tonnes. The terminal delivers oil year-round to markets in Europe and North America. Shipment of oil through the Varandey terminal enables preservation of its quality, which is superior to that of Russian Urals export blend: density of the oil is 35.5 API (compared with 32.0 API for Urals) and sulphur content is 0.71% (1.30% for Urals). So oil from the field is sold on the international market at a premium to the price for Urals blend.

The field is being developed by Naryanmarneftegaz, a joint venture between LUKOIL (70%) and ConocoPhillips (30%).

Commissioning of new fields,
fields




operations were cancelled. The Company is addressing the electricity supply problem at fields by building its own generating facilities, which run mainly on associated gas (see "Power Generation" on page 59).

Company efforts in Western Siberia are focused on limiting natural decline of crude production, due to the long period during which most fields in Western Siberia have been in development and relatively high level of reserve depletion. However, some of the Company's fields in the region have significant potential for production growth. The Kechimovskoye and Nivagalskoye fields showed record oil production growth in 2008.

Oil production at the Kechimovskoye field, which was commissioned in 1995, grew by 32.5% in 2008 compared with 2007 to 968,000 tonnes. The increase was obtained by production drilling: 81 new wells were commissioned with average daily oil flow of 27 tonnes, including 19 horizontal wells with average daily flow of 38.7 tonnes. High flows from wells commissioned in 2007 and operated throughout the whole reporting year (21 wells with average daily flow of 54 tonnes) also had a favourable impact on production growth. There were 8 sidetracks drilled at the field in 2008 and hydrofracturing of formation was carried out at 4 wells. Work also continued to create a system for maintaining reservoir pressure: 36 new injection wells were put under pressure in the reporting year. The Kechimovskoye field is one of the Company's largest investment projects in Western Siberia, and further 617 wells remained to be drilled at the field at the start of 2009 (466 oil production wells and 151 injection wells). High rates of production drilling are to be maintained in the near future, enabling further increase of crude production at the field.

Crude oil production at the Nivagalskoye field, which was brought into production in 1985, grew by 22.7% to 1.63 million tonnes. Most of the increase was due to commissioning of 21 new production wells, including 15 horizontal wells. Average daily flow of crude from new wells was 39.2 tonnes. A total of 17 injection wells were put under pressure to help maintain reservoir pressure and to increase compensation of liquid extraction by pumping water into the formation.

The Timan-Pechora oil & gas province provided production growth of more than 2 million tonnes for the Company in 2008. Production in this region totalled 16.69 million tonnes. As a result, the region's share in total production by the Group in Russia increased from 16% to 19%. The strong growth was due to joint commissioning with ConocoPhillips of the Company's largest field in Timan-Pechora, the Yuzhnaya Khylchuya field, where production exceeded 1.5 million tonnes (nearly 60,000 barrels per day) (see page 32). The Group brought a total of 4 fields into production in the

region during 2008. Timan-Pechora will be LUKOIL Group's key region for production growth in the medium term, and the Company is making every effort to bring main reserves in the region into development as quickly as possible. This will help to compensate natural decline of crude production in the Group's traditional operating regions.

Naryanmarneftegaz (the joint venture between LUKOIL Group and ConocoPhillips) produced 2.22 million tonnes of oil in 2008, which is 3.5 times more than in 2007. The increase was due to launch of production at the Yuzhnaya Khylchuya field in the north of Timan-Pechora.

The largest part of crude production growth in the Komi Republic was provided by the Pashshorskoye, Kyrtayelskoye and Perevoznoye fields, where output grew by 0.8 million tonnes.

Crude production at the Pashshorskoye field, which was brought into production in 2004, has already been growing at a fast rate for a number of years. Output at the field grew by 325,000 tonnes in 2008 in comparison with the previous year to a level of 954,000 tonnes. Most of the growth was due to commissioning of 7 new production wells with average daily flow of 192.3 tonnes of crude. The intensive drilling stage at the field has been completed, and plans for the immediate future are creation of a pressure system (during the first stage the field has been operated without special measures to maintain reservoir pressure) and special operations at existing wells.

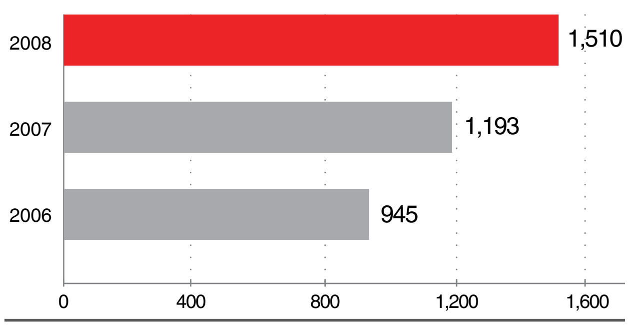
Crude production at the Kyrtayelskoye field grew in 2008 by 46.1% to 886,000 tonnes, primarily due to commissioning of 14 new wells with an average daily flow of 60.2 tonnes of crude. Highly efficient technical interventions on geology at declining wells also contributed much to the increase in production levels, including reconstruction of 3 wells by drilling of sidetracks (average increase in daily flow of crude at these wells was 91 tonnes). These measures, combined with steps to optimize the system for maintaining reservoir pressure (4 wells were brought under pressure), increased average daily flow of crude at the field from 42.1 to 49.1 tonnes.

Oil production by LUKOIL Group in the Urals region rose by 3.3% to 11.62 million tonnes, due in part to application of new technologies, such as drilling of sidetracks, radial drilling, and acid fracturing.

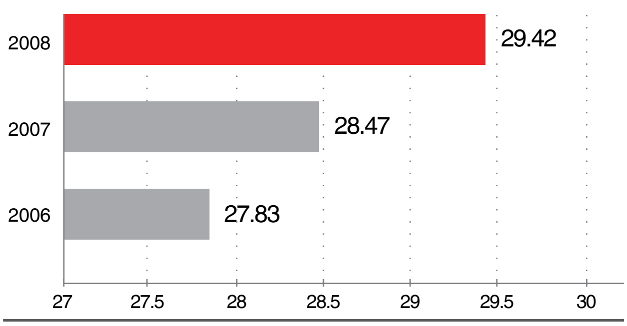
In 2008 the Company acquired sub-surface rights at a group of fields in Perm Territory, geologically confined to the unique Verkhnekamskoye potash-magnesium salt field. Hydrocarbon deposits at the fields are underneath deposits of potash-magnesium salts that are being commercially developed, and there are further complications due to conservation restrictions, which are in force on land where the license sectors are located (wildlife reserves, water conservation zones, urban settlements etc.). In order to comply with all the industrial and environmental safety requirements, oil field confined at the Verkhnekamskoye potash-magnesium salt field will be developed using unique multi-bore wells with horizontal reach in excess of 2 km. LUKOIL will also use a technology that separates salt formations using magnesian-phosphate tamping material with an expansion cement bond, and a system for constant monitoring of surface deformation. Crude production is scheduled to start in the fourth quarter of 2009. Future annual production will be in excess of 1.3 million tonnes of crude.

Oil production in the Volga region in 2008 was 3.26 million tonnes, representing an increase of 0.7% over 2007.

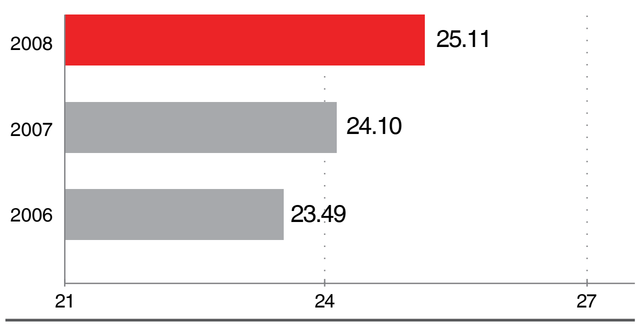
Oil production well launches, wells




Oil production wells, thousand wells




Oil production wells in use, thousand wells



Improvement of field development efficiency in the region has enabled the oil recovery ratio to be increased and production rates to be maintained at current levels, despite considerable depletion of reserves.

The Company paid particular attention in 2008 to preparations for development of fields on the Caspian Sea shelf. Development of these fields will be the main factor in oil production growth by the Company in the mid-term. The Yu. Korchagin and V. Filanovsky fields will be the first to be commissioned and will be the main sources of increase in oil output.

Crude production at the Yu.Korchagin field should start as early as in the fourth quarter of 2009. The field is located in the northern part of the Caspian Sea, 175 km from the city of Astrakhan. The depth of the sea in the area of the field varies from 10 to 13 meters. Field development plans envisage a system of horizontal production wells of super-extended length (more than 5 km). This will be the first-ever application of such an approach during field development in Russia. The production drilling phase is to be implemented between 2009 and 2015. Forecast annual crude production level is more than 2 million tonnes, and output of natural and associated gas should be in excess of 1 billion cubic meters. Work on construction of a floating oil storage facility, a single-point wharf and living quarters continued according to schedule in 2008. The development will be on a zero-discharge basis, to guarantee minimal impact on the natural environment of the Caspian Sea.

## International Projects

LUKOIL's share of production in international projects was 5.295 million tonnes, which is 4.5% less than in 2007. The reduction in production volumes was due mainly to sale in 2007 of a 50% stake in Caspian Investments Resources Ltd. However, there was the most significant production growth at the Tengiz project in Kazakhstan and the Shakh Deniz project in Azerbaijan, as well as at projects in Uzbekistan.

Production drilling in the Company's international projects was 591,000 meters, which is 81% more than in 2007. Such high growth of production drilling is explained by rapid field development as part of projects involving Caspian Investments Resources Ltd., as well as Kumkol and Meleiha. The number of oil production wells was 1,320, of which 1,148 were actually in use. A total of 327 new production wells were commissioned as part of international projects, in which the Company is a participant. Average daily oil flow from these wells was 72.2 tonnes.

The greatest crude production growth was from the Tengiz project in Kazakhstan. Crude production from the project (Company share) grew by 24% to 466,000 tonnes. Significant growth in production was due to capacity expansion: the number of production wells was increased from 74 to 95 in the course of the year.

There was rapid growth in production volumes of gas condensate at the Shakh Deniz project in Azerbaijan, which was brought into production in December 2006. The Group's share of gas condensate production amounted to 147,000 tonnes, which is 67.1% more than in 2007. Work is currently underway to drill a new well, whose commissioning will support further growth of production in the project.

There was considerable growth (by more than 6 times) in the Company's share of gas condensate production at the Khauzak-Shady area in Uzbekistan (being developed as part of the Kandym – Khauzak – Shady project), which was brought into production in 2007. The Group's share of production amounted to 12,000 tonnes. A total of 12 production wells were commissioned in the course of the year.

Increase of production in Uzbekistan was also due to acquisition in March 2008 of the South-West Gissar project. Production as part of the project at the Koshkuduk and South Kyzylbairak fields was 6,000 tonnes (Group share). 2 new wells were drilled during the reporting period, one of which was commissioned. Preparations also began for upgrading of the fields.

Production of oil and gas condensate as part of the Karachaganak project in Kazakhstan grew insignificantly in 2008 (by 0.2%), but the Company's share of production declined by 2.2% to 1.57 million tonnes due to change in the price environment. There were 4 multi-bore wells commissioned at Karachaganak in 2008, and drilling of another 3 such wells was completed. Work also continued on expanding capacities at the Karachaganak refining complex.

Rapid development of the Kumkol field in Kazakhstan continued during the reporting year. Production from the project was 1.63 million tonnes (Group share) and 53 production wells were commissioned. Average daily flow from new wells was 45.4 tonnes. In addition, 10 sidetracks were drilled. A method for utilization of associated gas was chosen and agreed with supervisory authorities in Kazakhstan, and work began to design and build an integrated gas treatment unit. Work continued in 2008 on updating project documents for the Kumkol and East Kumkol fields and development of the fields was taken further. Hydro-geological and hydrodynamic models have been developed for the Kumkol field, reserves have been recalculated and work has begun on a more detailed development plan.

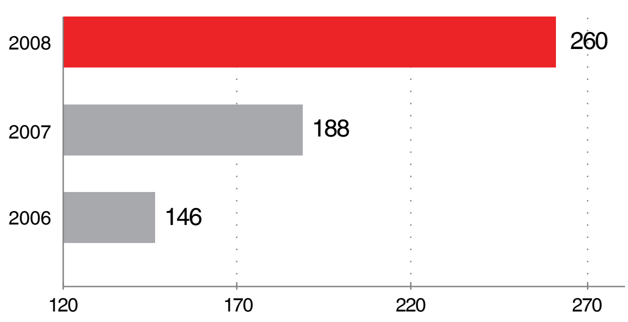
Production from the KarakudukMunai project in Kazakhstan grew by 24.9%, but the Company's share of production was 636,000 tonnes, which is 4.8% less than in 2007. This is due to sale in April 2007 of a 50% stake in Caspian Investments Resources Ltd. A gas utilization program was implemented and a gas treatment unit was commissioned during the reporting year. As a result the Company has significantly reduced harmful atmospheric emissions at the field, complying with strict environmental standards, and will obtain additional revenue from sale of products of gas processing. Geological and hydrodynamic models of the Karakuduk field were prepared in 2008 and work continued to drill over and develop the field. 48 new production wells were brought into operation.

Intensive development work continued at the North Buzachi field in Kazakhstan, including commissioning of 153 new production wells with average daily oil flows of 13.2 tonnes. Production of crude at North Buzachi increased by 6.2% to 1.71 million tonnes. However, LUKOIL Group's share of production fell to 428,000 tonnes, or by 18.4%. Pilot test work was started to inject polymer gels into rock formations. The oil treatment and pumping facility is being expanded to allow daily handling of up to 40,000 barrels, and work continued on the program for associated gas utilization.

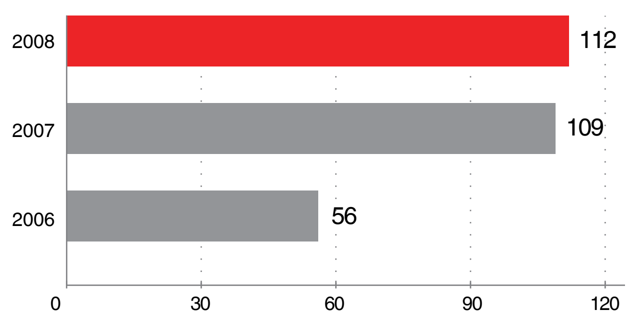
A total of 22 new production wells were launched at the Alibekmola and Kozhasai fields (the Kazakhoil Aktobe project in Kazakhstan). Total crude production at the fields was 759,000 tonnes, of which the Group share was 190,000 tonnes. Project documents were prepared and approved, consisting of an adjusted process flow chart for the Alibekmola field and the engineering process flow chart for development of the Kozhasai field. Additional geological-geophysical and hydrodynamic studies were carried out at wells in the Alibekmola and Kozhasai fields in order to optimize further development and construction work, creation of a reservoir pressure system, and implementation of an enhanced recovery program. Work continued on selecting the contractor and transaction approval for construction of gas utilization facilities. The schedule for implementation of the gas program was extended until the middle of 2011.

In Egypt 21 new wells were launched as part of the Meleiha project. Reserves at the concession were reappraised following drilling of 4 deep wells (4,000 meters). The geological report should be ready in 2009. In the WEEM project construction of a system for reservoir pressure maintenance and treatment of bottom water was completed, and 2 appraisal wells were drilled based on results of the 3D seismic survey carried out in 2006. Both wells drilled into formations containing oil, increasing project reserves. So correctness of the decision to pursue additional studies of the WEEM concession and to recommend extension of the license territory was confirmed. Group share in production from the Egyptian projects was 190,000 tonnes, a little less than in 2007.

Drilling of sidetracks,
sidetracks



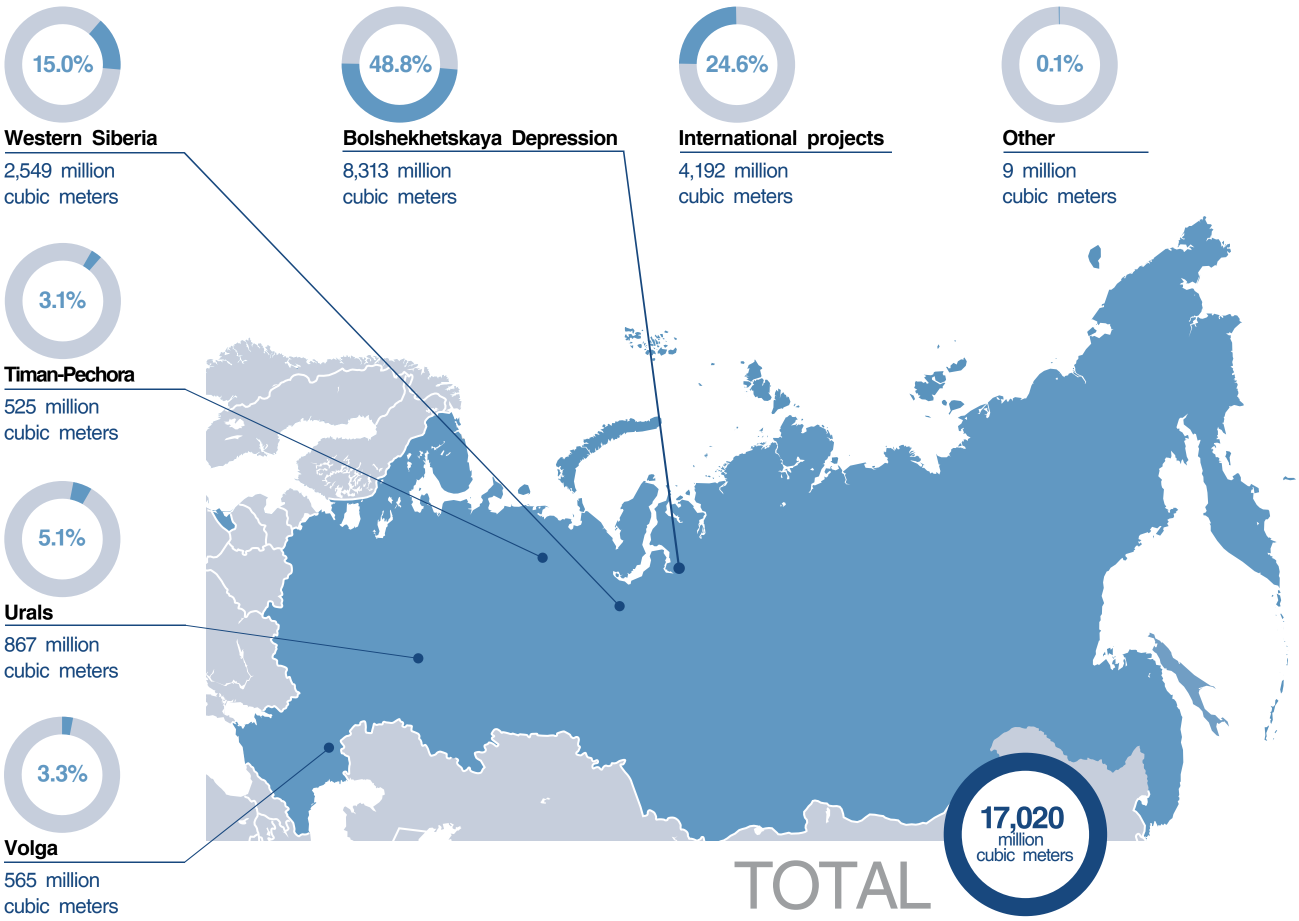

Drilling of horizontal wells,
wells




# Gas Field Development **and Production**

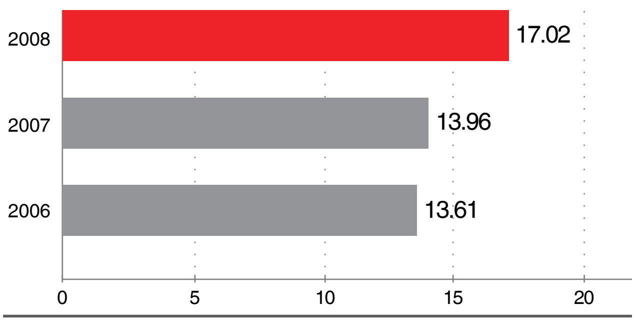
LUKOIL's gas program is based on accelerated growth of gas production both in Russia and abroad and increase in the share of gas to a third of total hydrocarbon production by the Group. The main aim of this strategy is to commercialize gas reserves and reduce the Company's exposure to major price volatility on the international oil market.

## LUKOIL Group Marketable Gas Production by Regions



Total gas production by LUKOIL Group in 2008 (including the share of production by equity affiliates) was 19.437 billion cubic meters (1.875 billion cubic feet per day). Output of marketable gas (net of own use, reinjection into reservoir formations and transport losses) was 17.020 billion cubic meters (1.642 billion cubic feet per day). Average daily production of marketable gas grew by 21.3% compared with 2007. LUKOIL Group net income from gas projects in Russia was over $170 million.

**Production of marketable gas,**
billion cubic meters




The Company had 387 gas production wells at the end of 2008, of which 278 were actually in use.

Production of natural gas was 13.888 billion cubic meters, of which 12.671 billion cubic meters was marketable gas. Growth in output of marketable natural gas was 31.3%, with 6.7% growth in Russia and 165.6% growth abroad. The share of production from projects outside Russia increased from 15% in 2007 to 31% in 2008. Major growth of gas production abroad was due to rapid development of the Kandym – Khauzak – Shady project in Uzbekistan.

Production of associated gas was 5.549 billion cubic meters, which is somewhat less than in 2007 due to decline in oil production. However, production of marketable associated gas exceeded the level of the previous year and amounted to 4.349 billion cubic meters. The growth was due to development of systems for utilization of associated gas at Company fields. Associated gas is used at fields for injection into formations to maintain reservoir pressure, for production of electrical energy at gas-fired generating stations, and for other production needs. Marketable associated gas is delivered to gas-processing plants and to local consumers.

The utilization rate for associated gas[1] rose to 70.4% in 2008, compared with 69.0% in 2007, thanks to development of systems for utilization of associated gas at Company fields including construction of compressor stations and gas pipelines. The level of utilization of associated gas at main Company fields in Western Siberia is around 95%.

The Company is pursuing construction of gas-fired power stations at fields as part of a small-scale generating program in order to further increase utilization of associated gas. This reduces gas flaring and gives cost savings on electricity, lowering oil lifting costs. The Company is now implementing a program for utilization of associated gas by organisations in LUKOIL Group during 2008–2010, which was approved in 2007 and aims to increase the utilization rate for associated gas to 95%.

Work was done in 2008 to prepare approvals and expert assessment of project documents for development of new gas fields. Volumes of gas supply from fields in the Bolshekhetskaya Depression (22.4 billion cubic meters per year) and the Vankor group of fields (5.6 billion cubic meters per year) to the first stage of the Yamburg – Tula trunk gas pipeline were agreed with Gazprom. In addition, technical solutions were designed in association with Rosneft for joint transportation of hydrocarbons from fields in the Vankor group and the Bolshekhetskaya Depression. It has been agreed that LUKOIL will accept input of up to 5.6 billion cubic meters of gas per year from the Vankor group of fields to the gas transportation system in the Bolshekhetskaya Depression and will transport the gas as far as the Yamburgskaya Gas Compressor Station, which is part of Gazprom's gas transportation network. In return, starting from 2011, Rosneft will accept annual inputs of up to 3 million tonnes per year of stable oil and condensate mixture from LUKOIL's Pyakyakhinskoye field to the Vankor – Purpe oil pipeline and transport them to Transneft's trunk oil pipeline system. In order for these operations to be achieved, LUKOIL will construct a 136-km gas pipeline from Pyakyakhinskoye to the Nakhodkinskoye field (including a 31-km section across the floodplain of the Messoyakha river) and also a 160-km product pipeline from the Pyakyakhinskoye field to the Vankor central collecting point by 2011, and a 60-km gas pipeline from Pyakyakhinskoye to the Khalmerpayutinskoye field by 2012.


[1] Share of produced gas in total gas extracted from formations. The remainder is flared off.

## Russia

Production of marketable gas in Russia in 2008 was 12.828 billion cubic meters, which is 4.5% more than in 2007. The share of natural gas was 68%, representing an increase of 1.5 percentage points. The Company had 299 gas production wells in Russia at the end of 2008, of which 209 were actually in use.

Most of the Company's natural gas production in 2008 in Russia (more than 95%) came from the Nakhodkinskoye field in the Bolshekhetskaya Depression. Gas production there in 2008 was 8.3 billion cubic meters, which is 7.7% more than in 2007. So production at the Company's largest gas field in Russia regained its 2006 level following reduction of output in 2007 due to reduced purchases by Gazprom.

Preparatory work continued for development launch at other fields in the Bolshekhetskaya Depression. According to the approved investment program for 2009, construction of facilities should begin at the Pyakyakhinskoye field and one well is to be put into production. Its output will be used for the Company's own needs. Production drilling at gas and condensate sites at the Pyakyakhinskoye field is scheduled for 2009–2011. Gas production at the Yuzhno-Messoyakhskoye gas and condensate field is due to start in 2013, and the Khalmerpayutinskoye gas and condensate field should be launched in 2014.

Achievement of planned production levels at all fields in the Bolshekhetskaya Depression will bring total production of natural gas by the Company in the region to 24 billion cubic meters.

## International Projects

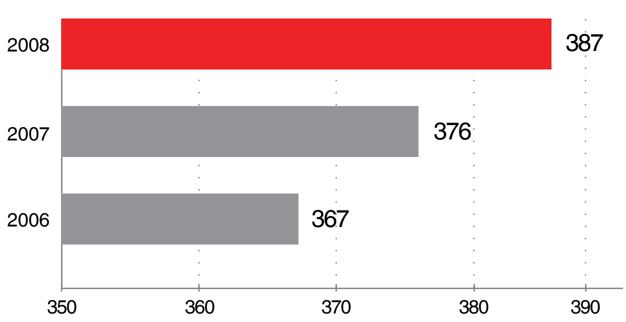
Production of marketable gas in 2008 as part of international projects was 4.192 billion cubic meters, which is 149.2% more than in 2007. The share of natural gas was 94%, representing an increase of nearly 6 percentage points. The Company had 88 gas production wells in international projects at the end of 2008, of which 69 were actually in use.

Most of the growth in gas production was at the Khauzak-Shady area, which was brought into production at the end of 2007 and is being developed as part of the Kandym – Khauzak – Shady project in Uzbekistan. Production of marketable gas at the Khauzak-Shady area was 2.340 billion cubic meters in 2008, or almost 56% of total marketable gas production by the Company abroad. Natural gas production at Khauzak-Shady reached its target level of 3 billion cubic meters per year in the second half of 2008. Production drilling continued at the area (27,000 meters of rock were drilled through) and 12 new wells were brought into production, providing daily gas flows of 452,300 cubic meters.

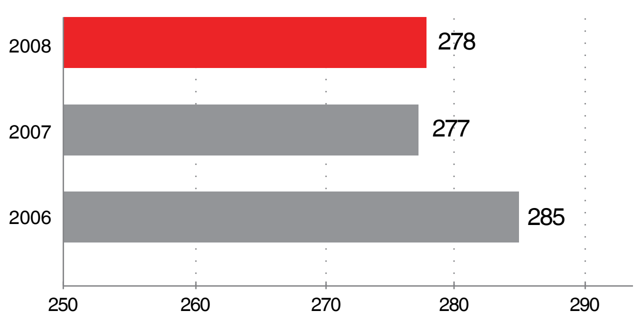
Production of marketable gas at the Karachaganak field in Kazakhstan was 1.069 billion cubic meters (Company share), representing an increase of 2.1% compared with 2007. Four multi-bore wells were commissioned at Karachaganak in 2008 and drilling was completed at three other multi-bore wells.

Gas production grew rapidly in 2008 at the Shakh Deniz project in Azerbaijan, which was brought into production in December 2006: production of marketable gas increased by 78.5% to 551 million cubic meters (Company share). Drilling of a new well is now in progress and its commissioning will contribute to further output growth in the project. Gas from the field is supplied to the domestic market and also to Georgia and Turkey via the South Caucasus pipeline.

Gas production wells,
wells




Gas production wells in use,
wells



LUKOIL

ANNUAL REPORT

2008

# Oil Refining, Gas Processing and Petrochemicals

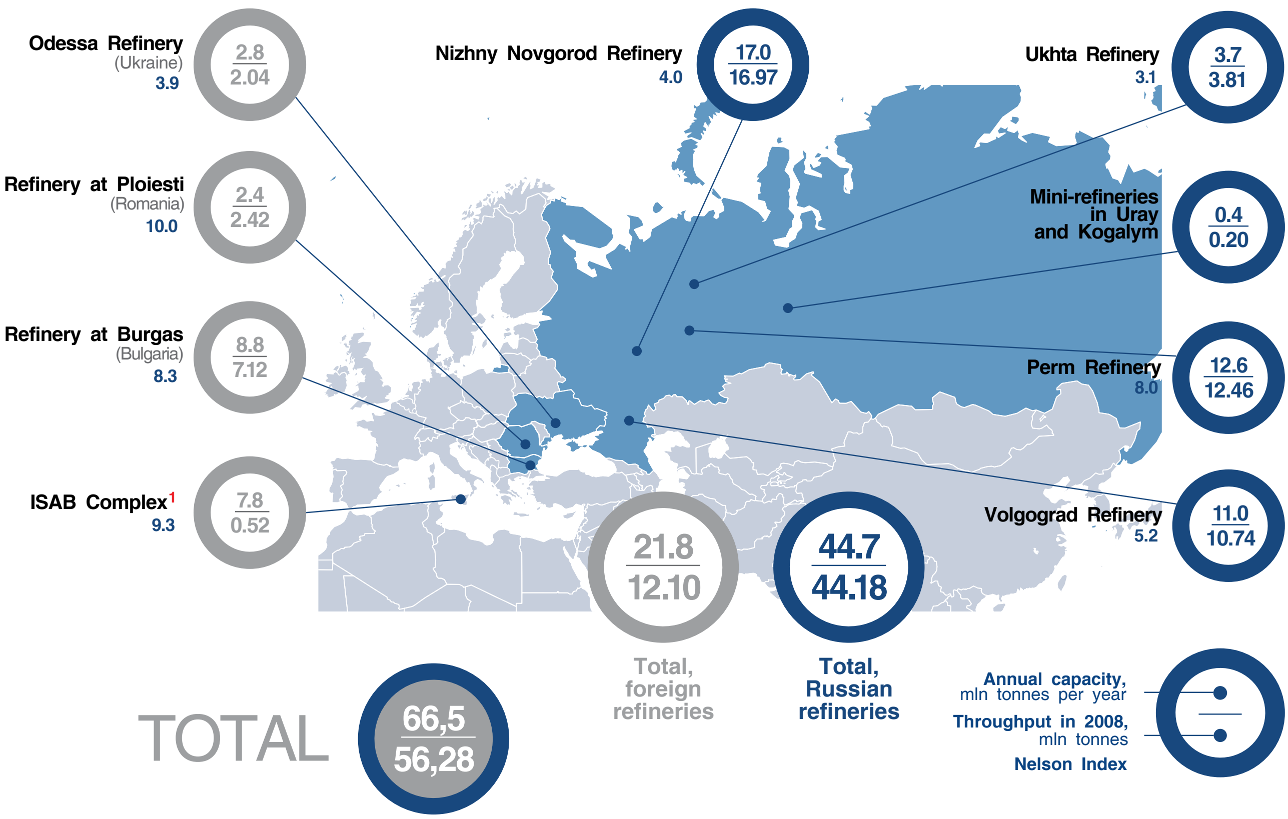
Strategy

- Maximizing refinery throughputs
- Production of high-quality, environmentally friendly petroleum products with high value added
- Increase of light-product yield
- Control over production costs
- Optimizing logistics: reduction of transportation expenses
- Increasing efficiency of trading operations
- Increasing retail sales of petroleum products and of non-fuel products and services via filling stations

Net income in 2008 in the Refining & Marketing segment reached an all-time high of $5.130 billion, which is 7.5% more than in 2007. Excellent financial results were achieved mainly through increase in refinery throughputs and retail sales volumes thanks to the relatively favourable macroeconomic environment and improvement of business efficiency in the segment.

# Oil Refining

## LUKOIL Group Refineries



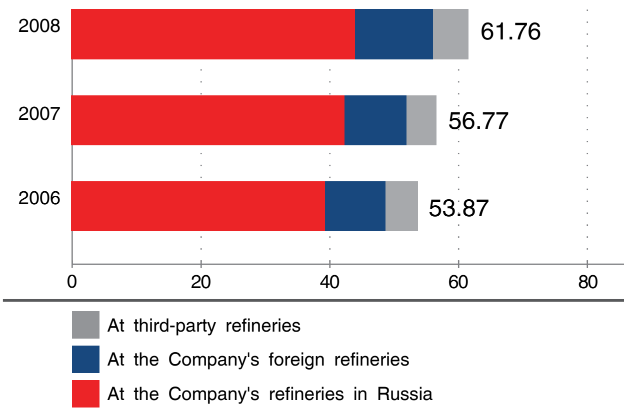

LUKOIL Group continued rapid development of its oil refining business during 2008 through modernization and expansion of refining capacities, and through participation in new promising projects.

The volume of refinery throughputs, including processing at third-party refineries, increased by 8.8% in 2008 compared with 2007 to 61.76 million tonnes, of which 56.28 million tonnes were refined at Group Refineries and the ISAB refining complex, representing an increase of 7.9% over 2007.

[1] Capacity of the ISAB complex is shown in accordance with the Company share (49%). The throughput represents the Company share in December 2008.

In the reporting year LUKOIL continued implementation of the program for modernization and reconstruction of its refineries, making capital expenditures of $1,023 million (compared with $830 million in 2007).

Refinery throughputs by LUKOIL, million tonnes



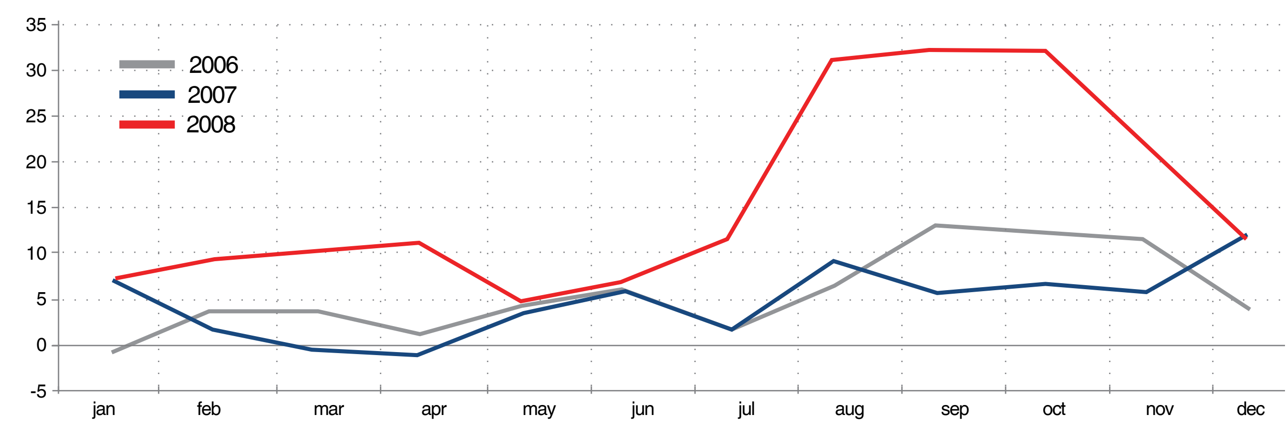

Pursuing its strategy for development of refining business abroad, LUKOIL signed an agreement in 2008 with the Italian company ERG S.p.A. for creation of a joint venture to manage the ISAB refining complex, located on the island of Sicily in Italy. The ISAB complex consists of two refineries joined by a system of pipelines and integrated into a single technological complex with total annual refining capacity of 16 million tonnes, as well as three tanker wharfs and a tank battery with capacity of 3.7 million cubic meters. In addition to the refining complex, the JV owns a 99 MW power station and some other infrastructure (see page 46 for more details). The acquisition greatly increased Company investments in refineries, which totalled $833 million in 2008, compared with $157 million in 2007.

Company refineries continued implementation of the Program to overcome gaps and lags compared with global industry leaders. A total of 191 measures were implemented during the year to raise energy efficiency, optimize production capacities and increase utilization rates, optimize personnel numbers and rotation, and to improve the reliability of equipment (increasing the period in operation between overhauls). Financial impact from implementation of these measures was $132 million,

including $98 million from optimization of production capacities. The biggest effect was achieved at the Group's refinery in Nizhny Novgorod ($60 million).

In addition to the Program, the Company developed a number of measures to cut operating costs. Savings as a result of these measures totalled $25 million.

Refining margin in Russia (average refinery in European Russia without catalytic cracking), $ per barrel



## Russian Refineries

Refinery throughputs at LUKOIL Group's own Russian refineries were 44.18 million tonnes in 2008, which is 3.8% more than in 2007. Capacity utilization reached 99.3%, which is the highest figure in the entire history of the Company. In order to obtain maximal advantage from the favourable macroeconomic environment, LUKOIL processed 3.19 million tonnes of crude oil at third-party refineries in Ufa.

The share of high-octane gasoline in total output of gasoline at Group refineries in Russia (not including mini-refineries) rose to 87.0% in 2008 (as against 83.5% in 2007). Refining depth was 76.0% and light-product yield increased to 50.4% (compared with 74.0% and 49.9%, respectively, in 2007).

The most significant output increases compared with 2007 were of vacuum gas oil (by 20.5%), heating oil (by 14.8%) and coke (by 13.6%).

Measures were implemented during the year to reduce operating costs and raise production efficiency at Russian refineries. This enabled reduction of irretrievable losses at refineries from 0.65% to 0.58% (against an average figure for Russia of 0.92%). Average personnel numbers were reduced by 4.6%.

Capital expenditures for modernization of the Company's refineries in Russia in the reporting year were $688 million (against $606 million in 2007) and investments were $64 million (against $157 million in 2007).

The Group's Nizhny Novgorod Refinery commissioned a vacuum residue visbreaking unit with annual capacity of 2.4 million tonnes. The unit increases margins from operations at the Refinery by reducing output of heating oil (by 930,000 tonnes per year) and increasing volumes of vacuum gas oil (by 860,000 tonnes per year). The new unit increases refining depth at the Nizhny Novgorod Refinery and raises production efficiency.

At the Volgograd Refinery, the vacuum block on distillation unit №6 was commissioned after an upgrade. This upgrade will increase production of vacuum gas oil and vacuum residue, and reduce fuel oil output. Design work also began for construction of a new distillation unit with annual capacity of 6 million tonnes.

A unit was commissioned at Volgograd for hydrotreatment of secondary gasolines, basic design was completed for construction of a delayed coking unit with annual capacity of 1 million tonnes, and the second stage of a unit for hydrotreatment of diesel fuel with annual capacity of 3 million tonnes was completed.

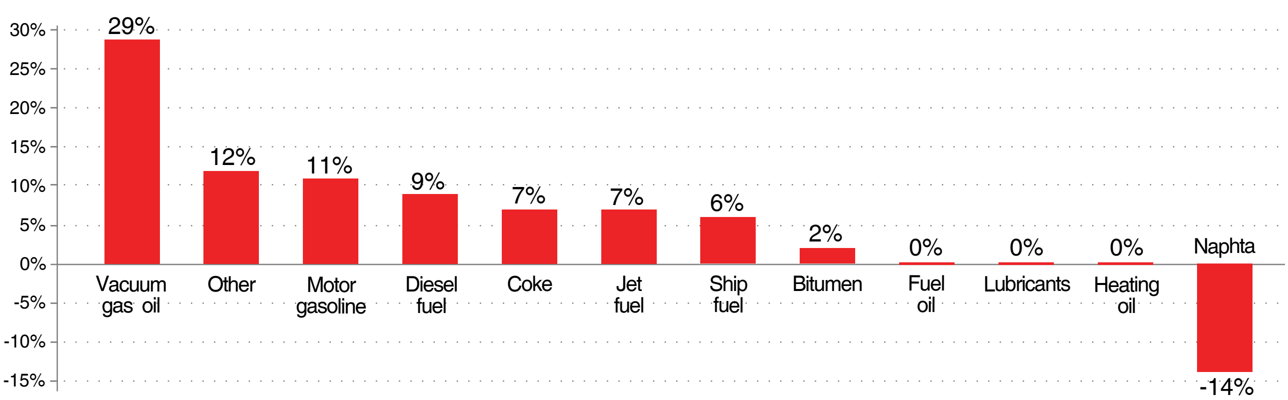
The Company's Perm Refinery modernized the atmospheric distillation block on distillation unit №4 to increase annual capacity by 125,000 tonnes. Capacity of the delayed coking unit was increased to 1 million tonnes per year, and a major overhaul of the crude oil deep refining complex was carried out. Annual capacity of the Refinery increased from 12.4 to 12.6 million tonnes.

The Perm Refinery commissioned a production complex for blending, packing, storing and dispatching of packaged oils during 2008. Work was also carried out on modernization of pipe stills in order to reduce energy costs and increase their efficiency.

During 2008 the Perm Refinery went over to 100% production of high-octane motor gasolines, which meet the Euro-3 standard.

Work continued at the Ukhta Refinery in 2008 to upgrade the catalytic reforming unit by addition of an isomerization block, which is due to be commissioned in 2009.

Change in output levels of petroleum products at Company refineries in 2008 compared with 2007, %[1]




[1] Excluding mini-refineries and the ISAB Complex.

## International Refineries

Refinery throughputs in 2008 at LUKOIL Group's international refineries and at the ISAB complex reached 12.10 million tonnes, which is 25.9% more than in 2007. The large increase is explained by recommissioning of the Odessa Refinery in April of the reporting year, following modernization. There was also significant growth in refinery throughputs at third-party refineries: these volumes were 2.29 million tonnes in 2008, compared with 1.02 million tonnes in 2007. Overall, taking account of processing at third-party refineries, LUKOIL refined 14.39 million tonnes of oil outside Russia in 2008, which is 35.4% more than in 2007. Capacity utilization at international refineries of the Group in 2008 was 82.7%.

Average refining depth at the Company's foreign refineries (not including the ISAB complex) was 79.7%, which is a little lower than in 2007. Light product yield (not including the ISAB complex) was 62.2% (as against 64.1% in 2007). Slight decline of these indicators is explained by commissioning of the Odessa Refinery, whose indicators are somewhat lower than those of other Company refineries abroad. Irretrievable losses at refineries outside Russia fell from 1.11% to 0.93% in 2008.

The highest rates of output growth at the Company's international refineries (not including the ISAB complex), compared with 2007, were for fuel oil (up 34.7%) and diesel fuel (up 19.4%). Production of motor gasoline increased by 13.7%.

Capital expenditures in modernization of Group foreign refineries were $335 million in 2008 ($224 million in 2007) and investments were $769 million.

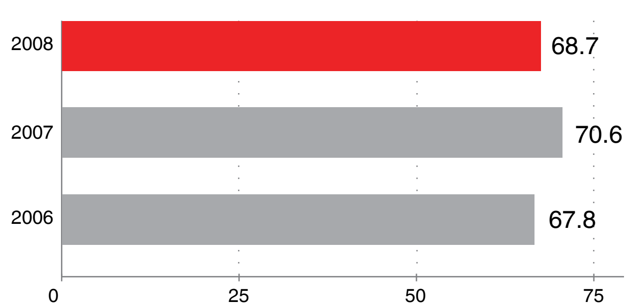
In April 2008 LUKOIL Group recommissioned the Odessa Refinery (Ukraine) after completion of an upgrade, which began in 2005. The Refinery's vacuum distillation unit was rebuilt as part of the upgrade, increasing its annual capacity from 2.4 to 2.8 million tonnes. The atmospheric unit was rebuilt for visbreaking, and the hydrotreatment complex and a number of general-use facilities were modernized. After completion of the upgrade the Refinery is capable of producing motor gasoline to Euro-3 standards, diesel fuel to Euro-4 standards, jet fuel, bitumen and liquefied gas.

At the Burgas Refinery (Bulgaria) work continued in 2008 on construction of a diesel fuel hydrotreatment unit and FCC gasoline hydrotreatment unit. Modernization of a diesel fuel hydrotreatment unit to enable production of fuel to Euro-5 standards was completed during the year.

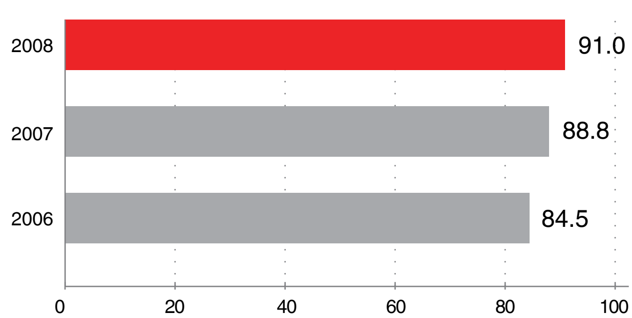
The Petrotel-LUKOIL Refinery (Romania) completed the bulk of required work to enable production of fuels to Euro-5 standards from 2009 and to improve levels of environmental safety at the Refinery. Upgrading work was completed on units for FCC gasoline hydrotreatment and diesel fuel hydrotreatment, the catalytic cracking unit, and also on the vacuum block of distillation unit №1. All of these units will be commissioned in 2009.

In December of the reporting year the Company started refining oil at the ISAB refining complex (island of Sicily, Italy). Crude throughput at the Complex (LUKOIL's share) in December was 520,500 tonnes.

Share of diesel fuel with sulfur content below 50 ppm in total diesel production, %[1]




Share of high-octane gasoline in total gasoline production, %[1]




[1] Excluding mini-refineries and the ISAB Complex.

# Acquisition **of the ISAB Refining Complex**

As part of the Group's strategy for development of its refining segment in Western Europe, LUKOIL signed an agreement in June 2008 with the Italian company ERG S.p.A. on creation of a joint venture to operate the ISAB refining complex, located on the island of Sicily in Italy.

The ISAB refining complex is one of the largest and most technically advanced in the Mediterranean region. Acquisition of a share in the complex increased LUKOIL's overall refining capacity by 13% and refining capacities abroad by 60%.

Acquisition of a share in the complex improves the balance between oil production and refining in the Company's asset portfolio, bringing it closer to that of other vertically integrated oil companies. The Group's ratio of refining capacity to crude oil production increased from 60% (at the end of 2007) to 70% (at the end of 2008) as a result of the ISAB acquisition.

Under the agreement each of the partners supplies crude oil for refining and sells finished products in line with its equity stake in the JV. ISAB is strategically positioned at the centre of oil and petroleum product trading routes across the Mediterranean Sea, at the intersection of flows from the Middle East, Libya, Algeria, Egypt, the Black Sea, and the Baku – Tbilisi – Ceyhan pipeline. On the one hand, this makes third-party crude oil available to LUKOIL, on the other hand it offers more profitable opportunities for selling the Company's own oil. It is estimated that the Company will be able to redirect up to 3 million tonnes of oil each year to greater advantage, increasing gross annual revenue by $100–150 million. Ownership of the stake in ISAB also enables the Group to obtain arbitrage on oil deliveries thanks to price differentials between the Black Sea and the Mediterranean.

ISAB is specialized in refining of non-heavy sour crude oil of similar quality to Urals blend, so that LUKOIL Group will be able to integrate the complex into its chain of crude oil export deliveries and reduce risks associated with volatility of prices for crude oil.

Acquisition of a stake in the complex will also enable LUKOIL to increase its trading positions and supply petroleum products to the Company's filling stations in the Balkans, Turkey and Western European countries.

Outputs from ISAB consist mainly of medium distillates, which are in growing demand in Western Europe. In the current context of worldwide economic crisis, this factor should mean that reduction of margins in the Mediterranean region will be less marked than in other regions.

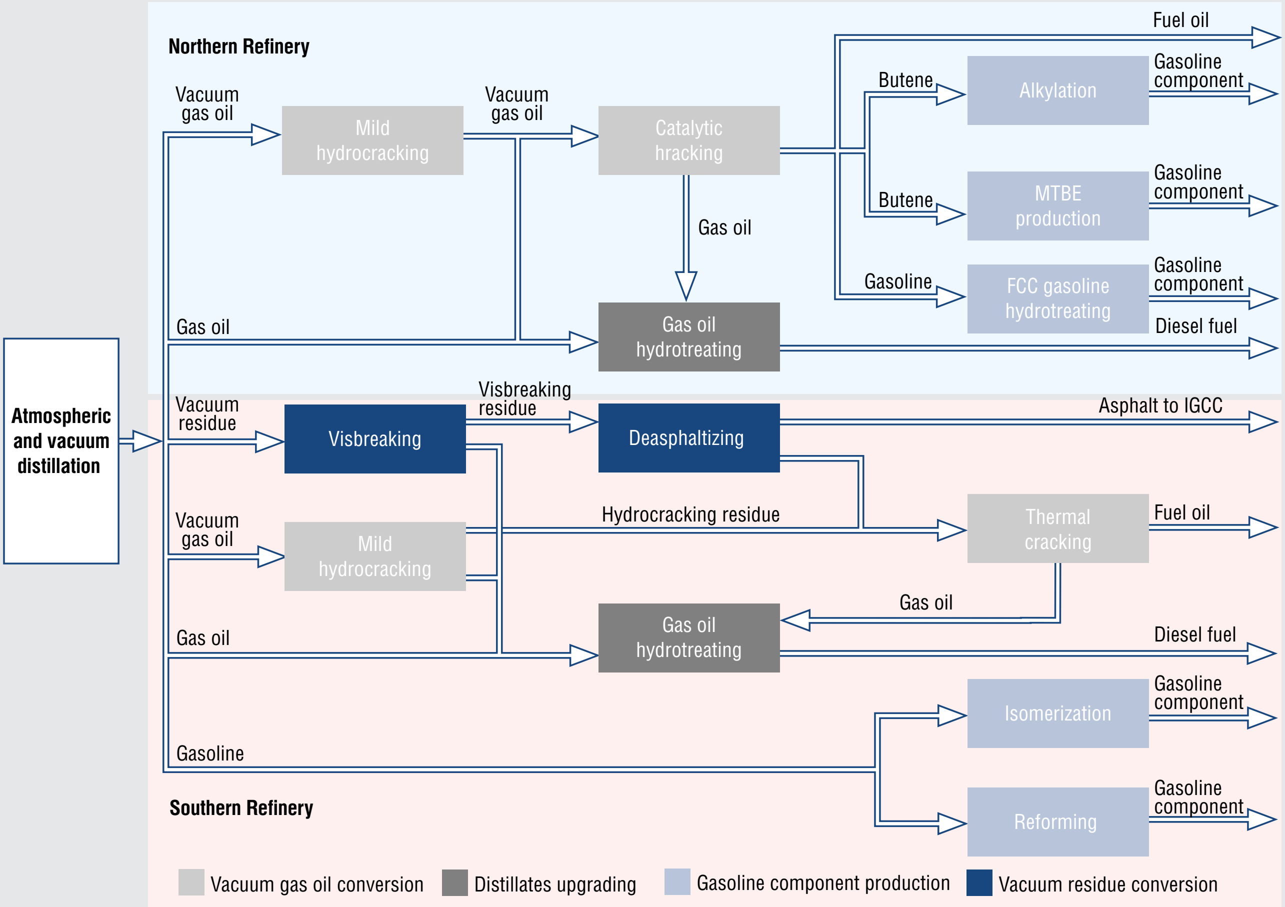
## Description of the ISAB Complex

ISAB is a large, high-technology oil refining complex, a so-called 'super-site', with Nelson Index of 9.3 and capacity of 16 million tonnes per year (320,000 barrels per day).

Depth of oil refining at the Complex in 2008 was 85% and output of light petroleum products was 75%, which exceeds average values for the Group's refineries abroad (80% and

The transaction gives LUKOIL Group both a highly profitable, technically advanced asset and a new and reliable partner – the company ERG S.p.A., which has more than 70-year business experience in the Mediterranean region. ERG S.p.A. is an independent energy and oil group specializing in refining and sale of petroleum products and power generation. It is one of the three largest oil refining companies in Italy, with about 12% of the country's refining capacities and a 9% share of petroleum product sales on the domestic market.

## Flow Diagram at ISAB Complex (Northern and Southern Refineries)




62% respectively). Diesel fuel and gasoline are the main outputs (48% and 19% of marketable products in 2008).

The ISAB complex consists of 2 refineries – the northern and southern refineries, – joined by a 12-km system of pipelines and integrated into a single technological complex. ISAB also has three sea tanker wharfs, a tank battery with storage capacity for 3.7 million cubic metres, a 99 MW power station and several other infrastructure assets. Annual capacity of the southern refinery is 11 million tonnes of crude oil and it is equipped with a visbreaking unit, light hydrocracking and thermal cracking units, and sulphur purification units, which enable refining of medium-to-heavy crude oil. Annual capacity of the northern refinery is 5 million tonnes of crude oil and it is equipped with catalytic cracking units, enabling production of large amounts of light fractions. The refinery produces both petroleum and petrochemical products.

Large-scale modernization of the complex, which began in 2003, was completed in July 2007 at a cost of more than 300 million euros (about $390 million). The aim of the modernization was to adapt the complex to growing demand for medium distillates on the Western European market. The modernization work integrated the northern and southern refineries into a single refining complex and increased conversion capacity. Annual catalytic cracking capacity after

### The Refining Industry in Italy

The oil refining sector in Italy is the largest in the European Union. There are 16 refineries operating in the country, owned by 11 different companies, with total capacity of about 2.2 million barrels per day, and 4 companies (Eni, ERG, ExxonMobil and Saras) account for roughly 80% of capacity. Annual production is about 95 million tonnes, or 15% of petroleum product output by the European Union. Around 60% of the total consists of diesel fuel and motor gasoline.

The main suppliers of crude oil to Italy are countries of the former USSR and Libya (about 60% of the total), as well as Iran, Iraq and Saudi Arabia. Italy's petroleum product output is used to meet domestic demand and is exported, mainly to Spain, the USA, Belgium, the Netherlands and Luxembourg.

completion of the work is 1.8 million tonnes, hydrocracking capacity is 4.5 million tonnes, thermal cracking capacity is 2.7 million tonnes, visbreaking capacity is 2.3 million tonnes, and deasphalting capacity is 1.6 million tonnes. Structural changes have caused reduction in overall complex capacity from 380,000 to 320,000 barrels per day, but this is more than compensated by increased profitability of the complex due to greater complexity of production (the Nelson Index has risen from 7.6 to 9.3). Modernization has also reduced air pollution from refining processes and enabled production of gasoline and fuel oil that meet European Union standards, which came into effect from January 1, 2009.

The main suppliers of inputs to the complex are countries of the Black Sea region (33% in 2008), North Africa (30%), the Persian Gulf (24%) and West Africa (12%).

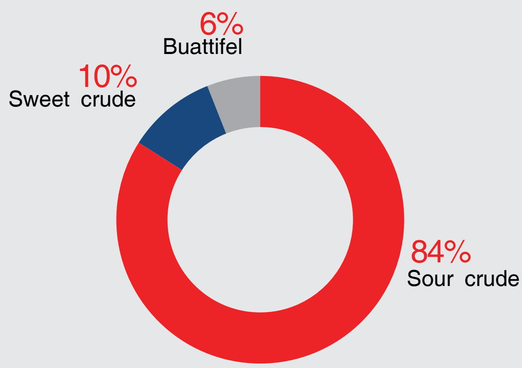
Most of ISAB's output (about 60%) is exported. The main customer for gasoline produced by the complex is the USA, and diesel fuel is bought mainly by European Union countries.

## Description of the Transaction

Transaction value was 1.45 billion euros (approximately $1.83 billion). On December 1, 2008 the Group closed the transaction by paying a first tranche of 600 million euros (about $762 million). Under the agreement, remaining payments were to be made in three separate tranches before the end of September 2009. However, the Company paid the whole amount at once and ahead of schedule in February 2009. There was a discount for early payment of 15 million euros ($19 million). The transaction has received approval from the European Commission, which found no breaches of provisions of EU anti-monopoly legislation.

A 49% stake in the JV belongs to the Company, and the Company's share may be increased in the future. ERG S.p.A. currently has 51% of the JV. The structure of the transaction allows ERG to sell its stake in the JV within 6 years from the time of closure of the transaction at market price (determined by an ind ependent appraiser). The parties manage the joint venture on parity basis.

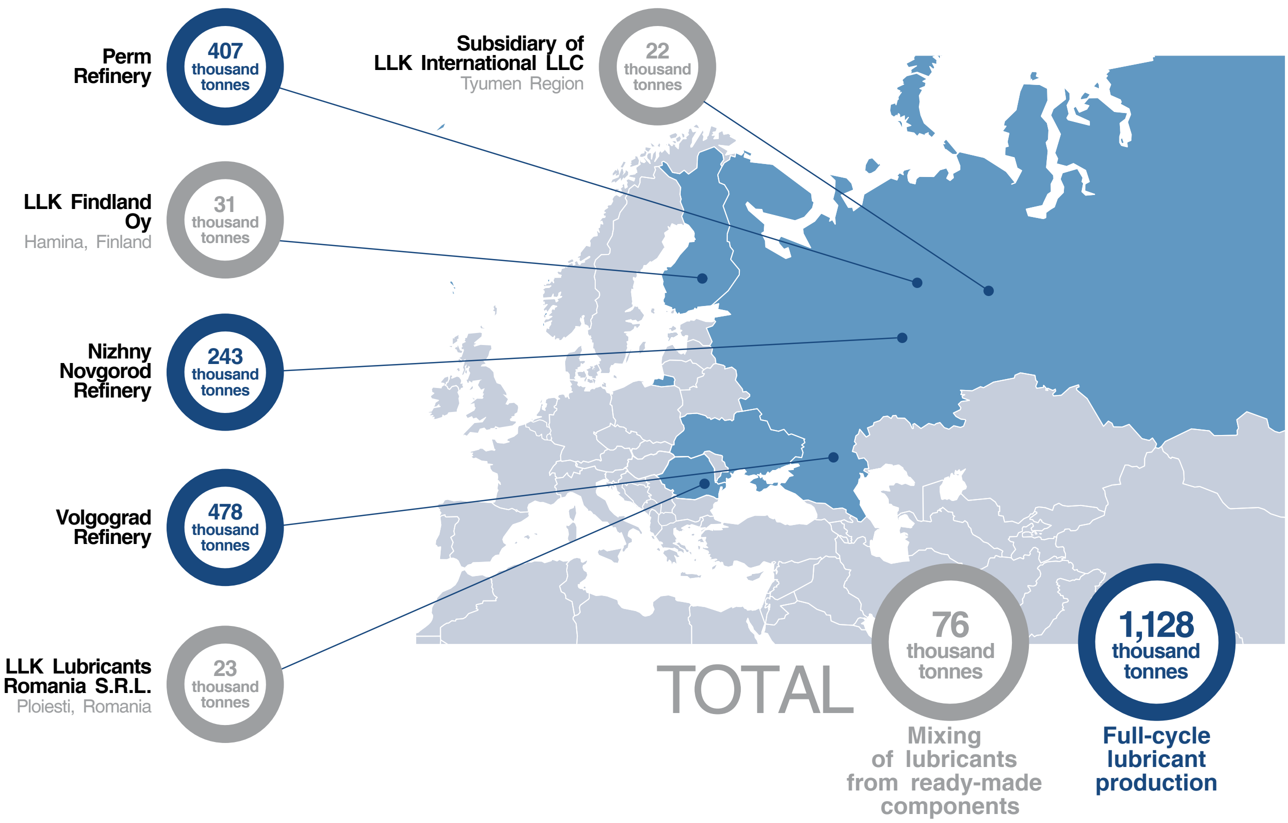
Crude oil refined at the ISAB Complex



## ISAB Complex: Main Crude Oil Sources and Petroleum Product Sales Directions


# Production of Oils and Lubricants

## Lubricant production at LUKOIL Group refineries



Production and sale of oils and lubricants is an important part of LUKOIL's business. The Group is constantly improving the quality of products and expanding their range, as well as raising efficiency of the sales system and diversifying business geography.

LUKOIL is the leader on the Russian oils and lubricants market accounting for about 45% of domestic production. Oils and lubricants are produced at Group refineries in Perm, Volgograd and Nizhny Novgorod. The Company also mixes lubricants from ready-made components (both produced by the Company and bought from third parties) at facilities in Russia, Finland and Romania.

Group refineries produced 1.13 million tonnes of oils and lubricants in 2008. Mixing of oils and lubricants at other Company facilities rose to 76,000 tonnes. Output of packaged oils was 231,000 tonnes.

LUKOIL produces over 120 brands of oils and lubricants to latest international standards. They include motor and transmission oils for all types of transport, base oils (used as inputs for production of ready-to-use oils, lubricants and additives), and lubricants for industrial equipment.

The Company worked hard in the accounting year to optimize production technologies and improve the quality of lubricant outputs. Steps were taken to increase marketable product yield, reduce energy consumption and raise the quality of base oils. As part of a policy to generate more value added from secondary products, the Company worked on launch, optimization of composition, and increase of production and sales volumes of engine flushes, petroleum penetrating fluids, plasticizers, petroleum jelly and other products. The Company started production of 16 new products in the course of 2008.

The joint venture between LUKOIL and Belarusian Naftan refinery, LLK-Naftan, met 41% of LUKOIL's own needs for additives during 2008, and this indicator will be increased to 80% in the medium term. The JV has increased output by 8 times, from 3,200 to 24,900 tonnes, since its creation in 2006.

The Company carries out sales of oils and lubricants in 35 countries worldwide and sales geography is constantly expanding. In 2008 LUKOIL began lubricant sales on 5 new markets: Turkey, Pakistan, Jordan, Taiwan and Dominica.

Constant expansion of the product range and improvement in the quality of Company oils and lubricants encourages growth in sales volumes. Sales of LUKOIL branded lubricants reached 182,000 tonnes in 2008, which is 27% more than in 2007. Main markets for sales of branded lubricants were Russia, Kazakhstan and Finland, and the biggest increases in exports were to Azerbaijan, Kazakhstan and Ukraine. Overall sales of packaged oils in the accounting year were 227,000 tonnes.

LUKOIL organized production of branded lubricants at company facilities in Perm and Romania in 2008 using canisters with a new design. The project enabled modernization of the production chain, and the Company bought first-class quality equipment as well as technologies licensed by world leaders in the industry.

The new design had positive impact on visual perception and quality of the product, which matches best western analogs, and also offers a high level of protection against counterfeit. Walls of the new canister have three layers and labels are heat moulded during extrusion. The canister has a two-part, moulded lid and laser marking.

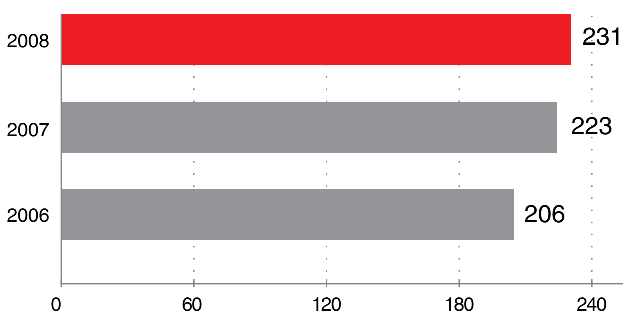
Qualities of the new formula and external design of the canister have been very positively received on the market.

LUKOIL signed an agreement in 2008 with the Russian automotive manufacturer, Severstal-Auto, on strategic cooperation over a period of 5 years. In accordance with the agreement, LUKOIL branded lubricants will be supplied to Severstal-Auto plants for use in production equipment, first filling of new automobiles, and also for use by the company's after-sales service. The parties will expand their cooperation in the future, working together on development of modern lubricants and other products of oil refining and gas processing.

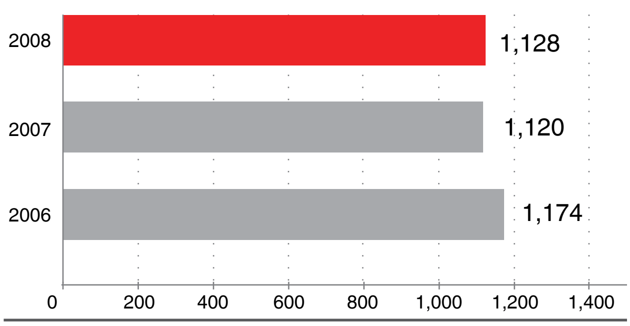
The Company has chosen a modern approach to its lubricant business, including creation of a system for management of customer relations. LUKOIL has been one of the first companies in the industry to offer a comprehensive service with full product support, from placement of client orders to delivery of the product and, ultimately, disposal of used lubricants. Thanks to this policy the Company now sells more than 80% of its lubricant output directly to end-users.

LUKOIL obtained new lubricant production capacities as part of the transaction to acquire assets of the Turkish company, Akpet, in 2008. Akpet facilities are capable of producing 12,000 tonnes of oils and lubricants annually (for more detailed information on the acquisition of Akpet, see page 10).

Production of packaged oils,
thousand tonnes




Oils and lubricants production at Company refineries,
thousand tonnes

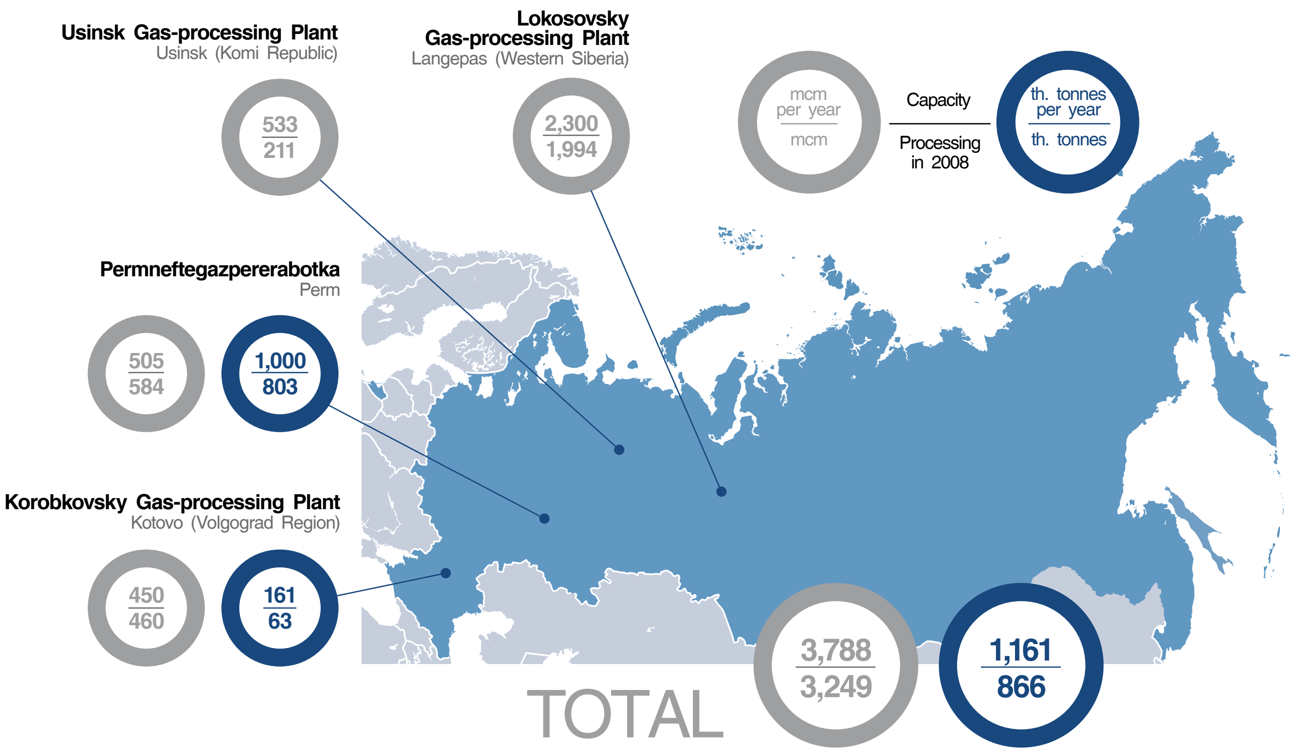



LUKOIL motor oils match international requirements of the Society of Automotive Engineers (SAE), the American Petroleum Institute (API), the European Automobile Manufacturers Association (ACEA) and the Russian Association of Automobile Engineers (AAE). Our oils are produced using the latest technologies and contain high-quality additives supplied by Russian and foreign producers.

High performance qualities of LUKOIL lubricants have been acknowledged by major automotive manufacturers in Russia and abroad. Company motor oils have passed tests at western certification centers on engines made by DaimlerChrysler, BMW, Volkswagen, MAN, Porsche, Volvo, Renault trucks and Cummins, and have been approved for use in these engines.

# Gas Processing

## LUKOIL Group Gas-processing Plants




Gas-processing plants of LUKOIL Group process associated gas from fields in Russia into marketable gas (fed into the Gazprom gas pipeline system) and liquid hydrocarbons.

In 2008 the Company's gas-processing plants processed 3.249 billion cubic meters of gas feedstock and 866,000 tonnes of natural gas liquids, which is roughly equal to levels in 2007.

During 2008 company plants produced 2.568 billion cubic meters of stripped gas, 965,000 tonnes of LPG and 841,000 tonnes of liquid hydrocarbons (stable gas naphtha, isopentane and hexane-heptane fractions, and natural gas liquids).

Work proceeded in the accounting year at the Company's Usinsk Gas-processing Plant on construction of an associated gas compressor unit with annual capacity of 500 million cubic meters, and on installation of a desulphurization unit with annual capacity of 100 million cubic metres.

The Permneftegazpererabotka plant carried out optimization of its output structure (outputs of unprofitable products were halted, the share of liquefied hydrocarbon gases in total production was increased, and deliveries were optimized).

Work was carried out at the Lokosovsky Gas-processing Plant in 2008 to upgrade heat-transfer fluid heaters.

Steps were taken during 2008 to introduce an improved production planning system at the Korobkovsky Gas-processing Plant.

# Petrochemicals

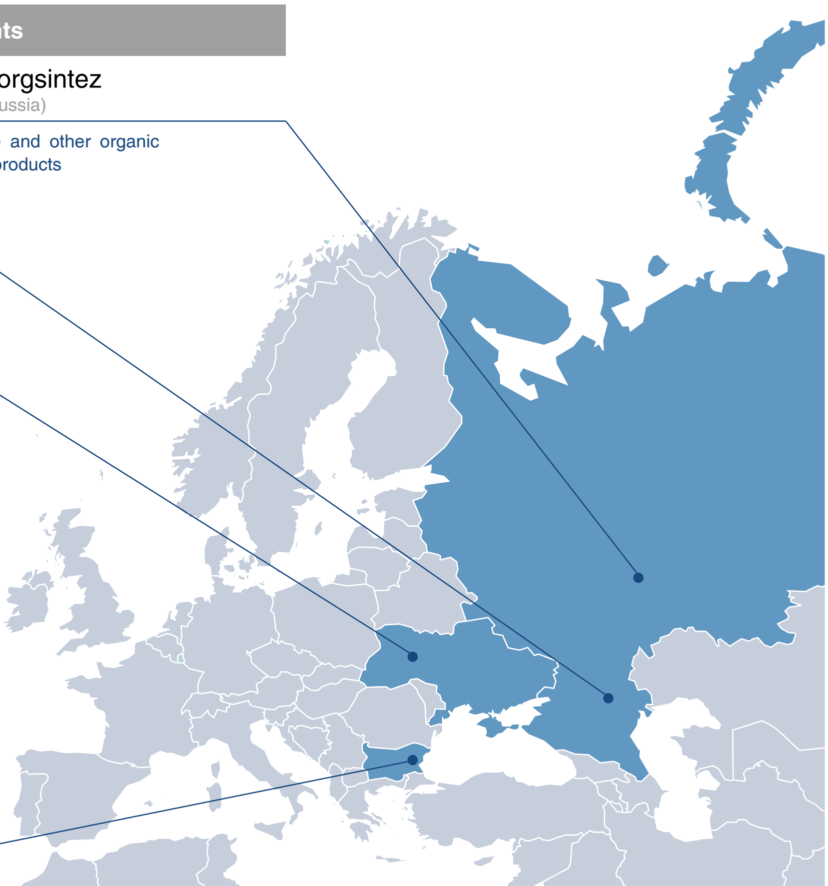
## LUKOIL Group Petrochemical Plants

**Petrochemical Plants**

**Stavrolen**
Budennovsk
(Stavropol Region, Russia)
Polyethylene and other products

**Saratovorgsintez**
Saratov (Russia)
Acrylonitrile and other organic synthesis products

**Karpatneftekhim**
Kalush (Ukraine)
Polyethylene, vinyl chloride and other products



**Refineries with petrochemical units**

**LUKOIL Neftokhim Burgas AD**
Burgas (Bulgaria)
Polymers and organic synthesis products

LUKOIL's petrochemical business is the biggest in Russia and Eastern Europe. Company plants in Russia, Ukraine and Bulgaria make pyrolysis and organic synthesis products, fuel fractions and polymer materials. LUKOIL meets a major share of Russian domestic demand for various chemicals and is a major exporter of chemicals to more than 30 countries worldwide.

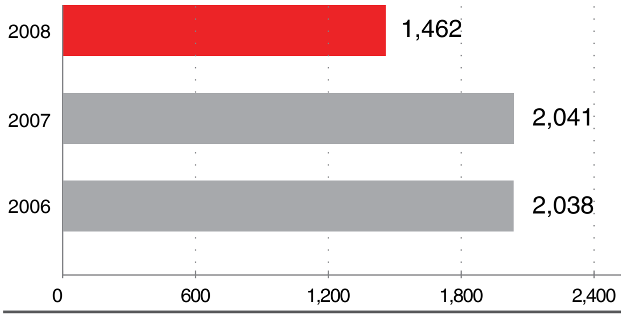
In accordance with its development strategy in the petrochemicals sector, LUKOIL is steadily increasing production of chemicals with high value added (polymers, monomers and organic synthesis products) and reducing production of chemicals with low value added (secondary pyrolysis products and fuel fractions).

LUKOIL petrochemical plants produced 1.462 million tonnes of petrochemicals in 2008. A 28% decline of volumes compared with 2007 is explained by halting of production at Karpatneftekhim in May 2008 for upgrading purposes.

The price environment on petrochemical product markets was very mixed in 2008. A steep rise in prices in the first half of the year was followed by substantial decline in the second half. As a result, the sale price for polyethylene in Russia rose by 5.0% in the course of the year and polypropylene prices rose by 9.4%, but the price for benzol fell by 13.6%. In Europe prices for all three products declined: polyethylene by 0.8%, polypropylene by 5.6% and benzol by 0.5%.

LUKOIL took steps in 2008 to modernize existing units and install new ones as part of Group strategy for development in the petrochemical sector. Capital expenditures in the petrochemical sector were $121 million in 2008.

Petrochemical production,
thousand tonnes




Production was halted at the Karpatneftekhim plant in May 2008 so that a large-scale upgrade could be carried out. Work is now in progress for installation of a chlorine and caustic soda production unit using membrane electrolysis

technology. Annual capacity of the new unit will be 182,000 tonnes of gaseous chlorine and 200,000 tonnes of caustic soda. The new capacities will enable Karpatneftekhim to produce caustic soda, which meets international quality standards, and to fully provide the plant's own chlorine needs. Commissioning of the unit is scheduled for the end of 2009.

Karpatneftekhim also continued work on construction of a unit to produce suspended polyvinylchloride with annual capacity of 300,000 tonnes. Its integration with the plant's capacities for production of vinylchloride monomer will greatly increase overall efficiency. Commissioning of the unit is scheduled for 2010.

The feeder aggregate to pyrolysis furnaces at Karpatneftekhim was overhauled in 2008. This work has enabled changes to feedstock structure and increase in ethylene yield, as well as reducing diesel fuel consumption and cutting production costs.

A sodium cyanide unit with 15,000 tonnes annual capacity was commissioned at Saratovorgsintez in 2008. The sodium cyanide production process uses DuPont technology, which is highly reliable and secure. Sodium cyanide is used in gold mining for separation of precious metals from ore material. Outputs from the new unit meet the greater part of needs of the Russian mining industry (about 20,000 tonnes of sodium cyanide per year), which were previously met by imports.

Work was carried out at Stavrolen to upgrade its storage facility for liquefied hydrocarbon gases in order to increase gas feedstock handling and processing from 200,000 to 400,000 tonnes per year. Commissioning of the facility is planned for the third quarter of 2010.

Modernization work on the polypropylene unit (120,000 tonnes annual capacity, commissioned in 2007) was continued in 2008: Stavrolen commissioned and fine-tuned the new compressor and modernized the polypropylene compounding line. This will ensure better product quality in the future and will reduce losses of propylene during the production process. The work was completed in the first quarter of 2009.

Stavrolen also nearly completed work on installation of a new polyethylene compounding line with annual capacity of 120,000 tonnes in 2008. Commissioning of the unit is scheduled for the second quarter of 2009. The new compounding line will improve quality of granulated polyethylene outputs and reduce energy costs. It will also enable expansion of Stavrolen's branded product range.

One of the main projects scheduled for implementation in the next few years is construction of the Caspian Gas-chemical Complex. The Complex will use natural gas and condensate produced by LUKOIL Group in the Caspian region and will have annual capacity of at least 600,000 tonnes of ethylene.

The purpose of the project is to increase value added through deeper processing of gas feedstock (ethane and natural gas liquids). The Caspian Complex will carry out refining of ethylene and its derivatives into polyethylene, polypropylene and other petrochemical products.

Conceptual engineering for the Complex was completed in 2008 and a general plan has been drawn up for positioning of production units and infrastructure facilities. The plan ensures full integration of the new production with the existing Stavrolen petrochemical complex.

As a part of the project for creation of the Caspian Gas-chemical Complex, plans for 2009 include preparation of special technical conditions for designing, construction and operation of a product pipeline from the Caspian Gas-processing Plant to Stavrolen and completion of competitive tendering to select license providers and engineering companies. The tendering process began in 2008.

LUKOIL

ANNUAL REPORT

2008

# Power Generation

LUKOIL created a new business sector in 2008: Power Generation. Creation of the new business sector is a part of the Company's Strategic development program for 2008–2017. Power business will be an important factor for growth of Company capitalization in the long term.

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The new sector will include all aspects of power business, from generation to transmission and sale of heat and electrical power, ensuring reliable supplies for the Company's own needs and for external customers. By the end of 2008, LUKOIL's Power generation business sector included UGK TGK-8 (TGK-8, acquired during the accounting year), the Company's own power generating facilities at oil & gas fields, and also a number of power generators in Bulgaria, Romania and Ukraine.

Output of electrical energy during 2008 by LUKOIL organizations was in excess of 16.2 billion kilowatt-hours (TGK-8 accounted for 90% of the total). Output of heat energy was more than 18.1 million Gcal, of which 85% was generated by TGK-8.

According to Company plans, the Power Generation business sector will consist of 4 parts:

- production and operation;
- transmission of heat and electrical energy;
- energy sales;
- investment and renovation.

Reorganization of the electricity business in accordance with Company plans should give positive economic effect of up to $40 million per year. Annual cash flow from sales of heat energy will increase by $6 million through elimination of cross-subsidization between production of heat and its sale.

## UGK TGK-8

LUKOIL Group signed an agreement for acquisition of 64.31% of shares in TGK-8 for $2.117 billion in March 2008. The cost of the acquisition included 23.55 million ordinary shares of LUKOIL (with market value of about $1,620 million). The transaction was completed in May 2008. Over the period from May to December 2008 the Group acquired an additional stake in TGK-8 for $1.075 billion. These acquisitions increased the Group's ownership stake in TGK-8 to 95.53%.

TGK-8 is the largest producer of electrical and heat energy in the Southern Federal District of Russia. The company consumes about 6 billion cubic meters of gas each year for generating purposes. TGK-8 has 20 power stations and 42 boiler plants (with installed electricity generating capacity of 3,602 MW and heat generating capacity of 13,542 Gcal per hour). The company's power stations are located in Astrakhan, Volgograd and Rostov regions, Krasnodar and Stavropol territories and the Republic of Dagestan in Russia. Overall share of the electricity market in regions where the company has presence is about 17%, and its share of heat energy markets is about 60%.

The company owns a heat network with overall length of over 1,500 kilometres. Total heat network, including leased and managed capacity, is about 2,200 kilometres in length.

LUKOIL expects to obtain major synergy effects from acquisition of TGK-8, since the Company will be able to provide non-stop supplies of natural gas from its fields located in the Northern Caspian and Astrakhan Region to TGK-8 power stations at an efficient price.

## Small-scale Generating

LUKOIL is continuing rapid development of its own power generating at fields. This enables substantial savings on electricity purchases and raises the level of utilization of associated gas, which is used as fuel for gas-fired generating. The Group has a total of 463 generating units in operation at fields with total capacity of 336.8 MW. Electricity output from these units in 2008 was 829.2 million kilowatt-hours, representing 5.9% of total consumption of electricity by the Group in its production activities.

LUKOIL applies the latest technologies in its investment projects for construction and upgrade of generating facilities. This will ensure increasing reliability of power supplies to LUKOIL enterprises. Spending on electricity is being significantly reduced thanks to efficiency improvements and use of the Company's own refined products as fuel.

## Energy-saving Technologies

LUKOIL works constantly to improve reliability of its electricity supply arrangements and to reduce spending on energy. The efforts have been coordinated through corporate programs (being implemented in 2006–2010) for energy saving and improvement of reliability of power supplies. Savings of fuel and energy resources in 2008 as a result of the energy-saving program were more than $42 million. Spending on measures as part of the program for improving reliability of electricity supplies was about $130 million in 2008, which is over 2.5 times more than in 2007. Implementation of the program has reduced power cuts and resulting underproduction of crude oil by more than 20%.

The Company approved an energy audit schedule for its oil & gas production subsidiaries in the period from 2006 to 2010. Purpose of the audit is to identify irrational consumption of resources and design measures to remove the source of the problem. In 2008 energy audits were carried out at LUKOIL-Usinskneftegaz and the Usinsk Gas-processing Plant as part of the schedule.

Rational use of electricity considerably reduces Group spending on purchase of energy resources. An automated system for measuring of electricity use was installed at all Company subsidiaries. The system takes advantage of three different levels of tariffs, in force at different times of the day, and increases accuracy in measurement of electricity consumption, reducing spending on electric power and keeping track of the Company's power supply arrangements.

LUKOIL

ANNUAL REPORT

2008

# Product Deliveries and Marketing

Strategy

- Optimizing logistics: control over transportation expenses
- Prompt management of trade flows
- Increasing efficiency of trade operations
- Increasing retail sales volume of petroleum products and of related products and services
- Retail network optimization

# Crude Oil Deliveries

Total crude oil deliveries by the Company in 2008 reached 101.3 million tonnes, which corresponds to the level of 2007. Due to increase in refining margins and growth of oil export tariffs in Russia LUKOIL maximized profits by prompt redirection of crude oil volumes from less efficient exports to the domestic market, primarily to its own and third-party refineries inside Russia.

The Company sold 2.10 million tonnes of crude oil in Russia during the year, which is 31% more than in 2007. Refining at the Company's own refineries inside Russia reached 44.18 million tonnes, which is 3.8% more than in 2007. In order to take advantage of favourable conditions on the domestic market the Company delivered 3.19 million tonnes of crude oil for processing to third-party refineries in Russia. In the accounting year 236,000 tonnes of crude oil were purchased in Russia, compared with 47,000 tonnes in 2007. The increase in purchases of crude oil is explained by growth of refinery throughputs in a context of lower crude oil production by the Company in Russia.

In order to optimize routes for crude oil flows LUKOIL reached an agreement in 2008 with Transneft to increase the volumes of crude oil pumped to the Volgograd Refinery from 27,500 to 29,900 tonnes per day, enabling increase of refinery throughputs at the Refinery. The annual economic effect is estimated at $135 million. Daily crude oil supplies to the Volgograd Refinery in the accounting year were increased by 11.4% to 29,500 tonnes, to the Nizhny Novgorod Refinery by 2.0% to 45,900 tonnes and to the Perm Refinery by 4.5% to 36,000 tonnes. Deliveries of crude oil to the Company's Ukhta Refinery declined slightly owing to a short halt in production for scheduled repairs.

Deliveries of crude oil to third parties on the domestic market in the accounting year, using price formula with a premium to the export formula, were 1.7 million tonnes, and gave an additional effect of $17 million.

Crude oil exports from Russia by LUKOIL subsidiaries (including oil purchased from other producers) declined by 6.8% in comparison with 2007, to 39.30 million tonnes,

owing to redirection of a part of export oil to the domestic market. The Company exported 31.20 million tonnes to the far-abroad countries and 8.10 million tonnes to the near-abroad countries. The Company managed its export deliveries efficiently in 2008, selecting the most profitable routes. The main routes for export of crude oil remained the ports of Primorsk and Novorossiysk, which accounted for 42% of total exports. A further 10% of exports were made by pipeline deliveries to Hungary and 8% to Poland.

As part of work to optimize export routes 0.7 million tonnes of crude oil were redirected from Black Sea routes to Belarus and Kazakhstan in the accounting year, which gave extra profits of $15 million.

Most export in 2008 was via the Transneft pipeline system. Deliveries via Transneft were 36.07 million tonnes (9.8% less than in 2007) and their share in overall exports amounted to 92%. The volume of export deliveries by-passing the Transneft system in 2008 increased by almost 50% to 3.23 million tonnes of crude oil, which is due to commissioning of the Company's Varandey terminal. Deliveries through Varandey were valued on the basis of actual quality of the crude oil, mainly at a premium to the Urals price. (There is no oil quality bank in the Transneft system, which is why crude oil of any quality supplied through this system is sold at the price for Urals blend crude, so that Urals blend is the Company's main export commodity).

The Company continued to develop its own export capacities, enabling reduction of transportation costs and making transport arrangements more flexible. A total of 2.8 million tonnes of oil were exported via the Company's own transport terminals in 2008, compared with 1.9 million tonnes in 2007.

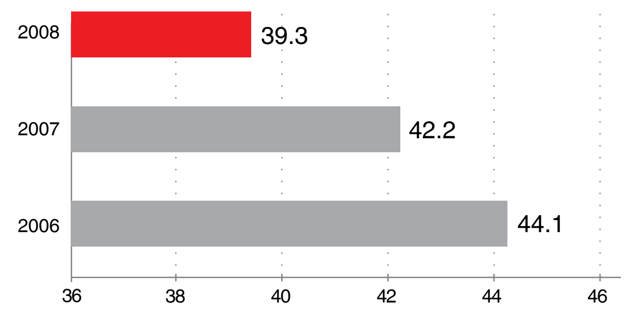
Work in the accounting year to improve pricing formulas raised sale prices of LUKOIL's export crude deliveries via the Druzhba pipeline. Total additional revenue thanks to improvement in price formulas was almost $4 million. Specifically, the sales formula for Poland was improved by 13 cents per barrel from January, and the price formula for deliveries to the Czech Republic was improved by 62 cents per barrel from October.

The Company continued to apply a new approach to price formation as part of work to improve efficiency of crude oil deliveries in 2008. The new approach takes account of developments on the international market for purposes of oil sales in Russia and the near-abroad countries. This has positive impact on quality of commercial decisions, which are better founded, since financial outcomes are more predictable at the time when deliveries are planned.

Crude oil deliveries to foreign refineries of LUKOIL Group and the ISAB refining complex were 12.10 million tonnes, representing a record 25.9% increase compared with 2007. This was achieved thanks to resumption of production at the Odessa Refinery after modernization and acquisition of a stake in new refining complex. Apart from deliveries to its own refineries, the Company also supplied crude oil for processing at third-party refineries (Naftan and the Mozyr Refinery in Belarus and the Panchevo Refinery in Serbia). Volumes of these deliveries in the accounting year were 2.29 million tonnes, which is more than twice the level in 2007.

In addition 37.44 million tonnes of crude oil were sold on the international market, including 4.32 million tonnes to countries of the near-abroad and 33.12 million tonnes to countries of the far-abroad.

Crude oil exports, million tonnes




**In 2008 LUKOIL Group fully completed construction work on the Varandey oil loading terminal with crude oil throughput capacity of up to 12 million tonnes per year (240,000 barrels per day).** The terminal began shipping oil in June 2008, and maintains shipments all year-round, despite severe climatic conditions. Crude oil for the terminal comes mainly from the Timan-Pechora oil & gas province, primarily from the Yuzhnaya Khylchuya field, which was brought into operation in the summer of 2008.

The work, which has been completed at Varandey, is as follows: building and commissioning of a stationary, ice-resistant loading terminal at sea, a shore side tank farm with a capacity of 325,000 cubic metres, two stretches of underwater pipeline, and also an oil accounting facility, auxiliary reservoirs, a pumping station, energy supply facilities, a housing estate for duty personnel, and other infrastructure. Capital expenditures during the whole period of construction were $1.1 billion, including $163 million in 2008.

The terminal operates as follows: ice-class shuttle tankers with deadweight tonnage of 70,000 tonnes transport oil to a floating reservoir in the ice-free waters off Murmansk, from where long-distance tankers with deadweight tonnage of 150,000 tonnes deliver the oil to Western Europe and the USA. About 2 million tonnes of crude oil were shipped out through the terminal in 2008.

# Gas Deliveries

The gas segment is a new and rapidly developing segment of business for LUKOIL Group. Expansion in the gas segment is one of our strategic tasks, emphasizing commercialization of gas reserves to boost Company value.

In 2008 sales of natural, associated, stripped and dry gas by the Group's Russian organizations totalled 12.066 billion cubic meters, which is 4.7% more than in 2007. Of this total, 9.397 billion cubic meters of gas were sold to Gazprom (including 7.856 billion cubic meters of natural gas from the Company's Nakhodkinskoye field) and 2.669 billion cubic meters of gas were sold to other consumers.

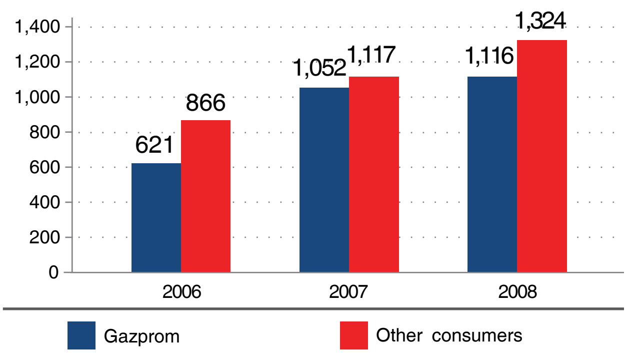
The average sale price for gas rose in the accounting year by 8% from 1,070 to 1,152 roubles per thousand cubic meters (1,116 roubles per thousand cubic meters for Gazprom and 1,324 roubles per thousand cubic meters for end-users).

In order to increase profit from sales and simplify arrangements for gas supply to end-users, volumes of gas supplies through Gaz-Oil Trading (a parity joint venture between LUKOIL and Gazprom) were increased in the accounting year to 1.541 billion cubic meters. This allowed a unified approach to pricing and made it simpler to organize gas transportation through the Gazprom gas-transportation system.

In 2008 the Company continued selling gas to other consumers at market prices through the Mezhregiongaz electronic trading platform: 815.1 million cubic meters of gas were sold by this means, which is 16% more than in 2007. Most of the growth was during the first three quarters of 2008. There was a fall in demand for gas in the fourth quarter, caused by a surplus of Gazprom output, unusually warm autumn and winter weather and decline in energy prices on world markets. Additional profit from selling gas through the Mezhregiongaz electronic trading platform rose by 2.3 times in 2008 to $10.5 million.

In order to minimize costs the Company carried out preparatory work in the accounting year, which will enable contracts to be made for direct gas supplies to end-users (specifically UGK TGK-8 and TGK-9), cutting out intermediaries.

**LUKOIL selling price for gas,**
roubles per thousand cubic metres



# Petroleum Product Marketing

## Wholesale Trading in Petroleum Products

LUKOIL's petroleum product wholesale business in Russia is carried out by its refineries and by 8 petroleum product organizations inside the Group, operating in 60 regions of the country. Volume of petroleum product wholesale in Russia in the accounting year was 13.31 million tonnes, which is 2.8% less than in 2007. Despite a sharp fall in world energy prices from August 2008, prices for main petroleum products on the domestic market remained 20–30% higher than export prices (taking account of transportation costs and export tariffs).

The planning system for deliveries of petroleum products from refineries was improved in 2008. In particular there was a changeover to 3-day summary schedules with counter parties for shipment of petroleum products through the month (instead of the 10-day schedules, which were used earlier). This makes planning of deliveries more transparent, ensures optimum capacity utilization at refineries and increases refinery throughputs.

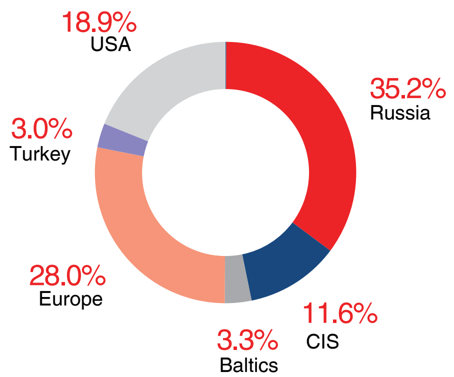
The Company continued prompt management of wholesale petroleum product supplies from its refineries in order to improve marketing efficiency. This enabled increase in sales of petroleum products under direct agreements at a premium to average wholesale market prices.

In order to minimize transportation costs and diversify delivery routes for supplies of petroleum products, transshipment of Company cargoes in 2008 was mainly through Russian ports. This allowed transport costs to be reduced by $14 million on southern routes and by more than $5 million on northern routes, as well as opening up new routes for deliveries of light petroleum products, and increasing volume of fuel oil transshipment through Russian ports by 28% in comparison with 2007. Deliveries of fuel oil and vacuum gas oil from ports in the Baltic countries (Tallinn and Klaipeda) were partly re-directed to Russian ports (including Vysotsk and St. Petersburg). This enabled transportation and transshipment savings of $13 million and $10 million for fuel oil and vacuum gas oil, respectively.

Company organizations exported 25.8 million tonnes of petroleum products to the near- and far-abroad in the accounting year, which is 2.6% more than in 2007. Exports were dominated by heating oil, diesel fuel/gas oil and vacuum gas oil, which accounted for more than 90% of total export volumes. The Company's petroleum product export structure mainly corresponds to structure of exports from Russia as a whole. Exports of marketable gasoline declined by more than 4 times and export of jet fuel by 30% due to increased levels of profitability on the domestic market and resulting re-direction of product volumes for sale inside Russia.

Railway remained the main means of transport for Group exports of petroleum products (82.7% of the total in 2008). Optimization of petroleum product deliveries by rail continued in 2008: LUKOIL used its own cars and cars provided by

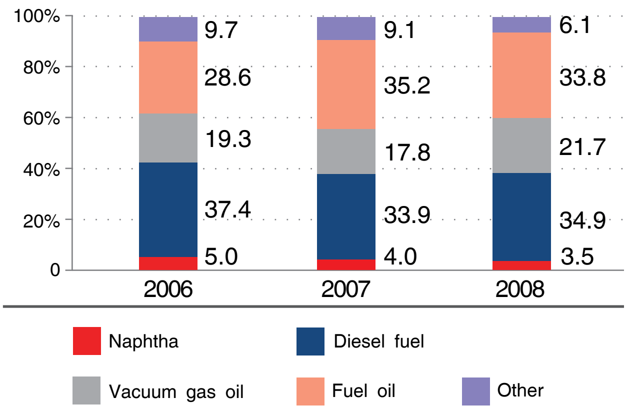
Structure of petroleum product sales in 2008 (wholesale and retail)



other private companies, tariff rates were lowered and the Company obtained discounts on main export routes. The Company was successful in combating overall increases in the cost of rail shipments.

The 2007 agreement with Russian Railways on development of rail infrastructure for shipment of up to 12 million tonnes of petroleum products per year to the Vysotsk terminal continued to be implemented in 2008, and it was decided to consider possible increase of shipment volume to 14 million tonnes. A total 12.6 million tonnes of petroleum products were shipped out through the terminal in the accounting year.

### Petroleum product export structure, %



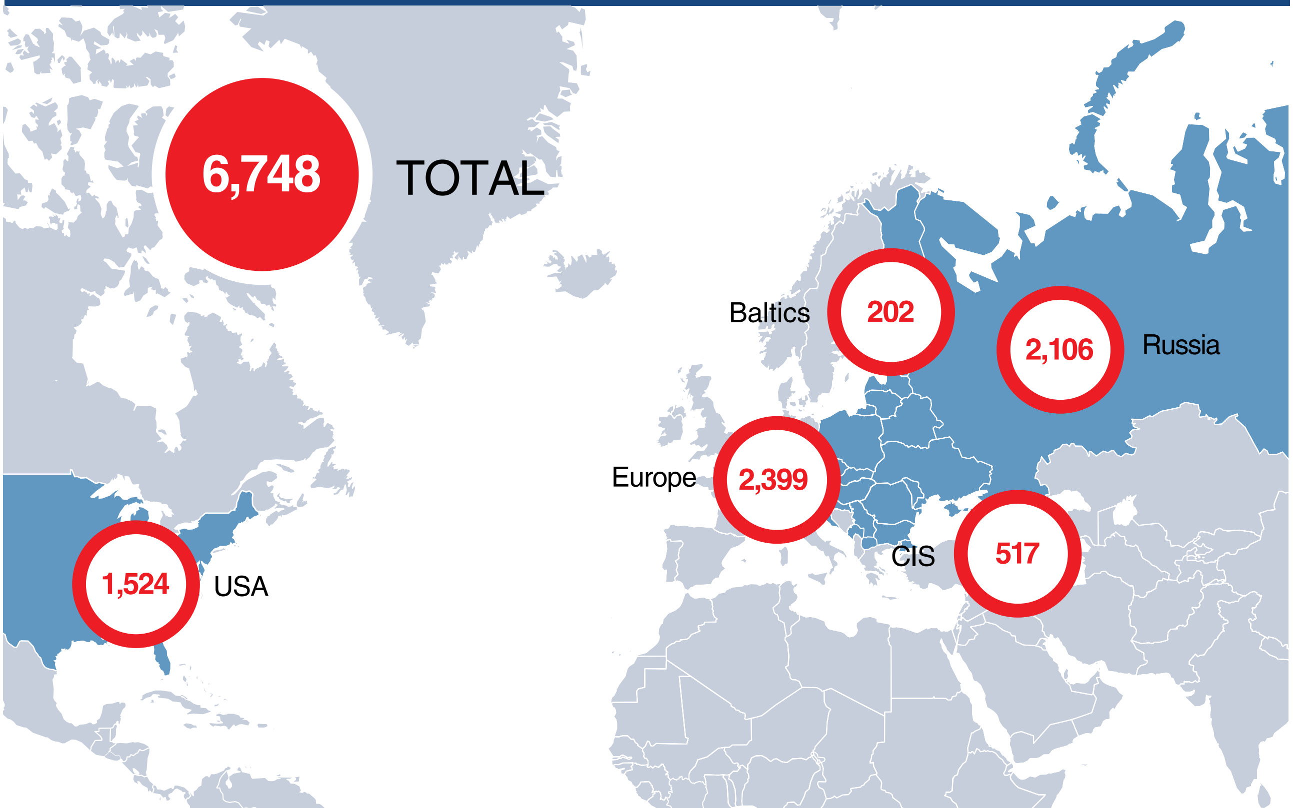

Petroleum products are also exported by water transport. From the start of navigation season, petroleum products are delivered for export by tankers from the Company's river terminals, enabling significant reduction of transportation costs. In 2008, transport savings due to export delivery of dark petroleum products by river instead of rail amounted to $62 million on southern routes and $18 million on northern routes.

About 7.5% of petroleum products by volume are exported through pipelines.

The Company is working continually to optimize delivery routes for exports of petroleum products. In 2008 there was a partial re-orientation of exports of diesel fuel with sulphur content of 10 ppm from the port of Svetly (Kaliningrad) to the port of Vysotsk (Leningrad Region). Transportation costs were cut by $14 million as a result. Other quantities of diesel fuel with the same specifications were re-directed from Vysotsk to Primorsk, which enabled costs to be reduced by $3 million.

LUKOIL is rapidly developing its international trading business in petroleum products by increasing the scale and geographical diversification of this business. The objective of LUKOIL's international trade is to place Company resources as efficiently as possible, including direct sale to end-users (by-passing third-party traders). Volume of the Group's wholesale petroleum product sales on the international market in 2008 was 67.67 million tonnes, which is 5.1% more than in 2007.

## LUKOIL Filling Station Network




The Company plays a significant role in petroleum product supplies to Western Europe. LUKOIL's share in total petroleum product imports by some countries in the region is quite substantial: 30% of imports of diesel fuel and vacuum gas oil in France, 11% of diesel fuel imports in Sweden, 11% of bunker fuel imports in Holland, 10% of the diesel fuel imports in Spain and 4% of fuel oil imports in Belgium.

LUKOIL has trading offices in 9 countries worldwide. LUKOIL makes deliveries of crude oil and petroleum products to markets in Europe, the USA and the Asia-Pacific region, as well as increasing its sales volumes in new regions (Africa, Latin America and the Middle East). The Company's trading business encompassed 82 countries worldwide during the accounting year.

In 2008 LUKOIL Group signed a memorandum of understanding with the Argentine companies ENARSA S.A. and POBATER S.A., concerning possibility of petroleum product deliveries (fuel oil and/or diesel fuel) to ENARSA using infrastructure of POBATER to store the fuel. The memorandum is for a term of 3 years and may be extended.

LUKOIL constantly monitors global hydrocarbon markets when planning placement of its own products. This gives opportunities for arbitrage deliveries, both from the Company's own resources and from third-party resources. The Company also blends petroleum products, including biofuels, on its main sales markets in order to achieve the best-possible match with consumer preferences and quality demands.

## Petroleum Product Retail

The Company's retail network extends to 25 countries, including Russia, the near-abroad countries and European countries (Azerbaijan, Belarus, Georgia, Moldova, Ukraine, Bulgaria, Hungary, Finland, Estonia, Latvia, Lithuania, Poland, Serbia, Montenegro, Romania, Macedonia, Cyprus, Turkey, Belgium, Luxemburg, Czech Republic, Slovakia and Croatia) as well as the USA, and includes 204 tank farm facilities with total capacity of 3.06 million cubic meters as well as 6,748 filling stations (including franchises).

Retail sales of the Company's petroleum products continued to grow in the accounting year: 14.16 million tonnes of petroleum products were sold through our own filling stations, which is 11.0% more than in 2007. Average Group sales per filling station (owned or leased) were 7.3 tonnes per day.

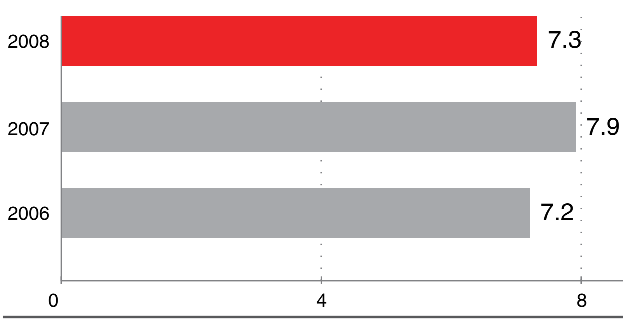
Growth of retail sales was achieved mainly by increasing the volume of sales in the Russian market and acquiring new assets.

There was rapid growth in the number of Company filling stations in 2008, by 11%. This result was achieved mainly through large acquisitions.

First, an agreement was signed to acquire a 100% stake in the Turkish company, Akpet, for $555 million. This company operates 689 filling stations, 8 petroleum product terminals with an overall capacity of 300,000 cubic meters, 5 storage facilities for liquefied hydrocarbon gas, 3 aircraft refuelling complexes, and also a plant for producing and packaging motor oils and lubricants.

We also acquired 75 filling stations and 1 tank farm from the Bulgarian company, Petrol (value of the transaction was about $367 million). Besides that 9 filling stations and a petroleum product terminal with capacity of 8,000 cubic meters were acquired in Croatia ($54 million transaction value), and 6 filling stations in Montenegro ($44 million). Average daily sales of petroleum products at the newly acquired filling stations exceed the average for the Company's European assets and stand at 13 and 9.5 tonnes, respectively.

Average daily sales of petroleum products per filling station, tonnes per day




LUKOIL Group also acquired a 100% stake in the companies Association GRAND and MEGA OIL M for total $493 million. These assets include 181 filling stations in Moscow and Moscow Region, and in Pskov, Kaluga, Novgorod and other regions. Total annual sales volume at these filling stations exceeds 300,000 tonnes. Average daily sales of petroleum products at the filling stations in Moscow and Moscow Region are 9.6 tonnes.

Also in 2008 a transaction was completed to increase the Company's stake in Udmurtnefteprodukt from 41.81% to 85.32%. Udmurtnefteprodukt owns about 100 filling stations, as well as 7 tank farms with reservoir capacity of 390,000 tonnes. Udmurtnefteprodukt's share of the retail petroleum product market in the Republic of Udmurtia is more than 65%.

Investments in the retail petroleum product sector in 2008 were $1,189 million.

The Company continued optimization of its filling station network in 2008, upgrading and disposing of stations and tank farms with low-efficiency: 15 low-efficiency filling stations were withdrawn from the Group in Europe, and 54 in the USA, while in Russia 4 filling stations and 5 tank farm facilities were withdrawn and 7 filling stations and one tank farm were sold. Construction and acquisition of highly-efficient stations continued, and upgrading was carried out at existing stations. In Europe 52 filling stations were built, 817 acquired and 70

were upgraded. In Russia 256 filling stations were acquired or built and 88 upgraded. Capital expenditures in the retail sector in 2008 were $726 million.

The Company continued to implement its program for development of a marketing and sales network for liquefied and compressed gas. The program envisages increase in sales volumes of these products in Russia to 530,000 tonnes per year in the period until 2014. Sales of liquefied and compressed gas by Group organizations in Russia were 100,000 tonnes in 2008.

At the end of 2008 the Group had 96 multi-fuel and gas-filling stations in Russia. The Company's strategy in the refining & marketing segment targets increase in these numbers to 318 in 2013 and 345 in 2017.

The Group's multi-fuel and gas retail network abroad consisted of 928 stations at the end of 2008. Total volume of liquefied and compressed gas sales by Company organizations outside Russia in the accounting year increased to 622,000 tonnes (against 486,000 in 2007), including retail sales of 427,000 tonnes.

## Russia

LUKOIL's retail network in Russia consists of 2,106 filling stations (including franchises) and 116 tank farm facilities with reservoir capacity of 1.26 million cubic meters. The filling stations and tank farms are operated by 8 petroleum product supply organizations, which do business in 60 of Russia's administrative regions.

Volume of retail sales of petroleum products on the domestic market in 2008 was 5.96 million tonnes, which is 22.9% more than in 2007. The significant increase is explained primarily by acquisition of new sales assets in the accounting year. Capital expenditures in the Russian retail sales sector were $357 million ($264 million in 2007), and investments were $560 million. In 2008, as part of its program for optimization of the sales network, the Company withdrew 4 filling stations and 5 tank farm facilities, sold 7 filling stations and 1 tank farm, leased out 19 filling stations and mothballed 1 tank farm facility. At the same time 256 filling stations were acquired or built and 88 upgraded.

Growth of demand, optimization and acquisition of highly-efficient assets led to average increase in daily sales of petroleum products per Company filling station in Russia to 9.8 tonnes in 2008 (from 9.4 tonnes in 2007).

There was steady growth through 2008 in sales of EKTO branded motor fuels, production of which was launched in 2006. In December 2008 sales volumes of EKTO gasolines were 85,300 tonnes, which is 2.3 times more than in January. Sales volumes of EKTO diesel fuel in December reached 78,700 tonnes, compared with 32,800 tonnes in January. Overall, there were 734,000 tonnes of EKTO gasoline

LUKOIL continued to develop relationships with Russia's regional governments in the petroleum product sales segment. An Agreement on cooperation was signed with the administration of Krasnodar Territory for the period to December 31, 2012. According to the document, LUKOIL intends to invest at least 600 million roubles by 2012 in construction of 60 new filling stations in Krasnodar Territory. The regional administration will use its legislative power to assist in obtaining approvals for construction of new and commissioning of existing facilities as well as on environmental protection and industrial safety issues. The parties will also cooperate on projects to prospect for and explore oil & gas fields in the region, and to transport and refine oil and gas.

LUKOIL and the Government of St. Petersburg made a cooperation agreement for 2008–2012. In accordance with the agreement, the Company will supply main types of high-quality petroleum products in St. Petersburg, including gasoline and diesel fuel which comply with Euro-3 and Euro-4 standards, as well as building new, environmentally safe filling stations in the city, and implementing joint socio-economic programs with the city Government. The St. Petersburg Government will help the Company to compile documentation for construction work, commissioning of facilities and environmental and industrial safety.

LUKOIL also signed an Agreement to cooperate with the administration of Sverdlovsk Region. According to provisions of the agreement, LUKOIL will ensure availability of gasoline, diesel fuel and motor oils and lubricants at the Company's small wholesale and retail network facilities in the Region, responding to seasonal demand for petroleum products. LUKOIL will use the services of regional industrial, scientific, planning and contracting organizations (selected on a competitive basis) for implementation of investment projects in the Region. The Government of Sverdlovsk Region agrees to coordinate dealings with local authorities on matters relating to use of publicly owned land (including land for roadside service facilities). The agreement will be in force until December 31, 2011.


sold in 2008, which exceeds the 2007 figure by 62%, and 709,000 tonnes of EKTO diesel fuel, which is 2.7 times more than in 2007. Sales geography of the new fuels also expanded: in 2007 there were 158 filling stations selling EKTO gasolines and 286 stations selling EKTO diesel fuel in 12 regions around the country, but in 2008 these figures rose to 433 and 737 filling stations, respectively, in 27 Russian regions. Characteristics of EKTO fuels fully meet European environmental standards (Euro-3 for gasolines and Euro-4 for diesel), and they offer improved performance features, which justify a price premium for quality. Additional effect obtained in 2008 from sales of EKTO fuels was over $10 million ($5.3 million in 2007). In 2008 EKTO motor fuel won the Brand of the year/EFFIE 2007 silver award in the Automotive category.

Development of the system of payment for petroleum products at filling stations using LICard fuel cards continued in 2008. The number of filling stations where these cards can be used grew by 11% to 2,787 stations, of which 1,791 belong to LUKOIL Group. The number of cards in circulation increased by 16% to 2.03 million. A total of 2.9 million tonnes of petroleum products were sold using LICards, which is a third more than in 2007.

The Program for development, in the period up to 2014, of retail sales of non-fuel products and services by LUKOIL Group's Russian petroleum product organizations moved forward in 2008. About 2,000 of our filling stations in Russia had their own shops by the end of 2008. Revenue from sale of non-fuel products and services through the Group's retail network in 2008 was over $140 million (38% of revenue was from sales of groceries, another 32% represented packaged products, 21% came from accessories and 9% from sale of services). The revenue increase reflects improvement in service quality at filling stations and expansion of the range of goods and services on offer. The program target for revenue by 2014 is about $300 million. Development of non-fuel business is an important factor for positioning of LUKOIL Group as customer-oriented company with European standards of service.

## International

LUKOIL's retail network in Europe, the near-abroad countries and the USA consists of 4,642 filling stations (including franchises) and 88 tank farms with reservoir capacity of 1.80 million cubic meters. The Company built 52 new filling stations outside Russia in the accounting year, acquired 817 and upgraded 70 stations. At the same time 69 filling stations were withdrawn (sold, closed down and mothballed).

Capital expenditures in international retail in 2008 were $369 million ($356 million in 2007), and investments were $629 million.

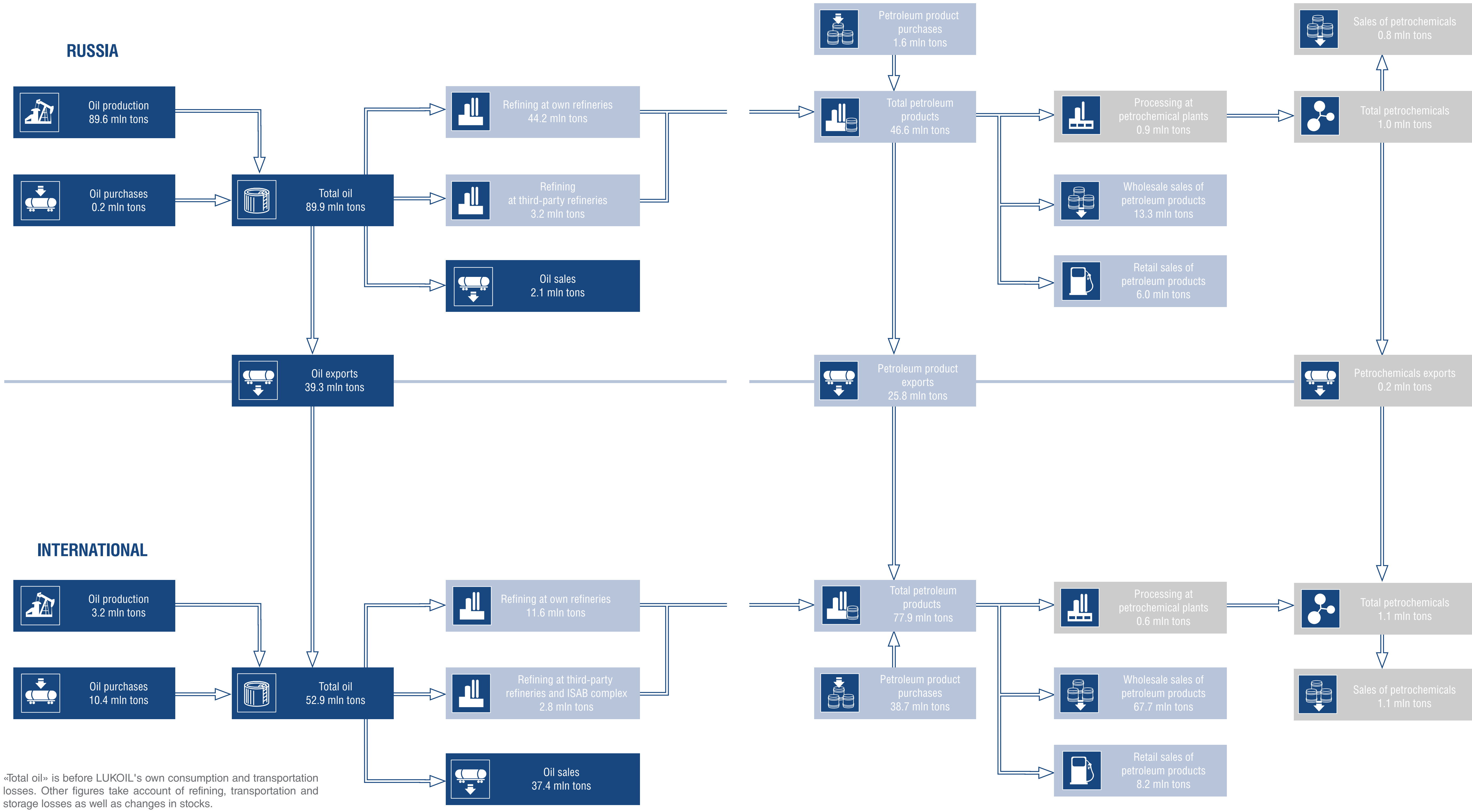
Retail sales of petroleum products on international markets in 2008 were 8.20 million tonnes (7.91 million tonnes in 2007). Average daily sales of petroleum products per filling station in Europe and countries of the near-abroad increased by 9% to 7.4 tonnes, thanks to sales network optimization and acquisition of highly efficient assets. Daily sales per station in the USA were 6.8 tonnes.

The Company continued rebranding of acquired marketing assets in the accounting year. Further progress was made in rebranding of filling stations purchased from ConocoPhillips at the end of 2006: 264 stations in Hungary, Poland, the Czech Republic, Belgium and Slovakia were rebranded (376 filling stations were acquired in total and rebranding of 49 stations in Finland was carried out in 2007). The Company also completed rebranding of filling stations in Croatia and Montenegro, which were acquired in the accounting year.

Abroad, as in Russia, LUKOIL is working hard to increase profitability of its filling stations, and development of retail sales of non-fuel products and services is a good way of doing this. Revenue from sales of non-fuel products and services at filling stations abroad increased to over $500 million in 2008, which is 1.5 times more than in 2007. The revenue growth was due to increase in numbers of filling stations in the Company's international network, broadening of the product range, improvement in the quality of customer service, optimization of work with suppliers and dynamic marketing activity.

The LICard system was in use at 642 filling stations outside Russia by the end of 2008 (up from 418 stations at the end of 2007).

# Trade Balance of LUKOIL Subsidiaries (2008)




«Total oil» is before LUKOIL's own consumption and transportation losses. Other figures take account of refining, transportation and storage losses as well as changes in stocks.


LUKOIL

ANNUAL REPORT

2008

# Technology and Innovation

Commitment to new technologies and innovation is one of LUKOIL's main competitive strengths. The Company's specialists are engaged both in development of new technologies and modernization of existing ones. Use of the most up-to-date technologies in all spheres of activity is an important factor in the Company's development and growth of business efficiency. LUKOIL's considerable successes in ensuring rational use of natural resources and protection of the environment would have been impossible without application of innovative technologies in these areas.

LUKOIL Group spent more than $95 million on research & development in 2008 (40% more than in 2007), of which almost $70 million represented R&D work in Exploration & Production.

LUKOIL obtained 63 intellectual property patents in the accounting year (for inventions, models, industrial patterns, and computer software). The Russian Patent Authority is currently considering more than 100 applications from LUKOIL for patenting of unique technical solutions and other copyright items. The Company had a total of 599 intellectual property items on its balance sheet at the end of 2008. LUKOIL is among leading companies, both in Russia and abroad, measured by commercialization rate of its intellectual property (about 40%).

In 2008 the Company designed its first Medium-term target program for scientific and technical development of the Group in 2010–2011, setting main priorities and directions for scientific and technical development, and also devised a plan for medium-term investments in R&D.

# Exploration & Production Technologies

Most R&D in the Exploration and Production segment was focused on development of geological and geophysical study techniques, improvement of reserve assessment methods (work continued on creating a methodology to assess hydrocarbon reserves in reservoirs with complex structure), as well as design and improvement of methods for increasing oil recovery and optimizing technological solutions used for development of new areas and deposits. The Company is particularly keen to develop technologies that ensure environmental safety during field development, most notably during development of offshore fields.

LUKOIL made much progress in development of new drilling methods during 2008 and applied them in practice. At the Condor Block in Colombia the Company completed drilling of the Lengupa-1 exploration well. This was the first-ever use by LUKOIL of casing pipes at a well, which was subject to extremely rapid absorption of drilling fluids.

At Block A in Saudi Arabia LUKOIL made use of Schlumberger's Power-V system in drilling of prospecting and exploration wells. In combination with PDC downhole motors and bits, this technique substantially reduced the time spent on drilling of sections for technical strings. For the first time in Saudi Arabia and the countries of the Persian Gulf a single bit drilled through all of the Unayzah formation and part of the Sarah formation: more than 1,300 meters of tough sandstone were drilled through at a rate of 1 to 12 meters per hour.

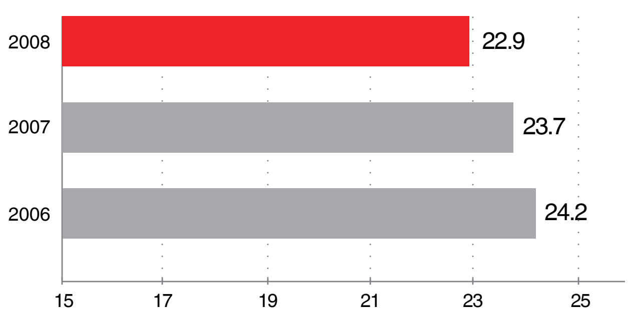
At the Karakuduk field, for the first time in Kazakhstan, the Company used multiple drilling of slant wells: 53 wells were completed, with an average daily flow rate of 21 tonnes.

At the Kumkol project, 57 wells were completed using a technology for drilling into the producing horizon with polymer solutions, shut-off by the production liner. This enables maximum preservation of the reservoir properties. Average flow rate from the wells is over 45 tonnes per day.

One of the most important outcomes of the Company's technology development efforts is increasingly widespread application of methods for intensifying oil production and enhanced oil recovery (EOR) techniques. These methods offer significant increase of recoverable reserves and oil production, enabling commercial development of high-viscosity oil, oil in almost impenetrable collectors and hard-to-recover reserves at late stages of field development. In recent years the share of oil produced at LUKOIL fields using various EOR techniques has been over 20% of total oil production.

The Group carried out 5,376 EOR operations in 2008, which is almost 100 more than in 2007. The Company applies physical, chemical, hydrodynamic and heat methods to stimulate extraction. Additional production in the accounting year thanks to application of EOR methods was 23 million tonnes, or almost 26% of total oil production by the Company in Russia.

Additional production from EOR in Russia, million tonnes



Most of the additional production volume (14 million tonnes, or 61.3%) was obtained using physical methods, primarily hydrofracturing.

The Company carried out 711 hydrofracturing operations at fields in 2008, achieving average growth in flow rate of 9.4 tonnes per day. The extent and the effectiveness of hydrofracturing operations in 2008 are comparable with analogous figures for 2007. It should be noted that, during the accounting period, hydrofracturing was applied as a method of intensifying production mainly at fields that had been in development for a long period of time and which had highly depleted reserves. In such conditions, LUKOIL succeeded in maintaining growth in oil flow from hydrofracturing at the 2007 level through improvement of hydrofracturing design, selection of wells using hydrodynamic models, and through tighter quality control over the materials and reagents, which were used by service companies.

Use of other EOR methods (hydrodynamic, heat, chemical methods and oil production intensification) gave 9 million tonnes of production. Use of chemical technologies grew during 2008 in comparison with 2007 from 1,004 to 1,324 operations, and additional production thanks to application of these methods rose to 1.6 million tonnes (an increase of more than 20%).

Drilling of sidetracks at existing wells has also proved a highly-efficient form of EOR. The Company continued to increase drilling of sidetracks in 2008, when 260 wells were drilled with sidetracks (up from 188 in 2007), giving average flow increase of 18.1 tonnes per day. The Company increased drilling of sidetracks by 1.5 times in the accounting year compared with 2007, but efficiency of this EOR method was almost unchanged in 2008.

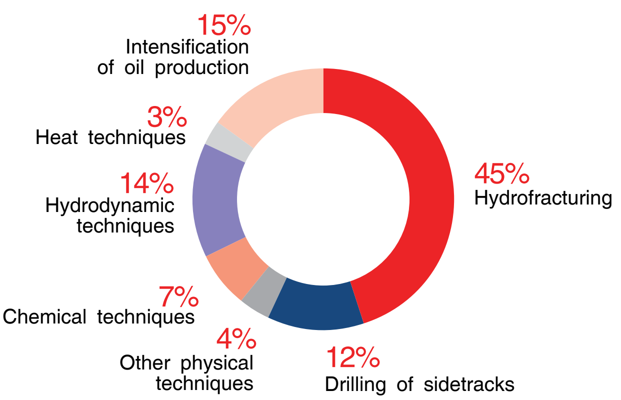
In 2008 test-production work using radial drilling continued in the Urals region. Drilling of radial channels at existing wells is a relatively inexpensive way of increasing production and bringing hard-to-recover reserves into development. 91 operations were carried out, giving average daily growth of oil flow by 6 tonnes. Additional production of oil as a result of application of the method was 67,000 tonnes, which is 3 times more than in 2007. Use of radial drilling technology in the Company's other oil producing regions is now being considered.

Another way of raising efficiency of crude oil production is drilling of horizontal wells, which offer well productivity growth of 1.5 times. A total of 112 new horizontal wells were commissioned in 2008 with average daily flow rate of 58.4 tonnes.

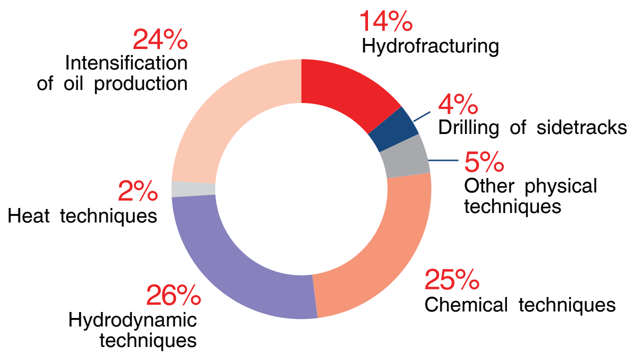
Further analysis of geological structure as well as geological and hydrodynamic modelling of currently developed areas were carried out at the high-viscosity permocarbon oil deposit of the Usinskoye field during 2008. Work is continuing to improve efficiency of thermal technologies in the system of vertical wells (work continues on application of technology for combined cyclic steam stimulation (CSS) treatments, and experimental work has begun on intensification of oil inflow by combined injection of a heat carrier and an oil-recovery composition). New thermal technologies are being introduced: steam-heat stimulation of rock formations in horizontal well systems; technology for perpendicular thermo-gravitational deposit draining; CCS technologies for horizontal wells, vertical wells with radial channels, and for an entire productive interval; and technologies for oil recovery by steam.

By the end of 2008 a total of 301 Company fields had been included in the multi-level system for monitoring field development using geological and hydrodynamic models. The system developed rapidly in the accounting year and almost 40 fields were modelled. Use of geological and hydrodynamic models allows optimal technological solutions to be put into effect during field development, conforming to peculiarities of geological structure and composition of available reserves. Modelling enables improvement of oil recovery rates and reduction of expenditures on field development.

Shares of various techniques in overall EOR production in 2008

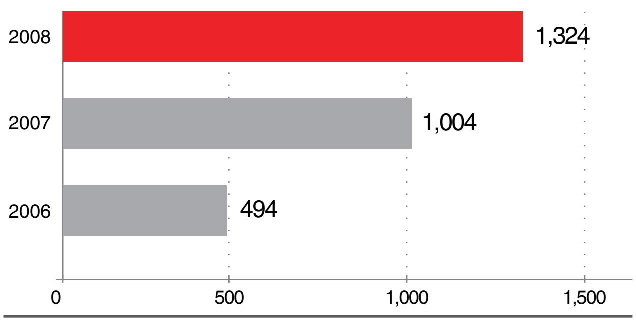



EOR techniques used by LUKOIL Group in 2008

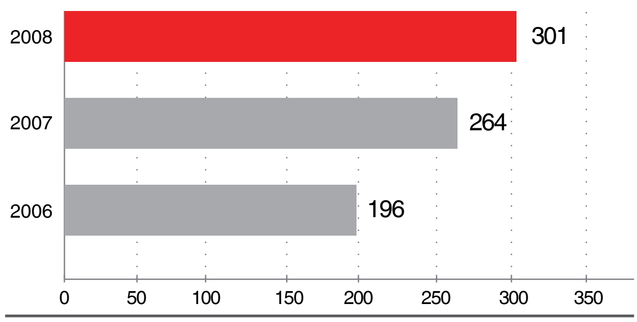


Models are widely used by the Company when drilling out fields and applying EOR methods. The number of geological and hydrodynamic models of Group fields in Russia should be increased to more than 300 by 2010, raising coverage of Group fields by geological and hydrodynamic modelling to 85%. Such modelling will cover all fields in Western Siberia, Timan-Pechora and Kaliningrad Region. Although commissioning of new production wells increased by more than 25% in 2008, the Company was able to exceed 2007 rates for average oil flow from new wells: oil flow from new wells increased by 5.6 tonnes, or 14.8%. The result reflects improving quality of geological and hydrodynamic models and increasing use of such models during production drilling, as well as continued work to improve well completion technologies, and widespread use of primary and secondary drilling into productive formation.

Chemical EOR operations, wells




Number of geological and hydrodynamic models of fields, models




# Refining **Technologies**

LUKOIL places much emphasis on development of new technological solutions, modernization and purchase of high-tech equipment that allows refining costs to be reduced and new types of high-quality products to be produced. Products with high value added generate extra profit for the Group, and constant improvement in quality serves the interests of consumers and the environment.

Large-scale work was carried out during 2008 to modernize existing units and launch new ones at Company refineries, in order to increase yield of high-quality products. A residue visbreaking unit was commissioned at the Nizhny Novgorod Refinery, which will substantially increase profitability of the enterprise by lowering output of fuel oil and raising production volumes of vacuum gas oil.

The Company's Perm Refinery modernized the atmospheric distillation block on distillation unit №4, capacity of the delayed coking unit was increased, and a major overhaul of the crude oil deep refining complex was carried out. Annual capacity of the Refinery increased from 12.4 to 12.6 million tonnes. During 2008 the Perm Refinery went over to 100% production of high-octane motor gasoline, which meets the Euro-3 standard.

Modernization of a diesel fuel hydrotreatment unit to enable production of fuel to Euro-5 standards was completed during the year at the Burgas Refinery in Bulgaria.

LUKOIL is also devoting much attention to development of up-to-date production technologies for oils, lubricants and additives. The Company has established a science-and-technology department, main functions of which are to develop and bring to market new, high-quality products suited to modern machinery, as well as creating new technologies and blends. This work is being carried out by Company specialists in close association with scientific centers in Russia.

The Company worked hard in the accounting year to optimize technological processes and units and to improve the quality of oils and lubricants produced. Measures were pursued to increase marketable product yield, reduce energy consumption and raise the quality of base oils. In order to create added value for secondary products, the Company began production of petroleum jelly and work was carried out to start production of flushing oil for engines, petroleum penetrating fluids and plasticizers. Long-term tests were also started on a new generation of oils for marine engines, in order to obtain approvals from leading manufacturers of marine engines. The Company started to manufacture 16 new products in the course of the year.

# Information **Technologies**

Use of the most up-to-date information technologies allows the Company to optimize business processes in various spheres of its operations. The Group continues to develop and install automated systems for managing production and technological processes, as well as information systems to manage Group companies. Improvement in telecommunication system, information security, and technical equipment used for computational and organisational purposes are priorities for LUKOIL's efforts in the IT sphere.

We attach much importance to use of technologies that enhance efficiency of managerial, as well as operational activity. An integrated management system (IMS) based on SAP R/3 has been introduced by the Company since 2001 in order to optimize management decision-making systems and to automate management accounting inside the Company. In 2008 the SAP-based IMS was in operational use at 22 of LUKOIL's producing and refining companies. Elements of the IMS are being gradually extended to all areas of Group business.

Installation of a global planning system with management reporting modules was completed during the accounting year. Data processing centers, created in 2008, are the basis for integration of the management systems in Group organisations.

Work continued in 2008 to prepare for installation of the IMS Global Solution and Information Infrastructure Monitoring System. These innovations will allow Company employees to work in a unified information space, making the system for management of LUKOIL operations more balanced and increasing reaction speeds.

LUKOIL

ANNUAL REPORT

2008

# Social Responsibility

MISSION OF LUKOIL:
“Our purpose is to harness natural energy resources for human benefit
We aim to support long-term economic growth, social stability, prosperity and progress in the regions where we operate, as well as caring for the environment and ensuring sustainable use of natural resources...”

# Protecting the Environment

The Company is guided in its work by the highest standards of protection for the environment and industrial safety. Group organisations make every effort to raise the level of environmental safety at production facilities, to reduce environmental impacts and to optimize use of natural resources. Ensuring environmental safety is a key consideration at all stages of project implementation, from the investment idea to disposal of production assets and equipment at the end of the project. The Company is fully conscious of its responsibility to society for maintenance of favourable environmental conditions and rational use of resources.

We aim to ensure that Company activity is in full compliance with national legislation and international standards of environmental protection, and that quality of our products matches the latest environmental requirements.

The Company completed implementation of the Environmental Safety Program at LUKOIL Group organizations for 2004–2008. More than $1.2 billion was spent on Program implementation in the course of five years. Results achieved by the Program make LUKOIL a leader in terms of main environmental indicators among companies in the fuel and energy sector.

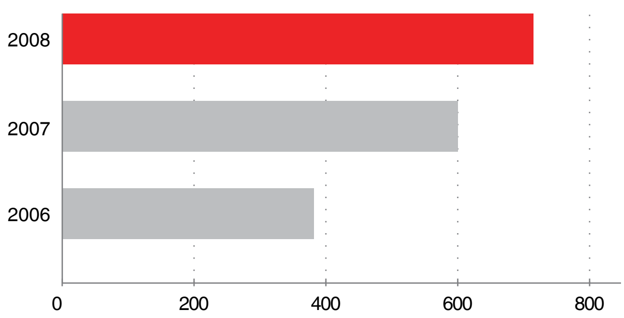
Overall, more than $700 million was spent by LUKOIL Group in 2008 on measures to ensure environmental safety (up from $600 million in 2007).

At the end of 2008 and start of 2009 the Company drafted a new Environmental Safety Program for 2009–2013. Priority aims of the Program are: further recycling of accumulated and newly generated waste; raising the level of utilization of associated gas to 95% by 2012; implementing the mechanisms of the Kyoto Protocol; and ensuring that the Group's environmental impact indicators comply with requirements of national and international legislation.

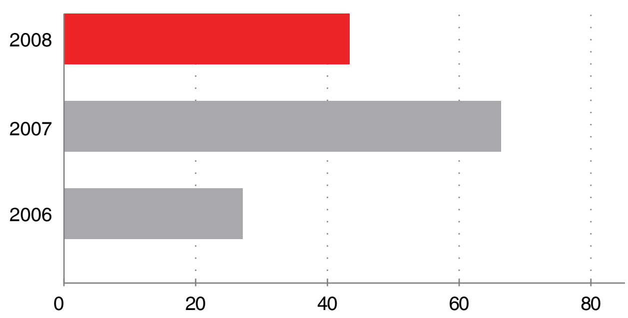
In 2008 the Company took part in a session of the Global Compact (supported by the World Bank) devoted to reduction of gas flaring and harmful substance emissions.

In the accounting year the majority of specific Company indices for impact on the environment were unchanged or better than in 2007 and remain considerably lower than average for the oil & gas sector in the Russian Federation. However, certain indicators worsened to some extent in 2008, particularly indicators for atmospheric emissions. This is explained by significant volumes of associated gas, which

Environmental spending,
$ million




Number of accidents with acknowledged environmental impact



were flared at new assets acquired and consolidated by the Company, and also by a rise in the number of accidents on pipelines due to corrosion and ageing of pipeline systems (while pumped liquids became more corrosive due to increase of the water cut in extracted crude oil).

The Company continued implementation of its Corporate concept for production planning by LUKOIL Group in compliance with provisions of the Kyoto Protocol. The concept includes creation of a corporate system to manage discharges of greenhouse gases, which will promote more efficient planning of Group production activity, reduction of development costs, and optimization of natural resource use. Inventory work (attested by independent experts) was carried out at Company facilities in 2008 to determine quantities of greenhouse gases discharge. Further pilot projects were put in place for systems of environmental monitoring of production processes.

LUKOIL is aware of the environmental benefits, which can be obtained by expanding output of high-quality products. Accordingly, more than 20% of all the Company's capital

The Company operates in conditions of strict environmental control by government and society, and must also take into account the ongoing reform of natural resource and conservation legislation in Russia and other countries. Thus, in 2008:

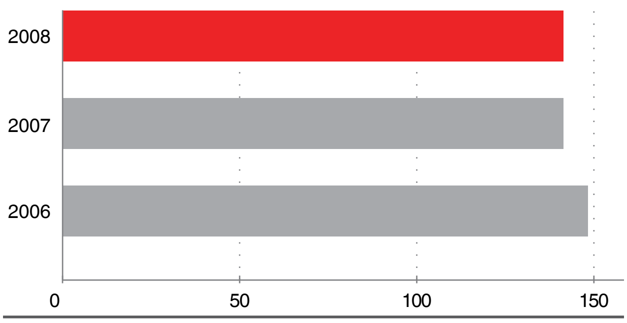
- The Ministry of Natural Resources of the Russian Federation was transformed into the Ministry of Natural Resources and the Environment of the Russian Federation, and assumed functions of developing and implementing government policy and legal regulation in the environmental sphere;
- a Procedure for state control in the environmental sphere was introduced by the Russian Government;
- a number of by-laws were adopted (including a methodology for calculating damage to water spaces due to breaches of water legislation, etc.) in connection with enactment of the new Water Code. This increased economic burden on Company enterprises (in 2008 more than $200,000 were paid out as a compensation for such damage);
- a number of amendments were made to legislation on waste arising from production and consumption, based on proposals by Company specialists. In particular, terminology and criteria, which dictate necessity of a license for natural resource activities, were made more specific, the requirement for government environmental expert assessment of materials supporting license applications was cancelled, and the provision exempting users of natural resources from payment for placement of wastes accumulated over a period of less than six months was legislatively reinforced. It was established that construction projects for waste storage and detoxification facilities require environmental expert assessment;
- a target figure for combustion of associated gas at flaring units was established by the Russian Government (not more than 5% of associated gas can be flared from 2012). If this figure is exceeded, payment for discharges into the atmosphere above the limit will be calculated using a multiplier.

The Company took account in timely fashion of amendments to Russian conservation legislation, so that LUKOIL Group was not subject to criticism or claims from monitoring and supervisory authorities in 2008.

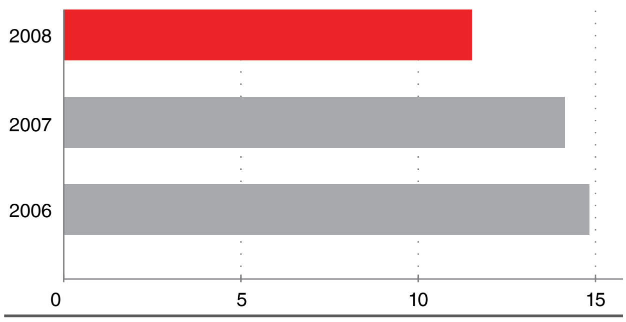
expenditure in 2008 was directed towards the Refining & Marketing segment. A significant portion of these investments is spent to organize production of fuel with improved environmental characteristics: LUKOIL continued to produce gasoline and diesel fuel in 2008, which conform to latest European standards. Gasoline sold under the EKTO (ecological fuel) brand ensures a significant reduction in emissions of carcinogens, sulphur and nitrogen compounds, and other harmful substances.

Measures to protect the environment are also being applied in the transportation and marketing segment. The Company's new filling stations are equipped with systems for returning gasoline fumes from the reservoir to tankers during discharge of petroleum products, as well as systems for preventing spillages of petroleum products from reservoirs and facilities for waste-water purification.

**Polluted land,**
hectares




**Waste water discharge,**
million cubic meters




# Industrial Safety and Labour Protection

One of the basic duties of the Company is to ensure safe working conditions and to care for the health of its employees.

LUKOIL continued work in the accounting year on implementation of its Program for industrial and labour safety, improvement of working conditions, and prevention and resolution of emergency situations at organizations in LUKOIL Group during 2006–2010. Spending on measures as part of the Program was about $200 million. Work as part of the Program included construction of new and modernization of old equipment and facilities, installation of modern automated management and accident prevention systems at industrial sites, and certification of work places with respect to working conditions and also measures to ensure that employees are provided with protective clothing and equipment.

There were 10 comprehensive and 15 targeted inspections at Group organizations in the accounting year to determine the state of industrial safety and labour protection, efficient functioning of industrial safety and labour protection management systems and enforcement of the Management Committee decision on increase of employees' responsibility for industrial safety and labour protection requirements. These actions were in response to a rise in the number of fatalities within the Company from 7 in 2007 to 13 in 2008. The main causes of accidents were breaches of labour and industrial safety codes. As a result of the inspections a number of measures were organized to improve employees' knowledge concerning industrial safety, thanks to which the situation was successfully brought under control. The measures included training of 112 management staff at LUKOIL's main industrial subdivisions, and subsequent certification of the training by the Rostekhnadzor central certification board.

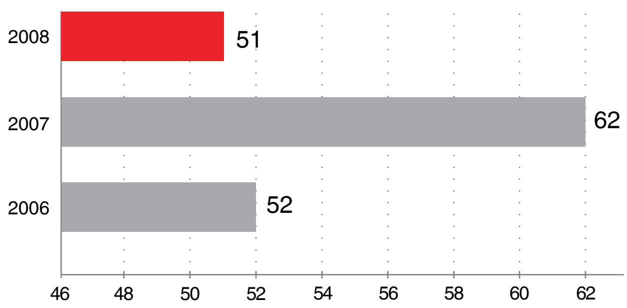
Work to ensure industrial safety, labour and environmental protection is carried out in accordance with LUKOIL's Policy on Industrial Safety, Labour and Environmental Protection in the 21st Century.

In 2001 LUKOIL became the first Russian oil company to undergo certification for compliance with the requirements of the ISO 14001 international standard and the OHSAS 18001 specification. In 2008 the Company successfully passed its first external audit by the supervisory authority of the Company's Industrial Safety, Labour and Environmental Protection Management System (for compliance with the standards).

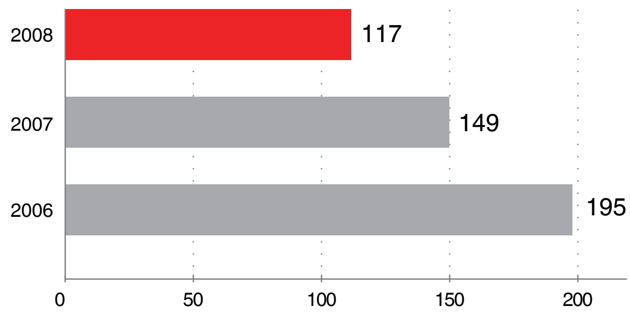
The **ISO 14001** standard attests that the Company has put an environmental policy in place, adheres to it in its operations, makes constant improvements to the environmental management system, and takes all necessary measures to prevent negative environmental impact.

The **OHSAS 18001** specification is intended to assist organizations in management of their project risks associated with protecting health and safety of employees and the general public. Key elements of the specification are identification, assessment and control over risk factors, as well as observance of legal requirements and consistent improvement of safety in the work place.

Number of accidents




Lost time injuries




# Personnel and Social Programs

We understand that the Company's success is entirely dependent on the people who work to achieve it. Our employees are a valuable asset, and one of the key factors behind the improvements of LUKOIL's business efficiency and shareholder value. The main aims of our social policy, therefore, are to improve work efficiency and social protection of our employees. The key objective is to motivate our employees and ensure that they have a personal interest in achievement of the best possible results by the Company.

We work constantly to improve standards of personnel management, helping the Company to develop steadily and successfully. A new stage was reached in 2008 through systematization of personnel management processes at LUKOIL Group organizations and improvement of the regulatory framework in this sphere. Specifically, work continued in the accounting year to implement the Functional strategy for personnel management at LUKOIL Group in 2008–2017.

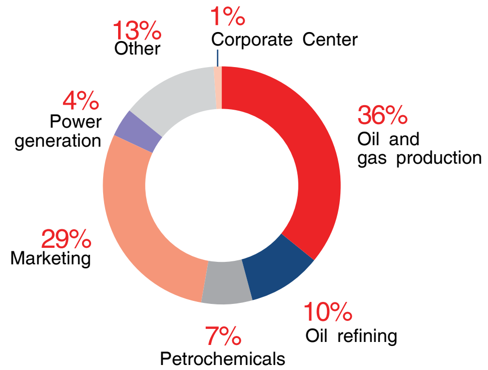
Work continued in 2008 on restructuring of LUKOIL Group, including the Company's Corporate centre, in order to increase efficiency of the Group's productive and financial activities and reduce expenses. Tasks included optimization of the organizational structure of existing sub-divisions and creation of new structural sub-divisions, as well as standaradization of organizational structure at subsidiaries. Withdrawal of non-core and low-margin assets from the Group was also continued. One result of these steps was reduction in personnel numbers at oil & gas production and refining organizations. However, company personnel numbers rose by 0.7% overall in 2008, mainly due to growth in numbers of employees in the rapidly expanding network of filling stations, and also through acquisition of new assets.

Improvements to the system of employee compensation are a priority in personnel management work, since they help to maintain employee motivation and enhance commitment of employees to growth of the Company shareholder value. LUKOIL carries out ongoing systematic analysis of the labour market in Company operating regions, as well as monitoring wage levels and compensatory payments. This helps to ensure that wage levels are competitive and assists in attracting new employees. Average wages at LUKOIL Group organizations rose by 15% in 2008.

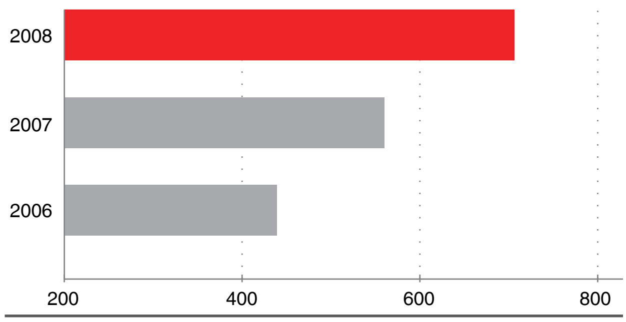
In addition to material incentives the Company uses moral encouragement as a way of developing personnel potential: 33 Company employees received national awards for professional excellence, and for conscientious and successful work, while 814 were awarded sectoral marks of distinction for their work, and 726 employees and 44 groups of workers were presented with Company awards in 2008. Also, the Company held a competition for the title of 'Best Employees and Organizations in LUKOIL Group'.

As well as material and moral incentives, LUKOIL is implementing a wide-ranging set of programs and measures, which constitute the Company's social package.

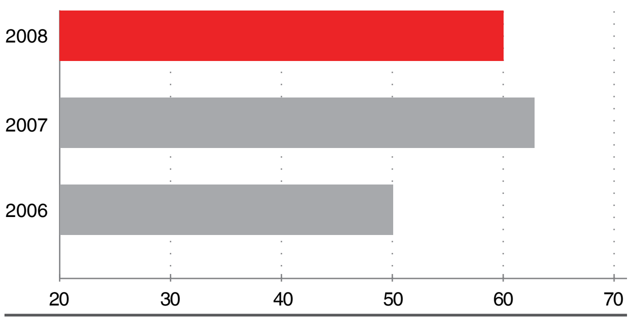
Employee structure by business segments (as of January 1, 2009)



Sales per employee, $ thousand




Net income per employee, thousand




Expenditure on this program in 2008 totalled $348 million. Main elements of the social package are:

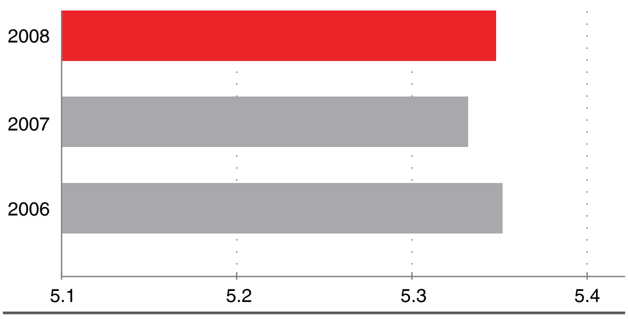
- Health care and medical treatment for Company employees, including voluntary health insurance;
- Creation of conditions for rest and recreation of employees and their families, organization of sport and fitness events;
- Help to employees in acquiring housing;
- Social support to women and families with children;
- Social support for young specialists;
- Non-state pension provision for employees, which has operated since 2004 on the principle of shared funding of non-state pensions by employee and employer. By the end of 2008 contributions by employees in LUKOIL's Russian organisations alone amounted to $20.5 million. The Company's total contributions under non-state pension provision programs in Russia and abroad for the accounting period were over $31 million.

An efficient system of social protection helps to attract qualified specialists to the Company, reduces employee turnover, strengthens corporate morale and is the basis for successful industrial activity.

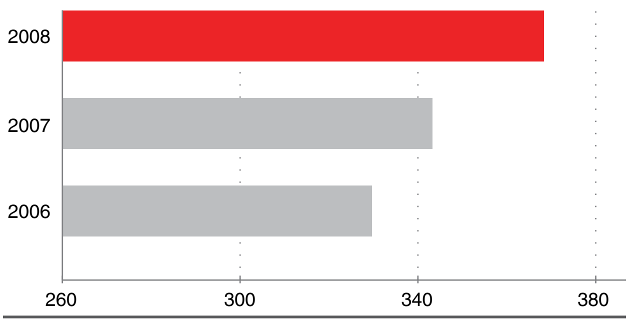
Professional training of our employees is very important for Company development. The Group has a functioning system of continuous staff training, helping its employees to acquire essential knowledge and professional skills. LUKOIL uses the whole spectrum of modern training aids: workshops, seminars away from the work place, special training programs, work placements abroad, training sessions, courses to gain higher qualifications, professional training days, distance learning, MBA programs, etc. The Company is developing cooperation with leading institutions of higher education, including the Gubkin Russian State Oil & Gas University, the Russian Government Financial Academy, the Oil & Gas Business Institute, and the Higher School of Economics. In 2008 a cooperation agreement was reached with the Diplomatic Academy of the Ministry of Foreign Affairs of the Russian Federation.

Improvement of the Company's Distance Learning System (DLS) is important for development of the professional training system for Company employees. The system had more than 4,100 registered users by the end of 2008, and more than 2,100 Company employees have been trained using the DLS framework.

Hydrocarbon production per employee, thousand boe




Refinery throughput per employee, tonnes




In 2008 LUKOIL worked hard on creation of Russia's first center for training of staff to work on offshore oil and gas facilities (in the city of Astrakhan). The Norwegian company Falck Nutec, a leader in training of personnel for work on offshore facilities, was selected as LUKOIL's main partner in the scheme.

A personnel exchange program was continued in 2008 as part of the strategic partnership between LUKOIL Group and ConocoPhillips. The fourth group of 16 employees was selected and dispatched for work placements in the US company. The fifth group of 13 people has also been selected.

Implementation of the program for training of Iraqi specialists (part of the Memorandum of Understanding and Cooperation signed with the Iraqi Oil Ministry in March 2004), was continued in the accounting year, when 148 Iraqis underwent a short course of work experience at Company subsidiaries, and 10 underwent training as part of a comprehensive annual program at Company enterprises in Perm, Perm State Technical University and the Gubkin Russian State Oil & Gas University. A total of 680 Iraqi specialists have taken part in work placements at Company enterprises since the program came into operation.

The Company gives priority to work with young specialists as part of the Group's comprehensive target program for cooperation with young people and young specialists in the period of 2005–2010. In 2008 the Company held the second and third competitions to select the Best Young Specialist of the Year from among Company employees: 235 competitors took part and there were 14 nominations as part of the competition. A total of 90 young specialists won prizes.

# Social Policy and Charity Activities

Social and charity programs are an integral part of the Company's corporate strategy and help to ensure constructive partnership with the state, business and society. Corporate programs have a targeted character and are based on the professional experience and human potential available in regions where the Company operates.

The Company continues to deliver on commitments, which it undertook voluntarily and on its own initiative under the LUKOIL Social Code. This Code is obligatory for all LUKOIL organizations and represents a set of principles and norms of socially responsible behaviour towards all parties whose interests are affected by Company business. Commitments under the Code are additional to commitments arising from collective negotiations with employees. These commitments apply to Company's employees, non-working pensioners and shareholders, as well as to commercial partners, the state and society as a whole.

As well as traditional forms of charity, LUKOIL carries out strategic charity programs and social investment programs, which find synergies between approaches to social problems and the Company's strategic aims. Total spending by the Company in 2008 for charity and social partnership was in excess of $180 million.

The Company's social and charity programs are highly appreciated by society. In 2008, LUKOIL Group was a prize winner in the annual competition 'Russian Corporate Donor 2008'. The Company won the nomination for 'Best Joint Program by Business, Non-profit Organizations and Regional (Local) Government'. This competition is an initiative by the Donors' Forum, the Ministry for Economic Development of the Russian Federation, the Russian Union of Industrialists and Entrepreneurs and the Commission of the Public Chamber of the Russian Federation for Charity, Aid and Voluntary Action. The competition panel acclaimed LUKOIL as the leading company by charity spending levels.

## Support for Children's Homes and Schools

Help for children is a Company priority, and underlies all of the social programs, which we have built and which we pursue: charitable programs, sponsorship, sports development programs for children and young people, and cultural programs. LUKOIL strives to achieve a balanced approach, providing support both to children who by virtue of their family circumstances or health find themselves in a worse situation than their contemporaries and to children with favourable family backgrounds, by helping them to develop their natural abilities and talents.

The Company provides support to children in more than 50 children's homes and boarding schools. The Company helps children leaving these institutions to obtain an education and good health care, acquire a profession and find their place in life. The Company provides financial support for various needs at the children's homes, schools and boarding schools, which it sponsors – from vacations for the children to major building repairs. Each year LUKOIL organizes summer vacations for children on the Black Sea and Caspian Sea coasts as well as educational trips around Russia for children from homes sponsored by the Company in the towns of Ishim, Langepas, Kirov, St. Petersburg, and Baku. LUKOIL has been providing grants since 2006 to students who continue their education in higher or vocational colleges after leaving these children's homes. In 2008 the Company began funding an educational program at the Astrakhan College of technology for 30 children from children's homes and underprivileged families, who will obtain jobs at Company enterprises in the region after they graduate.

The Group is particularly concerned with children with special needs. One project, which LUKOIL has maintained over a number of years, is called 'An illustrated book for every blind child', and is part of the program, 'Illustrated Books for Blind

Children'. Various publications were supplied to specialized children's institutions in Astrakhan Region in 2008 as part of this project.

## Education Programs

LUKOIL attaches great importance to training of young, qualified specialists, who will ensure success and prosperity of the Russian oil & gas industry in the future.

LUKOIL provides financial support to a number of higher education institutions which train oil & gas specialists. These include specialized universities and institutions in Moscow, St. Petersburg, Perm, Ukhta, Tyumen, Ufa, Volgograd, Arkhangelsk and Astrakhan. Sector training institutes in the near-abroad countries, such as the State Oil Academy of Azerbaijan, also receive support from LUKOIL. As well as supporting oil & gas institutes, LUKOIL also helps the Russian Civil Service Academy, the State University–Higher School of Economics, the Financial Academy (attached to the Russian Federal Government), the Diplomatic Academy, the Mendeleyev Chemical Engineering University, the Moscow Physics and Technical Institute, the Khrulev Military Logistics and Transport Academy, as well as secondary schools, including Moscow upper secondary school № 45.

Since 2000 the Company has paid grants to particularly talented students at oil industry and technical institutes. Such corporate grants are currently paid to 180 students in various towns and cities across Russia. LUKOIL plans to make this scheme more comprehensive by providing incentives to young people when they are still at school.

The Company also provides support for young teachers. About 70 talented young teachers at leading Russian oil & gas institutes receive grants from LUKOIL.

In addition, the Company helps institutions of higher education to improve their material and equipment provision by financing purchases of scientific equipment for laboratories, enabling the education process to stay up to date. During 2008 such assistance was provided to sectoral higher education institutions in Moscow, Tyumen, Perm, and Ukhta, and also to the Diplomatic Academy and Moscow upper secondary school № 45.

## Support for Medical Institutions

Assistance to the health care system in regions where the Company has operations, as well as support to a number of major specialized medical research centers, represents an integral part of the Company's social commitment. LUKOIL provides assistance to the Scientific Center for Obstetrics, Gynaecology and Perinatal Care, the Center for Haematology Research, the Russian Cardiovascular Scientific and Production Complex, and to the Medical Center of the Federal Agency of Specialized Construction.

## Social Project Competition

In addition to the traditional forms of charity assistance described above, LUKOIL's Charity Foundation and Company subsidiaries also organize social project competitions, which have proved to be an efficient way of channelling financial assistance to help improve social and economic conditions in regions, where the Company has operations. Allocation of prize money is based on principles of transparency, competitiveness and publicity. The purpose of the competitions is to support projects and initiatives, which originate from and address urgent needs of those regions.

The first LUKOIL social projects competition was held by LUKOIL-PERM in 2002.

LUKOIL's social project competitions were extended from Perm Region to Volgograd and Astrakhan Regions in 2004, to the Komi Republic and Western Siberia in 2005, to Nizhny Novgorod Region in 2007, and to Kaliningrad Region and Kalmykia in 2008. In the latter two regions, where the competitions were held for the first time in 2008, there were 12 and 8 winners (respectively) and they were selected from a total of 100 projects, which were put forward.

The number of participants and the quality of projects, which are put forward for funding, has increased year by year. The competition budget in 2008 was 25 times bigger than in 2002 and competition geography has expanded from a single Russian region to 10 regions. In 2008 a total of 318 projects received funding after being selected from more than 1600 project proposals, which were put forward in all the regions where competitions were held.

In the 7 years since they began, LUKOIL's social project competitions have proved their worth as a unique vehicle for nurturing social initiative. Experts have called attention to efficiency of the competition mechanism, which has a strong motivational element, and is seen as a model, which could be emulated in social programs of the Russian Federal Government. The mechanism enables project participants to develop their potential, set themselves goals and organize their progress towards achievement of those goals, helped by the informational and financial resources, which the Company puts at their disposal.

## Preserving Cultural and Spiritual Heritage

Support for cultural, historical and spiritual heritage is a traditional aspect of LUKOIL's charity activities. The Company does all it can to preserve and revive cultural, historical and religious values and traditions, whose loss would have inevitable negative impact on the lives of current and future generations, leading to spiritual degeneration and impoverishment of society as a whole.

LUKOIL provides support to a number of leading Russian museums, including the Pushkin Museum of Fine Art, Museums of the Moscow Kremlin, the Russian Museum, the Tretyakov Gallery and the Kirov Art Museum. In particular, the Company provided assistance in 2008 to the Tretyakov Gallery for restoration of the painting by the outstanding Russian artist Nikolay Ghe 'The Judgment of the Sanhedrin: He is Guilty!'. An exhibition by winners of the children's drawing competition, 'My picture of the Kremlin', was held in the Kremlin Armoury (part of the Museums of the Moscow Kremlin) to coincide with International Children's Day. The competition was part of a regional educational program carried out jointly by the Company and the Museums of the Moscow Kremlin.

A monument to the outstanding Russian engineer, Vladimir Shukhov, was erected opposite LUKOIL's headquarters in Moscow in 2008. The Company financed creation of the monument and presented it as a gift to the City of Moscow. In addition the LUKOIL Company Museum held an exhibition devoted to the work of Vladimir Shukhov. The exhibition was subsequently transferred to the Central State Museum of Modern Russian History.

LUKOIL also has programs of assistance to theatres and performing art groups. The Company has worked for many years with the Tchaikovsky Symphony Orchestra, conducted by Vladimir Fedoseyev, and also supports the Perm State Theatre of Opera and Ballet, the Volgograd Youth Theatre and other live art groups in regions of Company operations. The Company is a member of the Council of Patrons of the Bolshoi Theatre in Moscow.

LUKOIL makes significant contributions to restoration and preservation of religious traditions and spiritual heritage. In 2008 LUKOIL continued its program of support for restoration work at the Optina Pustyn Monastery in Kozelsk as well as providing funding for restoration of the Orthodox Cathedral of the Assumption in Budapest (Hungary). LUKOIL is a permanent sponsor of the Church of the Fedorovskaya Icon of the Mother of God in Astrakhan. The Company also provides assistance to the Church of the Icon of the Mother of God in Kaliningrad Region, the Bogoyavlensky Monastery, the Nunnery of the Assumption, the Bakharevsky Serafimo-Alexeyevsky Nunnery of the Kazanskaya Mother of God, and the Monastery of the Holy Tsar-Martyrs in Perm Region.

## Help to War Veterans and the Disabled

Oil workers and other veterans of the Great Patriotic War (World War II), as well as veterans of the labour front, have a special place in LUKOIL's social programs. Every year veterans who live in regions where the Company has operations receive special payments and gifts from the Company to coincide with Victory Day.

LUKOIL also provides financial assistance to people with disabilities. The Company helps them to earn a living independently and thus to feel a part of society.

## Support for Northern Peoples

Operations by Group companies in Siberia and the Far North of Russia can have significant impact on the living conditions of small indigenous peoples, creating various social and economic problems. LUKOIL respects the traditions and customs of these peoples and understands the importance of preserving their age-old way of life. The Company is therefore implementing special programs to help such indigenous groups, and LUKOIL's policy is to shift gradually from charity provision to economic partnership.

In the Nenets and Khanty-Mansiysk Autonomous Districts LUKOIL has made agreements with local administrations, with heads of lands that are traditionally inhabited and exploited by indigenous groups, and with social organizations. The agreements guarantee money compensation to indigenous families for use of their traditional lands, provision of tools and equipment for reindeer herding and household purposes, construction of housing and communications, and health care. The Company organizes traditional celebrations and sports events, as well as holding competitions which offer financing for projects to support spiritual, historical and cultural values of indigenous peoples. LUKOIL understands that material support alone is not enough, and that northern peoples also need help to improve education levels and find employment. The Company therefore works hard to provide various special training to local people and to find them subsequent employment in LUKOIL organizations.

## Sport

Company priorities in the sphere of fitness and sport include promotion of health and fitness pursuits among employees and their families, development of mass sport, support for professional sports teams in Russia, for national federations and for the national Olympic Movement, as well as assistance in development of children's sport in Russia.

The Company's main tool for promotion of fitness and mass sport among its employees is organization of international amateur sports competitions. The first such competition was held in 2001 in Astrakhan, the second in Perm in 2003, and the third in Kaliningrad in June 2005. The fourth winter event, celebrating the Company's 15th anniversary, was held in Kogalym in 2007.

The 4th international family sports competition, "Dad, mom and me – a sporty family", was held by LUKOIL in Perm in 2008 and was dedicated to the Year of the Family in Russia. Participants came to Perm in 31 teams from Russia, Romania, the Czech Republic, Latvia and Ukraine.

The Company is an important source of support for several leading Russian sports teams, including Spartak football club (Moscow), Zarya Kaspiya handball team in Astrakhan (known until 2007 as LUKOIL-Dinamo), the Spartak water polo team in Volgograd (known until 2007 as LUKOIL-Spartak), the Kaliningrad volleyball team, Dinamo-Yantar, and the Torpedo hockey team from Nizhny Novgorod.

The Company makes a large contribution to development of ski sport in Russia, providing support to the national ski-racing team and acting since 2006 as general sponsor to the Russian Federation of Ski Racing, and thus as sponsor of both the male and female national ski teams. LUKOIL also supports one of the biggest children's sport organizations in Russia, the Children's Football League, through which about 2,500 teams from all over Russia compete annually in regional and international championships. In 2008 the Company became a sponsor of the Student Basketball Foundation, under whose aegis Russia's first student basketball championship was held. More than 100 teams, consisting of students from Russian higher education institutions, took part in the championship.

As part of Company support for youth education the LUKOIL Sports Club teamed with leading Russian sportsmen and sport veterans in 2008 to implement the All-Russian charity program, "Live with Sport". The aim of the program was to promote a healthy lifestyle and create the conditions for regular involvement of young people in sport.

Events as part of the "Live with Sport" program were held in Perm Territory, Astrakhan, Volgograd and Chelyabinsk regions and the Komi Republic. Meetings and master classess with leading Russian sportsmen and sport veterans took place in 11 education institutions, involving more than 3,000 children. LUKOIL provided modern sports equipment and clothing for use by the children.

Sport means more to LUKOIL than backing sports teams – it is also a way of testing the Company's own products in extreme conditions. The victories and successes of LUKOIL Racing Team (Moscow), and Sura Motorcross Team (Penza) continue to prove the efficiency of LUKOIL fuels and motor oils.


LUKOIL

ANNUAL REPORT

2008

# Corporate Governance and Securities

The system of corporate governance, which has been put in place by LUKOIL, is an effective tool for protecting the rights and observing the interests of Company shareholders. Efficient corporate governance lowers the average-weighted cost of capital and reduces investment risks, making investments in LUKOIL more attractive and, as a consequence, raising shareholder value of the Company. The corporate governance system gives a special place to protecting the rights of minority shareholders.

# Corporate Governance

The system of corporate governance, which has been put in place by LUKOIL, is an effective tool for protecting the rights and observing the interests of Company shareholders. Efficient corporate governance lowers the average-weighted cost of capital and reduces investment risks, making investments in LUKOIL more attractive and, as a consequence, raising shareholder value of the Company. The corporate governance system gives a special place to protecting the rights of minority shareholders. Amendments to the LUKOIL Charter, made in 2005, expanded authority of the Board of Directors and established a principle of unanimous agreement on key matters (such as inclusion in the AGM agenda of issues related to any LUKOIL's charter capital increase above 10%; approval of a transaction or a number of interrelated transactions amounting to more than 7.5% of consolidated non-core asset value; and issue of securities which can be converted into more than 10% of the Company's outstanding shares within 12 months).

## Management

LUKOIL has a number of mechanisms in place, which help to make its management processes comply with best international practise and enable further improvement of their efficiency and transparency. A modern system of corporate governance has been put in place, 5 out of 11 members of the Board of Directors are independent, and BoD committees (for Strategy and Investment, Audit and HR and Compensation) have been operating successfully for a number of years. Company management maintains a high level of openness towards the investment community and the media, as confirmed by regular meetings of Company officials with investors and shareholders, organization of trips for representatives of the investment community to Company production regions, and conference calls and webcasts to accompany publication of financial results and for presentation of other important Company events. Professionalism of LUKOIL management has been repeatedly attested by experts over the years. In 2008 the annual rating by the Russian Association of Managers and Kommersant Publishing House, '1,000 Most Professional Russian Managers', gave leading positions to 7 top managers of LUKOIL.

## Changes in Group Structure

LUKOIL has been implementing a restructuring program since 2002. The main aim of the program is to increase shareholder value through increased transparency and efficiency of management processes, consolidation of core subsidiaries and withdrawal from the Group of non-core and inefficient assets.

The value of shares and share stakes of subsidiaries and affiliates, which were sold by the Group in 2008, amounted to $3 million. A total of $5.398 billion were paid out by the Group for acquisitions and consolidations in 2008. The biggest acquisitions by the Company in the accounting year were of stakes in UGK TGK-8 and in the ISAB Complex (island of Sicily, Italy).

### Major Corporate Transactions in 2008:

- in March 2008 LUKOIL signed an agreement on acquisition of a 64.31% stake in UGK TGK-8 for about $2,117 million. The deal was completed in May 2008. In the period from May to December 2008 a Group company bought a further stake in TGK-8 for $1,075 million. These acquisitions increased the Company's stake in TGK-8 to 95.53%.
- in June 2008 LUKOIL signed an agreement with the company ERG S.p.A. on creation of a joint venture

for management of the ISAB refining complex (island of Sicily, Italy). The Group's share in the JV is 49%. Total value of the deal is 1.45 billion euros (about $1.83 billion). In December 2008 the Group completed the deal by paying 600 million euros (about $762 million). The outstanding amount was settled ahead of schedule in February 2009. The seller has a put option, exercise of which would increase the Group stake in the JV for management of the ISAB complex to 100%.

- in November 2008 LUKOIL Group completed acquisition of 100% of Akpet, a company that operates 689 filling stations in Turkey (through dealer agreements) as well as owning 8 petroleum products terminals, 5 storage facilities for liquefied hydrocarbon gas and 3 aircraft refuelling complexes. The Company paid $555 million for the new asset.

## Financial Management

The Company's global approach to financial management is dictated by growth of the scale and geographical diversification of Company business. A system for centralized management of treasury operations, created in 2006, ensures efficient distribution of capital between Group organizations.

During the accounting year LUKOIL continued implementation of a system for pooling of cash balances and their efficient redistribution in Russia and abroad. The system reduces Group needs for external business financing, and increases profitability from investment of cash balances. The Company also continued its centralized external borrowing policy, which keeps the cost of consolidated debt at best-available market levels.

Company financing plans were implemented in full and in accordance with the schedule decided by management in 2008. This was in spite of the increasingly serious global financial crisis, which has led to bankruptcies among some of the largest banks, closure of capital markets and syndicated credit markets, lack of liquidity and steady growth of financing costs.

In June 2008 the Company took an unsecured syndicated credit of $1 billion. The credit consists of two tranches (a first tranche of $700 million for 5 years at a rate of LIBOR+0.95% per annum and a second tranche of $300 million for 3 years at LIBOR+0.85%). The money was used for settlement of sums outstanding from a credit for acquisition of Caspian Investments Resources Ltd.

In October and November 2008 the Company took two unsecured credits totalling $530 million for 3 years with an interest rate of LIBOR+3.25% per annum. The credits were used for a first payment to acquire 100% of shares of the Turkish company, Akpet, and a 49% stake in the ISAB refining complex (Italy).

It should be noted that LUKOIL was the only first-class Russian borrower, which succeeded in raising financing on such terms in the fourth quarter of 2008, when the market for club and syndicated credits was closed to Russian companies.

During 2008 LUKOIL continued to expand use of documentary operations (letters of credit and guarantees), replacing the practise of supplier advances. Use of bank guarantees and letters of credit for settlement purposes became standard for LUKOIL in the accounting year, and led to savings of the Company's own and borrowed capital, reduction of commercial and financial risks, and relatively low cost of bank letters of credit and guarantees, which were made available to the Company. Cost for the Company of documentary operations remained below 1% until October 2008 despite the volatile and difficult environment on financial markets in Russia and abroad. The Company's main partner banks subsequently raised their commission rates on such operations by more than two times, but cost of such operations for the Company remains below the market average even after this increase.

Financing under guarantees from export credit agencies was an important element in diversification of the credit portfolio and a source of investment financing for the Company in 2008. Shortages and increasingly high cost of credit resources mean that credits from export agencies now represent a unique source of cheaper funding for maximum periods (up to 12 years) in order to finance investment projects.

Overall economic effect from measures to optimize financial management during 2008 was $650 million, which is almost double the figure in 2007.

# Informational **Openness**

Since receiving a full listing on the London Stock Exchange in 2002 the Company has set up and successfully operates a system of corporate information disclosure for the investment community. LUKOIL's level of informational openness and quality of information disclosure fully comply with internationally accepted standards and with standards of the UK Financial Services Authority.

In 2008 LUKOIL won the annual competition, 'For strong corporate policy in the sphere of information disclosure' held by Interfax and AK&M agencies. The competition panel chose the winner based on fullness and timeliness of international financial reporting in accordance with international standards, disclosure of information about beneficiaries, and simultaneity of disclosure for Russian and international investors. Willingness of the Company to provide information during the recent crisis was particularly appreciated by experts.

The Company's policy of informational openness includes:

- quarterly publication of financial statements, prepared in accordance with US GAAP;
- annual publication of international audit of Company hydrocarbon reserves;
- conference calls and webcasts for the investment community to accompany publication of financial results and announcement of other important corporate events;
- trips for representatives of the investment community to Company operating regions;
- regular meetings with investors and shareholders;
- annual publication of an Analyst DataBook and Fact Book containing detailed industrial and financial statistics;
- publication every two years of a Company Sustainability Report on the Company's activities in the Russian Federation.

# Board of Directors and Management Committee

## Board of Directors of LUKOIL

**Valery GRAYFER**
Chairman of the LUKOIL Board of Directors
CEO of RITEK

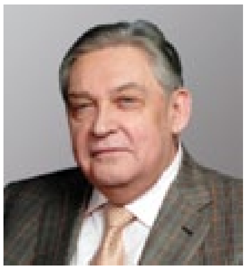
Born 1929
Graduated in 1952 from Moscow's Gubkin Oil Institute. Doctoral Candidate in Technical Sciences. Awarded six orders, four medals, and a diploma of the Supreme Soviet of the Tatar ASSR. Deputy to the USSR Oil Industry Minister from 1985, Head of the Tyumen Main Office for the Oil & Gas Industry. From 1992, CEO of RITEK. Chairman of the Board of Directors of LUKOIL from 2000. Professor of the Gubkin Russian State Oil & Gas University, Lenin Prize Winner and Russian Government Prize Winner.
Elected to the LUKOIL Board of Directors since 1996.

**Igor BELIKOV**
Independent Member of the LUKOIL Board of Directors*
Member of the LUKOIL BoD HR and Compensation Committee
Director of the Russian Institute of Directors

Born 1956
Graduated from Voronezh State University in 1980. Post-graduate student at the Africa Institute of the Academy of Sciences of the USSR (graduated in 1986), Doctoral Candidate in Historical Science. Studied as a trainee at London University.
Obtained a second higher education leading to a diploma in banking and insurance from the Institute for Improvement of Qualifications at the Financial Academy attached to the Government of the Russian Federation, obtained a certificate in corporate governance from Schulich Business School (Canada).
From 2001 to the present, Director of the Russian Institute of Directors. Co-author of the Russian Code of Corporate Conduct (2002) and of the first National Report on Corporate Governance (2004). From 2002 to 2004, member of the Expert Council at the Federal Commission for the Securities Market; from 2003 to 2004, Executive Secretary of the National Council for Corporate Governance; from 2004, member of the Expert Council on Corporate Governance at the Federal Financial Markets Service, Deputy Chairman of the Board of the Professional Society of Corporate Directors, Member of the International Corporate Governance Network. From 2003 to 2006, Expert of the Inter-governmental Expert Group for International Standards and Accounting at the United Nations Conference for Trade and Development (UNCTAD, Geneva).
Elected to the LUKOIL Board of Directors since 2008.

**Vagit ALEKPEROV**
President of LUKOIL
Member of the LUKOIL Board of Directors
Chairman of the LUKOIL Management Committee

Born 1950
Graduated in 1974 from the Azizbekov Institute of Oil and Chemistry in Azerbaijan. Doctor of Economics, current Member of the Russian Academy of Natural Sciences. Awarded four orders and eight medals. Winner of two Russian Government Prizes. Worked from 1968 in the oil industry in Azerbaijan and Western Siberia. From 1987 to 1990 CEO of Kogalymneftegaz (oil production company), a division of Glavtyumenneftegaz within the Ministry of the Oil & Gas Industry of the USSR. From 1990 to 1991, Deputy, then First Deputy to the USSR Oil & Gas Industry Minister. From 1992 to 1993, President of Langepasuraykogalymneft (oil production group). Chairman of the Board of Directors of LUKOIL from 1993 to 2000. President of LUKOIL from 1993.
Elected to the LUKOIL Board of Directors since 1993.



**Oleg KUTAFIN**
Member of the LUKOIL Board of Directors (until December 4, 2008)
President of the Moscow State Law Academy
Member of the LUKOIL BoD Audit Committee (until December 4, 2008)

Born 1937
Graduated in 1959 from Moscow State University. Professor and Doctor of Law. Member of the Russian Academy of Science, member of the Russian Academy of Education, awarded special recognition for contributions to Russian science. Rector of the Moscow State Law Academy from 1987 to 2007. From 2007 President of the Moscow State Law Academy. Chairman of the Russian Presidential Commission on Nationality. Deputy Secretary of the Public Chamber of the Russian Federation. Awarded orders for 'Services to Russia' (1st, 2nd, 3rd and 4th grades) and 10 medals.
Passed away on December 4, 2008.
Elected to the LUKOIL Board of Directors since 2001.

**Ravil MAGANOV**
Member of the LUKOIL Board of Directors
Member of the LUKOIL Management Committee
First Executive Vice-President of LUKOIL (Exploration & Production)
Member of the LUKOIL BoD Strategy and Investment Committee

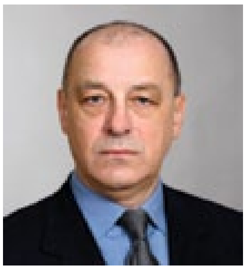
Born 1954
Graduated in 1977 from Moscow Gubkin Petrochemical & Gas Institute. Honored Employee of the Oil and Gas Industry of the Russian Federation. Awarded two orders and three medals. Winner of three Russian Government Prizes in science and technology. Chief Engineer, Deputy CEO, CEO of Langepasneftegaz (oil production company) from 1988 to 1993. Vice-President of LUKOIL from 1993 to 1994. First Vice-President of LUKOIL from 1994 to 2006. First Executive Vice-President of LUKOIL from 2006.
Elected to the LUKOIL Board of Directors since 1993.

**Richard MATZKE**
Independent member of the LUKOIL Board of Directors*
Chairman of the LUKOIL BoD Strategy and Investment Committee

Born 1937
Graduated from Iowa State University (1959), Pennsylvania State University (1961), and St. Mary's College in California (1977). Masters in Geology, MBA. President of Chevron Overseas Petroleum and Member of the Board of Directors of Chevron Corporation from 1989 to 1999. Vice-Chairman of Chevron and Chevron-Texaco Corporation from 2000 until 2002. Awarded a non-Government (sectoral) medal "For Development of the Russian Oil & Gas Industry" in 2006; winner of the national prize "Director of the Year, 2006" (Russia) in the "Independent Directors" nomination, organized by the Association of Independent Directors and PricewaterhouseCoopers.
Elected to the LUKOIL Board of Directors since 2002.

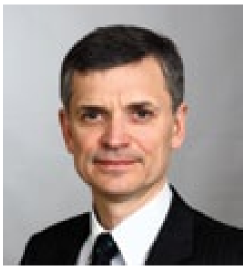
**Alexander SHOKHIN**
Independent Member of the LUKOIL Board of Directors*
President of the Russian Union of Industrialists and Entrepreneurs
President of the State University – Higher School of Economics
Chairman of the LUKOIL BoD HR and Compensation Committee
Member of the LUKOIL BoD Audit Committee (from February 13, 2009)

Born 1951
Graduated from Economics Faculty of Moscow State University in 1974, Doctor of Economic Science, Professor. Awarded an order and a medal. Began working career in 1969. Deputy Chairman of the Government of the Russian Federation, Minister of the Economy, Minister for Labour and Employment (1991–1994). Deputy of the State Duma of the Russian Federation (1994–2002). First Deputy Chairman of the State Duma of the Russian Federation (1996–1997). Chairman of Duma Fraction 'Our Home is Russia' (1997–1998). Deputy Chairman of the Russian Government in 1998. Chairman of the Supervisory Council of Renaissance Capital Investment Group (2002–2005). President of the Russian Union of Industrialists and Entrepreneurs (from 2005). Member of the Public Chamber of the Russian Federation, member of the Presidential Council for Priority National Projects and Demographic Policy, member of the Competitiveness and Enterprise Council of the Prime Minister of Russia, member of the Government Commission for Administrative Reform.
Elected to the LUKOIL Board of Directors since 2005.



**Sergei MIKHAILOV**
Independent Member of the LUKOIL Board of Directors*
CEO of the company Management-Consulting
Chairman of the LUKOIL BoD Audit Committee
Member of the LUKOIL BoD HR and Compensation Committee

Born in 1957
Graduated in 1979 from Dzerzhinsky Military Academy, in 1981 from the Moscow Aviation Institute (Further Qualification Faculty), and in 1998 from the Plekhanov Russian Economics Academy. Doctoral Candidate in Technical Sciences, Doctor of Economic Sciences, Professor. Awarded four medals. 1974–1992, service in armed forces. Head of Section, Deputy Chairman of the Russian Federal Property Fund from 1992 to 1996. Head of Restructuring and Investment Department of Ministry of Industry in 1996–1997. CEO of Management-Center (management company) from 1997 to 2003. CEO of the company Management-Consulting from 2001 to the present. From 2004, Chairman of the Board of Directors of Russian Mediagroup and of Capital Unit Investment Funds (Management Company), member of the Board of Directors of Spartak-Moscow Football Club and of Petrocommerce Commercial Bank. From 2005, member of the Board of Directors of IFD Capital and of Izvestiya Newspaper Editorial. From 2008, Chairman of the Board of Directors of Capital Investment Group, Member of the Board of Directors of Capital Management Company.
Elected to the LUKOIL Board of Directors since 2003.



**Nikolai TSVETKOV**
Member of the LUKOIL Board of Directors
Chairman of the Board of URALIB Financial Corporation
Member of the LUKOIL BoD HR and Compensation Committee

Born 1960
Graduated in 1980 from Dzerzhinsky Military Aviation Engineering School in Tambov, in 1988 from the Zhukovsky Air Force Academy and in 1996 from the Plekhanov Russian Economics Academy. Doctoral Candidate in Economics. President of NIKoil Oil Investment Company, Executive Director of LUKOIL's Securities Department, Vice-President of LUKOIL from 1994 to 1997. CEO of NIKoil investment bank from 1998 to 2003. Chairman of AVTOBANK–NIKOIL bank from 2003 to 2005. Chairman of BANK URALSIB Supervisory Council and Chairman of the Board of Directors of URALSIB Financial Corporation from 2007.
Elected to the LUKOIL Board of Directors since 1995 (excluding 1996 and 1997).

**Igor SHERKUNOV**
Member of the LUKOIL Board of Directors
President of FKM
Member of the LUKOIL BoD Strategy and Investment Committee
Member of the LUKOIL BoD Audit Committee

Born 1963
Graduated in 1985 from the Moscow Finance Institute, and in 1993 from the All-Russia Academy of Foreign Trade. Vice-President of LUKOIL Insurance Company from 1993 to 1996. CEO of LUKOIL-Reserve-Invest from 1996 to 2002. Chairman of the Board of Directors of Capital Investment Group from 2003 to 2008. President of the company FKM from 2008 and President of the Publishing house of Smena magazine from 2009.
Elected to the LUKOIL Board of Directors since 2001.

**Donald WALLETTE Jr**
Independent Member of the LUKOIL Board of Directors*
Russia/Caspian Region President of ConocoPhillips
Member of the LUKOIL BoD Strategy and Investment Committee

Born 1958
Graduated from the University of Southern California with a Degree in Chemical Engineering in 1981. ConocoPhillips Manager for Production Support and Optimization from 2002 to 2005. Vice-President for the Shtokman Project in the Russia/Caspian Region Division of ConocoPhillips in 2005 to 2006. Russia/Caspian Region President of ConocoPhillips from December 2006.
Elected to the LUKOIL Board of Directors since 2007.

* According to provisions of the Code of Corporate Conduct whose application is recommended by an instruction of the Federal Financial Markets Service, dated April 4, 2002.

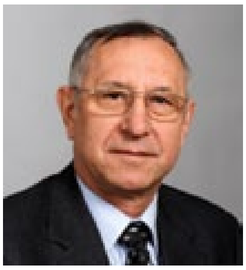
## Management Committee of LUKOIL

**Vagit ALEKPEROV**
President of LUKOIL
Member of the LUKOIL Board of Directors
Chairman of the LUKOIL Management Committee

Born 1950
Graduated in 1974 from the Azizbekov Institute of Oil and Chemistry in Azerbaijan. Doctor of Economics, current Member of the Russian Academy of Natural Sciences. Awarded four orders and eight medals. Winner of two Russian Government Prizes. Worked from 1968 in the oil industry in Azerbaijan and Western Siberia. From 1987 to 1990 CEO of Kogalymneftegaz (oil production company), a division of Glavtyumenneftegaz within the Ministry of the Oil & Gas Industry of the USSR. From 1990 to 1991, Deputy, then First Deputy to the USSR Oil & Gas Industry Minister. From 1992 to 1993, President of Langepasuraykogalymneft (oil production group). Chairman of the Board of Directors of LUKOIL from 1993 to 2000. President of LUKOIL from 1993.

**Leonid FEDUN**
Vice-President, Head of Main Division of Strategic Development and Investment Analysis of LUKOIL

Born 1956
Graduated in 1977 from Rostov Nedelin Higher Military School. Doctoral Candidate in Philosophy. Awarded an order and 7 medals. CEO of LUKoil Consulting from 1993 to 1994. Vice-President and Head of Main Division of Strategic Development and Investment Analysis of LUKOIL from 1994.



**Anatoly BARKOV**
Member of the LUKOIL Management Committee
Vice-President, Head of the Main Division of General Affairs, Corporate Security and Communications of LUKOIL

Born 1948
Graduated in 1992 from Ufa Oil Institute. Doctoral Candidate of Economics. Honored Employee of the Oil & Gas Industry of the Russian Federation. Awarded an order and 10 medals. Head of Operations, Head of Oil & Gas Production, Senior Engineer at Kogalymneftegaz from 1987 to 1992. Executive Director, then Director of the Department of Foreign Projects at Langepasuraykogalymneft in 1992–1993. Vice-President, Head of the Main Division of General Affairs, Corporate Security and Communications of LUKOIL from 1993.

**Evgueny KHAVKIN**
Member of the LUKOIL Management Committee
Secretary of the Board of Directors, Head of the BoD Office of LUKOIL

Born 1964
Graduated in 2003 from Moscow Institute of Economy, Management and Law. Awarded 2 medals. Worked in oil companies in Western Siberia from 1988. Deputy Head, then First Deputy Head of the BoD Office of LUKOIL from 1997 to 2003. BoD Secretary, Head of the BoD Office of LUKOIL from 2003.

**Jevan CHELOYANTS**
Member of the LUKOIL Management Committee
Vice-President, Head of the Main Technical Division of LUKOIL

Born 1959
Graduated in 1981 from Grozny Oil Institute. Honored Employee of the Oil & Gas Industry. Awarded a medal for 'Services to Russia' (2nd grade) and 4 medals. Winner of a Russian Government Prize. Section Head, then Deputy CEO for Foreign Economic Affairs of Langepasneftegaz from 1990 to 1993. Vice-President of LUKoil for Foreign Market Trading from 1993 to 1995. Vice-President of LUKOIL and Head of the Main Department for Maritime and Foreign Projects from 1995 to 2001. Vice-President, Head of the Main Division of Oil & Gas Production from 2001 to 2007. Vice-President and Head of the Main Technical Division of LUKOIL since 2007.

**Lyubov KHOBA**
Member of the LUKOIL Management Committee
Chief Accountant of LUKOIL

Born 1957
Graduated in 1992 from the Sverdlovsk Institute of National Economy. Doctoral Candidate of Economics. Honored Economist of the Russian Federation. Awarded 2 medals and an order. Chief Accountant at Kogalymneftegaz from 1991 to 1993. Chief Accountant at LUKOIL from 1993 to 2000. Vice-President of LUKOIL, Head of Financial Accounting from 2000 to 2003. Chief Accountant and Vice-President of LUKOIL from 2003 to 2004. Chief Accountant of LUKOIL from 2004.

**Sergey KUKURA**
Member of the LUKOIL Management Committee
First Vice-President of LUKOIL (Economics and Finance)

Born 1953
Graduated in 1979 from the Ivano-Frankovsk Institute of Oil & Gas. Doctor of Economic Science. Honored Economist of the Russian Federation. Awarded an order and five medals. Vice-President of Langepasuraykogalymneft from 1992 to 1993. First Vice-President of LUKOIL from 1993.

**Alexander MATYTSYN**
Member of the LUKOIL Management Committee
Vice-President, Head of the Main Division of Treasury and Corporate Financing of LUKOIL

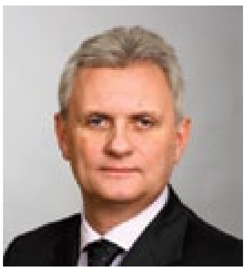
Born 1961
Graduated in 1984 from Moscow State University. Doctoral Candidate in Economic Science. MBA from Bristol University (1997). Awarded a medal for 'Services to Russia' (2nd grade). Director and CEO of international auditing firm KPMG from 1994 to 1997. Vice-President, Head of the Main Division of Treasury and Corporate Finance of LUKOIL from 1997.

**Ravil MAGANOV**
Member of the LUKOIL Board of Directors
Member of the LUKOIL Management Committee
First Executive Vice-President of LUKOIL (Exploration & Production)
Member of the LUKOIL BoD Committee on Strategy and Investment

Born 1954
Graduated in 1977 from Moscow Gubkin Petrochemical & Gas Institute. Honored Employee of the Oil and Gas Industry of the Russian Federation. Awarded two orders and three medals. Winner of three Russian Government Prizes in science and technology. Chief Engineer, Deputy CEO, CEO of Langepasneftegaz (oil production company) from 1988 to 1993. Vice-President of LUKOIL from 1993 to 1994. First Vice-President of LUKOIL from 1994 to 2006. First Executive Vice-President of LUKOIL from 2006.

**Anatoly MOSKALENKO**
Member of the LUKOIL Management Committee
Head of the Main Division of Human Resources of LUKOIL

Born 1959
Graduated in 1980 from Moscow Higher School of the Armed Forces, from the Military-Diplomatic Academy in 1987, and from the Russian Presidential Civil Service Academy in 2005. Doctoral Candidate in Economic Science. Awarded five orders and 20 medals. Served in the Armed Forces from 1976 to 2001. Head of Human Resources Department of LUKOIL from 2001 to 2003. Head of the Main Division of Human Resources at LUKOIL from 2003.



**Ivan MASLIAEV**
Member of the LUKOIL Management Committee
Head of the Main Division of Legal Support of LUKOIL

Born 1958
Graduated in 1980 from Moscow State University. Doctoral Candidate in Law. Honored Lawyer of the Russian Federation. Awarded three medals. Head of the Legal Department of Langepasuraykogalymneft from 1992 to 1993. Head of the LUKOIL Legal Department from 1994 to 1999. Head of the Main Division of Legal Support at LUKOIL since 2000.

**Vladimir MULYAK**
Member of the LUKOIL Management Committee
Vice-President, Head of the Main Division of Oil & Gas Production of LUKOIL

Born 1955
Graduated from Gubkin Petrochemical & Gas Institute in 1977. Doctoral Candidate in Geological and Mineralogical Sciences. Awarded a medal for 'Services to Russia' (2nd grade). Chief Engineer, Head of Lasyegannneft Oil & Gas production unit of LUKoil-Langepasneftegaz (1990–1996). First Deputy CEO for Production, CEO of production company Belorusneft (1996–2001). First Vice-President for Production of KomiTEK in 2001. Chief Engineer, First Deputy CEO, CEO of LUKOIL-Komi (2002–2007). Vice-President, Head of the Main Division of Oil & Gas Production of LUKOIL from 2007.

**Vladimir NEKRASOV**
Member of the LUKOIL Management Committee
First Vice-President of LUKOIL (Refining & Marketing)

Born 1957
Graduated in 1978 from Tyumen Industrial Institute. Doctoral Candidate in Technical Science, Member of the Academy of Mining Sciences. Awarded an order and three medals. Winner of a Russian Government Prize. Chief Engineer, CEO of Kogalymneftegaz (part of LUKOIL-Western Siberia) from 1992 to 1999. Vice-President of LUKOIL and CEO of LUKOIL-Western Siberia from 1999 to 2005. First Vice-President of LUKOIL since 2005.

**Vagit SHARIFOV**
Member of the LUKOIL Management Committee
Vice-President, Head of the Main Division of Control and Internal Audit of LUKOIL

Born 1945
Graduated in 1968 from Azerbaijan Azizbekov Institute of Oil and Chemistry. Doctor of Economics. Honored Employee of the Oil and Gas Industry of the Russian Federation. Awarded 2 orders and 6 medals. Senior Engineer, CEO of Volgogradnefteprodukt, and LUKoil-Volgogradnefteprodukt from 1985 to 1994. CEO of a branch of LUKOIL Finance from 1994 to 1995. CEO of LUKOIL regional office in Volgograd from 1995 to 1996. Vice-President of LUKOIL for Petroleum Product Marketing from 1996 to 2002. Vice-President, Head of the Main Division of Control and Internal Audit of LUKOIL from 2002.

**Valery SUBBOTIN**
Member of the LUKOIL Management Committee
Vice-President, Head of the Main Division of Supplies and Sales of LUKOIL

Born 1974
Graduated from Tyumen State University in 1996. From 1998 to 2003, worked at LUKOIL-Prague, LUKOIL-Bulgaria, and the Moscow Representative Office of the company Litasko. From 2003 to 2007, First Deputy Head of the Office of the Board of Directors of LUKOIL. From 2007, Vice-President, Head of the Main Division of Supplies and Sales of LUKOIL.

## Shares of BoD and Management Committee members in Charter Capital, as of December 31, 2008[1]

| BoD and Management Committee members | Stake, % |
|---|---|
| Vagit Alekperov | 20.60[2] |
| Igor Belikov | – |
| Donald Wallette, Jr | – |
| Valery Grayfer | 0.007 |
| Ravil Maganov | 0.49 |
| Richard Matzke | – |
| Sergei Mikhailov | 0.003 |
| Nikolai Tsvetkov | 1.05[2] |
| Igor Sherkunov | 0.06 |
| Alexander Shokhin | – |
| Anatoly Barkov | 0.07 |
| Sergei Kukura | 0.39 |
| Ivan Masliaev | 0.02 |
| Alexander Matytsyn | 0.30 |
| Anatoly Moskalenko | 0.009 |
| Vladimir Mulyak | 0.01 |
| Vladimir Nekrasov | 0.04 |
| Valery Subbotin | 0.005 |
| Leonid Fedun | 9.25[2] |
| Evgueny Khavkin | 0.01 |
| Lyubov Khoba | 0.34 |
| Jevan Cheloyants | 0.10 |
| Vagit Sharifov | – |

## Remuneration paid to Management Committee and BoD members of LUKOIL[3]

Each member of the Board of Directors was paid a remuneration of 4.3 million roubles in 2008 for carrying out their duties. There were additional payments for the roles of Board Chairman (1 million roubles), Chairman of a BoD Committee (500,000 roubles), as well as some other types of payment associated with duties of Board members and members of BoD Committees.

In the accounting year members of the Management Committee were paid remuneration equal to their monthly salary in their principle job. This payment is made in accordance with main conditions of contracts, drawn up with members of the Management Committee, subject to achievement of key corporate targets in the reporting period. Members of the Management Committee also received an annual base salary, annual bonus payments based on results of their work for the year, additional compensations of a social nature, and annual long-term premium payments.

| | Paid in 2008, thousand roubles | | | | |
|---|---|---|---|---|---|
| | Salary | Bonuses | Remuneration | Other payments | Total |
| BoD | - | - | 55,500.0 | 9,630.0[4] | 65,130.0 |
| Management Committee | 390,934.9 | 335,469.7 | 27,936.0 | 19,445.9 | 773,786.5 |

1 Share stakes of BoD and Management Committee members are shown in accordance with requirements of Russian law for disclosure of such information, and include shares held directly by Board/Management Committee members as well as shares held by nominee investors in their names.

2 Including beneficiary ownership.

3 For members of the Board of Directors who were simultaneously members of the Management Committee, remuneration received for membership of the Board of Directors is shown only in the 'Board of Directors' line, while salary, bonuses and remuneration to members of the Management Committee, and other payments are shown only in the 'Management Committee' line.

4 Compensation of expenses.

# Committees of the Board of Directors

## Strategy and Investment Committee

The purpose of this Committee is to draw up proposals to the BoD concerning:

- design of strategic goals for Company development;
- analysis of strategic development concepts, programs and plans of the Company;
- dividend amounts and procedure for dividend payment;
- distribution of Company profit and loss for the financial year.

The Committee consists of Richard Matzke (Chairman), Donald Wallette Jr, Ravil Maganov and Igor Sherkunov.

## HR and Compensation Committee

The purpose of this Committee is to make proposals to the BoD concerning:

- design of corporate personnel policy;
- policy and standards in selection of candidates to management positions in the Company, emphasizing importance of appointing the most highly qualified specialists.

The Committee consists of Alexander Shokhin (Chairman), Igor Belikov, Sergei Mikhailov and Nikolai Tsvetkov.

## Audit Committee

The purpose of this Committee is to make proposals to the BoD concerning:

- assessment of quality of services provided by the auditor, and observance by the auditor of auditing independence;
- selection and assessment of performance by the auditor.

The Committee consists of Sergei Mikhailov (Chairman), Igor Sherkunov and Alexander Shokhin (since February 13, 2009). Oleg Kutafin was also a member of the Committee until December 4, 2008.

# Internal Control **and Audit**

The system of control and internal audit is an integral part of the Company's corporate governance structure, enabling the Company to function efficiently and the interests of its shareholders and investors to be protected. The Group has created a Unified Control and Internal Audit Service, which ensures that management receives objective and accurate information on the business of organizations in LUKOIL Group and of its structural subdivisions.

There were 21 control and internal audit checks at organizations and structural subdivisions of LUKOIL Group during 2008, spread over all business segments. Their purpose is to ensure that Group organizations and structural subdivisions comply with current legal requirements, regional laws, and international norms and standards.

The main tasks of the checks were:
- analysis of business efficiency, including investment efficiency, of LUKOIL Group organizations;
- checking that business of Group organizations is in accordance with LUKOIL's strategic goals and monitoring compliance with Company management decisions, including decisions taken as a result of previous checks;
- identification of significant risks related to activity of Group organizations and working out recommendations on ways of minimizing risks;
- assessing measures by management of subsidiaries and structural subdivisions of the Company to ensure stable and efficient functioning of various components of the internal control system;
- assessing whether organization and conduct of financial accounting help to make operating and financial control more efficient, contribute to further growth of shareholder value and protect shareholder interests.

Audit recommendations and management decisions were designed based on outcome of the checks in order to raise efficiency of Company business, minimize any risks, which had been identified, and improve the system of internal control and risk management. The Control and Internal Audit Service constantly monitored execution of decisions by the Company's managing bodies, which were taken based on results of previous control and audit checks, in order to ensure efficiency of the internal audit system.

The Company works constantly to organize and coordinate audit activity in LUKOIL Group organizations. Audit commissions were elected and carried out their functions in 69 subsidiaries and affiliates of the Company during 2008.

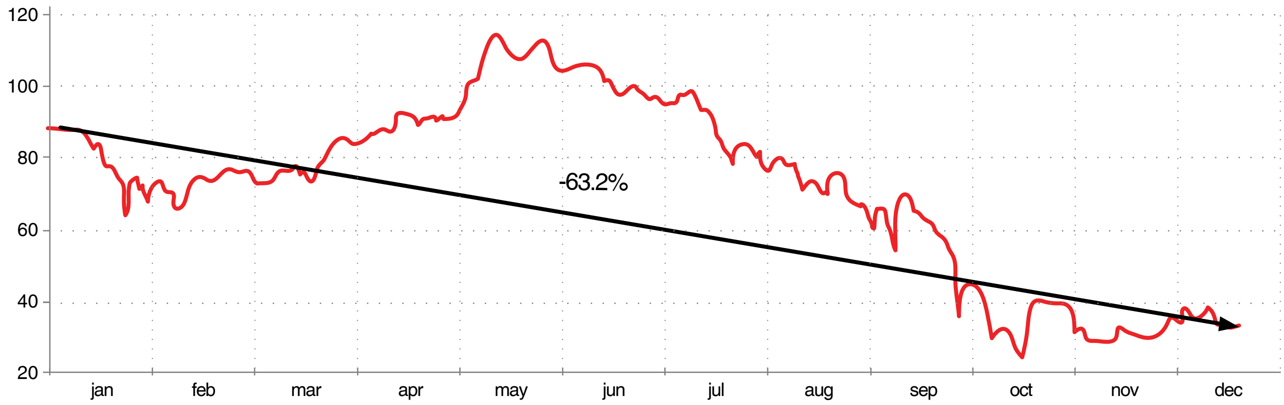
There was systematic control by the Company in 2008 over observance of established procedures and authorizations in conduct of transactions, which affect the interests of Company shareholders and investors. During 2008, in compliance with the procedure approved by the Management Committee on decision-making concerning participation in other organizations, the Control and Internal Audit Service prepared and submitted opinions to the Restructuring Commission of LUKOIL Group on 68 corporate transactions, of which 49 were approved.

During the accounting year the Company continued to develop its system for conduct of tendering procedures, which is an important element in the internal control system. During 2008 LUKOIL organized 1,141 tendering procedures with overall value of $4.6 billion. Cost of procurement of goods, work and services by LUKOIL Group was reduced by $26 million thanks to tighter control over conduct of tendering procedures, and improvements in the quality of assessment of tendering documentation and of proposals by tender participants.

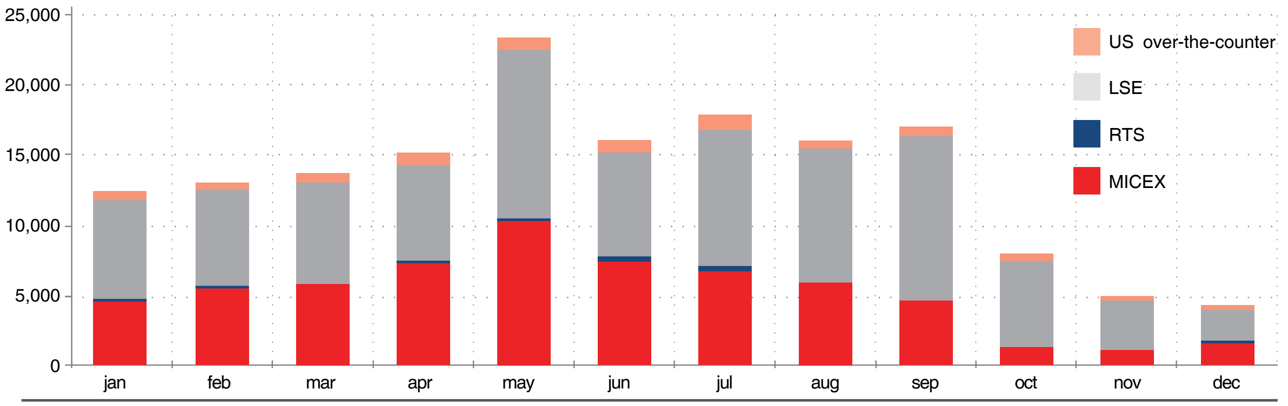
# Company Securities

Prices for LUKOIL shares were subject to major volatility in 2008, reflecting the situation on Russian and international stock markets. On the one hand the share price reached a record high of $113.2 during the reporting period. On the other hand there was a substantial fall in the second half of the year when the share price rolled back to levels, which it achieved 4 years ago.

LUKOIL share price on the RTS exchange (2008), $




Monthly trading in LUKOIL shares and depositary receipts (2008), $ million



Rapid growth of the LUKOIL share price in the first half of the year was mainly due to major rise of oil prices.

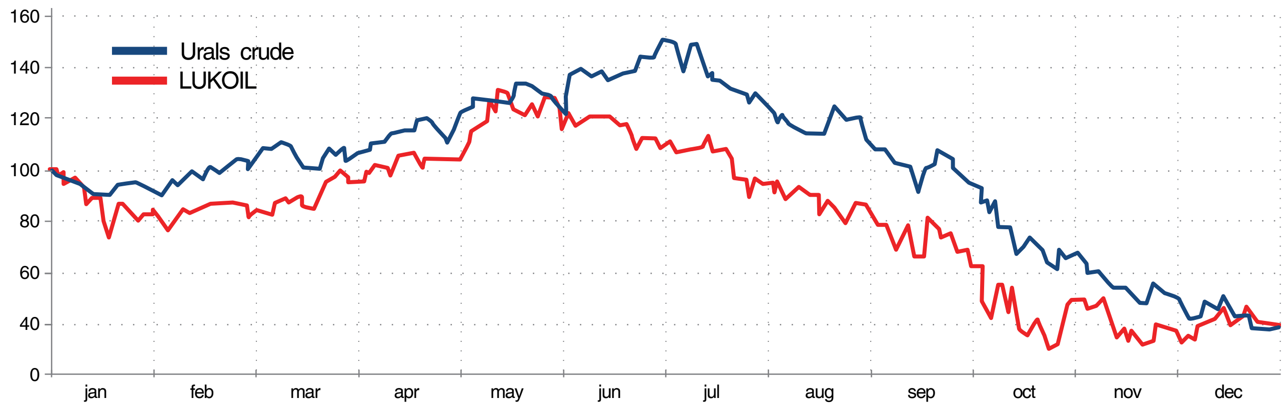
The share price decline in the second half of the year occurred as the international financial crisis became increasingly acute. The crisis led to numerous bankruptcies and worsening of the financial situation of companies worldwide, growth of inflation, decline of consumer demand, rise of unemployment, and, ultimately, fall in growth rates of the world economy. The most serious consequence of the crisis for the Company was substantial decline in oil prices, which hovered around a level of $35 per barrel at the end of 2008, and substantial capital outflows from emerging markets (including outflow of $130 billion from Russia in the course of the year). Russian internal factors also had impact on share prices (Russia's involvement in the conflict between Georgia and Southern Ossetia, corporate conflicts and investigations, and other negative factors). As a result the Russian share market was among the worst performers in emerging economies.

The LUKOIL share price declined by 63.2% during the accounting period (based on results of trading on the RTS Stock Exchange) to a level of $32 per share at the end of 2008. However, it should be noted that the RTS Index declined by 72.4% and the MICEX Index by 67.2% in 2008. So Company shares performed better than Russian stock indices, which indicate the average price trends of shares of Russian issuers. LUKOIL market capitalization as of December 31, 2008 was $27.2 billion.

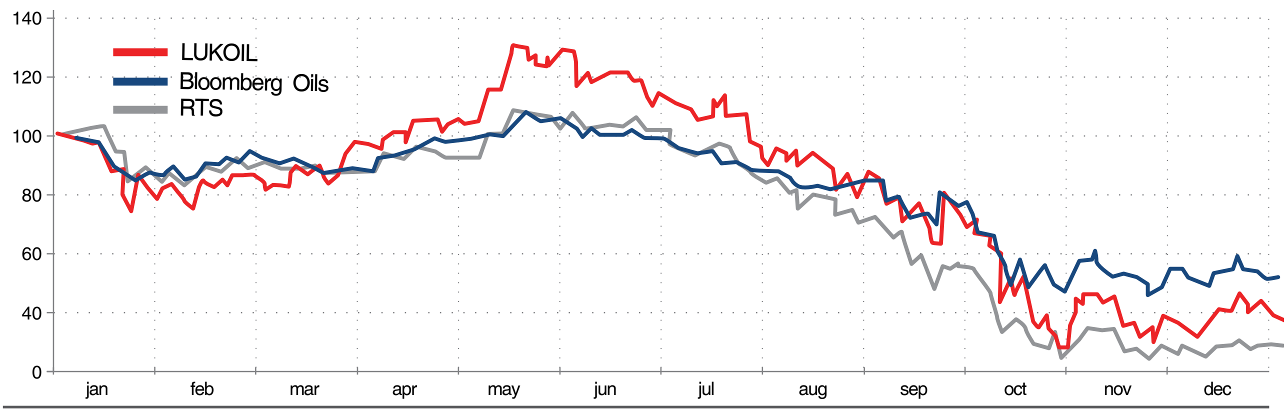
Despite the difficult situation on the stock market and in the overall economy LUKOIL shares were among the most liquid securities of Russian issuers during 2008 both in Russia and abroad. LUKOIL shares were among the top-3 shares on the Russian organized securities trading market by trading volumes during 2008. Shares of LUKOIL represented 12.8% and 14.2% of total volumes on main trading floors, the MICEX and the RTS Stock Exchange, respectively, in 2008.

Programs of American Depositary Receipts on Company shares continued to operate in the reporting year. These instruments are traded on the over-the-counter market in the USA and also on stock exchanges in London, Frankfurt, Munich, Stuttgart, etc. ADRs issued on ordinary shares were equivalent to 579 million shares (68.0% of Company charter capital) at the end of 2008. ADRs on

LUKOIL share price on the RTS exchange and Urals oil price (2008), %




LUKOIL share price, Bloomberg oils index and the RTS Index (2008), %



LUKOIL shares took second place by volumes of trading among ADRs of foreign issuers listed on the IOB system of the London Stock Exchange in 2008 (they represented 17.1% of total average monthly trading volumes in the IOB system).

Overall, despite the market collapse in the fourth quarter of the reporting year, average monthly trading in LUKOIL shares at stock exchanges and the US over-the-counter market was $13.4 billion in 2008 compared with $10.9 billion in 2007. Trading turnover in shares also increased, proving growth of investor interest in Company securities.

LUKOIL shares continued to be used as an underlying instrument for securities trading on the Russian stock futures market in the reporting year. Future contracts for delivery of LUKOIL shares were among main instruments on the futures section of the RTS Stock Exchange, taking fourth place behind future contracts on the RTS Index, Gazprom shares and the US dollar exchange rate.

LUKOIL reacts in a timely and rapid fashion to changes in the market environment, helping the Company to function successfully and maintain its attractiveness for investors despite instability of the world financial system. The Company has decided to reduce planned capital expenditures in 2008, which will help to achieve positive cash flow over the year. However, the capex reduction has not affected key growth projects, which will ensure that the Company shows positive production growth dynamics in 2009. This, in combination with possible return of oil prices to a fair level of $50–70 per barrel, serves as a guarantee of share price growth in the future.

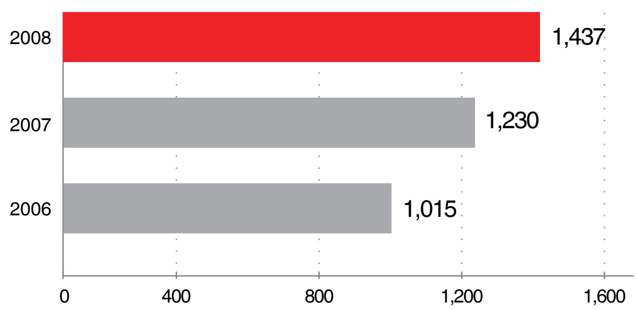
# Dividends

LUKOIL bases its dividend policy on a balance of interests between the Company and its shareholders, aiming to increase the Company's investment attractiveness and shareholder value, and to respect and strictly observe the rights of shareholders, as set out in acting legislation of the Russian Federation, the Company Charter and its internal documents.

In making per share dividend recommendations to the AGM the Board of Directors treats as axiomatic that per share dividend payment should not be less than 15% of net income reported in LUKOIL's consolidated US GAAP financial accounts. Dividends accrued in 2008 on results for 2007 were $1,510 million or 15.9% of consolidated net income of LUKOIL Group for 2007 under US GAAP.

The Company is steadily increasing its dividend payments. Dividends for 2008 recommended by the Board of Directors on April 23, 2009 for approval at the Annual General Meeting on June 25, 2009 are a record 50 roubles ($1.5 as of the date of the Board of Directors meeting) per ordinary share, which is 19% more than for 2007. Earnings per common share were $10.88 in 2008 compared with $11.48 in 2007. Dividend yield is 2.8%, which is the highest indicator shown by the Company in the last four years.

Dividends paid on Company common stock, $ million




## Dividend per common share, roubles, and dividend yield, %

| | Dividend, roubles | Dividend yield, %[2] |
|---|---|---|
| 2004 | 28 | 3.40 |
| 2005 | 33 | 2.76 |
| 2006 | 38 | 1.71 |
| 2007 | 42 | 2.02 |
| 2008[1] | 50 | 2.81 |

[1] Dividends recommended by the LUKOIL Board of Directors for approval at the Annual General Meeting of Shareholders.

[2] Dividend yield is calculated based on the average market price for LUKOIL shares and average exchange rate for year the dividend are paid for.

# CONSOLIDATED FINANCIAL STATEMENTS

## Independent Auditors' Report

The Board of Directors of OAO LUKOIL:

We have audited the accompanying consolidated balance sheets of OAO LUKOIL and its subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2008. These consolidated financial statements are the responsibility of the management of OAO LUKOIL. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of OAO LUKOIL and its subsidiaries as of December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2008, in conformity with accounting principles generally accepted in the United States of America.

ZAO KPMG

ZAO KPMG
Moscow, Russian Federation
March 31, 2009

# Consolidated balance sheets as of December 31, 2008 and 2007

(Millions of US dollars, unless otherwise noted)

| | Note | 2008 | 2007 |
|---|---|---|---|
| ASSETS | | | |
| CURRENT ASSETS | | | |
| Cash and cash equivalents | 3 | 2,239 | 841 |
| Short-term investments | | 505 | 48 |
| Accounts and notes receivable, net | 5 | 5,069 | 7,467 |
| Inventories | 6 | 3,735 | 4,609 |
| Prepaid taxes and other expenses | | 3,566 | 4,109 |
| Other current assets | | 519 | 625 |
| Assets held for sale | 10 | - | 70 |
| TOTAL CURRENT ASSETS | | 15,633 | 17,769 |
| Investments | 7 | 3,269 | 1,086 |
| Property, plant and equipment | 8 | 50,088 | 38,056 |
| Deferred income tax assets | 13 | 521 | 490 |
| Goodwill and other intangible assets | 9 | 1,159 | 942 |
| Other non-current assets | | 791 | 1,289 |
| TOTAL ASSETS | | 71,461 | 59,632 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | | |
| CURRENT LIABILITIES | | | |
| Accounts payable | | 5,029 | 4,554 |
| Short-term borrowings and current portion of long-term debt | 11 | 3,232 | 2,214 |
| Taxes payable | | 1,564 | 2,042 |
| Other current liabilities | | 750 | 918 |
| TOTAL CURRENT LIABILITIES | | 10,575 | 9,728 |
| Long-term debt | 12, 16 | 6,577 | 4,829 |
| Deferred income tax liabilities | 13 | 2,116 | 2,079 |
| Asset retirement obligations | 8 | 718 | 811 |
| Other long-term liabilities | | 465 | 395 |
| Minority interest in subsidiary companies | | 670 | 577 |
| TOTAL LIABILITIES | | 21,121 | 18,419 |
| STOCKHOLDERS' EQUITY | 15 | | |
| Common stock | | 15 | 15 |
| Treasury stock, at cost | | (282) | (1,591) |
| Additional paid-in capital | | 4,694 | 4,499 |
| Retained earnings | | 45,983 | 38,349 |
| Accumulated other comprehensive loss | | (70) | (59) |
| TOTAL STOCKHOLDERS' EQUITY | | 50,340 | 41,213 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | | 71,461 | 59,632 |

President of OAO LUKOIL — Alekperov V.Y.

Chief accountant of OAO LUKOIL — Khoba L.N.

The accompanying notes are an integral part of these consolidated financial statements.

## Consolidated statements of income for the years ended December 31, 2008, 2007 and 2006

(Millions of US dollars, unless otherwise noted)

| | Note | 2008 | 2007 | 2006 |
|---|---|---|---|---|
| REVENUES | | | | |
| Sales (including excise and export tariffs) | 23 | 107,680 | 81,891 | 67,684 |
| COSTS AND OTHER DEDUCTIONS | | | | |
| Operating expenses | | (8,126) | (6,172) | (4,652) |
| Cost of purchased crude oil, gas and products | | (37,851) | (27,982) | (22,642) |
| Transportation expenses | | (5,460) | (4,457) | (3,600) |
| Selling, general and administrative expenses | | (3,860) | (3,207) | (2,885) |
| Depreciation, depletion and amortization | | (2,958) | (2,172) | (1,851) |
| Taxes other than income taxes | 13 | (13,464) | (9,367) | (8,075) |
| Excise and export tariffs | | (21,340) | (15,033) | (13,570) |
| Exploration expenses | | (487) | (307) | (209) |
| Loss on disposals and impairments of assets | | (425) | (123) | (148) |
| INCOME FROM OPERATING ACTIVITIES | | 13,709 | 13,071 | 10,052 |
| Interest expense | | (391) | (333) | (302) |
| Interest and dividend income | | 163 | 135 | 111 |
| Equity share in income of affiliates | 7 | 375 | 347 | 425 |
| Currency translation (loss) gain | | (1,163) | 93 | 169 |
| Other non-operating expense | | (244) | (240) | (118) |
| Minority interest | | (83) | (55) | (80) |
| INCOME BEFORE INCOME TAX | | 12,366 | 13,018 | 10,257 |
| Current income taxes | | (4,167) | (3,410) | (2,906) |
| Deferred income tax | | 945 | (97) | 133 |
| TOTAL INCOME TAX EXPENSE | 13 | (3,222) | (3,507) | (2,773) |
| NET INCOME | | 9,144 | 9,511 | 7,484 |
| Per share of common stock (US dollars): | | | | |
| Basic | 15 | 10.88 | 11.48 | 9.06 |
| Diluted | 15 | 10.88 | 11.48 | 9.04 |

The accompanying notes are an integral part of these consolidated financial statements.

## Consolidated statements of stockholders' equity and comprehensive income for the years ended December 31, 2008, 2007 and 2006

(Millions of US dollars, unless otherwise noted)

| | 2008 | | 2007 | | 2006 | |
|---|---|---|---|---|---|---|
| | Stockholders' equity | Comprehensive income | Stockholders' equity | Comprehensive income | Stockholders' equity | Comprehensive income |
| Common stock | | | | | | |
| Balance as of January 1 | 15 | | 15 | | 15 | |
| BALANCE AS OF DECEMBER 31 | 15 | | 15 | | 15 | |
| Treasury stock | | | | | | |
| Balance as of January 1 | (1,591) | | (1,098) | | (527) | |
| Stock purchased | (219) | | (712) | | (782) | |
| Stock disposed | 1,528 | | 219 | | 211 | |
| BALANCE AS OF DECEMBER 31 | (282) | | (1,591) | | (1,098) | |
| Additional paid-in capital | | | | | | |
| Balance as of January 1 | 4,499 | | 3,943 | | 3,730 | |
| Premium on non-outstanding shares issued | 20 | | - | | 22 | |
| Effect of stock compensation plan | 103 | | 103 | | - | |
| Proceeds from sale of treasury stock in excess of carrying amount | 72 | | 453 | | 191 | |
| BALANCE AS OF DECEMBER 31 | 4,694 | | 4,499 | | 3,943 | |
| Retained earnings | | | | | | |
| Balance as of January 1 | 38,349 | | 30,061 | | 23,586 | |
| Net income | 9,144 | 9,144 | 9,511 | 9,511 | 7,484 | 7,484 |
| Dividends on common stock | (1,510) | | (1,223) | | (1,009) | |
| BALANCE AS OF DECEMBER 31 | 45,983 | | 38,349 | | 30,061 | |
| Accumulated other comprehensive loss, net of tax | | | | | | |
| Balance as of January 1 | (59) | | (21) | | - | |
| Pension benefits: | | | | | | |
| Prior service cost | (5) | (5) | (16) | (16) | - | - |
| Actuarial loss | (6) | (6) | (22) | (22) | - | - |
| Effect of initial adoption of SFAS No. 158 | - | | - | | (21) | |
| BALANCE AS OF DECEMBER 31 | (70) | | (59) | | (21) | |
| Total comprehensive income for the year | | 9,133 | | 9,473 | | 7,484 |
| TOTAL STOCKHOLDERS' EQUITY AS OF DECEMBER 31 | 50,340 | | 41,213 | | 32,900 | |

| | Share activity | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| | (thousands of shares) | (thousands of shares) | (thousands of shares) |
| Common stock, issued | | | |
| Balance as of January 1 | 850,563 | 850,563 | 850,563 |
| BALANCE AS OF DECEMBER 31 | 850,563 | 850,563 | 850,563 |
| Treasury stock | | | |
| Balance as of January 1 | (23,321) | (23,632) | (21,667) |
| Purchase of treasury stock | (2,899) | (8,756) | (9,017) |
| Disposal of treasury stock | 22,384 | 9,067 | 7,052 |
| BALANCE AS OF DECEMBER 31 | (3,836) | (23,321) | (23,632) |

## Consolidated statements of cash flows for the years ended December 31, 2008, 2007 and 2006
(Millions of US dollars)

| | Note | 2008 | 2007 | 2006 |
|---|---|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES | | | | |
| NET INCOME | | 9,144 | 9,511 | 7,484 |
| Adjustments for non-cash items: | | | | |
| Depreciation, depletion and amortization | | 2,958 | 2,172 | 1,851 |
| Equity share in income of affiliates, net of dividends received | | (238) | 209 | (106) |
| Dry hole write-offs | | 317 | 143 | 91 |
| Loss on disposals and impairments of assets | | 425 | 123 | 148 |
| Deferred income taxes | | (945) | 97 | (133) |
| Non-cash currency translation (gain) loss | | (423) | 193 | 86 |
| Non-cash investing activities | | (29) | (36) | (123) |
| All other items – net | | 404 | 297 | 89 |
| Changes in operating assets and liabilities: | | | | |
| Accounts and notes receivable | | 2,647 | (2,297) | 388 |
| Inventories | | 963 | (1,148) | (816) |
| Accounts payable | | (989) | 1,599 | 592 |
| Taxes payable | | (521) | 386 | (430) |
| Other current assets and liabilities | | 599 | (368) | (1,355) |
| NET CASH PROVIDED BY OPERATING ACTIVITIES | | 14,312 | 10,881 | 7,766 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | | | |
| Acquisition of licenses | | (12) | (255) | (7) |
| Capital expenditures | | (10,525) | (9,071) | (6,419) |
| Proceeds from sale of property, plant and equipment | | 166 | 72 | 310 |
| Purchases of investments | | (398) | (206) | (312) |
| Proceeds from sale of investments | | 636 | 175 | 216 |
| Sale of interests in subsidiaries and affiliated companies | | 3 | 1,136 | 71 |
| Acquisitions of subsidiaries and minority shareholding interest (including advances related to acquisitions), net of cash acquired | | (3,429) | (1,566) | (1,374) |
| NET CASH USED IN INVESTING ACTIVITIES | | (13,559) | (9,715) | (7,515) |
| CASH FLOWS FROM FINANCING ACTIVITIES | | | | |
| Net movements of short-term borrowings | | 974 | (59) | 700 |
| Cash received under sales-leaseback transaction | | 235 | - | - |
| Proceeds from issuance of long-term debt | | 2,884 | 2,307 | 1,092 |
| Principal repayments of long-term debt | | (1,547) | (1,632) | (1,077) |
| Dividends paid on company common stock | | (1,437) | (1,230) | (1,015) |
| Dividends paid to minority | | (168) | (78) | (119) |
| Financing from related party and third party minority shareholders | | 39 | 177 | - |
| Purchase of treasury stock | | (219) | (712) | (782) |
| Proceeds from sale of treasury stock | | - | 129 | - |
| Other – net | | 2 | - | 15 |
| NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES | | 763 | (1,098) | (1,186) |
| Effect of exchange rate changes on cash and cash equivalents | | (118) | 21 | 37 |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | | 1,398 | 89 | (898) |
| Cash and cash equivalents at beginning of year | | 841 | 752 | 1,650 |
| CASH AND CASH EQUIVALENTS AT END OF YEAR | 3 | 2,239 | 841 | 752 |

Supplemental disclosures of cash flow information

| | | | |
|---|---|---|---|
| Interest paid | 440 | 338 | 292 |
| Income taxes paid | 4,902 | 2,872 | 2,980 |

The accompanying notes are an integral part of these consolidated financial statements.

# Notes to Consolidated Financial Statements

(Millions of US dollars, except as indicated)

## NOTE 1. ORGANIZATION AND ENVIRONMENT

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

The Group 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 the twenty-four founding subsidiaries to 100%.

From formation, the Group has expanded substantially through consolidation of its interests, acquisition of new companies and establishment of new businesses.

### Business and economic environment

The Russian Federation has been experiencing political and economic change, that has affected and will continue to affect the activities of enterprises operating in this environment. Consequently, operations in the Russian Federation involve risks, which do not typically exist in other markets. In addition, the recent contraction in the capital and credit markets has further increased the level of economic uncertainty in the environment.

The accompanying financial statements reflect management's assessment of the impact of the business environment in the countries in which the Group operates on the operations and the financial position of the Group. The future business environments may differ from management's assessment.

### Basis of preparation

These consolidated financial statements have been prepared by the Company in accordance with accounting principles generally accepted in the United States of America ("US GAAP").

## NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Principles of consolidation

These 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. Equity investments and investments in other companies are included in "Investments" in the consolidated balance sheet.

### Use of estimates

The preparation of financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Significant items subject to such estimates and assumptions include the carrying value of oil and gas properties and other property, plant and equipment, goodwill impairment assessment, asset retirement obligations, deferred income taxes, valuation of financial instruments, and obligations related to employee benefits. Eventual actual amounts could differ from those estimates.

### Revenue

Revenues from the production and sale of crude oil and petroleum products 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.

## Foreign currency translation

The Company maintains its accounting records in Russian rubles. The Company's functional currency is the US dollar and the Group's reporting currency is the US dollar.

For operations in the Russian Federation and for the majority of operations outside the Russian Federation, the US dollar is the functional currency. Where the US dollar is the functional currency, monetary assets and liabilities have been translated into US dollars at the rate prevailing at each balance sheet date. Non-monetary assets and liabilities have been translated into US dollars at historical rates. Revenues, expenses and cash flows have been translated into US dollars at rates, which approximate actual rates at the date of the transaction. Translation differences resulting from the use of these rates are included in the consolidated statement of income.

For certain other operations outside the Russian Federation, where the US dollar is not the functional currency and the economy is not hyperinflationary, assets and liabilities are translated into US dollars at year-end exchange rates and revenues and expenses are translated at average exchange rates for the year. Resulting translation adjustments are reflected as a separate component of comprehensive income.

In all cases, foreign currency transaction gains and losses are included in the consolidated statement of income.

As of December 31, 2008, 2007 and 2006, exchange rates of 29.38, 24.55 and 26.33 Russian rubles to the US dollar, respectively, have been used for translation purposes.

The Russian ruble and other currencies of republics of the former Soviet Union are not readily convertible outside of their countries. Accordingly, the translation of amounts recorded in these currencies into US dollars should not be construed as a representation that such currency amounts have been, could be or will in the future be converted into US dollars at the exchange rate shown or at any other exchange rate.

## Cash and cash equivalents

Cash and cash equivalents include all highly liquid investments with an original maturity of three months or less.

## Cash with restrictions on immediate use

Cash funds for which restrictions on immediate use exist are accounted for within other non-current assets.

## Accounts and notes receivable

Accounts and notes receivable are recorded at their transaction amounts less provisions for doubtful debts. Provisions for doubtful debts are recorded to the extent that there is a likelihood that any of the amounts due will not be obtained. Non-current receivables are discounted to the present value of expected cash flows in future periods using the original discount rate.

## Inventories

Inventories, consisting primarily of stocks of crude oil, petroleum products and materials and supplies, are stated at the lower of cost or market value. Cost is determined using an "average cost" method.

## Investments

Debt and equity securities are classified into one of three categories: trading, available-for-sale, or held-to-maturity.

Trading securities are bought and held principally for the purpose of selling in the near term. Held-to-maturity securities are those securities in which a Group company has the ability and intent to hold until maturity. All securities not included in trading or held-to-maturity are classified as available-for-sale.

Trading and available-for-sale securities are recorded at fair value. Held-to-maturity securities are recorded at cost, adjusted for the amortization or accretion of premiums or discounts. Unrealized holding gains and losses on trading securities are included in the consolidated statement of income. Unrealized holding gains and losses, net of the related tax effect, on available-for-sale securities are reported as a separate component of comprehensive income until realized. Realized gains and losses from the sale of available-for-sale securities are determined on a specific identification basis. Dividends and interest income are recognized in the consolidated statement of income when earned.

A permanent decline in the market value of any available-for-sale or held-to-maturity security below cost is accounted for as a reduction in the carrying amount to fair value. The impairment is charged to the consolidated statement of income and a new cost base for the security is established. Premiums and discounts are amortized or accreted over the life of the related held-to-maturity or available-for-sale security as an adjustment to yield using the effective interest method and such amortization and accretion is recorded in the consolidated statement of income.

## Property, plant and equipment

Oil and gas properties are accounted for using the successful efforts method of accounting whereby property acquisitions, successful exploratory wells, all development costs, and support equipment and facilities are capitalized. Unsuccessful exploratory wells are expensed when a well is determined to be non-productive. Other exploratory expenditures, including geological and geophysical costs are expensed as incurred.

The Group continues to capitalize costs of exploratory wells and exploratory-type stratigraphic wells for more than one year after the completion of drilling if the well has found a sufficient quantity of reserves to justify its completion as a producing well and the company is making sufficient progress assessing the reserves and the economic and operating viability of the project. If these conditions are not met or if information that raises substantial doubt about the economic or operational viability of the project is obtained, the well would be assumed impaired, and its costs, net of any salvage value, would be charged to expense.

Depreciation, depletion and amortization of capitalized costs of oil and gas properties is calculated using the unit-of-production method based upon proved reserves for the cost of property acquisitions and proved developed reserves for exploration and development costs.

Production and related overhead costs are expensed as incurred.

Depreciation of assets not directly associated with oil production is calculated on a straight-line basis over the economic lives of such assets, estimated to be in the following ranges:

| | |
|---|---|
| Buildings and constructions | 5 – 40 years |
| Machinery and equipment | 5 – 20 years |

In addition to production assets, certain Group companies also maintain and construct social assets for the use of local communities. Such assets are capitalized only to the extent that they are expected to result in future economic benefits to the Group. If capitalized, they are depreciated over their estimated economic lives.

Significant unproved properties are assessed for impairment individually on a regular basis and any estimated impairment is charged to expense.

## Asset retirement obligations

The Group records the fair value of liabilities related to its legal obligations to abandon, dismantle or otherwise retire tangible long-lived assets in the period in which the liability is incurred. A corresponding increase in the carrying amount of the related long-lived asset is also recorded. Subsequently, the liability is accreted for the passage of time and the related asset is depreciated using the unit-of-production method.

## Goodwill and other intangible assets

Goodwill represents the excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed. It is assigned to reporting units as of the acquisition date. Goodwill is not amortized, but is tested for impairment at least on an annual basis and between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. The impairment test requires estimating the fair value of a reporting unit and comparing it with its carrying amount, including goodwill assigned to the reporting unit. If the estimated fair value of the reporting unit is less than its net carrying amount, including goodwill, then the goodwill is written down to its implied fair value.

Intangible assets with indefinite useful lives are tested for impairment at least annually. Intangible assets that have limited useful lives are amortized on a straight-line basis over the shorter of their useful or legal lives.

## 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.

## 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.

On January 1, 2007, the Group adopted FASB Interpretation No. 48, *"Accounting for Uncertainty in Income Taxes, an interpretation of Statement of Financial Accounting Standards No. 109"* (FIN 48). FIN 48 clarifies the accounting for uncertain tax positions, which requires an entity to recognize the effect of an income tax position only if that 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. The Company records interest and penalties relating to unrecognized tax benefits in income tax expense in the consolidated statements of income.

## Interest-bearing borrowings

Interest-bearing borrowings are initially recorded at the value of net proceeds received. Any difference between the net proceeds and the redemption value is amortized at a constant rate over the term of the borrowing. Amortization is included in the consolidated statement of income each year and the carrying amounts are adjusted as amortization accumulates.

If borrowings are repurchased or settled before maturity, any difference between the amount paid and the carrying amount is recognized in the consolidated statement of income in the period in which the repurchase or settlement occurs.

## Pension benefits

The expected costs in respect of pension obligations of Group companies are determined by an independent actuary. Obligations in respect of each employee are accrued over the reporting periods during which the employee renders service in the Group.

## Treasury stock

Purchases by Group companies of the Company's outstanding stock are recorded at cost and classified as treasury stock within Stockholders' equity. Shares shown as Authorized and Issued include treasury stock. Shares shown as Outstanding do not include treasury stock.

## Earnings per share

Basic earnings per share is computed by dividing net income available to common stockholders by the weighted-average number of shares of common stock outstanding during the reporting period. A calculation is carried out to establish if there is potential dilution in earnings per share if convertible securities were to be converted into shares of common stock or contracts to issue shares of common stock were to be exercised. If there is such dilution, diluted earnings per share is presented.

## Contingencies

Certain conditions may exist as of the balance sheet date, which may result in losses to the Group but the impact of which will only be resolved when one or more future events occur or fail to occur.

If a Group company's assessment of a contingency indicates that it is probable that a material loss has been incurred and the amount of the liability can be estimated, then the estimated liability is accrued and charged to the consolidated statement of income. If the assessment indicates that a potentially material loss is not probable, but is reasonably possible, or is probable, but cannot be estimated, then the nature of the contingent liability, together with an estimate of the range of possible loss, is disclosed in the notes to the consolidated financial statements. Loss contingencies considered remote or related to unasserted claims are generally not disclosed unless they involve guarantees, in which case the nature of the guarantee is disclosed.

## Environmental expenditures

Estimated losses from environmental remediation obligations are generally recognized no later than completion of remedial feasibility studies. Group companies accrue for losses associated with environmental remediation obligations when such losses are probable and reasonably estimable. Such accruals are adjusted as further information becomes available or circumstances change. Costs of expected future expenditures for environmental remediation obligations are not discounted to their present value.

## Use of derivative instruments

The Group's derivative activity is limited to certain petroleum products marketing and trading outside of its physical crude oil and petroleum products businesses and 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.

## Share-based payments

The Group accounts for liability classified share-based payment awards to employees at fair value on the date of grant and as of each reporting date. Expenses are recognized over the vesting period. Equity classified share-based payment awards to employees are valued at fair value on the date of grant and expensed over the vesting period.

## Comparative amounts

Certain prior period amounts have been reclassified to conform with current period presentation.

## Recent accounting pronouncements

In December 2008, the FASB issued FSP FAS 140-4 and FIN 46(R)-8, *"Disclosures about Transfers of Financial Assets and Interest in Variable Interest Entities."* This FSP amends FASB Statement No. 140, *"Accounting for transfers and Servicing of Financial Assets and Extinguishments of Liabilities,"* and requires additional disclosures about transfers of financial assets. It also amends FASB Interpretation No. 46 (R), *"Consolidation of Variable Interest Entities,"* and requires public entities, including sponsors that have a variable interest in a variable interest entity, to provide additional disclosures about their involvement with variable interest entities. This FSP is effective for the first reporting period ending after December 15, 2008. The adoption of the provisions of FSP FAS 140-4 and FIN 46(R)-8 did not have any impact on the Group's results of operations, financial position or cash flows.

In March 2008, the FASB issued SFAS No. 161, "*Disclosures about Derivative Instruments and Hedging Activities."* This Statement improves financial reporting about derivative instruments and hedging activities by enhanced disclosures of their effects on an entity's financial position, financial performance and cash flows. The Group is required to adopt the provisions of SFAS No. 161 no later than in the first quarter of 2009 and does not expect any material impact on its results of operations, financial position or cash flows upon adoption.

In December 2007, the FASB issued SFAS No. 141 (Revised), *"Business combinations."* This Statement will apply to all transactions in which an entity obtains control of one or more businesses. SFAS No. 141 (Revised) requires an entity to recognize the fair value of assets acquired and liabilities assumed in a business combination; to recognize and measure the goodwill acquired in the business combination or gain from a bargain purchase and modifies the disclosure requirements. The Group is required to prospectively adopt the provisions of SFAS No. 141 (Revised) for business combinations for which the acquisition date is on or after January 1, 2009. Early adoption of SFAS No. 141 (Revised) is prohibited.

In December 2007, the FASB issued SFAS No. 160, *"Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51."* This Statement will apply to all entities that prepare consolidated financial statements (except not-for-profit organizations) and will affect those which have an outstanding noncontrolling interest (or minority interest) in their subsidiaries or which have to deconsolidate a subsidiary. This Statement changes the classification of a non-controlling interest; establishing a single method of accounting for changes in the parent company's ownership interest that does not result in deconsolidation and requires a parent company to recognize a gain or loss when a subsidiary is deconsolidated. The Group is required to prospectively adopt the provisions of SFAS No. 160 in the first quarter of 2009, except for the presentation and disclosure requirements which shall be applied retrospectively. Early adoption of SFAS No. 160 is prohibited.

In February 2007, the FASB issued SFAS No. 159, *"The Fair Value Option for Financial Assets and Financial Liabilities."* This Statement expands the possibility of using fair value measurements and permits enterprises to choose to measure certain financial assets and financial liabilities at fair value. Enterprises shall report unrealized gains and losses on items for which the fair value option has been elected in earnings in each subsequent period. The Group adopted the provisions of SFAS No. 159 in the first quarter of 2008. The Group elected not to use the fair value option for its financial assets and financial liabilities not already carried at fair value in accordance with other standards. Therefore the adoption of SFAS No. 159 did not have any impact on the Group's results of operations, financial position or cash flows.

In September 2006, the FASB issued SFAS No. 157, *"Fair Value Measurements,"* which establishes a single authoritative definition of fair value, sets out a framework for measuring fair value and requires additional disclosures about fair value measurements. In February 2008, the FASB issued Staff Position FSP No. 157-2, *"Effective date of FASB Statement No. 157,"* which defers the effective date of SFAS No. 157 for certain nonfinancial assets and nonfinancial liabilities to the first quarter of 2009. The Group elected to adopt SFAS No. 157 with deferral permitted by FSP No. 157-2. The deferral applies to nonfinancial assets and liabilities measured in a business combination; long-lived assets, intangible assets and goodwill measured at fair value upon impairment and liabilities for asset retirement obligations. The Group does not expect any material impact on its results of operations, financial position or cash flows on adoption of SFAS No. 157 for these assets and liabilities. The initial adoption of SFAS No. 157 is limited to commodity derivative instruments (refer to Note 16. Financial and derivative instruments).

The initial adoption of the provisions of SFAS No. 157 did not have a material impact on the Group's results of operations, financial position or cash flows.

In September 2006, the FASB issued SFAS No. 158, *"Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans – an amendment of FASB Statements No. 87, 88, 106 and 132(R)."* This Statement requires an employer that sponsors one or more single-employer defined benefit plans to: (a) Recognize the funded status of a benefit plan in its statement of financial position; (b) Recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost; (c) Measure defined benefit plan assets and obligations as of the date of the employer's fiscal year-end statement of financial position (with limited exceptions); (d) Disclose in the notes to financial statements additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation. The provisions of this Statement were effective December 31, 2006, except for the requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end, which is effective December 31, 2008. The adoption of the provisions of SFAS No. 158 did not have a material impact on the Group's results of operations, financial position or cash flows.

## NOTE 3. CASH AND CASH EQUIVALENTS

| | As of December 31, 2008 | As of December 31, 2007 |
|---|---|---|
| Cash held in Russian rubles | 444 | 285 |
| Cash held in other currencies | 1,425 | 417 |
| Cash of a banking subsidiary in other currencies | 132 | 47 |
| Cash held in related party banks in Russian rubles | 182 | 80 |
| Cash held in related party banks in other currencies | 56 | 12 |
| TOTAL CASH AND CASH EQUIVALENTS | 2,239 | 841 |

## NOTE 4. NON-CASH TRANSACTIONS

The consolidated statement of cash flows excludes the effect of non-cash transactions, which are described in the following table:

| | Year ended December 31, 2008 | Year ended December 31, 2007 | Year ended December 31, 2006 |
|---|---|---|---|
| Non-cash investing activity | 29 | 36 | 123 |
| Non-cash acquisition of a subsidiary and minority shareholding interest | 1,969 | - | 314 |
| Settlement of stock-based compensation plan liability | - | 537 | - |
| Settlement of bond liability with the Company's common stock | - | - | 91 |
| TOTAL NON-CASH TRANSACTIONS | 1,998 | 573 | 528 |

The following table shows the effect of non-cash transactions on investing activity:

| | Year ended December 31, 2008 | Year ended December 31, 2007 | Year ended December 31, 2006 |
|---|---|---|---|
| Net cash used in investing activity | 13,559 | 9,715 | 7,515 |
| Non-cash acquisition of a subsidiary and minority shareholding interest | 1,969 | - | 314 |
| Non-cash investing activity | 29 | 36 | 123 |
| TOTAL INVESTING ACTIVITY | 15,557 | 9,751 | 7,952 |

## NOTE 5. ACCOUNTS AND NOTES RECEIVABLE, NET

| | As of December 31, 2008 | As of December 31, 2007 |
|---|---|---|
| Trade accounts and notes receivable (net of provisions of $133 million and $69 million as of December 31, 2008 and 2007, respectively) | 3,466 | 5,962 |
| Current VAT and excise recoverable | 855 | 1,196 |
| Other current accounts receivable (net of provisions of $38 million and $48 million as of December 31, 2008 and 2007, respectively) | 748 | 309 |
| TOTAL ACCOUNTS AND NOTES RECEIVABLE | 5,069 | 7,467 |

## NOTE 6. INVENTORIES

| | As of December 31, 2008 | As of December 31, 2007 |
|---|---|---|
| Crude oil and petroleum products | 2,693 | 3,609 |
| Materials for extraction and drilling | 439 | 477 |
| Materials and supplies for refining | 35 | 24 |
| Other goods, materials and supplies | 568 | 499 |
| TOTAL INVENTORIES | 3,735 | 4,609 |

## NOTE 7. INVESTMENTS

| | As of December 31, 2008 | As of December 31, 2007 |
|---|---|---|
| Investments in equity method affiliates and joint ventures | 2,988 | 836 |
| Long-term loans given by non-banking subsidiaries | 251 | 232 |
| Other long-term investments | 30 | 18 |
| TOTAL LONG-TERM INVESTMENTS | 3,269 | 1,086 |

## Investments in “equity method” affiliates and corporate joint ventures

The summarized financial information below is in respect of equity method affiliates and corporate joint ventures. The 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.

| | Year ended December 31, 2008 | | Year ended December 31, 2007 | | Year ended December 31, 2006 | |
|---|---|---|---|---|---|---|
| | Total | Group’s share | Total | Group’s share | Total | Group’s share |
| Revenues | 4,590 | 2,144 | 2,930 | 1,382 | 2,367 | 1,251 |
| Income before income taxes | 1,602 | 807 | 1,398 | 650 | 1,315 | 690 |
| Less income taxes | (869) | (432) | (605) | (303) | (529) | (265) |
| NET INCOME | 733 | 375 | 793 | 347 | 786 | 425 |

| | As of December 31, 2008 | | As of December 31, 2007 | |
|---|---|---|---|---|
| | Total | Group’s share | Total | Group’s share |
| Current assets | 2,023 | 982 | 1,320 | 618 |
| Property, plant and equipment | 5,872 | 2,841 | 2,082 | 1,082 |
| Other non-current assets | 544 | 269 | 181 | 88 |
| Total assets | 8,439 | 4,092 | 3,583 | 1,788 |
| Short-term debt | 158 | 47 | 204 | 89 |
| Other current liabilities | 1,188 | 557 | 682 | 329 |
| Long-term debt | 890 | 392 | 1,005 | 511 |
| Other non-current liabilities | 220 | 108 | 47 | 23 |
| NET ASSETS | 5,983 | 2,988 | 1,645 | 836 |

In June 2008, a Group company signed an agreement with ERG S.p.A. to establish a joint venture to operate the ISAB refinery complex in Priolo, Italy. In December 2008, the Group completed the acquisition of a 49% stake in the joint venture for 1.45 billion (approximately $1.83 billion). In December 2008, the Group company paid 600 million (approximately $762 million). The remaining amount was paid in February 2009. The seller has a put option, the effect of which would be to increase the Group’s stake in the company operating the ISAB refinery complex up to 100%. As of December 31, 2008, the fair value of this option for the Group is zero. The agreement states that each partner will be responsible for procuring crude oil and marketing refined products in line with its equity stake in the joint venture. The ISAB refinery complex has the flexibility to process Urals blend crude oil, and the Group intends to fully integrate its share of the ISAB refinery complex capacity into its crude oil supply and refined products marketing operations. The ISAB refinery complex has an annual refining capacity of 16 million tonnes. The ISAB refinery complex also includes three jetties and storage tanks totaling 3,700 thousand cubic meters.

# NOTE 8. PROPERTY, PLANT AND EQUIPMENT AND ASSET RETIREMENT OBLIGATIONS

| | At cost | | Net | |
|---|---|---|---|---|
| | As of December 31, 2008 | As of December 31, 2007 | As of December 31, 2008 | As of December 31, 2007 |
| Exploration and Production: | | | | |
| Western Siberia | 21,663 | 19,424 | 12,784 | 10,811 |
| European Russia | 21,842 | 18,776 | 15,881 | 13,303 |
| International | 5,910 | 4,360 | 5,009 | 3,716 |
| TOTAL | 49,415 | 42,560 | 33,674 | 27,830 |
| Refining, Marketing, Distribution and Chemicals: | | | | |
| Western Siberia | 122 | 22 | 107 | 16 |
| European Russia | 11,021 | 9,216 | 8,051 | 6,292 |
| International | 6,462 | 5,008 | 4,633 | 3,367 |
| TOTAL | 17,605 | 14,246 | 12,791 | 9,675 |
| Other: | | | | |
| Western Siberia | 178 | 156 | 89 | 69 |
| European Russia | 3,618 | 399 | 3,385 | 338 |
| International | 200 | 181 | 149 | 144 |
| TOTAL | 3,996 | 736 | 3,623 | 551 |
| TOTAL PROPERTY, PLANT AND EQUIPMENT | 71,016 | 57,542 | 50,088 | 38,056 |

In June 2008, the Company performed impairment testing of certain exploration and production assets located in oil fields in the Timan-Pechora region of Russia, due to a revision of geological models. The revision resulted in a reduction of planned development activities on these oil fields. The fair value of these assets was determined using the present value of the expected cash flows. As a result, the Company recognized an impairment loss of $156 million. In December 2008, the Group recognized an impairment loss of $58 million relating to retail petrol stations in the USA.

As of December 31, 2008 and 2007, the asset retirement obligations amounted to $728 million and $821 million, respectively, of which $10 million was included in “Other current liabilities” in the consolidated balance sheets as of each balance sheet date. During 2008 and 2007, asset retirement obligations changed as follows:

| | 2008 | 2007 |
|---|---|---|
| Asset retirement obligations as of January 1 | 821 | 618 |
| Accretion expense | 78 | 60 |
| New obligations | 54 | 91 |
| Changes in estimates of existing obligations | (88) | 20 |
| Spending on existing obligations | (8) | (10) |
| Property dispositions | (3) | (7) |
| Foreign currency translation and other adjustments | (126) | 49 |
| ASSET RETIREMENT OBLIGATIONS AS OF DECEMBER 31 | 728 | 821 |

## NOTE 9. GOODWILL AND OTHER INTANGIBLE ASSETS

The carrying value of goodwill and other intangible assets as of December 31, 2008 and 2007 was as follows:

| | As of December 31, 2008 | As of December 31, 2007 |
|---|---|---|
| Amortized intangible assets | | |
| Software | 500 | 410 |
| Licenses and other assets | 335 | 56 |
| Goodwill | 324 | 476 |
| TOTAL GOODWILL AND OTHER INTANGIBLE ASSETS | 1,159 | 942 |

All goodwill amounts relate to the refining, marketing and distribution segment. In December 2008, the Group recognized an impairment loss of $100 million relating to goodwill on acquisition of Beopetrol due to the change in the economic environment. Beopetrol is a marketing and distribution company operating a chain of retail petrol stations in Serbia. The fair value of Beopetrol was determined using the present value of the expected cash flows.

## NOTE 10. DISPOSITIONS OF SUBSIDIARIES AND ASSETS

In December 2007, a Group company committed to a plan to sell 162 petrol stations, located in Pennsylvania and southern New Jersey, USA, previously acquired from ConocoPhillips in 2004. In February 2008, this company entered into an agreement to sell these petrol stations to a third party investor. In June 2008, the agreement between the Group company and the investor was cancelled. Therefore these petrol stations were classified out of assets held for sale as of December 31, 2007.

In December 2005, the Company made a decision to sell ten tankers. A Group company finalized the sale of eight tankers in May 2006, for a price that approximated their carrying value of $190 million. The sale of the remaining two tankers was finalized in April 2008, for a price that approximated their carrying value of $70 million. As of December 31, 2007, the Group classified these tankers as assets held for sale in the consolidated balance sheet.

In April 2007, a Group company completed the sale of 50% of its interest in Caspian Investment Resources Ltd. (formerly Nelson Resources Limited), which has exploration and production operations in western Kazakhstan, to Mittal Investments S.A.R.L. for $980 million. In addition, Mittal Investments S.A.R.L. paid a liability in the amount of approximately $175 million, which represented 50% of Caspian Investment Resources Ltd. outstanding debt to Group companies.

## NOTE 11. SHORT-TERM BORROWINGS AND CURRENT PORTION OF LONG-TERM DEBT

| | As of December 31, 2008 | As of December 31, 2007 |
|---|---|---|
| Short-term borrowings from third parties | 2,301 | 938 |
| Current portion of long-term debt | 931 | 1,276 |
| TOTAL SHORT-TERM BORROWINGS AND CURRENT PORTION OF LONG-TERM DEBT | 3,232 | 2,214 |

Short-term borrowings are substantially unsecured and primarily payable in US dollars. The weighted-average interest rate on short-term borrowings from third parties was 5.15% and 5.97% per annum as of December 31, 2008 and 2007, respectively.

# NOTE 12. LONG-TERM DEBT

| | As of December 31, 2008 | As of December 31, 2007 |
|---|---|---|
| Long-term loans and borrowings from third parties (including loans from banks in the amount of $3,333 million and $2,391 million as of December 31, 2008 and 2007, respectively) | 3,384 | 2,439 |
| Long-term loans and borrowings from related parties | 2,165 | 1,745 |
| 6.356% Non-convertible US dollar bonds, maturing 2017 | 500 | 500 |
| 6.656% Non-convertible US dollar bonds, maturing 2022 | 500 | 500 |
| 7.25% Russian ruble bonds, maturing 2009 | 204 | 244 |
| 7.10% Russian ruble bonds, maturing 2011 | 272 | 326 |
| 8.00% Russian ruble bonds, maturing 2012 | 8 | - |
| 7.40% Russian ruble bonds, maturing 2013 | 204 | 244 |
| Capital lease obligations | 271 | 107 |
| Total long-term debt | 7,508 | 6,105 |
| Current portion of long-term debt | (931) | (1,276) |
| TOTAL NON-CURRENT PORTION OF LONG-TERM DEBT | 6,577 | 4,829 |

## Long-term loans and borrowings

Long-term loans and borrowings include amounts repayable in US dollars of $3,844 million and $3,157 million and amounts repayable in Russian rubles of $3,187 million and $2,607 million as of December 31, 2008 and 2007, respectively. Long-term loans and borrowings have maturity dates from 2009 through 2038. Approximately 6% of this debt is secured by export sales and property, plant and equipment. The weighted-average interest rate on long-term loans and borrowings from third parties was 4.09% and 5.77% per annum as of December 31, 2008 and 2007, respectively. A number of long-term loan agreements contain certain financial covenants due levels of which are being maintained by the Group.

A Group company has an unsecured syndicated loan agreement with an outstanding amount of $1,000 million as of December 31, 2008, with maturity dates up to 2013. The loan was arranged by ABN AMRO Bank, Banco Bilbao Vizcaya Argentaria, BNP Paribas, The Bank of Tokyo-Mitsubishi UFJ, ING Bank, Mizuho Corporate Bank and WestLB. Borrowings under this agreement bear interest from three month LIBOR plus 0.85% to three months LIBOR plus 0.95% per annum.

A number of the Group companies have unsecured loan agreements with an outstanding amount of $530 million as of December 31, 2008, maturing up to 2011. The loan was arranged by ABN AMRO Bank, The Bank of Tokyo-Mitsubishi UFJ, Barclays Capital, BNP Paribas, Citibank, Dresdner Kleinwort, ING Bank and WestLB. Borrowings under this agreement bear interest at three month LIBOR plus 3.25% per annum.

The Company has an unsecured syndicated loan agreement with European Bank for Reconstruction and Development with an outstanding amount of $286 million as of December 31, 2008, maturity dates up to 2017. Borrowings under this agreement bear interest from six month LIBOR plus 0.45% to six month LIBOR plus 0.65% per annum.

A Group company has an unsecured syndicated loan agreement with CALYON and ABN AMRO Bank with an outstanding amount of $205 million as of December 31, 2008, maturing up to 2010. Borrowings under this agreement bear interest at one month LIBOR plus 0.85% per annum.

A Group company has a secured loan agreement, arranged by Credit Suisse, supported by an Overseas Private Investment Corporation guarantee, with an outstanding amount of $190 million as of December 31, 2008. Borrowings under this agreement bear interest at six month LIBOR plus 4.8% per annum and have maturity dates up to 2015.

The Company has an unsecured syndicated loan agreement, arranged by ABN AMRO Bank and CALYON with an outstanding amount of $175 million as of December 31, 2008, maturing up to 2012. Borrowings under this agreement bear interest at three month LIBOR plus 0.40% per annum.

A Group company has a secured loan agreement with European Bank for Reconstruction and Development with an outstanding amount of $110 million as of December 31, 2008, maturing up to 2017. Borrowings under this agreement bear interest at six month LIBOR plus 0.35% per annum.

As of December 31, 2008, the Group has a number of other loan agreements with fixed rates with a number of banks and organizations totaling $204 million, maturing from 2009 to 2021. The weighted average interest rate under these loans was 6.02% per annum.

As of December 31, 2008, the Group has a number of other floating rate loan agreements with a number of banks and organizations totaling $684 million, maturing from 2009 to 2019. The weighted average interest rate under these loans was 5.58% per annum.

A Group company has a number of loan agreements with ConocoPhillips, the Group's related party, with an outstanding amount of $2,165 million as of December 31, 2008. This amount includes $1,842 million landed by ConocoPhillips to a joint venture OOO Narianmarneftegaz ("NMNG") (refer to Note 18. Consolidation of Variable Interest Entity). Borrowings under these agreements bear interest at fixed rates ranging from 6.8% to 8.2% per annum and have maturity dates up to 2038. These agreements are a part of the Company's broad-based strategic alliance with ConocoPhillips and this financing is used to develop oil production and distribution infrastructure in the Timan-Pechora region of the Russian Federation.

### US dollar bonds

In June 2007, a Group company issued non-convertible bonds totaling $1 billion. $500 million were placed with a maturity of 10 years and a coupon yield of 6.356% per annum. Another $500 million were placed with a maturity of 15 years and a coupon yield of 6.656% per annum. All bonds were placed at nominal value and have a half year coupon period.

### Russian ruble bonds

In January 2007, OAO UGK TGK-8 ("TGK-8"), a newly acquired subsidiary (refer to Note 17. Business combinations) issued 3.5 million non-convertible bonds with a face value of 1,000 Russian rubles each. These bonds were placed at their face value with a maturity of 5 years, with a coupon yield of 8.0% per annum and they have a half year coupon period. In June 2008, after the acquisition, TGK-8 redeemed approximately 3.26 million bonds in accordance with the conditions of the bonds issue.

In December 2006, the Company issued 14 million non-convertible bonds with a face value of 1,000 Russian rubles each. Eight million bonds were placed with a maturity of 5 years and a coupon yield of 7.10% per annum and six million bonds were placed with a maturity of 7 years and a coupon yield of 7.40% per annum. All bonds were placed at the face value and have a half year coupon period.

In November 2004, the Company issued 6 million non-convertible bonds with a face value of 1,000 Russian rubles each, maturing on November 23, 2009. The bonds have a half year coupon period and bear interest at 7.25% per annum.

### Maturities of long-term debt

Annual maturities of total long-term debt during the next five years, including the portion classified as current, are $931 million in 2009, $939 million in 2010, $1,292 million in 2011, $455 million in 2012, $542 million in 2013 and $3,349 million thereafter.

## NOTE 13. TAXES

The Group is taxable in a number of jurisdictions within and outside of the Russian Federation and, as a result, is subject to a variety of taxes as established under the statutory provisions of each jurisdiction.

The total cost of taxation to the Group is reported in the consolidated statement of income as "Total income tax expense" for income taxes, as "Excise and export tariffs" for excise taxes, export tariffs and petroleum products sales taxes and as "Taxes other than income taxes" for other types of taxation. In each category taxation is made up of taxes levied at various rates in different jurisdictions.

Until January 1, 2009, operations in the Russian Federation were subject to a Federal income tax rate of 6.5% and a regional income tax rate that varied from 13.5% to 17.5% at the discretion of the individual regional administration. Starting on January 1, 2009, the Federal income tax rate is 2.0% and regional income tax rate varies from 13.5% to 18.0%. The Group's foreign operations are subject to taxes at the tax rates applicable to the jurisdictions in which they operate.

As of January 1, 2008 and 2007, and during 2008 and 2007, the Group did not have any unrecognized tax benefits and thus, no interest and penalties related to unrecognized tax benefits were accrued. The Group's policy is to record interest and penalties related to unrecognized tax benefits as components of income tax expense. In addition, the Group does not expect that the amount of unrecognized tax benefits will change significantly within the next 12 months.

The Company and its Russian subsidiaries file standalone income tax returns in Russia. With a few exceptions, income tax returns in Russia are open to examination by the Russian tax authorities for the tax years beginning in 2006.

There are not currently, and have not been during the three years ended December 31, 2008, any provisions in the taxation legislation of the Russian Federation to permit the Group to reduce taxable profits in a Group company by offsetting tax losses in another Group company against such profits. Tax losses of a Group company in the Russian Federation may, however, be used fully or partially to offset taxable profits in the same company in any of the ten years following the year of loss.

Domestic and foreign components of income before income taxes were:

| | Year ended December 31, 2008 | Year ended December 31, 2007 | Year ended December 31, 2006 |
|---|---|---|---|
| Domestic | 12,004 | 11,702 | 9,215 |
| Foreign | 362 | 1,316 | 1,042 |
| INCOME BEFORE INCOME TAXES | 12,366 | 13,018 | 10,257 |

Domestic and foreign components of income taxes were:

| | Year ended December 31, 2008 | Year ended December 31, 2007 | Year ended December 31, 2006 |
|---|---|---|---|
| Current | | | |
| Domestic | 3,614 | 2,940 | 2,419 |
| Foreign | 553 | 470 | 487 |
| CURRENT INCOME TAX EXPENSE | 4,167 | 3,410 | 2,906 |
| Deferred | | | |
| Domestic | (754) | 135 | (40) |
| Foreign | (191) | (38) | (93) |
| DEFERRED INCOME TAX (BENEFIT) EXPENSE | (945) | 97 | (133) |
| TOTAL INCOME TAX EXPENSE | 3,222 | 3,507 | 2,773 |

The following table is a reconciliation of the amount of income tax expense that would result from applying the Russian combined statutory income tax rate to income before income taxes to total income taxes:

| | Year ended December 31, 2008 | Year ended December 31, 2007 | Year ended December 31, 2006 |
|---|---|---|---|
| Income before income taxes | 12,366 | 13,018 | 10,257 |
| Notional income tax at Russian statutory rate | 2,968 | 3,124 | 2,462 |
| Increase (reduction) in income tax due to: | | | |
| Non-deductible items, net | 667 | 477 | 481 |
| Foreign rate differences | 159 | 84 | 47 |
| Effect of enacted tax rate changes | (299) | - | - |
| Domestic regional rate differences | (261) | (237) | (232) |
| Change in valuation allowance | (12) | 59 | 15 |
| TOTAL INCOME TAX EXPENSE | 3,222 | 3,507 | 2,773 |

Taxes other than income taxes were:

| | Year ended December 31, 2008 | Year ended December 31, 2007 | Year ended December 31, 2006 |
|---|---|---|---|
| Mineral extraction tax | 12,267 | 8,482 | 7,281 |
| Social taxes and contributions | 512 | 442 | 356 |
| Property tax | 405 | 313 | 247 |
| Other taxes and contributions | 280 | 130 | 191 |
| TAXES OTHER THAN INCOME TAXES | 13,464 | 9,367 | 8,075 |

Deferred income taxes are included in the consolidated balance sheets as follows:

| | As of December 31, 2008 | As of December 31, 2007 |
|---|---|---|
| Other current assets | 92 | 73 |
| Deferred income tax assets – non-current | 521 | 490 |
| Other current liabilities | (49) | (147) |
| Deferred income tax liabilities – non-current | (2,116) | (2,079) |
| NET DEFERRED INCOME TAX LIABILITY | (1,552) | (1,663) |

The following table sets out the tax effects of each type of temporary differences which give rise to deferred income tax assets and liabilities:

| | As of December 31, 2008 | As of December 31, 2007 |
|---|---|---|
| Accounts receivable | 22 | 12 |
| Long-term liabilities | 230 | 267 |
| Inventories | 17 | 14 |
| Property, plant and equipment | 226 | 238 |
| Accounts payable | 10 | 39 |
| Long-term investments | 97 | 3 |
| Operating loss carry forwards | 489 | 464 |
| Other | 194 | 136 |
| Total gross deferred income tax assets | 1,285 | 1,173 |
| Less valuation allowance | (196) | (208) |
| DEFERRED INCOME TAX ASSETS | 1,089 | 965 |
| Property, plant and equipment | (2,226) | (2,206) |
| Accounts payable | (4) | (5) |
| Accounts receivable | (21) | (1) |
| Long-term liabilities | (237) | (199) |
| Inventories | (57) | (65) |
| Long-term investments | - | (4) |
| Other | (96) | (148) |
| DEFERRED INCOME TAX LIABILITIES | (2,641) | (2,628) |
| NET DEFERRED INCOME TAX LIABILITY | (1,552) | (1,663) |

As a result of acquisitions and business combinations during 2008 and 2007, the Group recognized a net deferred tax liability of $891 million and $158 million, respectively.

As of December 31, 2008, retained earnings of foreign subsidiaries included $15,664 million for which deferred taxation has not been provided because remittance of the earnings has been indefinitely postponed through reinvestment and, as a result, such amounts are considered to be indefinitely invested. It is not practicable to estimate the amount of additional taxes that might be payable on such undistributed earnings.

In accordance with SFAS No. 52, *"Foreign currency translation,"* and SFAS No. 109, *"Accounting for Income Taxes,"* deferred tax assets and liabilities are not recognized for the changes in exchange rate effects resulting from the translation of transactions and balances from the Russian rubles to the US dollar using historical exchange rates. Also, in accordance with SFAS No. 109, no deferred tax assets or liabilities are recognized for the effects of the related statutory indexation of property, plant and equipment.

Based upon the levels of historical taxable income and projections for future taxable income over the periods in which the deferred income tax assets are deductible, management believes it is more likely than not that Group companies will realize the benefits of the deductible temporary differences and loss carry forwards, net of existing valuation allowances as of December 31, 2008 and 2007.

As of December 31, 2008, the Group had operating loss carry forwards of $2,104 million of which $12 million expire during 2009, $8 million expire during 2010, $1 million expire during 2011, $27 million expire during 2012, $77 million expire during 2013, $5 million expire during 2014, $22 million expire during 2015, $304 million expire during 2016, $328 million expire during 2017, $660 million expire during 2018, $1 million expire during 2019, $67 million expire during 2026, $77 million expire during 2027, $135 million expire during 2028, $2 million expire during 2029 and $378 million have indefinite carry forward.

## NOTE 14. PENSION BENEFITS

The Company sponsors a postretirement benefits program. The primary component of the post employment and post retirement benefits program is a defined benefit pension plan that covers the majority of the Group's employees. This plan is administered by a non-state pension fund, LUKOIL-GARANT, and provides pension benefits primarily based on years of service and final remuneration levels. The Company also provides several long-term employee benefits such as death-in-service benefit and lump-sum payments upon retirement of a defined benefit nature and other defined benefits to certain old age and disabled pensioners who have not vested any pensions under the pension plan.

The Company's pension plan primarily consists of a defined benefit plan enabling employees to contribute a portion of their salary to the plan and at retirement to receive a lump sum amount from the Company equal to all past contributions made by the employee up to 7% of their annual salary. Employees also have the right to receive upon retirement the benefits accumulated under the previous pension plan that was replaced in December 2003. These benefits have been fixed and included in the benefit obligation as of December 31, 2008 and 2007. The amount was determined primarily based on a formula including past pensionable service and relative salaries as of December 31, 2003.

On December 31, 2006, the Group adopted the provisions of SFAS No. 158, *"Employers' Accounting for Defined Benefit Pension and Other Post retirement Plans – an amendment of FASB Statements No. 87, 88, 106, and 132(R)."* This Statement requires employers to recognize the funded status of all postretirement defined benefit plans in the statement of financial position with corresponding adjustments to accumulated other comprehensive income. The adjustment to accumulated other comprehensive income at adoption represents the net unrecognized actuarial gains and unrecognized prior service costs, both of which were previously netted against the plan's funded status in the statement of financial position. These amounts will be subsequently recognized as net periodic benefit cost. Further, actuarial gains and losses that arise in subsequent periods and are not recognized as net periodic benefit cost in the same periods will be recognized as a component of other comprehensive income. These amounts will be subsequently recognized as a component of net periodic benefit cost on the same basis as the amounts recognized in accumulated other comprehensive income at adoption of SFAS No. 158.

The Company uses December 31 as the measurement date for its post employment and post retirement benefits program. An independent actuary has assessed the benefit obligations as of December 31, 2008 and 2007.

The following tables provide information about the benefit obligations and plan assets as of December 31, 2008 and 2007. The benefit obligations below represent the projected benefit obligation of the pension plan.

| | 2008 | 2007 |
|---|---|---|
| BENEFIT OBLIGATIONS | | |
| Benefit obligations as of January 1 | 328 | 258 |
| Effect of exchange rate changes | (56) | 20 |
| Service cost | 22 | 15 |
| Interest cost | 19 | 16 |
| Plan amendments | 21 | 29 |
| Actuarial loss | (5) | 30 |
| Acquisitions | 1 | - |
| Benefits paid | (42) | (40) |
| BENEFIT OBLIGATIONS AS OF DECEMBER 31 | 288 | 328 |

| | 2008 | 2007 |
|---|---|---|
| PLAN ASSETS | | |
| Fair value of plan assets as of January 1 | 108 | 94 |
| Effect of exchange rate changes | (18) | 7 |
| Return on plan assets | 6 | 10 |
| Employer contributions | 35 | 37 |
| Acquisitions | (1) | - |
| Benefits paid | (42) | (40) |
| FAIR VALUE OF PLAN ASSETS AS OF DECEMBER 31 | 88 | 108 |
| Funded status | (200) | (220) |
| AMOUNTS RECOGNIZED IN THE CONSOLIDATED BALANCE SHEET AS OF DECEMBER 31, 2008 AND 2007 | | |
| Accrued benefit liabilities included in “Other long-term liabilities” | (164) | (220) |
| Accrued benefit liabilities included in “Other current liabilities” | (36) | - |

Weighted average assumptions used to determine benefit obligations as of December 31, 2008 and 2007:

| | 2008 | 2007 |
|---|---|---|
| Discount rate | 9.00% | 6.34% |
| Rate of compensation increase | 8.61% | 8.12% |

Weighted average assumptions used to determine net periodic benefit costs for the year ended December 31, 2008 and 2007:

| | 2008 | 2007 |
|---|---|---|
| Discount rate | 6.34% | 6.60% |
| Rate of compensation increase | 8.12% | 7.10% |
| Expected rate of return on plan assets | 10.49% | 9.34% |

Included in accumulated other comprehensive loss as of December 31, 2008 and 2007, are the following before-tax amounts that have not yet been recognized in net periodic benefit cost:

| | 2008 | 2007 |
|---|---|---|
| Unamortized prior service cost | 92 | 82 |
| Unrecognized actuarial gain | (5) | (4) |
| TOTAL COSTS | 87 | 78 |

Amounts recognized in other comprehensive loss during the year ended December 31, 2008 and 2007:

| | 2008 | 2007 |
|---|---|---|
| Additional loss arising during the period | (1) | 29 |
| Re-classified gain amortization | - | 1 |
| Additional prior service cost from plan amendment | 21 | 29 |
| Re-classified prior service cost amortization | (11) | (8) |
| NET AMOUNT RECOGNIZED FOR THE PERIOD | 9 | 51 |

The real returns on bonds and equities are based on what is observed in the international markets over extended periods of time. In the calculation of the expected return on assets no use is made of the historical returns LUKOIL-GARANT has achieved.

In addition to the plan assets, LUKOIL-GARANT holds assets in the form of an insurance reserve. The purpose of this insurance reserve is to satisfy pension obligations should the plan assets not be sufficient to meet pension obligations. The Group's contributions to the pension plan are determined without considering the assets in the insurance reserve.

The plans are funded on a discretionary basis through a solidarity account, which is held in trust with LUKOIL-GARANT. LUKOIL-GARANT does not allocate separately identifiable assets to the Group or its other third party clients. All funds of plan assets and other individual pension accounts are managed as a pool of investments.

The asset allocation of the investment portfolio maintained by LUKOIL-GARANT for the Group and its clients was as follows:

| Type of assets | As of December 31, 2008 | As of December 31, 2007 |
|---|---|---|
| Promissory notes of Russian issuers | 6% | 6% |
| Russian corporate bonds | 36% | 33% |
| Russian municipal bonds | 2% | - |
| Bank deposits | 22% | 8% |
| Equity securities of Russian issuers | 10% | 22% |
| Russian state bonds | - | 2% |
| Shares of OAO LUKOIL | 2% | 3% |
| Shares in investment funds | 20% | 17% |
| Other assets | 2% | 9% |
| | 100% | 100% |

The investment strategy employed by LUKOIL-GARANT includes an overall goal to attain a maximum investment return, while guaranteeing the principal amount invested. The strategy is to invest with a medium-term perspective while maintaining a level of liquidity through proper allocation of investment assets. Investment policies include rules and limitations to avoid concentrations of investments.

The investment portfolio is primarily comprised of two types of investments: securities with fixed yield and equity securities. The securities with fixed yield include mainly high yield corporate bonds and promissory notes of banks with low and medium risk ratings. Maturities range from one to three years.

Components of net periodic benefit cost were as follows:

| | Year ended December 31, 2008 | Year ended December 31, 2007 | Year ended December 31, 2006 |
|---|---|---|---|
| Service cost | 22 | 15 | 14 |
| Interest cost | 19 | 16 | 19 |
| Less expected return on plan assets | (11) | (9) | (8) |
| Amortization of prior service cost | 11 | 8 | 6 |
| Actuarial gain | - | (1) | (2) |
| TOTAL NET PERIODIC BENEFIT COST | 41 | 29 | 29 |

Total employer contributions for 2009 are expected to be $27 million. An amount of $13 million before-tax is included in other comprehensive income and expected to be recognized in the net periodic benefit cost in 2009.

The following benefit payments, which reflect expected future services, as appropriate, are expected to be paid:

| | 2009 | 2010 | 2011 | 2012 | 2013 | 5-year period 2009-2013 | 5-year period 2014-2018 |
|---|---|---|---|---|---|---|---|
| Pension benefits | 55 | 16 | 16 | 18 | 15 | 120 | 71 |
| Other long-term employee benefits | 36 | 20 | 21 | 22 | 23 | 122 | 127 |
| TOTAL EXPECTED BENEFITS TO BE PAID | 91 | 36 | 37 | 40 | 38 | 242 | 198 |

# NOTE 15. STOCKHOLDERS' EQUITY

## Common stock

| | As of December 31, 2008 (thousands of shares) | As of December 31, 2007 (thousands of shares) |
|---|---|---|
| Authorized and issued common stock, par value of 0.025 Russian rubles each | 850,563 | 850,563 |
| Common stock held by subsidiaries, not considered as outstanding | (82) | (1,248) |
| Treasury stock | (3,836) | (23,321) |
| OUTSTANDING COMMON STOCK | 846,645 | 825,994 |

## Dividends and dividend limitations

Profits available for distribution to common stockholders in respect of any reporting period are determined by reference to the statutory financial statements of the Company prepared in accordance with the laws of the Russian Federation and denominated in Russian rubles. Under Russian Law, dividends are limited to the net profits of the reporting year as set out in the statutory financial statements of the Company. These laws and other legislative acts governing the rights of shareholders to receive dividends are subject to various interpretations.

The Company's net profits were 66,926 million Russian rubles, 64,917 million Russian rubles and 55,130 million Russian rubles respectively for 2008, 2007 and 2006, pursuant to the statutory financial statements, which at the US dollar exchange rates as of December 31, 2008, 2007 and 2006, amounted to $2,278 million, $2,645 million and $2,094 million, respectively.

At the annual stockholders' meeting on June 26, 2008, dividends were declared for 2007, in the amount of 42 Russian rubles per common share, which at the date of the meeting was equivalent to $1.80. Dividends payable by the Company of $12 million and $35 million are included in "Other current liabilities" in the consolidated balance sheets as of December 31, 2008 and 2007, respectively.

At the annual stockholders' meeting on June 28, 2007, dividends were declared for 2006, in the amount of 38 Russian rubles per common share, which at the date of the decision was equivalent to $1.47.

At the annual stockholders' meeting on June 28, 2006, dividends were declared for 2005, in the amount of 33 Russian rubles per common share, which at the date of the decision was equivalent to $1.22.

## Earnings per share

The basic for calculation of diluted earnings per share for these years is as follows:

| | Year ended December 31, 2008 | Year ended December 31, 2007 | Year ended December 31, 2006 |
|---|---|---|---|
| Net income | 9,144 | 9,511 | 7,484 |
| Add back interest on 3.5% Convertible US dollar bonds, maturing 2007 (net of tax at effective rate) | - | - | 4 |
| TOTAL DILUTED NET INCOME | 9,144 | 9,511 | 7,488 |
| Weighted average number of outstanding common shares (thousands of shares) | 840,108 | 828,335 | 826,131 |
| Add back treasury shares held in respect of convertible debt (thousands of shares) | - | 166 | 2,557 |
| WEIGHTED AVERAGE NUMBER OF OUTSTANDING COMMON SHARES, AFTER DILUTION (THOUSANDS OF SHARES) | 840,108 | 828,501 | 828,688 |

# NOTE 16. FINANCIAL AND DERIVATIVE INSTRUMENTS

## Commodity derivative instruments

The Group uses derivative instruments in its international petroleum products marketing and trading operations. The types of derivative instruments used include futures and swap contracts, used for hedging purposes, and purchase and sale contracts that qualify as derivative instruments. The Group maintains a system of controls over these activities that includes policies covering the authorization, reporting and monitoring of derivative activity.

In the first quarter of 2008, the Group adopted SFAS No. 157, *"Fair Value Measurements"* with the deferral permitted by FSP No. 157-2, *"Effective date of FASB Statement No. 157."* SFAS No. 157 requires disclosures that categorize assets and liabilities measured at fair value into one of three different levels depending on the observability of the inputs employed in the measurement.

Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities.

Level 2 inputs are observable inputs, other then quoted prices included within Level 1, for the asset or liability, either directly or indirectly through market-corroborated inputs.

Level 3 inputs are unobservable inputs for the asset or liability reflecting assumptions about pricing by market participants.

Commodity purchase and sale contracts are generally valued using quotations provided by brokers and price index developers such as Platts and Oil Price Information Service. These are classified as Level 2.

Futures and swap contracts are valued using industry standard models that consider various assumptions, including quoted forward prices for commodities, time value, volatility factors and contractual prices for the underlying instruments, as well as other relevant economic measures. The degree to which these inputs are observable in the forward markets determines whether the option is classified as Level 2 or Level 3.

The Group recognized the following financial results from the use of derivative instruments: income of $902 million, expense of $575 million and income of $183 million during 2008, 2007 and 2006, respectively. The result is included in "Cost of purchased crude oil, gas and products" in the consolidated statements of income. The fair value of derivative contracts outstanding and recorded on the consolidated balance sheets was a net asset of $340 million and a net liability of $50 million as of December 31, 2008 and 2007, respectively.

The fair value hierarchy of commodity derivative instruments accounted for at fair value on a recurring basis as of December 31, 2008, was:

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Assets | - | 451 | - | 451 |
| Liabilities | - | (111) | - | (111) |
| NET ASSETS | - | 340 | - | 340 |

## Fair value

The fair values of cash and cash equivalents, current accounts and notes receivable, and liquid securities are approximately equal to their value as disclosed in the consolidated financial statements.

The fair value of long-term receivables included in other non-current assets approximates the amounts disclosed in the consolidated financial statements. The fair value of long-term receivables was determined by discounting with estimated market interest rates for similar financing arrangements.

The fair value of long-term debt differs from the amount disclosed in the consolidated financial statements. The estimated fair value of long-term debt as of December 31, 2008 and 2007, was $5,425 million and $6,250 million, respectively, as a result of discounting using estimated market interest rates for similar financing arrangements. These amounts include all future cash outflows associated with the long-term debt repayments, including the current portion and interest. Market interest rates mean the rates of raising long-term debt by companies with a similar credit rating for similar tenors, repayment schedules and similar other main terms.

# NOTE 17. BUSINESS COMBINATIONS

In the fourth quarter of 2008, the Group acquired a 100% interest in ZAO Association Grand and OOO Mega Oil M for $493 million. ZAO Association Grand and OOO Mega Oil M are holding companies, owning 181 petrol stations in Moscow, the Moscow region and other regions of central European Russia. This acquisition was made in order to expand the Group's presence on the most advantageous retail market in the Russian Federation. The Group preliminarily allocated $638 million to property, plant and equipment, $46 million to other assets, $122 million to deferred tax liability and $69 million to other liabilities.

In July 2008, a Group company signed an agreement to acquire a 100% interest in the Akpet group for $555 million. The transaction was finalized in November 2008. The amended agreement provided for three payments of purchase consideration: the first payment in amount of $250 million was paid at the date of finalization; second and third deferred payments should be paid by the end of April 2009 and October 2009, respectively. The Akpet group operates 689 petrol filling stations on the basis of dealer agreements and owns eight refined product terminals, five LNG storage tanks, three jet fuel terminals and a lubricant production plant in Turkey. The Group preliminarily allocated $206 million to intangible assets and $414 million to property, plant and equipment.

In March 2008, a Group company entered into an agreement with a related party, whose management and directors include members of the Group's management and Board of Directors, to acquire a 64.31% interest in TGK-8 for approximately $2,117 million. The purchase consideration partly consists of 23.55 million shares of common stock of the Company (at a market value of approximately $1,620 million). The transaction was finalized in May 2008. The following table summarizes the determined fair value of the assets acquired and liabilities assumed of TGK-8 at the date of acquisition. Value of property, plant and equipment was determined by an independent appraiser.

| | |
|---|---|
| Cash and short-term investments | 724 |
| Other current assets | 266 |
| Property, plant and equipment | 2,092 |
| Other non-current assets | 319 |
| TOTAL ASSETS ACQUIRED | 3,401 |
| Current liabilities | (196) |
| Non-current deferred tax liabilities | (357) |
| Long-term debt | (149) |
| Minority interest | (582) |
| TOTAL LIABILITIES ASSUMED | (1,284) |
| NET ASSETS ACQUIRED | 2,117 |

From May to December 2008, a Group company acquired additional interests in TGK-8 for a total of $1,075 million. These acquisitions increased the Group's ownership to 95.53%. As a result of this additional acquisition the Group recognized property, plant and equipment and a deferred tax liability amounting to $802 million and $192 million, respectively. TGK-8 is a power generating company which owns power plants located in the Astrakhan, Volgograd and Rostov regions, the Krasnodar and Stavropol Districts, and the Republic of Dagestan of the Russian Federation. This acquisition is made in accordance with the Company's plans to develop its electric power business.

In March 2008, a Group company entered into an agreement to acquire 75 petrol stations and storage facilities in Bulgaria for approximately $367 million. The transaction was finalized in the second quarter of 2008. The Group determined the fair value of assets acquired and as a result recognized property, plant and equipment of $367 million.

In June 2007, the Group acquired a 100% interest in companies owning 376 petrol stations in Europe for $444 million from ConocoPhillips, its related party. The Group acquired these petrol stations to expand its presence in the European market. The Group determined the fair value of the assets acquired and liabilities assumed at the date of acquisition. As a result the Group recognized goodwill, property, plant and equipment, other assets and liabilities amounting to $25 million, $499 million, $166 million and $246 million, respectively. Goodwill relates to the refining, marketing and distribution segment and is non-deductible for tax purposes.

In January 2007, a Group company acquired the remaining 34% of the share capital of OOO Geoilbent for $300 million. The acquisition increased the Group's ownership to 100%. Prior to this acquisition the Group accounted for its investment using the equity method of accounting due to the fact that the minority shareholder held substantive participating rights. OOO Geoilbent was an exploration and production company operating in the West Siberian region of the Russian Federation.

During 2007, the Group acquired 7.65% of the share capital of OAO LUKOIL-Nizhegorodnefteorgsintez ("Nizhegorodnefteorgsintez") from minority shareholders for $154 million. During 2008, the Group additionally acquired 3.09% of the share capital of Nizhegorodnefteorgsintez for $64 million. As of December 31, 2008, the Group's ownership in Nizhegorodnefteorgsintez was 100%. Nizhegorodnefteorgsintez is a refinery plant located in European Russia.

These business combinations did not have a material impact on the Group's consolidated operations for the periods ended December 31, 2008 and 2007. Therefore, no pro-forma income statement information has been provided.

## NOTE 18. CONSOLIDATION OF VARIABLE INTEREST ENTITY

The Group and ConocoPhillips have a joint venture NMNG which develops oil reserves in the Timan-Pechora region of the Russian Federation. The Group and ConocoPhillips have equal voting rights over the joint venture's activity and effective ownership interests of 70% and 30%, respectively.

The Group determined that NMNG is a variable interest entity as the Group's voting rights are not proportionate to its ownership rights and all of NMNG's activities are conducted on behalf of the Group and ConocoPhillips, its related party. The Group is considered to be the primary beneficiary and has consolidated NMNG.

NMNG's total assets were approximately $7.1 billion and $5.1 billion as of December 31, 2008 and 2007, respectively.

The Group and ConocoPhillips agreed to provide financing to NMNG by means of long-term loans in proportion to their effective ownership interests. These loans mature from 2035 to 2038, with the option to be extended for a further 35 years with the agreement of both parties. As of December 31, 2008, borrowings under these agreements bear fixed interest in the range of 6.8% to 8.2% per annum.

As of December 31, 2008, the amount outstanding to ConocoPhillips from NMNG was $1,842 million, which consists of a number of loans with a weighted-average interest rate of 7.82% per annum. This amount is presented within "Long-term loans and borrowings from related parties."

## NOTE 19. FINANCIAL GUARANTEES

The Group has entered into various guarantee arrangements. These arrangements were entered into in order to optimize affiliated companies' financing terms. The undiscounted maximum amount of potential future payments for the guarantees issued in favour of equity companies (including LUKARCO) was $161 million and $361 million as of December 31, 2008 and 2007, respectively.

### Guarantees on debt

LUKARCO, an investee recorded under the equity method of accounting has a loan facility on which $178 million was drawn as of December 31, 2008. Borrowings under this loan bear interest at LIBOR plus 2.5% per annum, maturing by May 1, 2012. To enhance the credit standing of LUKARCO, the Company guarantees 54% of the interest payment as well as the repayment of 54% of the loan at maturity. The total amount of the Company's guarantees was $98 million and $348 million, which include $2 million and $19 million related to accrued interest on the outstanding amount, as of December 31, 2008 and 2007, respectively. Payments are due if the Company is notified that LUKARCO is not able to fulfil its obligations at maturity date. The Company's guarantee is secured by its 54% interest in LUKARCO with the carrying value of $586 million and $462 million as of December 31, 2008 and 2007, respectively. There are no material amounts being carried as liabilities for the Group's obligations under this guarantee.

# NOTE 20. COMMITMENTS AND CONTINGENCIES

## Capital expenditure, exploration and investment programs

The Group owns and operates refineries in Bulgaria (LUKOIL Neftochim Bourgas AD) and Romania (Petrotel-LUKOIL). As a result of Bulgaria and Romania joining the European Union in 2007, LUKOIL Neftochim Bourgas AD and Petrotel-LUKOIL are required to upgrade their refining plants to comply with the requirements of European Union legislation in relation to the quality of produced petroleum products and environmental protection. These requirements are stricter than existing Bulgarian and Romanian legislation. The Group estimates the amount of future capital commitment required to upgrade LUKOIL Neftochim Bourgas AD and Petrotel-LUKOIL to be approximately $357 million and $42 million, respectively.

Group companies have commitments under the terms of existing license agreements in the Russian Federation of $1,168 million over the next 5 years and of $231 million thereafter. Management believes that a significant portion of these commitments will be fulfilled by the services to be provided by Eurasia Drilling Company and ZAO Globalstroy-Engineering as discussed below.

In connection with the sale of LUKOIL-Burenie (now Eurasia Drilling Company) in 2004 the Group signed a five year contract for drilling services. Under the terms of the contract, drilling services of approximately $791 million will be provided by Eurasia Drilling Company during 2009.

The Company has signed a four-year agreement for the 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 2009 to be approximately $549 million.

Group companies have commitments for capital expenditure contributions in the amount of $751 million related to various production sharing agreements over the next 29 years.

The Group has a commitment to purchase equipment for modernization of its petrochemical refinery Karpatnaftochim Ltd., located in Ukraine, during 2009 in the amount of $118 million.

The Group has a commitment to execute the capital construction program of TGK-8 (refer to Note 17. Business combinations). Under the terms of this program, power plants with total capacity of 890 MW should be constructed by the end of 2012. As of December 31, 2008, the Group estimates the amount of this commitment to be approximately $1,225 million.

Group companies have investment commitments relating to oil deposits in Iraq of $495 million to be spent within 3 years from when exploitation becomes possible. Due to significant changes in the political and economic situation in Iraq the future of this contract is not clear, however, the Group is actively pursuing its legal right to this contract in Iraq in alliance with ConocoPhillips.

## Operating lease obligations

The Group's companies have commitments of $1,412 million primarily for the lease of vessels and petroleum distribution outlets. Commitments for minimum rentals under these leases as of December 31, 2008 are as follows:

| | As of December 31, 2008 |
|---|---|
| 2009 | 489 |
| 2010 | 268 |
| 2011 | 170 |
| 2012 | 139 |
| 2013 | 109 |
| beyond | 237 |

## Insurance

The insurance industry in the Russian Federation and certain other areas where the Group has operations is in the course of development. Management believes that the Group has adequate property damage coverage for its main production assets. In respect of third party liability for property and environmental damage arising from accidents on Group property or relating to Group operations, the Group has insurance coverage that is generally higher than insurance limits set by the local legal requirements. Management believes that the Group has adequate insurance coverage of the risks that could have a material effect on the Group's operations and financial position.

## Environmental liabilities

Group companies and their predecessor entities have operated in the Russian Federation and other countries for many years and, within certain parts of the operations, environmental related problems have developed. Environmental regulations are currently under consideration in the Russian Federation and other areas where the Group has operations. Group companies routinely assess and evaluate their obligations in response to new and changing legislation.

As liabilities in respect of the Group's environmental obligations are able to be determined, they are charged against income. The likelihood and amount of liabilities relating to environmental obligations under proposed or any future legislation cannot be reasonably estimated at present and could become material. Under existing legislation, however, management believes that there are no significant unrecorded liabilities or contingencies which could have a materially adverse effect on the operating results or financial position of the Group.

## Social assets

Certain Group companies contribute to Government sponsored programs, the maintenance of local infrastructure and the welfare of their employees within the Russian Federation and elsewhere. Such contributions include assistance with the construction, development and maintenance of housing, hospitals and transport services, recreation and other social needs. The funding of such assistance is periodically determined by management and is appropriately capitalized or expensed as incurred.

## Taxation environment

The taxation systems in the Russian Federation and other emerging markets where Group companies operate are relatively new and are characterized by numerous taxes and frequently changing legislation, which is often unclear, contradictory, and subject to interpretation. Often, differing interpretations exist among different tax authorities within the same jurisdictions and among taxing authorities in different jurisdictions. Taxes are subject to review and investigation by a number of authorities, which are enabled by law to impose severe fines, penalties and interest charges. In the Russian Federation a tax year remains open for review by the tax authorities during the three subsequent calendar years; however, under certain circumstances a tax year may remain open longer. Recent events within the Russian Federation suggest that the tax authorities are taking a more assertive position in their interpretation and enforcement of tax legislation. Such factors may create taxation risks in the Russian Federation and other emerging markets where Group companies operate that are substantially more significant than those in other countries where taxation regimes have been subject to development and clarification over long periods.

The tax authorities in each region may have a different interpretation of similar taxation issues which may result in taxation issues successfully defended by the Group in one region being unsuccessful in another region. There is some direction provided from the central authority based in Moscow on particular taxation issues.

The Group has implemented tax planning and management strategies based on existing legislation at the time of implementation. The Group is subject to tax authority audits on an ongoing basis, as is normal in the Russian environment and other republics of the former Soviet Union, and, at times, the authorities have attempted to impose additional significant taxes on the Group. Management believes that it has adequately met and provided for tax liabilities based on its interpretation of existing tax legislation. However, the relevant tax authorities may have differing interpretations and the effects on the financial statements, if the authorities were successful in enforcing their interpretations, could be significant.

## Litigation and claims

On November 27, 2001, ADC, a Canadian diamond development company, filed a lawsuit in the District Court of Denver, Colorado against OAO Archangelskgeoldobycha ("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 total damages of approximately $4.8 billion, including 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 Supreme Court found, however, that the trial court made a procedural error by not holding an evidentiary hearing before making its ruling concerning general jurisdiction regarding the Company, which is whether the Company had systematic and continuous contacts in the State of Colorado at the time the lawsuit was filed. In a modified opinion dated December 19, 2005, the Colorado Supreme Court remanded the case to the Colorado Court of Appeals (instead of the District Court) to consider whether the lawsuit should have been dismissed on alternative grounds (i.e., forum non conveniens). On June 29, 2006, the Colorado Court of Appeals declined to dismiss the case based on forum non conveniens. The Company filed a petition for certiorari on August 28, 2006, asking the Colorado Supreme Court to review this decision. This petition has been rejected. On March 5, 2007, the Colorado Supreme Court remanded the case to the District Court. On June 11, 2007, the District Court ruled it would conduct an evidentiary hearing on the issue of whether the Company is subject to general personal jurisdiction in the State of Colorado. Two pre-trial conferences were held with the Court in January 2009. The Court has allowed limited discovery to proceed. Discovery is limited to questions regarding jurisdiction. The Court has not set a hearing date for the termination of jurisdiction. Management does not believe that the ultimate resolution of this matter will have a material adverse effect on the Group's financial condition.

On February 20, 2004, the Stockholm District Court overturned the decision of the Arbitral Tribunal of the

Arbitration Institute of the Stockholm Chamber of Commerce ("Arbitration Tribunal"), made on June 25, 2001, dismissing ADC's action against AGD based on lack of jurisdiction. ADC's lawsuit against AGD was initially filed with the Arbitral Tribunal claiming alleged non-performance under an agreement between the parties and its obligation to transfer the diamond exploration license to Almazny Bereg. This lawsuit claimed compensation of damages amounting to $492 million. In March 2004, AGD filed an appeal against the Stockholm District Court decision with the Swedish Court of Appeals. On November 15, 2005, the Swedish Court of Appeals denied AGD's appeal and affirmed the Stockholm District Court decision. On December 13, 2005, AGD filed an appeal against the Swedish Court of Appeals decision with the Swedish Supreme Court. On April 13, 2006, the Swedish Supreme Court denied the application of AGD for appeal against the Swedish Court of Appeal's decision dated November 15, 2005. On May 6, 2006, a Notice of Arbitration was received on behalf of ADC. On December 20, 2006, the first session of the Arbitration Tribunal with participation of both parties took place in order to define procedural issues related to the tribunal. As a result of the hearing the Arbitration Tribunal issued a detailed procedural order setting out the rules and timetable for the conduct of the arbitration. In May 2007, ADC filed a statement of claim that requested the Tribunal to require AGD to transfer the diamond exploration license to Almazny Bereg. On October 22, 2007, AGD submitted a statement of defense. On February 5, 2009, the Arbitration Tribunal issued a procedural order setting out the rules and timetable for the conduct of the arbitration in 2009. Management does not believe that the ultimate resolution of this matter will have a material adverse effect on the Group's financial condition.

In July 2008, the Federal Anti-monopoly Service of the Russian Federation filled a suit against major Russian oil companies, including the Company, alleging that they violated anti-trust law by abusing their dominant position on the oil products market. A judgment was delivered which has been appealed in the Moscow Arbitration Court. The case was scheduled to be heard in late March 2009. During the second half of 2008 and the first quarter of 2009, new suits were filed against the Company and some of the Group's companies alleging violation of the anti-trust law. The alleged violations primarily involve fixing monopolistically high prices for oil products (gasoline, diesel and jet fuels, and fuel oil), and taking concerted action to fix and maintain prices for oil products. Overall, the claims may total between $79 million and $240 million. The indictments filed by the anti-monopoly authorities have been appealed in the Court. Management believes that the Group's companies have followed all legal requirements and, consequently, 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.

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.

## NOTE 21. RELATED PARTY TRANSACTIONS

In the rapidly developing business environment in the Russian Federation, companies and individuals have frequently used nominees and other forms of intermediary companies in transactions. The senior management of the Company considers that the Group has appropriate procedures in place to identify and properly disclose transactions with related parties in this environment and has disclosed all of the relationships identified which it deemed to be significant. Related party sales and purchases of oil and oil products were primarily to and from affiliated companies and the Company's shareholder ConocoPhillips. Insurance services are provided by the related parties, whose management and directors include members of the Group's management.

Below are related party transactions not disclosed elsewhere in the financial statements. Refer also to Notes 3, 4, 7, 12, 14, 17, 18, 19 and 22 for other transactions with related parties.

Sales of oil and oil products to related parties were $436 million, $652 million and $754 million for the years ended December 31, 2008, 2007 and 2006, respectively.

Other sales to related parties were $86 million, $77 million and $19 million for the years ended December 31, 2008, 2007 and 2006, respectively.

Purchases of oil and oil products from related parties were $1,877 million, $1,333 million and $1,739 million for the years ended December 31, 2008, 2007 and 2006, respectively.

Purchases of construction services from related parties were $14 million, $30 million and $13 million for the years ended December 31, 2008, 2007 and 2006, respectively.

Other purchases from related parties were $33 million, $26 million and $49 million for the years ended December 31, 2008, 2007 and 2006, respectively.

Purchases of insurance services from related parties were $93 million, $143 million and $133 million during the years ended December 31, 2008, 2007 and 2006, respectively.

Amounts receivable from related parties, including loans and advances, were $248 million and $563 million as of December 31, 2008 and 2007, respectively. Amounts payable to related parties were $36 million and $139 million as of December 31, 2008 and 2007, respectively.

## NOTE 22. COMPENSATION PLAN

During the period from 2003 to 2006, the Company had a compensation plan available to certain members of management, which provided compensation based upon share appreciation rights on the Company's common stock. The number of shares or rights allocated to individuals under the plan was 8.8 million shares. These rights vested in December 2006. In February 2007, the Group settled the plan. As a result of this settlement employees purchased 8.8 million shares held by the Group as treasury stock at the grant price for $129 million and resold 1.5 million shares back to the Group for $134 million. The accrued liability in relation to this plan of $537 million was extinguished through the issuance of 7.3 million shares.

In December 2006, the Company introduced a new compensation plan to certain members of management for the period from 2007 to 2009, which is based on assigned shares and provides compensation consisting of two parts. The first part represents annual bonuses that are based on the number of assigned shares and amount of dividend per share. The payment of these bonuses is contingent on the Group meeting certain financial KPIs in each financial year. The second is based upon the Company's common stock appreciation from 2007 to 2009, with rights vesting after the date of the compensation plan's termination. The number of assigned shares is approximately 15.5 million shares.

For the first part of the share plan the Group recognizes a liability based on expected dividends and number of assigned shares.

The second part of the share plan is classified as equity. The grant date fair value of the plan is estimated at $289 million. The fair value was estimated using the Black-Scholes-Merton option-pricing model, assuming a risk-free interest rate of 6.00% per annum, an expected dividend yield 1.59% per annum, expected term of three years and a volatility factor of 30.07%. The expected volatility factor was estimated based on the historical volatility of the Company's shares for the previous three year period up to January 2007.

Related to this plan the Group recorded $134 million and $125 million of compensation expense during the years ended December 31, 2008 and 2007, respectively, of which $103 million are recognized as an increase in additional paid-in capital in each period and $22 million are included in "Other long-term liabilities" of the consolidated balance sheets as of December 31, 2008 and 2007. The total recognized tax benefit related to this accrual is $21 million and $30 million for the years ended December 31, 2008 and 2007.

As of December 31, 2008, there was $83 million of total unrecognized compensation cost related to unvested benefits. This cost is expected to be recognized periodically by the Group up to December 2009.

## NOTE 23. SEGMENT INFORMATION

Presented below is information about the Group's operating and geographical segments for the years ended December 31, 2008, 2007 and 2006, in accordance with SFAS No. 131, *"Disclosures about Segments of an Enterprise and Related Information."*

The Group has four operating segments – exploration and production; refining, marketing and distribution; chemicals and other business segments. These segments have been determined based on the nature of their operations. Management on a regular basis assesses the performance of these operating segments. The exploration and production segment explores for, develops and produces primarily crude oil. The refining, marketing and distribution segment processes crude oil into refined products and purchases, sells and transports crude oil and refined petroleum products. The chemicals segment refines and sells chemical products. Activities of the other business operating segment include power generation business and development of businesses beyond the Group's traditional operations.

Geographical segments have been determined based on the area of operations and include three segments. They are Western Siberia, European Russia and International.

## Operating segments

| 2008 | Exploration and production | Refining, marketing and distribution | Chemicals | Other | Elimination | Consolidated |
|---|---|---|---|---|---|---|
| Sales | | | | | | |
| Third parties | 1,753 | 103,132 | 2,067 | 728 | - | 107,680 |
| Inter-segment | 25,854 | 1,582 | 28 | 2,057 | (29,521) | - |
| TOTAL SALES | 27,607 | 104,714 | 2,095 | 2,785 | (29,521) | 107,680 |
| Operating expenses and total cost of purchases | 3,779 | 67,061 | 1,934 | 2,361 | (29,158) | 45,977 |
| Depreciation, depletion and amortization | 1,938 | 817 | 34 | 169 | - | 2,958 |
| Interest expense | 870 | 570 | 4 | 295 | (1,348) | 391 |
| Income tax expense | 820 | 2,496 | 14 | (162) | 54 | 3,222 |
| Net income | 4,234 | 5,130 | (117) | (160) | 57 | 9,144 |
| Total assets | 47,130 | 45,039 | 940 | 12,751 | (34,399) | 71,461 |
| Capital expenditures | 7,889 | 2,150 | 121 | 429 | - | 10,589 |

| 2007 | Exploration and production | Refining, marketing and distribution | Chemicals | Other | Elimination | Consolidated |
|---|---|---|---|---|---|---|
| Sales | | | | | | |
| Third parties | 1,527 | 77,960 | 2,348 | 56 | - | 81,891 |
| Inter-segment | 22,331 | 2,191 | 19 | 325 | (24,866) | - |
| TOTAL SALES | 23,858 | 80,151 | 2,367 | 381 | (24,866) | 81,891 |
| Operating expenses and total cost of purchases | 3,813 | 52,032 | 1,904 | 206 | (23,801) | 34,154 |
| Depreciation, depletion and amortization | 1,427 | 663 | 28 | 54 | - | 2,172 |
| Interest expense | 611 | 621 | 4 | 218 | (1,121) | 333 |
| Income tax expense | 1,838 | 1,642 | 23 | 4 | - | 3,507 |
| Net income | 4,686 | 4,770 | 148 | 243 | (336) | 9,511 |
| Total assets | 43,395 | 41,091 | 1,004 | 8,412 | (34,270) | 59,632 |
| Capital expenditures | 7,262 | 1,822 | 171 | 117 | - | 9,372 |

| 2006 | Exploration and production | Refining, marketing and distribution | Chemicals | Other | Elimination | Consolidated |
|---|---|---|---|---|---|---|
| Sales | | | | | | |
| Third parties | 1,659 | 64,116 | 1,869 | 40 | - | 67,684 |
| Inter-segment | 18,989 | 1,786 | 22 | 216 | (21,013) | - |
| TOTAL SALES | 20,648 | 65,902 | 1,891 | 256 | (21,013) | 67,684 |
| Operating expenses and total cost of purchases | 3,232 | 43,098 | 1,561 | 138 | (20,735) | 27,294 |
| Depreciation, depletion and amortization | 1,269 | 542 | 19 | 21 | - | 1,851 |
| Interest expense | 451 | 341 | 2 | 187 | (679) | 302 |
| Income tax expense | 1,617 | 1,129 | 23 | 4 | - | 2,773 |
| Net income | 3,578 | 3,652 | 96 | 272 | (114) | 7,484 |
| Total assets | 34,152 | 32,168 | 794 | 7,340 | (26,217) | 48,237 |
| Capital expenditures | 5,120 | 1,475 | 172 | 119 | - | 6,886 |

## Geographical segments

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| Sales of crude oil within Russia | 600 | 440 | 376 |
| Export of crude oil and sales of crude oil by foreign subsidiaries | 24,007 | 19,258 | 17,649 |
| Sales of petroleum products within Russia | 13,872 | 9,583 | 8,151 |
| Export of petroleum products and sales of petroleum products by foreign subsidiaries | 62,542 | 47,154 | 37,459 |
| Sales of chemicals within Russia | 880 | 733 | 569 |
| Export of chemicals and sales of chemicals by foreign subsidiaries | 1,232 | 1,569 | 1,260 |
| Other sales within Russia | 2,335 | 1,644 | 1,167 |
| Other export sales and other sales by foreign subsidiaries | 2,212 | 1,510 | 1,053 |
| TOTAL SALES | 107,680 | 81,891 | 67,684 |

| 2008 | Western Siberia | European Russia | International | Elimination | Consolidated |
|---|---|---|---|---|---|
| Sales | | | | | |
| Third parties | 138 | 19,905 | 87,637 | - | 107,680 |
| Inter-segment | 15,436 | 38,808 | 40 | (54,284) | - |
| TOTAL SALES | 15,574 | 58,713 | 87,677 | (54,284) | 107,680 |
| Operating expenses and total cost of purchases | 2,011 | 19,789 | 78,220 | (54,043) | 45,977 |
| Depletion, depreciation and amortization | 832 | 1,499 | 627 | - | 2,958 |
| Interest expense | 37 | 196 | 260 | (102) | 391 |
| Income taxes | 603 | 2,203 | 362 | 54 | 3,222 |
| Net income | 1,848 | 7,615 | (449) | 130 | 9,144 |
| Total assets | 17,136 | 37,598 | 23,577 | (6,850) | 71,461 |
| Capital expenditures | 2,915 | 5,660 | 2,014 | - | 10,589 |

| 2007 | Western Siberia | European Russia | International | Elimination | Consolidated |
|---|---|---|---|---|---|
| Sales | | | | | |
| Third parties | 118 | 13,226 | 68,547 | - | 81,891 |
| Inter-segment | 14,045 | 31,781 | 30 | (45,856) | - |
| TOTAL SALES | 14,163 | 45,007 | 68,577 | (45,856) | 81,891 |
| Operating expenses and total cost of purchases | 1,995 | 17,323 | 59,692 | (44,856) | 34,154 |
| Depletion, depreciation and amortization | 649 | 969 | 554 | - | 2,172 |
| Interest expense | 22 | 244 | 239 | (172) | 333 |
| Income taxes | 988 | 2,087 | 432 | - | 3,507 |
| Net income | 3,587 | 5,341 | 884 | (301) | 9,511 |
| Total assets | 16,227 | 32,764 | 20,805 | (10,164) | 59,632 |
| Capital expenditures | 2,253 | 5,448 | 1,671 | - | 9,372 |

| 2006 | Western Siberia | European Russia | International | Elimination | Consolidated |
|---|---|---|---|---|---|
| Sales | | | | | |
| Third parties | 318 | 10,693 | 56,673 | - | 67,684 |
| Inter-segment | 11,673 | 26,773 | 33 | (38,479) | - |
| TOTAL SALES | 11,991 | 37,466 | 56,706 | (38,479) | 67,684 |
| Operating expenses and total cost of purchases | 1,751 | 14,038 | 49,757 | (38,252) | 27,294 |
| Depletion, depreciation and amortization | 568 | 781 | 502 | - | 1,851 |
| Interest expense | 17 | 104 | 234 | (53) | 302 |
| Income taxes | 849 | 1,530 | 394 | - | 2,773 |
| Net income | 2,769 | 4,117 | 978 | (380) | 7,484 |
| Total assets | 12,967 | 25,483 | 18,921 | (9,134) | 48,237 |
| Capital expenditures | 1,487 | 3,944 | 1,455 | - | 6,886 |

The Group's international sales to third parties include sales in Switzerland of $47,066 million, $35,868 million and $31,037 million for the years ended December 31, 2008, 2007 and 2006, respectively. The Group's international sales to third parties include sales in the USA of $12,171 million, $11,481 million and $9,112 million for the years ended December 31, 2008, 2007 and 2006, respectively. These amounts are attributed to individual countries based on the jurisdiction of subsidiaries making the sale.

## Supplementary Information on Oil and Gas Exploration and Production Activities (Unaudited)

(Millions of US dollars, except as indicated)

This section provides unaudited supplemental information on oil and gas exploration and production activities in accordance with SFAS No. 69, *"Disclosures About Oil and Gas Producing Activities"* in six separate tables:

I. Capitalized costs relating to oil and gas producing activities
II. Costs incurred in oil and gas property acquisition, exploration, and development activities
III. Results of operations for oil and gas producing activities
IV. Reserve quantity information
V. Standardized measure of discounted future net cash flows
VI. Principal sources of changes in the standardized measure of discounted future net cash flows

Amounts shown for equity companies represent the Group's share in its exploration and production affiliates, which are accounted for using the equity method of accounting.

### I. Capitalized costs relating to oil and gas producing activities

| As of December 31, 2008 | International | Russia | Total consolidated companies | Group's share in equity companies | Total |
|---|---|---|---|---|---|
| Unproved oil and gas properties | 519 | 507 | 1,026 | 158 | 1,184 |
| Proved oil and gas properties | 5,391 | 42,248 | 47,639 | 855 | 48,494 |
| Accumulated depreciation, depletion, and amortization | (901) | (14,649) | (15,550) | (209) | (15,759) |
| NET CAPITALIZED COSTS | 5,009 | 28,106 | 33,115 | 804 | 33,919 |

Net capitalized costs related to asset retirement obligations in the amount of $439 million, as of December 31, 2008, was included in net capitalized costs.

| As of December 31, 2007 | International | Russia | Total consolidated companies | Group's share in equity companies | Total |
|---|---|---|---|---|---|
| Unproved oil and gas properties | 454 | 446 | 900 | 20 | 920 |
| Proved oil and gas properties | 3,906 | 36,664 | 40,570 | 677 | 41,247 |
| Accumulated depreciation, depletion, and amortization | (644) | (13,813) | (14,457) | (164) | (14,621) |
| NET CAPITALIZED COSTS | 3,716 | 23,297 | 27,013 | 533 | 27,546 |

Net capitalized costs related to asset retirement obligations in the amount of $406 million, as of December 31, 2007, was included in net capitalized costs.

| As of December 31, 2006 | International | Russia | Total consolidated companies | Group's share in equity companies | Total |
|---|---|---|---|---|---|
| Unproved oil and gas properties | 351 | 511 | 862 | 13 | 875 |
| Proved oil and gas properties | 4,887 | 30,817 | 35,704 | 746 | 36,450 |
| Accumulated depreciation, depletion, and amortization | (644) | (13,125) | (13,769) | (166) | (13,935) |
| NET CAPITALIZED COSTS | 4,594 | 18,203 | 22,797 | 593 | 23,390 |

Net capitalized costs related to asset retirement obligations in the amount of $310 million, as of December 31, 2006, was included in net capitalized costs.

## II. Costs incurred in oil and gas property acquisition, exploration, and development activities

| Year ended December 31, 2008 | International | Russia | Total consolidated companies | Group's share in equity companies | Total |
|---|---|---|---|---|---|
| Acquisition of properties - proved | 806 | 6 | 812 | - | 812 |
| Acquisition of properties - unproved | 49 | 5 | 54 | 6 | 60 |
| Exploration costs | 357 | 313 | 670 | 9 | 679 |
| Development costs | 719 | 6,430 | 7,149 | 139 | 7,288 |
| TOTAL COSTS INCURRED | 1,931 | 6,754 | 8,685 | 154 | 8,839 |

| Year ended December 31, 2007 | International | Russia | Total consolidated companies | Group's share in equity companies | Total |
|---|---|---|---|---|---|
| Acquisition of properties - proved | - | 393 | 393 | - | 393 |
| Acquisition of properties - unproved | 27 | 486 | 513 | - | 513 |
| Exploration costs | 180 | 366 | 546 | 12 | 558 |
| Development costs | 670 | 5,887 | 6,557 | 103 | 6,660 |
| TOTAL COSTS INCURRED | 877 | 7,132 | 8,009 | 115 | 8,124 |

| Year ended December 31, 2006 | International | Russia | Total consolidated companies | Group's share in equity companies | Total |
|---|---|---|---|---|---|
| Acquisition of properties - proved | 50 | 529 | 579 | - | 579 |
| Acquisition of properties - unproved | 5 | 769 | 774 | - | 774 |
| Exploration costs | 192 | 276 | 468 | 11 | 479 |
| Development costs | 594 | 3,901 | 4,495 | 157 | 4,652 |
| TOTAL COSTS INCURRED | 841 | 5,475 | 6,316 | 168 | 6,484 |

## III. Results of operations for oil and gas producing activities

The Group's results of operations for oil and gas producing activities are presented below. In accordance with SFAS No. 69, sales and transfers to Group companies are based on market prices. Income taxes are based on statutory rates. The results of operations exclude corporate overhead and interest costs.

| Year ended December 31, 2008 | International | Russia | Total consolidated companies | Group's share in equity companies | Total |
|---|---|---|---|---|---|
| Revenue | | | | | |
| Sales | 1,839 | 24,307 | 26,146 | 1,112 | 27,258 |
| Transfers | - | 17,941 | 17,941 | 11 | 17,952 |
| TOTAL REVENUES | 1,839 | 42,248 | 44,087 | 1,123 | 45,210 |
| Production costs (excluding production taxes) | (202) | (3,006) | (3,208) | (74) | (3,282) |
| Exploration expense | (356) | (131) | (487) | (7) | (494) |
| Depreciation, depletion, and amortization | (313) | (1,572) | (1,885) | (52) | (1,937) |
| Accretion expense | - | (25) | (25) | - | (25) |
| Taxes other than income taxes | (61) | (24,668) | (24,729) | (170) | (24,899) |
| Related income taxes | (294) | (3,272) | (3,566) | (481) | (4,047) |
| TOTAL RESULTS OF OPERATIONS FOR PRODUCING ACTIVITIES | 613 | 9,574 | 10,187 | 339 | 10,526 |

| Year ended December 31, 2007 | International | Russia | Total consolidated companies | Group's share in equity companies | Total |
|---|---|---|---|---|---|
| Revenue | | | | | |
| Sales | 1,351 | 15,232 | 16,583 | 883 | 17,466 |
| Transfers | - | 15,444 | 15,444 | 79 | 15,523 |
| TOTAL REVENUES | 1,351 | 30,676 | 32,027 | 962 | 32,989 |
| Production costs (excluding production taxes) | (140) | (2,638) | (2,778) | (76) | (2,854) |
| Exploration expense | (158) | (149) | (307) | (13) | (320) |
| Depreciation, depletion, and amortization | (259) | (1,130) | (1,389) | (33) | (1,422) |
| Accretion expense | - | (21) | (21) | - | (21) |
| Taxes other than income taxes | (7) | (17,087) | (17,094) | (134) | (17,228) |
| Related income taxes | (384) | (2,378) | (2,762) | (336) | (3,098) |
| TOTAL RESULTS OF OPERATIONS FOR PRODUCING ACTIVITIES | 403 | 7,273 | 7,676 | 370 | 8,046 |

| Year ended December 31, 2006 | International | Russia | Total consolidated companies | Group's share in equity companies | Total |
|---|---|---|---|---|---|
| Revenue | | | | | |
| Sales | 1,207 | 14,241 | 15,448 | 714 | 16,162 |
| Transfers | - | 11,747 | 11,747 | 374 | 12,121 |
| TOTAL REVENUES | 1,207 | 25,988 | 27,195 | 1,088 | 28,283 |
| Production costs (excluding production taxes) | (151) | (2,161) | (2,312) | (97) | (2,409) |
| Exploration expense | (52) | (157) | (209) | (5) | (214) |
| Depreciation, depletion, and amortization | (261) | (973) | (1,234) | (50) | (1,284) |
| Accretion expense | - | (29) | (29) | - | (29) |
| Taxes other than income taxes | (17) | (15,644) | (15,661) | (258) | (15,919) |
| Related income taxes | (316) | (1,659) | (1,975) | (322) | (2,297) |
| TOTAL RESULTS OF OPERATIONS FOR PRODUCING ACTIVITIES | 410 | 5,365 | 5,775 | 356 | 6,131 |

## IV. Reserve quantity information

Proved reserves are the estimated quantities of oil and gas reserves which geological and engineering data demonstrate will be recoverable with reasonable certainty in future years from known reservoirs under existing economic and operating conditions (i.e. prices and costs as of the date the estimate is made). 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.

Proved developed reserves are the quantities of proved reserves expected to be recovered through existing wells with existing equipment and operating methods.

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.

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. Most part of these licenses expire between 2013 and 2014. Management believes the licenses will be extended to produce subsequent to their current expiry dates. The Group is in the process of extending all of its production licenses in the Russian Federation and has already extended a portion of these licenses. To date there have been no unsuccessful license renewal applications.

Estimated net proved oil and gas reserves and changes thereto for the years 2008, 2007 and 2006, are shown in the tables set out below.

| Millions of barrels | Consolidated subsidiaries | | | Group's share in equity companies | Total |
|---|---|---|---|---|---|
| | International | Russia | Total | | |
| CRUDE OIL | | | | | |
| January 1, 2006 | 408 | 15,366 | 15,774 | 340 | 16,114 |
| Revisions of previous estimates | 15 | (278) | (263) | 12 | (251) |
| Purchase of hydrocarbons in place | - | 226 | 226 | - | 226 |
| Extensions and discoveries | 14 | 527 | 541 | 10 | 551 |
| Production | (27) | (648) | (675) | (28) | (703) |
| Sales of reserves | - | (10) | (10) | - | (10) |
| December 31, 2006 | 410 | 15,183 | 15,593 | 334 | 15,927 |
| Revisions of previous estimates | 2 | 35 | 37 | (23) | 14 |
| Purchase of hydrocarbons in place* | - | 178 | 178 | (104) | 74 |
| Extensions and discoveries | 20 | 463 | 483 | 35 | 518 |
| Production | (26) | (668) | (694) | (19) | (713) |
| Sales of reserves | (105) | - | (105) | - | (105) |
| December 31, 2007 | 301 | 15,191 | 15,492 | 223 | 15,715 |
| Revisions of previous estimates | 80 | (1,205) | (1,125) | 1 | (1,124) |
| Purchase of hydrocarbons in place | 17 | 19 | 36 | 5 | 41 |
| Extensions and discoveries | 30 | 493 | 523 | 6 | 529 |
| Production | (24) | (660) | (684) | (19) | (703) |
| DECEMBER 31, 2008 | 404 | 13,838 | 14,242 | 216 | 14,458 |
| Proved developed reserves | | | | | |
| December 31, 2006 | 217 | 9,714 | 9,931 | 245 | 10,176 |
| December 31, 2007 | 164 | 9,715 | 9,879 | 180 | 10,059 |
| DECEMBER 31, 2008 | 208 | 8,806 | 9,014 | 156 | 9,170 |

The minority interest share included in the above total proved reserves was 426 million barrels, 559 million barrels and 563 million barrels as of December 31, 2008, 2007 and 2006, respectively. The minority interest share included in the above proved developed reserves was 203 million barrels, 228 million barrels and 191 million barrels as of December 31, 2008, 2007 and 2006, respectively. Substantially all minority interests relate to the reserves in the Russian Federation.

* Purchase of hydrocarbons in place for equity companies includes transfers of reserves to the consolidated group upon those equity companies becoming subject to consolidation.

| Billions of cubic feet | Consolidated subsidiaries | | | Group's share in equity companies | Total |
|---|---|---|---|---|---|
| | International | Russia | Total | | |
| NATURAL GAS | | | | | |
| January 1, 2006 | 3,669 | 21,431 | 25,100 | 198 | 25,298 |
| Revisions of previous estimates | 667 | 795 | 1,462 | 5 | 1,467 |
| Purchase of hydrocarbons in place | - | 3 | 3 | - | 3 |
| Extensions and discoveries | - | 398 | 398 | 1 | 399 |
| Production | (60) | (494) | (554) | (11) | (565) |
| Sales of reserves | - | (5) | (5) | - | (5) |
| December 31, 2006 | 4,276 | 22,128 | 26,404 | 193 | 26,597 |
| Revisions of previous estimates | 506 | 550 | 1,056 | (2) | 1,054 |
| Purchase of hydrocarbons in place* | - | 19 | 19 | (14) | 5 |
| Extensions and discoveries | 207 | 630 | 837 | 7 | 844 |
| Production | (87) | (482) | (569) | (10) | (579) |
| December 31, 2007 | 4,902 | 22,845 | 27,747 | 174 | 27,921 |
| Revisions of previous estimates | 566 | (386) | 180 | 4 | 184 |
| Purchase of hydrocarbons in place | 1,395 | 4 | 1,399 | - | 1,399 |
| Extensions and discoveries | 118 | 310 | 428 | 7 | 435 |
| Production | (175) | (500) | (675) | (11) | (686) |
| DECEMBER 31, 2008 | 6,806 | 22,273 | 29,079 | 174 | 29,253 |
| Proved developed reserves: | | | | | |
| December 31, 2006 | 1,108 | 6,234 | 7,342 | 138 | 7,480 |
| December 31, 2007 | 1,369 | 6,553 | 7,922 | 133 | 8,055 |
| DECEMBER 31, 2008 | 1,912 | 5,893 | 7,805 | 114 | 7,919 |

The minority interest share included in the above total proved reserves was 34 billion cubic feet, 49 billion cubic feet and 43 billion cubic feet as of December 31, 2008, 2007 and 2006, respectively. The minority interest share included in the above proved developed reserves was 24 billion cubic feet, 30 billion cubic feet and 27 billion cubic feet as of December 31, 2008, 2007 and 2006, respectively. Substantially all minority interests relate to the reserves in the Russian Federation.

## V. Standardized measure of discounted future net cash flows

The standardized measure of discounted future net cash flows, related to the above oil and gas reserves, is calculated in accordance with the requirements of SFAS No. 69. Estimated future cash inflows from production are computed by applying year-end prices for oil and gas to year-end quantities of estimated net proved reserves. Adjustment in this calculation for future price changes is limited to those required by contractual arrangements in existence at the end of each reporting year. Future development and production costs are those estimated future expenditures necessary to develop and produce year-end estimated proved reserves based on year-end cost indices, assuming continuation of year-end economic conditions. Estimated future income taxes are calculated by applying appropriate year-end statutory tax rates. These rates reflect allowable deductions and tax credits and are applied to estimated future pre-tax net cash flows, less the tax bases of related assets. Discounted future net cash flows have been calculated using a ten percent discount factor. Discounting requires a year-by-year estimate of when future expenditures will be incurred and when reserves will be produced.

The information provided in the tables set out below does not represent management's estimate of the Group's expected future cash flows or of the value of the Group's proved oil and gas reserves. Estimates of proved reserve quantities are imprecise and change over time as new information becomes available. Moreover, probable and possible reserves, which may become proved in the future, are excluded from the

* Purchase of hydrocarbons in place for equity companies includes transfers of reserves to the consolidated group upon those equity companies becoming subject to consolidation.

calculations. The arbitrary valuation prescribed under SFAS No. 69 requires assumptions as to the timing and amount of future development and production costs. The calculations should not be relied upon as an indication of the Group's future cash flows or of the value of its oil and gas reserves.

| As of December 31, 2008 | International | Russia | Total consolidated companies | Group's share in equity companies | Total |
|---|---|---|---|---|---|
| Future cash inflows | 26,612 | 312,334 | 338,946 | 5,546 | 344,492 |
| Future production and development costs | (18,647) | (185,733) | (204,380) | (3,074) | (207,454) |
| Future income tax expenses | (318) | (21,250) | (21,568) | (516) | (22,084) |
| Future net cash flows | 7,647 | 105,351 | 112,998 | 1,956 | 114,954 |
| Discount for estimated timing of cash flows (10% p.a.) | (6,132) | (64,296) | (70,428) | (950) | (71,378) |
| Discounted future net cash flows | 1,515 | 41,055 | 42,570 | 1,006 | 43,576 |
| Minority share in discounted future net cash flows | - | 1,333 | 1,333 | - | 1,333 |

Included as a part of the $207 billion of future production and development costs are $6.4 billion of future dismantlement, abandonment and rehabilitation costs.

| As of December 31, 2007 | International | Russia | Total consolidated companies | Group's share in equity companies | Total |
|---|---|---|---|---|---|
| Future cash inflows | 34,051 | 660,363 | 694,414 | 17,892 | 712,306 |
| Future production and development costs | (13,015) | (442,801) | (455,816) | (4,639) | (460,455) |
| Future income tax expenses | (2,414) | (48,552) | (50,966) | (3,568) | (54,534) |
| Future net cash flows | 18,622 | 169,010 | 187,632 | 9,685 | 197,317 |
| Discount for estimated timing of cash flows (10% p.a.) | (9,576) | (106,185) | (115,761) | (4,857) | (120,618) |
| Discounted future net cash flows | 9,046 | 62,825 | 71,871 | 4,828 | 76,699 |
| Minority share in discounted future net cash flows | - | 1,379 | 1,379 | - | 1,379 |

Included as a part of the $460 billion of future production and development costs are $7.8 billion of future dismantlement, abandonment and rehabilitation costs.

| As of December 31, 2006 | International | Russia | Total consolidated companies | Group's share in equity companies | Total |
|---|---|---|---|---|---|
| Future cash inflows | 24,767 | 421,215 | 445,982 | 13,896 | 459,878 |
| Future production and development costs | (9,476) | (284,993) | (294,469) | (5,699) | (300,168) |
| Future income tax expenses | (2,867) | (30,307) | (33,174) | (2,271) | (35,445) |
| Future net cash flows | 12,424 | 105,915 | 118,339 | 5,926 | 124,265 |
| Discount for estimated timing of cash flows (10% p.a.) | (6,282) | (66,489) | (72,771) | (3,038) | (75,809) |
| Discounted future net cash flows | 6,142 | 39,426 | 45,568 | 2,888 | 48,456 |
| Minority share in discounted future net cash flows | - | 1,158 | 1,158 | - | 1,158 |

Included as a part of the $300 billion of future production and development costs are $6.6 billion of future dismantlement, abandonment and rehabilitation costs.

## VI. Principal sources of changes in the standardized measure of discounted future net cash flows

| CONSOLIDATED COMPANIES | 2008 | 2007 | 2006 |
|---|---|---|---|
| DISCOUNTED PRESENT VALUE AS AT JANUARY 1 | 71,871 | 45,568 | 52,088 |
| Net changes due to purchases and sales of minerals in place | (279) | (46) | 571 |
| Sales and transfers of oil and gas produced, net of production costs | (15,663) | (11,848) | (9,014) |
| Net changes in prices and production costs estimates | (113,710) | 75,908 | 17,496 |
| Net changes in mineral extraction taxes | 79,317 | (43,384) | (30,592) |
| Extensions and discoveries, less related costs | 1,423 | 2,947 | 1,753 |
| Development costs incurred during the period | 3,528 | 2,308 | 2,383 |
| Revisions of previous quantity estimates | (3,520) | 980 | 223 |
| Net change in income taxes | 11,054 | (6,562) | 4,002 |
| Other changes | 123 | 185 | (300) |
| Accretion of discount | 8,426 | 5,815 | 6,958 |
| DISCOUNTED PRESENT VALUE AT DECEMBER 31 | 42,570 | 71,871 | 45,568 |

| GROUP'S SHARE IN EQUITY COMPANIES | 2008 | 2007 | 2006 |
|---|---|---|---|
| DISCOUNTED PRESENT VALUE AS AT JANUARY 1 | 4,828 | 2,888 | 2,659 |
| Net changes due to purchases and sales of minerals in place | 17 | (367) | - |
| Sales and transfers of oil and gas produced, net of production costs | (872) | (739) | (728) |
| Net changes in prices and production costs estimates | (6,343) | 3,622 | 906 |
| Net changes in mineral extraction taxes | 901 | (643) | (632) |
| Extensions and discoveries, less related costs | 38 | 1,020 | 45 |
| Development costs incurred during the period | 51 | 74 | 47 |
| Revisions of previous quantity estimates | 13 | (716) | 153 |
| Net change in income taxes | 1,553 | (629) | (13) |
| Other changes | 239 | (38) | 104 |
| Accretion of discount | 581 | 356 | 347 |
| DISCOUNTED PRESENT VALUE AT DECEMBER 31 | 1,006 | 4,828 | 2,888 |

| TOTAL | 2008 | 2007 | 2006 |
|---|---|---|---|
| DISCOUNTED PRESENT VALUE AS AT JANUARY 1 | 76,699 | 48,456 | 54,747 |
| Net changes due to purchases and sales of minerals in place | (262) | (413) | 571 |
| Sales and transfers of oil and gas produced, net of production costs | (16,535) | (12,587) | (9,742) |
| Net changes in prices and production costs estimates | (120,053) | 79,530 | 18,402 |
| Net changes in mineral extraction taxes | 80,218 | (44,027) | (31,224) |
| Extensions and discoveries, less related costs | 1,461 | 3,967 | 1,798 |
| Development costs incurred during the period | 3,579 | 2,382 | 2,430 |
| Revisions of previous quantity estimates | (3,507) | 264 | 376 |
| Net change in income taxes | 12,607 | (7,191) | 3,989 |
| Other changes | 362 | 147 | (196) |
| Accretion of discount | 9,007 | 6,171 | 7,305 |
| DISCOUNTED PRESENT VALUE AT DECEMBER 31 | 43,576 | 76,699 | 48,456 |

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

The following report represents management's discussion and analysis of the financial condition and results of operations of OAO LUKOIL as of December 31, 2008, and each of the years ended December 31, 2008, 2007 and 2006, and significant trends 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 189 for a discussion of some of the factors that could cause actual results to differ materially.*

## Key financial and operational results

| | 2008 | Change to 2007, % | 2007 | Change to 2006, % | 2006 |
|---|---|---|---|---|---|
| Sales (millions of US dollars) | 107,680 | 31.5 | 81,891 | 21.0 | 67,684 |
| Net income (millions of US dollars) | 9,144 | (3.9) | 9,511 | 27.1 | 7,484 |
| EBITDA (millions of US dollars) | 15,552 | 1.1 | 15,388 | 25.1 | 12,299 |
| Taxes, other than income tax (including excises and export tariffs) | (34,804) | 42.6 | (24,400) | 12.7 | (21,645) |
| Basic earnings per share of common stock (US dollars) | 10.88 | (5.2) | 11.48 | 26.7 | 9.06 |
| Diluted earnings per share of common stock (US dollars) | 10.88 | (5.2) | 11.48 | 27.0 | 9.04 |
| Hydrocarbon production by the Group including our share in equity affiliates (thousands of BOE) | 803,109 | 1.0 | 795,099 | 1.5 | 783,194 |
| Crude oil production by the Group including our share in equity affiliates (thousands of tonnes) | 95,240 | (1.5) | 96,645 | 1.5 | 95,235 |
| Gas available for sale produced by the Group including our share in equity affiliates (millions of cubic meters) | 17,020 | 22.0 | 13,955 | 2.5 | 13,612 |
| Refined products produced by our subsidiaries (thousands of tonnes) | 52,455 | 7.4 | 48,819 | 6.9 | 45,670 |
| Hydrocarbon proved reserves including our share in equity affiliates (millions of BOE) | 19,334 | (5.1) | 20,369 | – | 20,360 |

During 2008, our net income was $9,144 million, which is $367 million, or 3.9%, less than in 2007.

In 2008, the main driver of our performance was international hydrocarbon prices. In the nine months of 2008, high level of hydrocarbon prices and high refining margins resulted in our outstanding financial results despite effect of growing tax and transportation expenses and the real ruble appreciation. However, a slump in hydrocarbon prices in the fourth quarter of 2008 along with a loss resulting from the ruble devaluation, and high level of export duties rates in the beginning of the quarter led to a quarterly loss amounted to $1.6 billion. Nevertheless, we secured Company cash inflows from operating activities and gained noticeable free cash flow in 2008. These and other drivers impacting the results of our operations are considered below in detail.

## Segment information

Our operations are divided into three main business segments:

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

Other businesses include a power generation business, banking, finance and other activities. Each of our three main segments is dependent on the other, with a portion of the revenues of one segment being a part of the costs of the other. In particular, our Refining, Marketing and Distribution segment purchases crude oil from our Exploration and Production segment. As a result of certain factors considered in the "Domestic crude oil and refined products prices" section on page 163, 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 refining crude oil 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 23 "Segment information" to our consolidated financial statements.

# Executive overview

## Recent developments and outlook

The following has been achieved in 2008:

### Exploration and production

- 11 new oil and gas fields were brought on line (2007: 13 oil and gas fields).
- In August, we began commercial production on the first stage of the Yuzhnoye Khylchuyu oil field. In December, the Company completed the construction of the second stage of the field. We produced 1,527 thousand tonnes from this field to December 31, 2008.

### Refining

- We acquired 49% interest in the ISAB refinery complex in Priolo, Italy. The ISAB has an annual refining capacity of 16 million tonnes.
- In April, the Odessa refinery was put back into operation after the completion of the wide-scale upgrade started in August 2005. Annual capacity of the Odessa refinery was extended up to 2.8 million tonnes per year.

### Marketing

- The Company acquired 689 petrol stations and various downstream infrastructure in Turkey, 75 petrol stations and storage facilities in Bulgaria.
- In the Russian Federation we acquired petrol stations networks of companies ZAO Association Grand, OOO Mega Oil M, and we increased from 41.81% to 85.32% our share in OAO Udmurtnefteproduct. Therefore, we increased our network by 272 stations.

### Other

- We entered power generation and distribution business by acquiring OAO UGK TGK-8 (“TGK-8”), which increases synergy and efficiency of the Group business.

Other achievements in 2008 are described in detail in other parts of this report.

## Changes in the Group structure, acquisition and disposition of assets

In the fourth quarter of 2008, the Group acquired a 100% interest in ZAO Association Grand and OOO Mega Oil M for $493 million. ZAO Association Grand and OOO Mega Oil M are holding companies, owning 181 petrol stations in Moscow, the Moscow region and other regions of central European Russia. This acquisition was made in order to expand the Group’s presence on the most advantageous retail markets in the Russian Federation.

In July 2008, a Group company signed an agreement to acquire a 100% interest in the Akpet group for $555 million. The transaction was finalized in November 2008. The amended agreement provided for three payments of purchase consideration: the first payment in amount of $250 million was paid at the date of finalization; second and third deferred payments should be paid by the end of April 2009 and October 2009, respectively. The Akpet group operates 689 petrol filling stations on the basis of dealer agreements and owns eight refined product terminals, five LNG storage tanks, three jet fuel terminals and a lubricant production plant in Turkey.

In June 2008, a Group company signed an agreement with ERG S.p.A. to establish a joint venture to operate the ISAB refinery complex in Priolo, Italy. In December 2008, the Group completed the acquisition of a 49% stake in the joint venture for 1.45 billion (approximately $1.83 billion). In December 2008, the Group company paid 600 million (approximately $762 million). The remaining amount was paid in February 2009. The seller has a put option, the effect of which would be to increase the Group's stake in the company operating the ISAB refinery complex up to 100%. The agreement states that each partner will be responsible for procuring crude oil and marketing refined products in line with its equity stake in the joint venture. The ISAB refinery complex has the flexibility to process Urals blend crude oil, and the Group intends to fully integrate its share of the ISAB refinery complex capacity into its crude oil supply and refined products marketing operations. The ISAB refinery complex has an annual refining capacity of 16 million tonnes. The ISAB refinery complex also includes three jetties and storage tanks totaling 3,700 thousand cubic meters.

In December 2005, the Company made a decision to sell ten tankers. A Group company finalized the sale of eight tankers in May 2006, for a price that approximated their carrying value of $190 million. The sale of the remaining two tankers was finalized in April 2008, for a price that approximated their carrying value of $70 million.

In March 2008, a Group company entered into an agreement to acquire 75 petrol stations and storage facilities in Bulgaria for approximately $367 million. The transaction was finalized in the second quarter of 2008.

In March 2008, a Group company acquired 100% of the share capital of the SNG Holdings Ltd. group for $578 million. The purchase agreement provided for two additional components of contingent purchase consideration in amount of $100 million each. During 2008, all conditions for contingent purchase consideration were met and a Group company completely settled its obligation under the purchase agreement. The SNG Holdings Ltd. group holds a 100% interest in a production sharing agreement in oil and gas condensate fields located in the South-Western Gissar and Ustyurt regions of Uzbekistan. The purpose of the acquisition was to increase the Group's presence in the Uzbekistan oil and gas sector.

In March 2008, a Group company entered into an agreement with a related party, whose management and directors include members of the Group's management and Board of Directors, to acquire a 64.31% interest in TGK-8 for approximately $2,117 million. The purchase consideration partly consists of 23.55 million shares of common stock of the Company (at a market value of approximately $1,620 million). The transaction was finalized in May 2008. From May to December 2008, a Group company acquired additional interests in TGK-8 for a total of $1,075 million. These acquisitions increased the Group's ownership to 95.53%. TGK-8 is one of the major gas consumers in the Southern Federal District with an annual consumption of 6 billion cubic meters per year. Its power plants are located in Astrakhan, Volgograd and Rostov regions, Krasnodar and Stavropol Districts, and the Republic of Dagestan of the Russian Federation with total productive capacity of 3.6 GW. By purchasing TGK-8 LUKOIL expects significant synergies through natural gas supplies from the Company's gas fields located in the Northern Caspian and in Astrakhan region, which will allow the Company to reach efficient gas price. This acquisition is made in accordance with the Company's plans to develop its electric power business.

During 2007, the Group acquired 7.65% of the share capital of OAO "LUKOIL-Nizhegorodnefteorgsintez" ("Nizhegorodnefteorgsintez") from minority shareholders for $154 million. During 2008, the Group additionally acquired 3.09% of the share capital of Nizhegorodnefteorgsintez for $64 million. As of December 31, 2008, the Group's ownership in Nizhegorodnefteorgsintez was 100%. Nizhegorodnefteorgsintez is a refinery plant located in European Russia.

In December 2007, a Group company acquired a distribution network of 55 petrol stations and storage facilities in the Rostov region, for $56 million. The acquisition of this distribution network will enable the Company to double petroleum products marketing output in the region. We expect our refined products sales in this region to increase up to 200 thousand tonnes per year, which represents 12% of the local retail market as a result of this acquisition.

In June 2007, the Group finalized the acquisition of a 100% interest in companies owning 376 petrol stations in Europe, including 156 in Belgium and Luxembourg, 49 in Finland, 44 in the Czech Republic, 30 in Hungary, 83 in Poland and 14 in Slovakia, for $444 million from ConocoPhillips, its related party. The stations located in Finland were re-branded as Teboil stations in 2007. The most part of the petrol stations in other European countries were re-branded as LUKOIL stations during 2008.

In November 2006, a Group company entered into an agreement with Mittal Investments S.A.R.L. to sell 50% of its interest in Caspian Investment Resources Ltd. ("Caspian", formerly Nelson Resources Limited), which has exploration and production operations in western Kazakhstan, for $980 million. This transaction was completed on April 20, 2007. In addition, Mittal Investments S.A.R.L. paid a liability in the amount of $175 million, which represented 50% of Caspian's outstanding debt to Group companies.

In January 2007, a Group company acquired the remaining 34% of the share capital of OOO Geoilbent for $300 million. The acquisition increased the Group's ownership to 100%. Prior to this acquisition the Group accounted for its investment using the equity method of accounting due to the fact that the minority shareholder held substantive participating rights. OOO Geoilbent was an exploration and production company operating in the West Siberian region of the Russian Federation.

## Resource base

The table below summarizes the net oil-equivalent proved reserves of consolidated subsidiaries and our share in equity affiliates:

| (millions of BOE) | December 31, 2008 | Changes in 2008 | | | December 31, 2007 |
|---|---|---|---|---|---|
| | | Production* | Extensions, discoveries and changes in structure | Revision of previous estimates | |
| Western Siberia | 10,494 | (486) | 454 | (861) | 11,387 |
| Timan-Pechora | 3,017 | (126) | 69 | (391) | 3,465 |
| Ural region | 2,165 | (90) | 15 | 10 | 2,230 |
| Volga region | 1,670 | (28) | 8 | (9) | 1,699 |
| Other in Russia | 234 | (16) | 21 | (20) | 249 |
| Outside Russia | 1,754 | (71) | 308 | 178 | 1,339 |
| Proved oil and gas reserves | 19,334 | (817) | 875 | (1,093) | 20,369 |
| Probable oil and gas reserves | 11,767 | | | | 12,187 |
| Possible oil and gas reserves | 5,282 | | | | 6,301 |

* Gas production shown before own consumption.

The Company's proved reserves as of January 1, 2009 amount to 19.3 billion BOE and comprise of 14.5 billion BOE of crude oil and 29.3 trillion cubic feet of gas.

In 2008, the increase in Company's proved reserves due to geological exploration and production drilling amounted to 601 million BOE.

Acquisitions increased our proved reserves by 274 million BOE, mainly due to the acquisition of 100% share of the PSA project in South-Western Gissar and Ustyurt region in Uzbekistan.

However, the Company's reserves estimation was affected by the global economic crisis and respective decrease in commodities and raw materials prices. The Urals blend oil price as of the estimation date was nearly three times lower as compared to the level of previous year estimation. This decrease affected the economic feasibility of the Company's reserves development and resulted in a transfer of 1.1 billion BOE from the proved reserves category into the category of inexpedient resources.

These reserves are not to be developed in the near future, and their transfer to a lower category will not affect the Company's present plans.

The Company expects transfer of the most of the resources dismissed due to economic reasons to the proved reserves category in case of oil price growth.

# Operational highlights

## Hydrocarbon production

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| Daily production of hydrocarbons, including Company's share in equity affiliates (thousand BOE per day) | 2,194 | 2,178 | 2,145 |
| crude oil | 1,921 | 1,953 | 1,926 |
| natural and petroleum gas* | 273 | 225 | 219 |
| Hydrocarbon extraction expenses (US dollar per BOE) | 4.12 | 3.58 | 3.08 |

* Gas available for sale (excluding gas produced for our own consumption).

Crude oil production. In 2008, our total daily crude oil production decreased by 1.6%, compared to 2007. We produced (including the Company's share in equity affiliates) 702.9 million barrels, or 95.2 million tonnes.

The following table represents our production in 2008 and 2007 by major regions.

| | | Change to 2007 | | | |
|---|---|---|---|---|---|
| (thousands of tonnes) | 2008 | Total, % | Change in structure | Organic change | 2007 |
| Western Siberia | 56,187 | (6.1) | 105 | (3,767) | 59,849 |
| Timan-Pechora | 16,685 | 14.5 | – | 2,109 | 14,576 |
| Ural region | 11,548 | 3.3 | – | 365 | 11,183 |
| Volga region | 3,041 | 0.8 | – | 24 | 3,017 |
| Other in Russia | 2,185 | 3.6 | – | 75 | 2,110 |
| Crude oil production in Russia | 89,646 | (1.2) | 105 | (1,194) | 90,735 |
| Crude oil produced internationally | 3,200 | (6.2) | (360) | 148 | 3,412 |
| Total crude oil produced by consolidated subsidiaries | 92,846 | (1.4) | (255) | (1,046) | 94,147 |
| Our share in crude oil production of equity affiliates: | | | | | |
| in Russia | 299 | (18.1) | (69) | 3 | 365 |
| outside Russia | 2,095 | (1.8) | – | (38) | 2,133 |
| TOTAL CRUDE OIL PRODUCTION | 95,240 | (1.5) | (324) | (1,081) | 96,645 |

The main oil producing region of the Company is Western Siberia. In the oil fields of Western Siberia the Company produced 60.5% of its crude oil in 2008 (63.6% in 2007 and 63.8% in 2006). In 2008, the Western Siberian producing assets continued to mature resulting in a production decline and water cut increase. A significant impact on our production in the period was caused by a lack of sufficient power generating capacities to meet the growing demand for extra power from a wide range of oil producers in Western Siberia as they faced the need to scale up pumping operations supporting crude oil production operations. In order to compensate for the decrease in crude oil production the Company is opening up oil fields in the Timan-Pechora and Caspian regions. In August 2008, we began commercial production on the first stage of the Yuzhnoye Khylchuyu oil field, located in the Timan-Pechora region. We produced 1.5 million tonnes from this field to December 31, 2008. In 2009, we expect to reach annual production of 7.5 million tonnes on the Yuzhnoye Khylchuyu oil field. This oil field is developed within our strategic partnership with ConocoPhillips.

The structural decrease in overseas crude oil production reflects the changes in ownership of Caspian, where the Group reduced its interest from 100% to 50% at the end of April 2007.

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, including vertically integrated oil companies that lack refining capacity or are unable to export their crude oil. Then we either refine or export this purchased crude oil. Crude oil purchased on international markets is used for trading activities, for supplying our overseas refineries or for processing at third party refineries.

| | 2008 | | 2007 | | 2006 | |
|---|---|---|---|---|---|---|
| | (thousand of barrels) | (thousand of tonnes) | (thousand of barrels) | (thousand of tonnes) | (thousand of barrels) | (thousand of tonnes) |
| Crude oil purchases in Russia | 1,730 | 236 | 345 | 47 | 13,561 | 1,850 |
| Crude oil purchases internationally | 76,078 | 10,379 | 32,802 | 4,475 | 37,390 | 5,101 |
| TOTAL CRUDE OIL PURCHASED | 77,808 | 10,615 | 33,147 | 4,522 | 50,951 | 6,951 |

The increase in volumes of crude oil purchased internationally resulted from increased refining and trading. In 2008, we purchased 5,029 thousand tonnes in order to process at our and at third party refineries (including 416 thousand tonnes at the ISAB refinery complex) compared to 1,534 thousand tonnes in 2007.

Gas production. In 2008, we produced 17,020 million cubic meters of gas available for sale (including our share in equity affiliates), an increase of 22.0%, compared to 2007.

Our major gas production field is the Nakhodkinskoe gas field, where we produced 8,313 million cubic meters of natural gas in 2008, compared to 7,719 million cubic meters in 2007. In mid-2007, we began production from the Shakh-Deniz field in Azerbaijan where our share in gas production totaled 552 million cubic meters in 2008. At the end of 2007, we began production from the Khauzak gas field in Uzbekistan, where we produced 2,340 million cubic meters of natural gas in 2008.

## Refining, marketing and trading

We operate four refineries located in European Russia and three refineries located overseas – in Bulgaria, Ukraine and Romania. In August 2005, we closed the Odessa refinery to commence a wide-scale upgrade. In April 2008, we put it back into operation after the completion of the upgrade. Annual capacity of the Odessa refinery amounts to 2.8 million tonnes. In 2008, we acquired 49% interest in the ISAB refinery in Priolo, Italy.

Compared to 2007, production at our refineries increased by 7.4%. Russian refineries increased production by 4.2%. In the second quarter of 2008, the production of our Ukhta refinery was lower than the average quarterly level by approximately 0.4 million tonnes due to a planned overhaul. In 2007, our refinery throughput in Russia was lower than planned by approximately 0.2 million tonnes due to a fire at the Volgograd refinery in March 2007. We recovered crude oil throughput at the refinery by the end of April 2007. The production of our overseas refineries increased by 23.1% in 2008, compared to 2007, primarily due to putting into operation the Odessa refinery. Besides, our share of refined products produced on the ISAB refinery amounted to 578 thousand tonnes.

The Group is constantly improving the refined products mix at our refineries in order to produce more profitable products of higher quality. At our Russian refineries we produced 7,224, 7,218 and 6,542 thousand tonnes of Euro 4 and Euro 5 diesel fuel in 2008, 2007 and 2006, respectively. In 2008, 2007 and 2006, our production of Euro 3 gasoline amounted to 4,191, 852 and 548 thousand tonnes, respectively.

Along with our own production of refined products we refined crude oil at third party refineries. In Russia we refined crude oil at third party refineries primarily to supply our network in the Ural region and for export sales. To supply our retail networks in Eastern Europe we refined crude oil at third party refineries in Belarus and Serbia. In early 2007, we decreased processing of our crude oil at Belarussian refineries due to a reduction in profitability of these operations resulting from changes in legislation. However, the growth in refining margins at the end of 2007 and beginning of 2008 resulted in increased volumes of refining in Belarus. Refined products processed in Belarus are used for supplying our local retail network and for wholesale export.

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 2008, the total volume of refined products purchased from third parties for wholesale and retail network supply was 38,687 thousand tonnes, or $29,741 million (compared to 38,694 thousand tonnes, or $23,883 million, in 2007, and 35,928 thousand tonnes, or $19,413 million, in 2006).

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

The following table represents volumes of refinery throughput, refined products produced and purchased.

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| | (thousand barrels per day) | | |
| Own refinery throughput* | 1,113 | 1,044 | 978 |
| Refinery throughput at the affiliated and the third parties refineries | 120 | 93 | 100 |
| TOTAL REFINERY THROUGHPUT | 1,233 | 1,137 | 1,078 |
| | (thousand of tonnes) | | |
| Refined products produced at the Group refineries in Russia* | 42,067 | 40,381 | 37,459 |
| Refined products produced at the Group refineries outside Russia | 10,388 | 8,438 | 8,211 |
| TOTAL REFINED PRODUCTS PRODUCED AT THE GROUP REFINERIES | 52,455 | 48,819 | 45,670 |
| Refined products produced at the third party refineries in Russia | 2,881 | 3,270 | 3,002 |
| Refined products produced at affiliated and third party refineries outside Russia | 2,701 | 945 | 1,586 |
| TOTAL REFINED PRODUCTS PRODUCED AT AFFILIATED AND THIRD PARTY REFINERIES | 5,582 | 4,215 | 4,588 |
| Refined products purchased in Russia | 1,635 | 1,543 | 919 |
| Refined products purchased internationally | 38,743 | 38,745 | 36,034 |
| TOTAL REFINED PRODUCTS PURCHASED | 40,378 | 40,288 | 36,953 |

* Excluding mini refineries.

## Exports of crude oil and refined products from Russia

In 2008, our export of crude oil from Russia was 6.8% less than in 2007. In 2008, we exported 43.8% of our total domestic crude oil production (46.5% in 2007, and 50.2% in 2006). The decrease of export was due to growth of crude oil refining volumes in Russia and a decrease in crude oil production.

The volumes of crude oil exported from Russia by our subsidiaries are summarized as follows:

| | 2008 | | 2007 | | 2006 | |
|---|---|---|---|---|---|---|
| | (thousand of barrels) | (thousand of tonnes) | (thousand of barrels) | (thousand of tonnes) | (thousand of barrels) | (thousand of tonnes) |
| Exports of crude oil using Transneft export routes | 264,393 | 36,070 | 293,163 | 39,995 | 304,034 | 41,478 |
| Exports of crude oil bypassing Transneft | 23,639 | 3,225 | 15,818 | 2,158 | 19,461 | 2,655 |
| TOTAL CRUDE OIL EXPORTS | 288,032 | 39,295 | 308,981 | 42,153 | 323,495 | 44,133 |

In 2008, the crude oil exported through our own export infrastructure was 2,824 thousand tonnes, or 52.1% more than in 2007.

In June 2008, we finalized construction of the offshore ice-resistant terminal in Varandey, with an annual capacity of 12 million tonnes. The Varandey oil export terminal will be used to export crude oil produced by the Group in Timan-Pechora, including our joint-venture with ConocoPhillips.

In 2008, we exported from Russia 25.8 million tonnes of refined products, an increase of 2.6%, compared to 2007. We export from Russia primarily diesel fuel, fuel oil and gasoil. These products account for approximately 93% of our refined products export volumes.

# 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 our revenues. During 2008, the Brent crude oil price fluctuated between $33 and $144 per barrel, reached its peak of $144.2 at the beginning of July and minimum of $33.6 at the end of December.

In the first half of 2008, the price growth was driven by an escalation in geopolitical tensions, which was strengthened by financial market speculation. The continued US dollar fluctuations and supply concerns due to a storm threat in the Gulf of Mexico also boosted prices. In the third quarter of 2008, the spread of crude oil price was significant. The financial crisis sent the crude oil price to a nine-month minimum. However this decline was followed by short-term price growth. The downward trend became settled and in the fourth quarter of 2008, crude oil price dropped to four year minimum. Crude oil prices are now below the level at which development of many oilfields becomes profitable. If the trend lasts, a concern over a shortage of hydrocarbon supply may appear. Considerable amounts of crude oil are sold on futures market with the delivery scheduled at the end of 2009 and stored in supertankers rather than sold on spot markets. This indicates that crude oil is seriously underpriced.

Substantially all the crude oil we export is Urals blend. The following table shows the average crude oil and refined product prices for 2008, 2007 and 2006.

| | 2008 | Change to 2007, % | 2007 | Change to 2006, % | 2006 |
|---|---|---|---|---|---|
| | (in US dollars per barrel, except for figures in percent) | | | | |
| Brent crude | 97.26 | 34.4 | 72.39 | 11.1 | 65.16 |
| Urals crude (CIF Mediterranean)* | 94.76 | 36.6 | 69.38 | 13.1 | 61.37 |
| Urals crude (CIF Rotterdam)* | 94.83 | 37.1 | 69.16 | 12.9 | 61.23 |
| | (in US dollars per metric tonne, except for figures in percent) | | | | |
| Fuel oil 3.5% (FOB Rotterdam) | 459.74 | 35.6 | 339.00 | 18.2 | 286.91 |
| Diesel fuel (FOB Rotterdam) | 901.53 | 42.2 | 634.09 | 9.7 | 577.92 |
| High-octane gasoline (FOB Rotterdam) | 836.79 | 20.2 | 695.97 | 12.4 | 619.29 |

Source: Platts.

* 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. At the same time it should be noted that in 2007 and 2008, our domestic crude oil sales prices were nearly at the level of our export net back price.

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 2008, 2007 and 2006.

| | 2008 | Change to 2007, % | 2007 | Change to 2006, % | 2006 |
|---|---|---|---|---|---|
| | (in US dollars per metric tonne, except for figures in percent) | | | | |
| Fuel oil | 255.55 | 31.6 | 194.19 | 10.9 | 175.07 |
| Diesel fuel | 710.56 | 41.0 | 503.84 | 6.4 | 473.44 |
| High-octane gasoline (Regular) | 740.11 | 17.1 | 631.93 | 13.0 | 559.11 |
| High-octane gasoline (Premium) | 807.77 | 13.3 | 712.81 | 15.5 | 617.41 |

Source: Kortes (excluding VAT).

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

A substantial part of our revenues is either denominated in US dollars or is correlated to some extent with US dollar crude oil prices, while most of our costs in the Russian Federation are settled in Russian rubles. Therefore, ruble inflation and movements of exchange rates can significantly affect the results of our operations. In particular, the real appreciation of the ruble against the US dollar generally causes our costs to increase in US dollar terms. 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 17.4% in 2008, compared to 2007. However, as a result of global economic crisis the exchange rate of the ruble to the US dollar decreased in the second half of 2008. In the fourth quarter of 2008, the appreciation of the purchasing power of the US dollar in Russia was 7.4%, compared to the third quarter of 2008. The year-end ruble-dollar exchange rate exceeded the opening by 19.7% that resulted in considerable currency translation loss.

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

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| Ruble inflation (CPI), % | 13.3 | 11.9 | 9.1 |
| Change of the ruble-dollar exchange rate, % | (19.7) | 6.8 | 8.5 |
| Average exchange rate for the period (ruble to US dollar) | 24.86 | 25.58 | 27.19 |
| Exchange rate at the end of the period (ruble to US dollar) | 29.38 | 24.55 | 26.33 |

## 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 2008, 2007 and 2006, the tax charge on the operations in Russia was approximately 86% of our total tax charge.

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

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

The effective rates of total taxes and tariffs (total taxes, including income taxes, taxes other than on income and excise and export tariffs, divided by income before taxes and tariffs) for 2008, 2007 and 2006, respectively, were 81%, 75% and 77%. In 2008, tax expenses in Russia were about 56% 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.

| | | 2008* | Change to 2007, % | 2007* | Change to 2007, % | 2006* |
|---|---|---|---|---|---|---|
| Export tariffs on crude oil | $/tonne | 355.08 | 71.8 | 206.70 | 4.9 | 197.01 |
| Export tariffs on refined products | | | | | | |
| Light distillates (gasoline), middle distillates (jet fuel), diesel fuel and gasoils | $/tonne | 251.53 | 65.9 | 151.59 | 5.7 | 143.40 |
| Liquid fuels (fuel oil) | $/tonne | 135.51 | 66.0 | 81.64 | 5.7 | 77.27 |
| Excise on refined products | | | | | | |
| Straight-run gasoline | RUR/tonne | 2,657.00 | – | 2,657.00 | – | 2,657.00 |
| High-octane gasoline | RUR/tonne | 3,629.00 | – | 3,629.00 | – | 3,629.00 |
| Low-octane gasoline | RUR/tonne | 2,657.00 | – | 2,657.00 | – | 2,657.00 |
| Diesel fuel | RUR/tonne | 1,080.00 | – | 1,080.00 | – | 1,080.00 |
| Motor oils | RUR/tonne | 2,951.00 | – | 2,951.00 | – | 2,951.00 |
| Mineral extraction tax | | | | | | |
| Crude oil | RUR/tonne | 3,328.35 | 34.6 | 2,472.67 | 9.1 | 2,265.69 |
| Natural gas | RUR/1,000 $m^3$ | 147.00 | – | 147.00 | – | 147.00 |

* Average values.

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

| | | 2008* | Change to 2007, % | 2007* | Change to 2007, % | 2006* |
|---|---|---|---|---|---|---|
| Excise on refined products | | | | | | |
| Straight-run gasoline | $/tonne | 106.90 | 2.9 | 103.88 | 6.3 | 97.74 |
| High-octane gasoline | $/tonne | 146.01 | 2.9 | 141.89 | 6.3 | 133.49 |
| Low-octane gasoline | $/tonne | 106.90 | 2.9 | 103.88 | 6.3 | 97.74 |
| Diesel fuel | $/tonne | 43.45 | 2.9 | 42.23 | 6.3 | 39.73 |
| Motor oils | $/tonne | 118.73 | 2.9 | 115.38 | 6.3 | 108.55 |
| Mineral extraction tax | | | | | | |
| Crude oil | $/tonne | 133.91 | 38.5 | 96.68 | 16.0 | 83.34 |
| Natural gas | $/1,000 $m^3$ | 5.91 | 2.9 | 5.75 | 6.3 | 5.41 |

* Average values.

These 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.** During 2005-2008, the base rate was 419 rubles per metric tonne extracted and it was adjusted depending on the international market price of Urals blend and the ruble exchange rate. The tax rate was zero when the average Urals blend international market price for a tax period is less than or equal to $9.00 per barrel. Each $1.00 per barrel increase in the international Urals blend price over the threshold ($9.00 per barrel) resulted 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).

Effective from January 1, 2009, the tax rate calculation was changed. The base rate remained the same, while the threshold crude oil price up to which the tax rate is zero was raised from $9.00 to $15.00 per barrel. This leads to a $1.3 per barrel decrease in crude oil extraction tax expenses in Russia. Also, the list of regions where, depending on the period and volume of production, zero crude oil extraction tax rate applies was extended. In particular, it now includes Caspian offshore and the Nenetsky Autonomous District, where the Group explores and produces hydrocarbons.

Effective from January 1, 2007, 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, depending on the period and volume of production. For crude oil produced in other regions the tax rate calculation described above should be multiplied by a coefficient characterizing the depletion of a particular oilfield. The coefficient is equal to 1.0 for oilfields with depletion below 80%. Each 1% increase of depletion of a particular oilfield above 80% results in a decrease of the coefficient by 0.035. The minimum value of the coefficient is 0.3. The depletion level assessment is based on crude oil production and reserves information reported to the Russian government.

**Natural gas extraction tax rate.** The mineral extraction tax on natural gas production is calculated using a flat rate. The current rate of 147 rubles per thousand cubic meters of natural gas extracted is effective since January 1, 2006.

**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 by $0.65 per barrel exported.

Prior to October 1, 2008, the Russian government set export tariff rates for two-month periods. The rates in a specific two-month period were based on Urals blend international market prices in the preceding two months. Thus, the calculation method that the Russian government employed to determine export tariff rates resulted in a two-month gap between movements in crude oil prices and the revision of the export duty rate based on those crude oil prices.

This method of calculation was amended in September 2008. The Russian government set the specific crude oil export duty rate for October, November and December 2008 at $372.20, $287.30 and $192.10 per tonne, respectively, in order to compensate oil companies the negative effect of sharply decreased crude oil prices. Effective from December 2008, the crude oil export duty rate is revised monthly on the basis of the immediately preceding one-month period of crude oil price monitoring.

**Export duty rates on refined products** are set by the Russian government. The rate of export duty depends on internal demand for refined products and international crude oil market conditions.

**Crude oil and refined products exported to CIS countries**, other than Ukraine, are not subject to export duties. Crude oil exported from Russia to Belarus is subject to export duties calculated with an application of a coefficient 0.335 in 2008 (0.293 in 2007) to the regular export duty rate set by the Government of the Russian Federation. Starting on January 1, 2009, this coefficient was increased to 0.356.

**Income tax.** Before 2009, operations in the Russian Federation were subject to an income tax rate of 24%. The Federal income tax rate was 6.5% and a regional income tax rate varied from 13.5% to 17.5% at the discretion of the individual regional administrations. Starting on January 1, 2009, the Federal income tax rate was decreased to 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.

## 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 of crude oil production companies to the markets is dependent on the extent of diversification of 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 Transneft. Access to the Transneft crude oil export pipeline network is allocated quarterly, based on recent volumes produced and delivered through the pipeline and proposed export destinations. The crude oil transported by Transneft is Urals blend – a mix of crude oils of various qualities. Therefore Russian companies that produce crude oil of a higher quality, can not obtain benefits from selling it using Transneft's pipeline. Alternative access to international markets bypassing Transneft export routes can be obtained through railroad transport, by tankers, and by the own export infrastructure of oil producing companies. Our own export infrastructure includes the Vysotsk terminal in the Leningrad region, the Varandey terminal in the Nenetsky Autonomous District and the Svetly terminal in the Kaliningrad region. We use the Varandey terminal to export crude oil produced by our joint venture with ConocoPhillips located in Northern Timan-Pechora. The Svetly terminal exports crude oil primarily produced by OOO LUKOIL-Kaliningradmorneft, our subsidiary operating in the Kaliningrad region, and refined products. We use the Vysotsk terminal to export refined products. In the future we expect to use the terminal to export both crude oil and refined products, depending on market conditions. Currently it has capacity of 12 million tonnes per year and it can be expanded up to 15 million tonnes per year.

Transportation of refined products in Russia is performed by railway transport and the pipeline system of OAO AK Transnefteproduct. Russian railway infrastructure is owned and operated by OAO Russian Railways. Both these companies are state-owned. Besides transportation of refined products, OAO Russian Railways provides oil companies with crude oil transportation services. We transport the major part of our refined products by railway transport.

As the activities of the above mentioned companies fall under the scope of natural monopolies, the fundamentals of their tariff policies are defined by the state authorities to ensure the balance of interests of the state and all participants in the transportation process. Transportation tariffs of natural monopolies are set by the Federal Service for Tariffs of the Russian Federation ("FST"). The tariffs are dependent on transport destination, delivery volume, distance of transportation, and several other factors. Changes in the tariffs depend on inflation forecasts by the Ministry of Economic Development of the Russian Federation, the investment needs of owners of transport infrastructure, other macroeconomic factors, and compensation of economically reasonable expenses, incurred by entities of natural monopolies. Tariffs are to be revised by FST at least annually.

# Year ended December 31, 2008, compared to years **ended December 31, 2007 and December 31, 2006**

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

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| | (millions of US dollars) | | |
| REVENUES | | | |
| Sales (including excise and export tariffs) | 107,680 | 81,891 | 67,684 |
| COSTS AND OTHER DEDUCTIONS | | | |
| Operating expenses | (8,126) | (6,172) | (4,652) |
| Cost of purchased crude oil, gas and products | (37,851) | (27,982) | (22,642) |
| Transportation expenses | (5,460) | (4,457) | (3,600) |
| Selling, general and administrative expenses | (3,860) | (3,207) | (2,885) |
| Depreciation, depletion and amortization | (2,958) | (2,172) | (1,851) |
| Taxes other than income taxes | (13,464) | (9,367) | (8,075) |
| Excise and export tariffs | (21,340) | (15,033) | (13,570) |
| Exploration expense | (487) | (307) | (209) |
| Loss on disposals and impairments of assets | (425) | (123) | (148) |
| INCOME FROM OPERATING ACTIVITIES | 13,709 | 13,071 | 10,052 |
| Interest expense | (391) | (333) | (302) |
| Interest and dividend income | 163 | 135 | 111 |
| Equity share in income of affiliates | 375 | 347 | 425 |
| Currency translation (loss) gain | (1,163) | 93 | 169 |
| Other non-operating expense | (244) | (240) | (118) |
| Minority interest | (83) | (55) | (80) |
| INCOME BEFORE INCOME TAXES | 12,366 | 13,018 | 10,257 |
| Current income taxes | (4,167) | (3,410) | (2,906) |
| Deferred income taxes | 945 | (97) | 133 |
| TOTAL INCOME TAX EXPENSE | (3,222) | (3,507) | (2,773) |
| NET INCOME | 9,144 | 9,511 | 7,484 |
| Basic earnings per share of common stock (in US dollars) | 10.88 | 11.48 | 9.06 |
| Diluted earnings per share of common stock (in US dollars) | 10.88 | 11.48 | 9.04 |

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

## Sales revenues

| Sales breakdown | 2008 | 2007 | 2006 |
|---|---|---|---|
| | (millions of US dollars) | | |
| CRUDE OIL | | | |
| Export and sales on international markets other than CIS | 22,382 | 18,346 | 16,859 |
| Export and sales to CIS | 1,625 | 912 | 790 |
| Domestic sales | 600 | 440 | 376 |
| | 24,607 | 19,698 | 18,025 |
| REFINED PRODUCTS | | | |
| Export and sales on international markets | | | |
| Wholesale | 50,553 | 37,971 | 30,302 |
| Retail | 11,989 | 9,183 | 7,157 |
| Domestic sales | | | |
| Wholesale | 8,049 | 5,862 | 5,431 |
| Retail | 5,823 | 3,721 | 2,720 |
| | 76,414 | 56,737 | 45,610 |
| PETROCHEMICALS | | | |
| Export and sales on international markets | 1,232 | 1,569 | 1,260 |
| Domestic sales | 880 | 733 | 569 |
| | 2,112 | 2,302 | 1,829 |
| GAS AND GAS PRODUCTS | | | |
| Export and sales on international markets | 926 | 562 | 432 |
| Domestic sales | 985 | 831 | 533 |
| | 1,911 | 1,393 | 965 |
| OTHER | 2,636 | 1,761 | 1,255 |
| TOTAL SALES | 107,680 | 81,891 | 67,684 |

| Sales volumes | 2008 | 2007 | 2006 |
|---|---|---|---|
| CRUDE OIL | (thousands of barrels) | | |
| Export and sales on international markets other than CIS | 242,784 | 268,974 | 278,972 |
| Export and sales to CIS | 31,629 | 19,879 | 21,682 |
| Domestic sales | 15,408 | 11,757 | 13,363 |
| CRUDE OIL | (thousands of tonnes) | | |
| Export and sales on international markets other than CIS | 33,122 | 36,695 | 38,059 |
| Export and sales to CIS | 4,315 | 2,712 | 2,958 |
| Domestic sales | 2,102 | 1,604 | 1,823 |
| | 39,539 | 41,011 | 42,840 |
| REFINED PRODUCTS | (thousands of tonnes) | | |
| Export and sales on international markets | | | |
| Wholesale | 67,669 | 64,394 | 57,558 |
| Retail | 8,200 | 7,910 | 7,171 |
| Domestic sales | | | |
| Wholesale | 13,314 | 13,704 | 15,155 |
| Retail | 5,964 | 4,853 | 3,995 |
| | 95,147 | 90,861 | 83,879 |
| TOTAL SALES VOLUME OF CRUDE OIL AND REFINED PRODUCTS | 134,686 | 131,872 | 126,719 |

| Realized average sales prices | 2008 | | 2007 | | 2006 | |
|---|---|---|---|---|---|---|
| | ($/barrel) | ($/tonne) | ($/barrel) | ($/tonne) | ($/barrel) | ($/tonne) |
| AVERAGE REALIZED PRICE INTERNATIONAL | | | | | | |
| Oil (excluding CIS) | 92.19 | 675.76 | 68.21 | 499.96 | 60.43 | 442.96 |
| Oil (CIS) | 51.38 | 376.58 | 45.86 | 336.15 | 36.46 | 267.22 |
| Refined products | | | | | | |
| Wholesale | | 747.06 | | 589.66 | | 526.46 |
| Retail | | 1 462.14 | | 1 160.90 | | 998.05 |
| AVERAGE REALIZED PRICE WITHIN RUSSIA | | | | | | |
| Oil | 38.97 | 285.66 | 37.43 | 274.37 | 28.16 | 206.43 |
| Refined products | | | | | | |
| Wholesale | | 604.55 | | 427.74 | | 358.38 |
| Retail | | 976.40 | | 766.67 | | 680.79 |

During 2008, our revenues increased by $25,789 million, or by 31.5%, compared to 2007 (in 2007 by $14,207 million, or by 21.0%, compared to 2006).

The total volume of crude oil and refined products sold was 134.7 million tonnes, which represents a slight increase compared to 2007. Our revenues from crude oil sales increased by $4,909 million, or by 24.9%, compared to 2007 (in 2007 by $1,673 million, or by 9.3%, compared to 2006). Our revenue from sales of refined products increased by $19,677 million, or by 34.7% (in 2007 by $11,127 million, or by 24.4%, compared to 2006).

Sales of crude oil and refined products on international markets, including the CIS, accounted for 84.1% of the total sales volume in 2008 (in 2007 – 84.7%, and in 2006 – 83.4%).

The increase in sales was principally due to the following:

- increase in hydrocarbon prices in the first half of 2008
- increase in crude oil refining, resulting from high refining margins in the first half of 2008

In the fourth quarter of 2008, our revenue was seriously affected by the slump in hydrocarbon prices resulted from the global economic crisis. As a result, the total revenue in the fourth quarter was nearly $14 billion less than in the third quarter. This comprised of $3.8 billion decrease in crude oil revenue and $9.7 billion decrease in refined product revenue.

## Sales of crude oil

### 2008 vs. 2007

The 24.9% increase in our total crude oil sales from 2007 to 2008 was attributable primarily to an increase in our international crude oil sales revenues (excluding CIS). This sales revenue, which accounted for approximately 91.0% of our total crude oil sales revenue in 2008 and 93.1% in 2007, increased by 22.0% primarily due to an increase in sales prices by 35.2%. At the same time the volume of international crude oil sales decreased by 9.7%, compared to 2007 as a result of decreased crude oil production and increased crude oil refining in Russia.

### 2007 vs. 2006

The 9.3% increase in our total crude oil sales from 2006 to 2007 was attributable primarily to an increase in our international crude oil sales revenues (excluding CIS). This sales revenue, which accounted for approximately 93.1% of our total crude oil sales revenue in 2007 and 93.5% in 2006, increased by 8.8% primarily due to an increase in sales prices by 12.9%. At the same time the total volume of crude oil sales decreased by 3.6%, compared to 2006 as a result of increased crude oil refining in Russia.

## Sales of refined products

### 2008 vs. 2007

In 2008, our revenue from the wholesale of refined products outside Russia increased by $12,582 million, or by 33.1%, compared to 2007, mainly due to an increase in the average realized price.

In 2008, our revenue from international retail sales increased by $2,806 million, or by 30.6%, compared to 2007, mainly due to an increase in average retail prices by 25.9%. The increase of retail sales volumes outside Russia amounted to 290 thousand tonnes, or 3.7%. This increase was attributable to the expansion of our retail network. In 2008, we acquired petrol stations in Turkey, petrol stations and storage facilities in Bulgaria, besides, in the second quarter of 2007, we acquired petrol stations in seven European countries. Our international retail sales include supplies of refined products to third party retail networks under long-term contracts with pricing similar to retail pricing.

In 2008, our revenue from the wholesale of refined products on the domestic market increased by $2,187 million, or by 37.3%, compared to the previous year, due to an increase in the average realized price by 41.3%.

In 2008, our revenue from retail sales in Russia increased by $2,102 million, or by 56.5%, compared to 2007, due to an increase both in sales volumes and prices. Revenue from retail sales was 42.0% of total refined products sales in Russia in 2008 (in 2007 – 38.8%).

**2007 vs. 2006**

The average realized wholesale price of refined products outside Russia increased by $63.20 per tonne, or by 12.0%, compared to 2006. Wholesale volumes of refined products sold outside Russia increased by 6,836 thousand tonnes, or by 11.9%, primarily due to increased volumes of export from Russia. As a result, our revenue from the wholesale sales of refined products outside Russia increased by $7,669 million, or by 25.3%.

During 2007, retail sales of refined products outside Russia increased by 739 thousand tonnes, or by 10.3%, compared to 2006. This increase is attributable to additional sales volumes generated by the 376 petrol stations acquired from ConocoPhillips in the second quarter of 2007. Refined products sales at those stations were 769 thousand tonnes in the period June-December 2007. Average retail prices increased to $1,160.90 per tonne, or by 16.3%. As a result, our revenue from retail sales increased by $2,026 million, or by 28.3%, compared to 2006. In 2007, revenue from retail sales was 19.5% (in 2006 – 19.1%) of total refined products sales outside Russia. Our international retail sales include supplies of refined products to third party retail networks under long-term contracts with pricing similar to retail pricing.

In 2007, the average domestic wholesale realized price on refined products increased by $69.36 per tonne, or by 19.4%, compared to 2006. In 2007, the wholesale of refined products within Russia decreased by 1,451 thousand tonnes, or by 9.6%, compared to 2006. As a result, our revenue from the wholesale of refined products on the domestic market increased by 7.9%. Volumes of refined products, which were not utilized in the domestic wholesale market were directed to a retail segment or exported from Russia.

In 2007, retail sales within Russia increased by 858 thousand tonnes, or by 21.5%, compared to 2006. Average retail prices increased to $766.67 per tonne, or by 12.6%. As a result, our revenue from retail sales increased by $1,001 million in 2007, or by 36.8%, compared to 2006. Revenue from retail sales was 38.8% of total refined products sales in Russia in 2007 (in 2006 – 33.4%).

## Sales of petrochemical products

**2008 vs. 2007**

In 2008, our revenue from sales of petrochemical products decreased by $190 million, or by 8.3%, compared to 2007. This resulted from the decrease in sales volumes by 15.5%. At the same time the prices increased by 8.6%. The decrease in volumes resulted from a temporary shutdown of our petrochemical plant Karpatnaftochim Ltd., Ukraine. In May 2008, this plant was stopped for modernization and construction of chlorine and caustic production line. Moreover, overall negative situation on the world petrochemical markets led to decrease of the sales volumes.

**2007 vs. 2006**

Revenue from sales of petrochemical products increased in 2007 by $473 million, or by 25.9%, compared to 2006. This increase in revenue resulted from both price and volume factors.

## Sales of gas and gas products

**2008 vs. 2007**

In 2008, sales of gas and gas refined products amounted to $1,911 million, which is 37.2% more than in 2007. This was due to an increase in gas products and natural gas sales revenues. Gas products sales revenue increased by $215 million, or by 21.9%, compared to 2007, mainly as a result of an increase in prices for gas products both in Russia and abroad. Natural gas sales revenue amounted to $690 million (an increase of 77.4%, compared to 2007). This increase was a result of the commencement of natural gas production in Uzbekistan and Azerbaijan, and an increase in average realized prices in Russia.

Our major purchaser of natural gas produced in the Russian Federation is OAO Gazprom. In 2008, we sold 7,856 million cubic meters of natural gas to OAO Gazprom (7.2 billion cubic meters in 2007), and the average realized price increased by 2.9% to $42.6 per 1,000 cubic meters.

**2007 vs. 2006**

In 2007, sales of natural gas amounted to $389 million (an increase by 69.1%, compared to 2006). In 2007, we sold 7.2 billion cubic meters of natural gas to OAO Gazprom at $41.4 per 1,000 cubic meters.

## Sales of other products

Other sales include sales through our retail network, other services provided and goods not related to our primary activities (such as electricity, heat, transportation, etc.) sold by our production and marketing companies and revenue of our electric power generating companies.

**2008 vs. 2007**

In 2008, other sales increased by $875 million, or by 49.7%.

During 2008, sales of goods and other products from our retail outlets amounted to $613 million, an increase of $188 million above the level of 2007. This was mainly attributable to the expansion of our retail network.

The Group develops its electric power business. Related sales increased by $528 million, compared to 2007, mainly as a result of the acquisition of TGK-8.

**2007 vs. 2006**

Other sales increased by $934 million, or by 42.1%, mainly as a result of the growth in other sales and services provided to third parties.

## Operating expenses

Operating expenses include the following:

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| | (millions of US dollars) | | |
| Hydrocarbon extraction expenses | 3,208 | 2,757 | 2,312 |
| Own refining expenses | 1,115 | 880 | 730 |
| Refining expenses at third parties and affiliated refineries | 439 | 242 | 230 |
| Excise included in processing fee paid to third parties refineries* | 116 | 158 | – |
| Petrochemical expenses | 235 | 272 | 247 |
| Expenses on crude oil transportation to refineries | 1,072 | 848 | 686 |
| Other operating expenses | 1,691 | 1,271 | 861 |
| | 7,876 | 6,428 | 5,066 |
| Change in operating expenses in crude oil and refined products inventory originated within the Group** | 250 | (256) | (414) |
| TOTAL OPERATING EXPENSES | 8,126 | 6,172 | 4,652 |
| COST OF PURCHASED CRUDE OIL, PETROLEUM AND CHEMICAL PRODUCTS | 37,851 | 27,982 | 22,642 |

* As a result of amendments to the Russian tax legislation, effective from January 1, 2007, the responsibility to pay excises on refined products (except for straight-run gasoline) was transferred from traders and retailers to refineries. Therefore excises are included in processing fees.

** The change in operating expenses in crude oil and refined products inventory originating within the Group includes extraction and refining expenses related to crude oil and refined products produced by the Group during the reporting period, but not sold to third parties.

Compared to 2007, operating expenses increased by $1,954 million, or by 31.7%, which is mainly explained by the growth of other operating expenses, hydrocarbon extraction expenses, processing and refining costs. Real appreciation of the ruble against the US dollar is a significant factor affecting our operating expenses in Russia. The devaluation of the purchasing power of the US dollar in the Russian Federation in 2008 was 17.4%, compared to 2007.

### 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.

**2008 vs. 2007**

In 2008, our extraction expenses increased by $451 million, or by 16.4%, compared to 2007. The increase resulted from the effect of the real ruble appreciation against the US dollar, increased expenses for energy supply, materials, artificial stimulation of reservoirs and labor. Our average hydrocarbon extraction cost per barrel of oil equivalent increased from $3.58 to $4.12, or by 15.1%, compared to 2007. At the same time in the forth quarter of 2008 our extraction cost decreased to $4.01 per barrel, compared to $4.29 per barrel in the third quarter of 2008 due to the ruble devaluation.

**2007 vs. 2006**

In 2007, our extraction expenses rose by $445 million, or by 19.2%, compared to 2006. The increase resulted from an increase in hydrocarbon production by our subsidiaries to 774.6 million BOE, which is an increase of 2.8%, compared to 2006, the effect of the real ruble appreciation, increased expenses for energy supply, materials and labor. In 2007, extraction expenses included approximately $45 million of expenses related to changes in the Group structure. Our average hydrocarbon extraction cost per barrel of oil equivalent increased from $3.08 to $3.58, or by 16.1%, compared to 2006.

## Own refining expenses

**2008 vs. 2007**

In 2008, refining expenses increased by $235 million, or by 26.7%, compared to 2007.

Refining expenses at our domestic refineries increased by 19.8%, or by $129 million, mainly as a result of increased expenses for power supply, real ruble appreciation against the US dollar and increased production volumes.

Refining expenses at our international refineries increased by 46.5%, or by $106 million. This resulted mainly from increased expenses for power supply, the effect of appreciation of the exchange rates of the Romanian and Bulgarian currencies to the US dollar, and an increase in production volumes mainly as a result of commencement of operations of Odessa refinery after a wide-scale upgrade.

**2007 vs. 2006**

In 2007, refining expenses increased by $150 million, or by 20.5%, compared to 2006.

Refining expenses at our domestic refineries increased by 25.4%, or by $132 million, as a result of increased production volume, the effect of the real ruble appreciation, and due to large-scale overhauls at the Perm refinery in the second quarter of 2007.

Refining expenses at our international refineries increased by 8.6%, or by $18 million. This resulted mainly from a general increase in refining costs including an effect of an appreciation of the exchange rates of Romanian and Bulgarian currencies, which are tied to Euro, to the US dollar.

## Refining expenses at third party and affiliated refineries

Along with our own production of refined products we refined crude oil at third party refineries both in Russia and overseas.

**2008 vs. 2007**

In 2008, refining expenses at third party and affiliated refineries increased by 81.4%, compared to 2007, as a result of increased refining costs in Russia that are linked to crude oil prices. Also, we increased refining volumes in Belarus, and, in December 2008, we commenced crude oil refining at the ISAB refinery complex.

**2007 vs. 2006**

In 2007, refining expenses at third party refineries increased by 5.2%, compared to 2006, as a result of increased refining costs in Russia, which was partially offset by decreased refining volumes in Belarus.

## Petrochemical operating expenses

**2008 vs. 2007**

In 2008, operating expenses of our petrochemical companies decreased by $37 million, or by 13.6%, compared to 2007, due to decrease of production volumes. The decrease resulted from a temporary shutdown of our petrochemical plant Karpatnaftochim Ltd., Ukraine. In May 2008, this plant was stopped for modernization and construction of chlorine and caustic production line.

**2007 vs. 2006**

In 2007, operating expenses of our petrochemical companies increased by $25 million, or by 10.1%, compared to 2006. This was mainly due to increase of expenses at our Stavrolen petrochemical plant as a result of putting in operation of polypropylene production facilities.

## Expenses on crude oil transportation to refineries

**2008 vs. 2007**

Expenses on crude oil transportation to refineries increased in 2008 by $224 million, or by 26.4%, compared to 2007, due to an increase in transportation tariffs and volumes transported.

**2007 vs. 2006**

Expenses on crude oil transportation to refineries increased in 2007 by $162 million, or by 23.6%, compared to 2006, due to an increase in transportation tariffs and volumes transported.

## 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 sales of electricity, heat, transportation services, other goods, etc., operating expenses of our gas processing plants, the costs of other services provided and goods sold by our marketing companies, and operating expenses of our power generating companies and of other non-core businesses of the Group.

### 2008 vs. 2007

In 2008, our other operating expenses increased by $420 million, or by 33.0%, compared to 2007. This was due to a general increase in other sales including growth of transportation and other services provided by the Group in the international segment. Half of the increase of other operating expenses was attributable to changes in Group structure, mainly to the acquisition of TGK-8 in May 2008.

### 2007 vs. 2006

In 2007, other operating expenses increased by $410 million, or by 47.6%, compared to 2006. This was due to a general increase in other sales including growth of transportation and other services provided by the Group in the international segment.

## Cost of purchased crude oil, gas and products

### 2008 vs. 2007

Cost of purchased crude oil, gas and products increased by $9,869 million in 2008, or by 35.3%, compared to 2007, due to increases in international crude oil and refined products prices and an increase in volumes of crude oil purchases.

Cost of purchased crude oil, gas and products includes the result of hedging of international crude oil and refined products sales. In 2008, we recognized a $902 million gain from hedging, compared to an expense of $575 million in 2007.

Cost of purchased crude oil, gas and products in 2008 included purchases of natural gas and fuel oil to supply TGK-8.

### 2007 vs. 2006

Cost of purchased crude oil, gas and products increased by $5,340 million in 2007, or by 23.6%, compared to 2006, primarily due to an increase in international refined products trading volumes and prices.

In 2007, we recognized a $575 million expense on hedging of international crude oil and refined products sales, compared to a gain of $183 million in 2006.

## Transportation expenses

### 2008 vs. 2007

In 2008, our transportation expenses increased by $1,003 million, or by 22.5%, compared to 2007. This was due to an increase in transportation tariffs and an overall increase in refined products sales volumes in Russia and internationally.

Our actual transportation expenses related to crude oil and refined products deliveries to various export destinations, weighted by volumes transported, changed in 2008, compared to the previous year, as follows: crude oil and refined products freight rates increased by 15.7% and 20.4%, respectively; crude oil pipeline tariffs increased by 15.9%; railway tariffs for refined products transportation increased by 13.6%.

### 2007 vs. 2006

In 2007, our transportation expenses increased by $857 million, or by 23.8%, compared to 2006. This was due to an increase in transportation tariffs, the increased volumes of refined products export from Russia, changes in exports destinations and an overall increase in sales volumes.

Average transportation tariffs weighted by volumes of the Group's crude oil and refined products export deliveries to different locations changed in 2007, compared to the previous year as follows: crude oil sea shipping tariffs increased by 11.6%; crude oil pipeline tariffs increased by 13.8%; railway tariffs for refined products transportation increased by 35.1%.

## Selling, general and administrative expenses

Selling, general and administrative expenses include general business expenses, 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.

### 2008 vs. 2007

In 2008, our selling, general and administrative expenses increased by $653 million, or by 20.4%, compared to 2007.

The growth was mainly due to real ruble appreciation, expansion of our activities both in Russia and internationally, and an overall increase in selling expenses.

### 2007 vs. 2006

In 2007, our selling, general and administrative expenses increased by $322 million, or by 11.2%, compared to 2006.

The growth was mainly due to real ruble appreciation, expansion of our activities both in Russia and internationally, indexation of salaries and increase in information technology expenses.

This was partially offset by the decrease in the cost related to our share-based management compensation plan. In 2007, such expenses amounted to $125 million, compared to $280 million in 2006.

Selling, general and administrative expenses in 2007 also included approximately $69 million of expenses related to the changes in the Group structure.

## Depreciation, depletion and amortization

Depreciation, depletion and amortization expenses include depletion of assets fundamental to production, depreciation of other productive and non-productive assets and certain intangible assets.

**2008 vs. 2007**

Our depreciation, depletion and amortization expenses increased by $786 million, or by 36.2%, compared to 2007. The increase was a result of the Company's capital expenditures and the corresponding increase in depreciable assets, in particular due to putting in production the Yuzhnoe Khylchuyu oil field. Besides, the decrease of our proved reserves resulted in an increase in depreciation of our oil and gas producing assets.

**2007 vs. 2006**

Our depreciation, depletion and amortization expenses increased by $321 million, or by 17.3%, compared to 2006. The increase was a result of the Company's capital expenditures and the corresponding increase in depreciable assets. This increase included approximately $36 million related to the changes in the Group structure.

## Exploration expenses

**2008 vs. 2007**

During 2008, exploration expense increased by $180 million, or by 58.6%, compared to 2007. Dry hole costs increased by $174 million to $317 million.

In 2008, we charged to expense the costs of three dry wells in Saudi Arabia totaling $122 million. The amount of $93 million was charged to expense in the fourth quarter of 2008 in regard of our project Yalama in Azerbaijan. Also, we expensed dry hole costs related to our projects in Kazakhstan and Columbia in amount of $20 million and $45 million, respectively.

**2007 vs. 2006**

During 2007, the amount charged to exploration expense increased by $98 million, or by 46.9%, compared to 2006. Dry hole costs increased by $52 million up to $143 million.

In the first half of 2007, we completed assessment of two exploratory wells drilled in Saudi Arabia. One of the wells was dry, and its cost of $51 million was charged to expense in 2007. The second well discovered a natural gas reservoir. Also, in beginning of 2008, we finalized geological evaluation of another exploratory well drilled in Saudi Arabia, which was found to be dry. Its cost of $21 million was charged to expense in 2007. Other overseas dry hole costs amounted to $20 million.

The dry hole costs in Russia amounted to $51 million and primarily related to Volga, Timan-Pechora and Western Siberia regions.

## Loss on disposals and impairments of assets

**2008 vs. 2007**

In 2008, loss on disposals and impairments of assets amounted to $425 million, compared to $123 million in 2007.

In 2008, the loss included $156 million related to impairment of certain oil and gas assets located in the Timan-Pechora region. The impairment resulted from a decrease in crude oil reserves due to revision of geological models. The loss also included $171 million related to impairment of goodwill and certain retail assets in the United States and Serbia due to the change in the economic environment.

The losses include the financial result from disposals of a number of non-core assets and individually insignificant impairments of non-performing business units.

**2007 vs. 2006**

Loss on disposals and impairments of assets in 2007 amounted to $123 million, compared to $148 million in 2006.

## Interest expense

**2008 vs. 2007**

In 2008, interest expense amounted to $391 million, which is $58 million, or 17.4%, more than in previous year. In 2008, interest expense was affected by termination of interest capitalization related to certain assets in Timan-Pechora due to completion of their construction and general increase in our indebtedness.

**2007 vs. 2006**

In 2007, interest expense increased by $31 million, or by 10.3%, compared to 2006, resulting from an overall increase in our indebtedness. At the same time, the weighted-average interest rate on our long-term indebtedness decreased, compared to the level of 2006.

## 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.

**2008 vs. 2007**

Compared 2007, our share in income of affiliates increased by $28 million, or by 8.1%.

**2007 vs. 2006**

Compared to 2006, our share in income of affiliates decreased by $78 million, or by 18.4%, primarily due to the changes in affiliates' structure.

## Currency translation (loss) gain

In 2008, currency translation loss amounted to $1,163 million, of which $876 million refer to the Russian segment of the Group, and $287 million – to the international segment. Those losses mostly refer to the fourth quarter results.

The main reasons for those losses were decrease in the US dollar value of the ruble-nominated accounts receivables, advances, VAT recoverable, other taxes prepaid (less value of ruble-nominated liabilities), and fluctuations of euro-dollar exchange rate, which affected results of some operations performed by the Group outside of Russia.

## Taxes other than income taxes

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| | (millions of US dollars) | | |
| In Russia | | | |
| Mineral extraction taxes | 12,267 | 8,482 | 7,281 |
| Social security taxes and contributions | 435 | 385 | 309 |
| Property tax | 374 | 284 | 219 |
| Other taxes | 180 | 105 | 160 |
| TOTAL IN RUSSIA | 13,256 | 9,256 | 7,969 |
| International | | | |
| Social security taxes and contributions | 77 | 57 | 47 |
| Property tax | 31 | 29 | 28 |
| Other taxes | 100 | 25 | 31 |
| TOTAL INTERNATIONALLY | 208 | 111 | 106 |
| TOTAL | 13,464 | 9,367 | 8,075 |

**2008 vs. 2007**

In 2008, taxes other than income taxes increased by 43.7%, or by $4,097 million, compared to 2007, mainly due to an increase in mineral extraction tax resulting from an increase in the crude oil extraction tax rate.

**2007 vs. 2006**

In 2007, taxes other than income taxes increased by 16.0%, or by $1,292 million, compared to 2006, due to an increase in mineral extraction tax resulting from an increase of crude oil extraction tax rate by 16.0%.

## Excise and export tariffs

Our excise and export tariffs include taxes on sales of refined products and export tariffs on the export of crude oil and refined products.

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| | (millions of US dollars) | | |
| In Russia | | | |
| Excise tax and sales taxes on refined products | 956 | 734 | 610 |
| Crude oil export tariffs | 11,911 | 8,160 | 7,833 |
| Refined products export tariffs | 4,119 | 2,654 | 2,281 |
| TOTAL IN RUSSIA | 16,986 | 11,548 | 10,724 |
| International | | | |
| Excise tax and sales taxes on refined products | 3,984 | 3,468 | 2,835 |
| Crude oil export tariffs | 143 | – | 1 |
| Refined products export tariffs | 227 | 17 | 10 |
| TOTAL INTERNATIONALLY | 4,354 | 3,485 | 2,846 |
| TOTAL | 21,340 | 15,033 | 13,570 |

**2008 vs. 2007**

In spite of a decrease in crude oil export volumes, export tariffs increased by $5,569 million, or by 51.4%, compared to 2007, due to the increase in tariff rates.

The growth in international excises was mainly due to the increase in volumes sold as a result of expansion of our retail network in Europe, the appreciation of the Euro against the US dollar, as the excise rates in most European countries we operate in are either denominated in Euro or tied to it.

**2007 vs. 2006**

Excise and export tariffs increased by $1,463 million, or by 10.8%, compared to 2006. The increase in export tariffs resulted mainly from the increase of tariff rates. The volume factor of the tariffs' increase due to expansion of refined products export from Russia was partially offset by reduction of crude oil export.

The growth in international excises was mainly due to the effect of acquisition of the European petrol stations from ConocoPhillips, an increase in 2007 of excise rates in Bulgaria, substantial increase of refined product sales in Romania, and implementation in May, 2006, of a new sales-tax on export of refined products in Romania.

## Income taxes

**2008 vs. 2007**

In 2008, our total income tax expense decreased by $285 million, or by 8.1%, compared to 2007, due to decrease in income before income tax by $652 million, or 5.0%, and recalculation of deferred taxes in Russia and Kazakhstan.

In 2008, our effective income tax rate was 26.1%, compared to 26.9% in 2007, which is higher than the maximum statutory rate for the Russian Federation (24%).

Starting from January 1, 2009, the income tax rate in the Russian Federation was decreased from 24.0% to 20.0%. Moreover, starting from 2009, the tax burden is reduced in Kazakhstan. As a result of this amendment we recalculated the deferred tax assets and liabilities as of December 31, 2008 at reduced income tax rate, which resulted in $299 million of income tax benefit in 2008, that we recognized in the fourth quarter.

**2007 vs. 2006**

Our total income tax expense increased by $734 million, or by 26.5%, compared to 2006, due to an increase of income before income tax by $2,761 million, or by 26.9%.

Our effective income tax rate in 2007 was 26.9% (in 2006 it was 27.0%), which is higher than the maximum statutory rate for the Russian Federation (24%).

The Group's effective income tax rate for the periods presented differs from the statutory income tax rate primarily due to domestic and foreign rate differences and the incurrence of costs that are either not tax deductible or only deductible to a certain limit.

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

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| | (millions of US dollars) | | |
| NET INCOME | 9,144 | 9,511 | 7,484 |
| Add back: | | | |
| Income tax expense | 3,222 | 3,507 | 2,773 |
| Depreciation and amortization | 2,958 | 2,172 | 1,851 |
| Interest expense | 391 | 333 | 302 |
| Interest and dividend income | (163) | (135) | (111) |
| EBITDA | 15,552 | 15,388 | 12,299 |

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

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| | (millions of US dollars) | | |
| Net cash provided by operating activities | 14,312 | 10,881 | 7,766 |
| Net cash used in investing activities | (13,559) | (9,715) | (7,515) |
| Net cash provided by (used in) financing activities | 763 | (1,098) | (1,186) |

## Operating activities

Our primary source of cash flow is funds generated from our operations. During 2008, cash generated by operating activities was $14,312 million, an increase of 31.5% compared to 2007. In 2008, our operating cash inflows were supported by a decrease of working capital by $2,699 million, compared to January 1, 2008. This was mainly caused by:

- a decrease in inventory of $963 million primarily resulted from a decrease in hydrocarbons prices
- a $1,595 million net decrease in trade accounts receivable and payable
- a $378 million net decrease in tax accounts receivable and payable

Positive effect of the above mentioned factors was partially eliminated by the net increase of other assets and liabilities of $237 million.

## Investing activities

An increase in cash used in investing activities resulted from an increase in cash paid for acquisitions of subsidiaries and cash spent on capital expenditures.

In 2008, we made a final payment of $157 million and two contingent payments of $200 million for the acquisition of upstream assets in Uzbekistan (SNG Holdings Ltd.). During 2008, we paid $64 million for the increase in our share of the share capital of our refinery in Nizhny Novgorod and $1,222 million as the cash part of the consideration for the TGK-8 acquisition. As first installments for the acquisitions of the 49% stake in the ISAB refinery complex and petrol stations in Turkey we paid $762 million and $250 million respectively. We also paid $343 million and $221 million for acquisitions of petrol stations in Bulgaria and petrol station networks in Russia. The other payments were primarily advances related to acquisitions of marketing assets in Russia and abroad.

In 2007, cash flows from investing activities included $1,155 million of cash received from the sale of our 50% interest in Caspian.

In 2008, capital expenditures increased by $1,454 million, or by 16.0%, compared to 2007 (for a detailed analysis of capital expenditures see a later section).

During 2007, the Company paid $255 million for the acquisition of licenses for crude oil exploration and production on two oil fields in the Komi Republic. Payments for acquisition of licenses in 2008 were $12 million.

## Financing activities

In 2008, net movements of short-term and long-term debt generated an inflow of $2,311 million, compared to an inflow of $616 million in 2007.

Net inflows in 2008 included long-term loans of $889 million received from ConocoPhillips as its part of financing of our joint venture in the Timan-Pechora region. In 2007, we received $672 million from ConocoPhillips as its part of financing the joint venture.

Cash inflows in 2008 included $235 million related to the sale of 7,449 LPG and oil tank-wagons, which were leased back by the Group under a capital lease agreement.

During 2007, as a result of the settlement of a stock-based compensation plan, employees purchased 8.8 million shares held by the Group as treasury stock at the grant price for $129 million and resold 1.5 million shares back to the Group for $134 million.

## Credit rating

In 2008, Standard & Poor's Ratings Services affirmed its long-term corporate credit rating and all debt ratings on the Company at BBB-. Standard & Poor's changed our outlook from positive to stable.

In 2008, Moody's affirmed the Company's long-term corporate family rating and long-term issuer rating of Baa2 and stable outlook.

In 2008, Fitch Ratings affirmed the Company's long-term issuer default rating of BBB- and short-term issuer default rating of F3. Fitch Ratings changed our outlook from positive to stable in February 2009.

A rating is not a recommendation to buy, sell or hold securities and may be subject to revision, suspension or withdrawal at any time by the assigning rating organization. Similar ratings on the Company and/or on different types of securities do not necessarily mean the same thing. The ratings do not address the marketability of any of our securities or their market price. Any change in the credit ratings of the Company or our securities could adversely affect the price that a subsequent purchaser will be willing to pay for our securities. We recommend that you analyze the significance of each rating independently from any other rating.

## Analysis of capital expenditures

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| | (millions of US dollars) | | |
| CAPITAL EXPENDITURES* | | | |
| EXPLORATION AND PRODUCTION | | | |
| Russia | 6,813 | 6,391 | 4,334 |
| International | 1,076 | 871 | 786 |
| TOTAL EXPLORATION AND PRODUCTION | 7,889 | 7,262 | 5,120 |
| REFINING, MARKETING AND DISTRIBUTION | | | |
| Russia | 1,377 | 1,177 | 916 |
| International | 773 | 645 | 559 |
| TOTAL REFINING, MARKETING AND DISTRIBUTION | 2,150 | 1,822 | 1,475 |
| CHEMICALS | | | |
| Russia | 23 | 73 | 121 |
| International | 98 | 98 | 51 |
| TOTAL CHEMICALS | 121 | 171 | 172 |
| OTHER | 429 | 117 | 119 |
| TOTAL CAPITAL EXPENDITURES | 10,589 | 9,372 | 6,886 |
| ACQUISITIONS OF SUBSIDIARIES AND MINORITY SHAREHOLDING INTEREST** | | | |
| EXPLORATION AND PRODUCTION | | | |
| Russia | 4 | 77 | 1,469 |
| International | 357 | 357 | 91 |
| TOTAL EXPLORATION AND PRODUCTION | 361 | 434 | 1,560 |
| REFINING, MARKETING AND DISTRIBUTION | | | |
| Russia | 636 | 685 | 122 |
| International | 1,397 | 511 | – |
| TOTAL REFINING, MARKETING AND DISTRIBUTION | 2,033 | 1,196 | 122 |
| OTHER | 3,194*** | 38 | 32 |
| Less cash acquired | (190) | (102) | (26) |
| TOTAL ACQUISITIONS | 5,398 | 1,566 | 1,688 |

* Including non-cash transactions and prepayments.
** Including prepayments related to acquisitions of subsidiaries and minority shareholding interest and non-cash transactions.
*** Including $1,969 million of non-cash part of consideration for acquisition of TGK-8.

During 2008, our capital expenditures, including non-cash transactions, amounted to $10,589 million, which is $13.0% more than in 2007. The growth mainly resulted from expenditures in our exploration and production segment, which increased by $627 million, or by 8.6%, compared to 2007. The exploration and production capital expenditures in new regions decreased by $414 million. The capital expenditures in the traditional exploration and production region of Western Siberia increased by $570 million mainly as a result of an increase in production drilling. The capital expenditures in European Russia increased by $292 million as a result of an increase in exploratory drilling and investments in pipelines and machinery. An increase in the capital expenditures in our overseas exploration projects (excluding the Caspian region) amounted to $179 million and was primarily related to our projects in Kazakhstan and Saudi Arabia. The increase in other segment was due to expenditures of TGK-8.

Due to unfavorable conditions on hydrocarbon markets the Company reduced the planned level of capital expenditures for 2009 from $11.2 billion down to $6.5 billion. In case of crude oil price decreases the Company is ready to further reduce capital expenditures in order to maintain positive cash flows. This decrease will not affect the Company's key projects.

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

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| | (millions of US dollars) | | |
| Northern Timan-Pechora | 1,878 | 2,357 | 1,526 |
| Yamal | 161 | 75 | 135 |
| Caspian region* | 420 | 441 | 212 |
| TOTAL | 2,459 | 2,873 | 1,873 |

* Russian and international projects.

# Contractual obligations, other contingencies and **off balance sheet arrangements**

## Capital commitments and contractual obligations

The Group owns and operates refineries in Bulgaria (LUKOIL Neftochim Bourgas AD) and Romania (Petrotel-LUKOIL). As a result of Bulgaria and Romania joining the European Union in 2007, LUKOIL Neftochim Bourgas AD and Petrotel-LUKOIL are required to upgrade their refining plants to comply with the requirements of European Union legislation in relation to the quality of produced petroleum products and environmental protection. These requirements are stricter than existing Bulgarian and Romanian legislation. The Group estimates the amount of future capital commitment required to upgrade LUKOIL Neftochim Bourgas AD and Petrotel-LUKOIL to be approximately $357 million and $42 million, respectively.

Group companies have commitments under the terms of existing license agreements in the Russian Federation of $1,168 million over the next 5 years and of $231 million thereafter. Management believes that a significant portion of these commitments will be fulfiled by the services to be provided by Eurasia Drilling Company and ZAO Globalstroy-Engineering as discussed below.

In connection with the sale of LUKOIL-Burenie (now Eurasia Drilling Company) in 2004 the Group signed a five year contract for drilling services. Under the terms of the contract, drilling services of approximately $791 million will be provided by Eurasia Drilling Company during 2009.

The Company has signed a four-year agreement for the 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 2009 to be approximately $549 million.

Group companies have commitments for capital expenditure contributions in the amount of $751 million related to various production sharing agreements over the next 29 years.

The Group has a commitment to purchase equipment for modernization of its petrochemical refinery Karpatnaftochim Ltd., located in Ukraine, during 2009 in the amount of $118 million.

The Group has a commitment to execute the capital construction program of TGK-8. Under the terms of this program, power plants with total capacity of 890 MW should be constructed by the end of 2012. As of December 31, 2008, the Group estimates the amount of this commitment to be approximately $1,225 million.

Group companies have investment commitments relating to oil deposits in Iraq of $495 million to be spent within 3 years from when exploitation becomes possible. Due to significant changes in the political and economic situation in Iraq the future of this contract is not clear, however, the Group is actively pursuing its legal right to this contract in Iraq in alliance with ConocoPhillips.

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

| (millions of US dollars) | Total | 2009 | 2010 | 2011 | 2012 | 2013 | After |
|---|---|---|---|---|---|---|---|
| ON BALANCE SHEET | | | | | | | |
| Short term debt | 2,301 | 2,301 | – | – | – | – | – |
| Long-term bank loans and borrowings | 3,333 | 635 | 829 | 944 | 377 | 243 | 305 |
| Long-term non-bank loans and borrowings | 51 | 6 | 8 | 7 | 1 | 26 | 3 |
| Long-term loans and borrowings from related parties | 2,165 | – | 44 | 44 | 44 | 44 | 1,989 |
| 6.356% Non-convertible US dollar bonds, maturing 2017 | 500 | – | – | – | – | – | 500 |
| 6.656% Non-convertible US dollar bonds, maturing 2022 | 500 | – | – | – | – | – | 500 |
| 7.25% Russian ruble bonds, maturing 2009 | 204 | 204 | – | – | – | – | – |
| 7.10% Russian ruble bonds, maturing 2011 | 272 | – | – | 272 | – | – | – |
| 8.00% Russian ruble bonds, maturing 2012 | 8 | – | – | – | 8 | – | – |
| 7.40% Russian ruble bonds, maturing 2013 | 204 | – | – | – | – | 204 | – |
| Capital lease obligations | 271 | 86 | 58 | 25 | 25 | 25 | 52 |
| TOTAL | 9,809 | 3,232 | 939 | 1,292 | 455 | 542 | 3,349 |
| OFF BALANCE SHEET | | | | | | | |
| Capital commitments under oil and gas license agreements in Russia* | 1,399 | 200 | 370 | 272 | 238 | 88 | 231 |
| Operating lease obligations | 1,412 | 489 | 268 | 170 | 139 | 109 | 237 |
| Capital commitment in LUKOIL-Neftochim Bourgas AD | 357 | 319 | 6 | 32 | – | – | – |
| Capital commitment in LUKOIL-Petrotel | 42 | 8 | 2 | 4 | 5 | 10 | 13 |
| Commitment for modernization of the petrochemical refinery in Ukraine | 118 | 93 | 25 | – | – | – | – |
| Capital commitments in PSAs | 751 | 462 | 122 | 104 | 26 | 1 | 36 |
| Capital commitments in TGK-8 | 1,225 | – | – | – | 1,225 | – | – |
| Obligation under contract with Eurasia Drilling Company | 791 | 791 | – | – | – | – | – |
| Obligation under contract with ZAO Globalstroy-Engineering | 549 | 549 | – | – | – | – | – |

* Management believes that a significant portion of these commitments will be fulfiled by the services to be performed by Eurasia Drilling Company and ZAO Globalstroy-Engineering.

## Off balance sheet arrangements

LUKARCO, an investee recorded under the equity method of accounting has a loan facility on which $178 million was drawn as of December 31, 2008. Borrowings under this loan bear interest at LIBOR plus 2.5% per annum, maturing by May 1, 2012. To enhance the credit standing of LUKARCO, the Company guarantees 54% of the interest payment as well as the repayment of 54% of the loan at maturity. The total amount of the Company's guarantees was $98 million and $348 million, which include $2 million and $19 million related to accrued interest on the outstanding amount, as of December 31, 2008 and 2007, respectively. Payments are due if the Company is notified that LUKARCO is not able to fulfil its obligations at maturity date. The Company's guarantee is secured by its 54% interest in LUKARCO with the carrying value of $586 million and $462 million as of December 31, 2008 and 2007, respectively. There are no material amounts being carried as liabilities for the Group's obligations under this guarantee.

Commitment Expiration by Period

| (millions of US dollars) | Total | 2009 | 2010 | 2011 | 2012 | 2013 | After |
|---|---|---|---|---|---|---|---|
| Guarantees of equity affiliate's debt | 161 | 136 | 25 | – | – | – | – |

## Litigation and claims

On November 27, 2001, ADC, a Canadian diamond development company, filed a lawsuit in the District Court of Denver, Colorado against OAO Archangelskgeoldobycha ("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 total damages of approximately $4.8 billion, including 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 Supreme Court found, however, that the trial court made a procedural error by not holding an evidentiary hearing before making its ruling concerning general jurisdiction regarding the Company, which is whether the Company had systematic and continuous contacts in the State of Colorado at the time the lawsuit was filed. In a modified opinion dated December 19, 2005, the Colorado Supreme Court remanded the case to the Colorado Court of Appeals (instead of the District Court) to consider whether the lawsuit should have been dismissed on alternative grounds (i.e., forum non conveniens). On June 29, 2006, the Colorado Court of Appeals declined to dismiss the case based on forum non conveniens. The Company filed a petition for certiorari on August 28, 2006, asking the Colorado Supreme Court to review this decision. This petition has been rejected. On March 5, 2007, the Colorado Supreme Court remanded the case to the District Court. On June 11, 2007, the District Court ruled it would conduct an evidentiary hearing on the issue of whether the Company is subject to general personal jurisdiction in the State of Colorado. Two pre-trial conferences were held with the Court in January 2009. The Court has allowed limited discovery to proceed. Discovery is limited to questions regarding jurisdiction. The Court has not set a hearing date for the termination of jurisdiction. Management does not believe that the ultimate resolution of this matter will have a material adverse effect on the Group's financial condition.

On February 20, 2004, the Stockholm District Court overturned the decision of the Arbitral Tribunal of the Arbitration Institute of the Stockholm Chamber of Commerce ("Arbitration Tribunal"), made on June 25, 2001, dismissing ADC's action against AGD based on lack of jurisdiction. ADC's lawsuit against AGD was initially filed with the Arbitral Tribunal claiming alleged non-performance under an agreement between the parties and its obligation to transfer the diamond exploration license to Almazny Bereg. This lawsuit claimed compensation of damages amounting to $492 million. In March 2004, AGD filed an appeal against the Stockholm District Court decision with the Swedish Court of Appeals. On November 15, 2005, the Swedish Court of Appeals denied AGD's appeal and affirmed the Stockholm District Court decision. On December 13, 2005, AGD filed an appeal against the Swedish Court of Appeals decision with the Swedish Supreme Court. On April 13, 2006, the Swedish Supreme Court denied the application of AGD for appeal against the Swedish Court of Appeal's decision dated November 15, 2005. On May 6, 2006, a Notice of Arbitration was received on behalf of ADC. On December 20, 2006, the first session of the Arbitration Tribunal with participation of both parties took place in order to define procedural issues related to the tribunal. As a result of the hearing the Arbitration Tribunal issued a detailed procedural order setting out the rules and timetable for the conduct of the arbitration. In May 2007, ADC filed a statement of claim that requested the Tribunal to require AGD to transfer the diamond exploration license to Almazny Bereg. On October 22, 2007, AGD submitted a statement of defense. On February 5, 2009, the Arbitration Tribunal issued a procedural order setting out the rules and timetable for the conduct of the arbitration in 2009. Management does not believe that the ultimate resolution of this matter will have a material adverse effect on the Group's financial condition.

In July 2008, the Federal Anti-monopoly Service of Russian Federation filled a suit against major Russian oil companies, including the Company, alleging that they violated anti-trust law by abusing their dominant position on the oil products market. A judgment was delivered which has been appealed in the Moscow Arbitration Court. The case was scheduled to be heard in late March 2009. During the second half of 2008 and the first quarter 2009, new suits were filed against the Company and some of the Group's companies alleging violation the anti-trust law. The alleged violations primarily involve fixing monopolistically high prices for oil products (gasoline, diesel and jet fuels, and fuel oil), and taking concerted action to fix and maintain prices for oil products. Overall, the claims may total between $79 million and $240 million. The indictments filed by anti-monopoly authorities have been appealed in the Court. Management believes that the Group's companies have followed all legal requirements and, consequently, 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.

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 from the production and sale of crude oil and petroleum products 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 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. Most part of these licenses expire between 2013 and 2014. Management believes the licenses will be extended to produce subsequent to their current expiry dates. The Group is in the process of extending all of its production licenses in the Russian Federation and has already extended a portion of these licenses. To date there have been no unsuccessful license renewal applications.

## Impairment of long-lived assets

Long lived assets, such as oil and gas 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.

## 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. In accordance with SFAS No. 143, *"Accounting for Asset Retirement Obligations,"* 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 outside of its physical crude oil and petroleum products businesses and 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 December 2008, the FASB issued FSP FAS 140-4 and FIN 46(R)-8, *"Disclosures about Transfers of Financial Assets and Interest in Variable Interest Entities."* This FSP amends FASB Statement No. 140, *"Accounting for transfers and Servicing of Financial Assets and Extinguishments of Liabilities,"* and requires additional disclosures about transfers of financial assets. It also amends FASB Interpretation No. 46 (R), *"Consolidation of Variable Interest Entities,"* and requires public entities, including sponsors that have a variable interest in a variable interest entity, to provide additional disclosures about their involvement with variable interest entities. This FSP is effective for the first reporting period ending after December 15, 2008. The adoption of the provisions of FSP FAS 140-4 and FIN 46(R)-8 did not have any impact on the Group's results of operations, financial position or cash flows.

In March 2008, the FASB issued SFAS No. 161, *"Disclosures about Derivative Instruments and Hedging Activities."* This Statement improves financial reporting about derivative instruments and hedging activities by enhanced disclosures of their effects on an entity's financial position, financial performance and cash flows. The Group is required to adopt the provisions of SFAS No. 161 no later than in the first quarter of 2009 and does not expect any material impact on its results of operations, financial position or cash flows upon adoption.

In December 2007, the FASB issued SFAS No. 141 (Revised), *"Business combinations."* This Statement will apply to all transactions in which an entity obtains control of one or more businesses. SFAS No. 141 (Revised) requires an entity to recognize the fair value of assets acquired and liabilities assumed in a business combination; to recognize and measure the goodwill acquired in the business combination or gain from a bargain purchase and modifies the disclosure requirements. The Group is required to prospectively adopt the provisions of SFAS No. 141 (Revised) for business combinations for which the acquisition date is on or after January 1, 2009. Early adoption of SFAS No. 141 (Revised) is prohibited.

In December 2007, the FASB issued SFAS No. 160, *"Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51."* This Statement will apply to all entities that prepare consolidated financial statements (except not-for-profit organizations) and will affect those which have an outstanding noncontrolling interest (or minority interest) in their subsidiaries or which have to deconsolidate a subsidiary. This Statement changes the classification of a non-controlling interest; establishing a single method of accounting for changes in the parent company's ownership interest that does not result in deconsolidation and requires a parent company to recognize a gain or loss when a subsidiary is deconsolidated. The Group is required to prospectively adopt the provisions of SFAS No. 160 in the first quarter of 2009, except for the presentation and disclosure requirements which shall be applied retrospectively. Early adoption of SFAS No. 160 is prohibited.

In February 2007, the FASB issued SFAS No. 159, *"The Fair Value Option for Financial Assets and Financial Liabilities."* This Statement expands the possibility of using fair value measurements and permits enterprises to choose to measure certain financial assets and financial liabilities at fair value. Enterprises shall report unrealized gains and losses on items for which the fair value option has been elected in earnings in each subsequent period. The Group adopted the provisions of SFAS No. 159 in the first quarter of 2008. The Group elected not to use the fair value option for its financial assets and financial liabilities not already carried at fair value in accordance with other standards. Therefore the adoption of SFAS No. 159 did not have any impact on the Group's results of operations, financial position or cash flows.

In September 2006, the FASB issued SFAS No. 157, *"Fair Value Measurements,"* which establishes a single authoritative definition of fair value, sets out a framework for measuring fair value and requires additional disclosures about fair value measurements. In February 2008, the FASB issued Staff Position FSP No. 157-2, *"Effective date of FASB Statement No. 157,"* which defers the effective date of SFAS No. 157 for certain nonfinancial assets and nonfinancial liabilities to the first quarter of 2009. The Group elected to adopt SFAS No. 157 with deferral permitted by FSP No. 157-2. The deferral applies to nonfinancial assets and liabilities measured in a business combination; long-lived assets, intangible assets and goodwill measured at fair value upon impairment and liabilities for asset retirement obligations. The Group does not expect any material impact on its results of operations, financial position or cash flows on adoption of SFAS No. 157 for these assets and liabilities. The initial adoption of SFAS No. 157 is limited to commodity derivative instruments.

The initial adoption of the provisions of SFAS No. 157 did not have a material impact on the Group's results of operations, financial position or cash flows.

In September 2006, the FASB issued SFAS No. 158, *"Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans – an amendment of FASB Statements No. 87, 88, 106 and 132(R)."* This Statement requires an employer that sponsors one or more single-employer defined benefit plans to: (a) Recognize the funded status of a benefit plan in its statement of financial position; (b) Recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost; (c) Measure defined benefit plan assets and obligations as of the date of the employer's fiscal year-end statement of financial position (with limited exceptions); (d) Disclose in the notes to financial statements additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation. The provisions of this Statement were effective December 31, 2006, except for the requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end, which is effective December 31, 2008. The adoption of the provisions of SFAS No. 158 did not have a material impact on the Group's 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
- echnological 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.

# Reference Information

The most complete and up-to-date information about LUKOIL can always be found on the Company's website: www.lukoil.ru (Russian) or www.lukoil.com (English).

The site also provides information about trends and results of LUKOIL's business, accurate, up-to-date information about events concerning the Company and the whole spectrum of LUKOIL activities, as well as details of the Company's social and environmental policies.

The Investor Centre section of the site presents the company's financial and industrial results, dividend history, share prices, presentations for investors, and Company reports.

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## LUKOIL Reports

Electronic versions of the following reports are available on the Company web site:

1. Report on Company Business.
2. Consolidated Financial Accounts.
3. Quarterly Consolidated Financial Accounts.
4. Management Discussion and Analysis of Financial Condition and Results of Operations
5. Analyst DataBook.
6. Fact book.

## Concepts and Terms Used in this Report

Mentions of "OAO LUKOIL", "LUKOIL Group", "the Group", "LUKOIL", "the Company", "we" and "our" are equivalent for the purposes of this Report and refer to LUKOIL Group of companies, to LUKOIL and/or its subsidiary enterprises, depending upon the context, in which the terms are used.

The average rouble/dollar exchange rate for 2008 (24.86 roubles/dollar) is used in conversion of rouble figures for expression in dollars, unless otherwise indicated.

Figures for reserves and production of oil include oil, gas condensate and gas liquids.

"Regions" with a capital "R" refers to administrative divisions of the Russian Federation,
"regions" with a small "r" refers to general geographical divisions.

"Reference fuel" is a rough measure to enable comparisons between different types of fuel, based on their energy content. 1 tonne of reference fuel = one tonne of crude oil = 1,000 cubic meters of natural gas.

Percentage change of operating data in mln tons in 2008 is calculated basing on the data in thousand tons.

## Abbreviations

boe – barrels of oil equivalent (1 boe = 6,000 cubic feet of gas)
km – kilometer
ppm – parts per million
PSA – production sharing agreement
RTS – Russian Trading System
MICEX – Moscow Interbank Currency Exchange