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

You should read the following discussion and analysis of our financial condition and results of operations for the year ended 31 December 2005 and 2004 in conjunction with our consolidated financial statements as of and for the year ended 31 December 2005 and 2004. The consolidated financial statements and the related notes thereto have been prepared in accordance with International Financial Reporting Standards (IFRS). All Russian rouble amounts have been stated at their nominal value for all periods shown.

The financial and operating information contained in this "Management's Discussion and Analysis of Financial Condition and Results of Operations" comprises information of OAO NOVATEK, its consolidated subsidiaries and its share of the results of associates. Accordingly, production volumes in the following discussion and analysis exclude volumes of Tarkosaleneftegas and Khancheyneftegas prior to the consolidation of these entities in December 2004. Prior to that date, sales volumes and revenues include the volumes of Tarkosaleneftegas and Khancheyneftegas only to the extent we purchased such production from Tarkosaleneftegas and Khancheyneftegas. We have, however, been responsible for managing the development and operations of these associates for the periods prior to the consolidation.

In June 2004, we sold our oil and gas construction services business to focus on our core activities of oil and gas exploration and production. Our oil and gas construction services activities primarily consisted of drilling services and construction of oil and gas infrastructure and facilities for related and external parties within the Russian Federation.

OVERVIEW

We are Russia's largest independent natural gas producer and the second-largest producer of natural gas in Russia after Gazprom. In terms of proved natural gas reserves, we are the third largest holder of natural gas resources in Russia after Gazprom and LUKOIL.

Our exploration, development, production, processing and marketing of natural gas, gas condensate, crude oil and related oil products have been conducted primarily within the Russian Federation and, historically, most of our revenues were derived from sales within the Russian Federation. However, with the commissioning of the Purovsky Gas Condensate Processing Plant (Purovsky Plant) in June 2005, we plan to export the majority of our stable gas condensate directly to international markets, significantly increasing the share of our revenues derived from international sales.

Recent developments

Significant events occurring subsequent to period ended 31 December 2005 are as follows:

- In November and December 2005, we established Novatek Overseas AG and Runitek GmbH, both registered in Switzerland, to manage the administration, marketing and trading of crude oil, stable gas condensate, liquefied petroleum gas, and other oil products to international markets. Effective 1 January 2006, we commenced export sales through our newly established foreign subsidiaries.
- In February 2006, we were assigned a Ba2/stable outlook Corporate Family Rating from Moody's Investor Service. Concurrently Moody's Interfax Rating Agency (majority-owned by Moody's Investor Service) has assigned us an Aa2.ru long-term national scale rating. This is the first time that we have received credit ratings from Moody's Investor Service. The Corporate Family Rating reflects our global default and loss expectation while the Interfax Rating reflects the standard of our credit quality relative to our domestic peers.
- In February 2006, we were assigned a BB- /stable Corporate Credit Rating from Standard and Poor's. This is the first time that we have received a credit rating from Standard and Poor's. The Corporate Credit Rating reflects our global default and loss expectation.

CERTAIN FACTORS AFFECTING OUR RESULTS OF OPERATIONS

Consolidation

Since 2002, we have pursued a strategy of increasing our holdings in, and focusing on, our core oil and gas assets and made a number of acquisitions and disposals to further this strategy. Our three core fields are held in our wholly-owned subsidiaries Tarkosaleneftegas and Yurkharovneftegas. With the completion of the December 2004 acquisitions discussed below, we now own 100 percent of Tarkosaleneftegas (in May 2005, Khancheyneftegas was merged into Tarkosaleneftegas). As a result of these acquisitions and our other consolidation and restructuring initiatives over the past three years, we have simplified our holding structure, allowing us to directly manage our core assets and improving the overall transparency of our financial reporting.

Acquisitions

In December 2004, we undertook a series of transactions whereby we acquired a 67.7 percent interest in Tarkosaleneftegas and a 57.0 percent interest in Khancheyneftegas in exchange for the issuance of 789,276 new ordinary shares of OAO NOVATEK, resulting in these companies becoming fully consolidated subsidiaries as at 31 December 2004.

Prior to our acquisitions of additional interests in Tarkosaleneftegas and Khancheyneftegas in December 2004, we purchased approximately 56 percent of Tarkosaleneftegas' hydrocarbon production and 100 percent of Khancheyneftegas' hydrocarbon production and then resold the production to third parties. Subsequent to the acquisitions, Tarkosaleneftegas' and Khancheyneftegas' activities were consolidated into our financial position and results of operations. Accordingly, all purchases from, sales to and balances with Tarkosaleneftegas and Khancheyneftegas have been eliminated in our consolidated balance sheets at 31 December 2005 and 2004 and in our consolidated statement of income for the year ended 31 December 2005, and each line item within our total operating expenses for year ended 31 December 2005 includes the corresponding results of Tarkosaleneftegas and Khancheyneftegas for the periods. Prior to the year ended 31 December 2004, we accounted for Tarkosaleneftegas and Khancheyneftegas under the equity method of accounting as investments in associates, and thus the operating costs of the two acquired entities were effectively included (pro rata to the percentage of volumes purchased) within purchases of crude oil, gas condensate and natural gas in our consolidated statements of income for the year ended 31 December 2004.

As part of the December 2004 acquisitions we have committed to sell a total volume of 37.5 bcm of natural gas over a five year period starting in January 2005 to the Itera Group, and have classified the sales volumes as "ex-field" sales. This contract will have an effect on the relative proportion of "ex-field" sales and "end-customer" sales during that period; however it is currently one of our highest margin contracts. In 2005, we sold 6.9 bcm to the Itera Group in accordance with this commitment.

Divestitures

Historically, our business has included various non-core business activities, including oil and gas construction services, banking and telecommunications. In June 2004, we sold to our shareholders our oil and gas construction services business to focus on our core activities of oil and gas exploration and production. Our oil and gas construction services activities primarily consisted of drilling services and construction of oil and gas infrastructure and facilities for related and external parties within the Russian Federation.

In 2004, we sold to Gazprom a subsidiary of Purneftegasgeologiya, which held the mineral license in the West-Tarkosalinskoye field, in return for an 8.34 percent interest in Purneftegasgeologiya. In connection with this transaction, we retained a right to 10 percent of the natural gas extracted from the Cenomanian horizon and 100 percent of the hydrocarbons extracted from the Valanginian horizon, the latter of which we retain 50 percent of based on a joint venture agreement, of the West-Tarkosalinskoye field for the duration of the license.

In 2004, other disposals included the sale of our telecommunication business as well as other non-core businesses. In May 2005, we disposed of our equity interest in NOVA Bank to our shareholder.

In June 2005, we disposed of our 66 percent participation interest in Geoilbent to LUKOIL and one of its subsidiaries for RR 5.1 billion. We accounted for our interest in Geoilbent under the equity method as all significant operating and financing decisions required the consent of the other shareholder, and thus we were not able to control Geoilbent. In June 2005, we disposed of our 25.1 percent share interest in Tambeyneftegas to Gazprombank-Invest for RR 120 million. Also in June 2005, we disposed of our 34 percent interest in Selkupneftegas to Rosneft for RR 573 million. The disposals were the result of our strategy to focus on the development of our upstream natural gas and gas condensate assets and divest assets where we do not exercise operational control over the development of the asset.

Transactions with related parties

Historically, we have had significant transactions with our shareholders, companies related to our shareholders, our associated companies and other related parties. Such transactions have included the purchase and sale of natural gas, gas condensate, crude oil, construction and other related services, the holding of equity securities, and the provision of and receipt of loans, guarantees and other non-cash settlements. Our reported statements of income, balance sheets and statements of cash flows would be different had such transactions been conducted amongst unrelated parties. The production volumes of natural gas, gas condensate and crude oil purchased from Tarkosaleneftegas prior to December 2004 represented a combination of our direct equity interest in the field's production volumes and volumes attributable to the equity interest held by our principal shareholders in an aggregate volume of approximately 56% of Tarkosaleneftegas' total production. We have purchased 100% of the natural gas production volumes from Khancheyneftegas since it commenced commercial production in 2003. In 2004, we began purchasing volumes attributable to our equity interest in Geoilbent. Prior to that period, Geoilbent marketed its volumes independently.

With the consolidation of our key producing assets, as discussed in the "Acquisitions" section above, and the disposal of Geoilbent, as discussed in the "Divestitures" section above, we estimate that the volume of related party transactions that we will conduct in the future will be significantly reduced.

Natural gas prices

As an independent natural gas producer, we are not subject to the government's regulation of natural gas prices. Historically, we have sold most of our natural gas at prices higher than the regulated prices set by the government for Gazprom's domestic gas sales, although the prices we can achieve are strongly influenced by the prices regulated by the Federal Tariffs Service (FTS). The terms for delivery of natural gas affect our average realized prices. Natural gas sold "ex-field" is sold primarily to wholesale gas traders, in which case the buyer is responsible for the payment of gas transportation tariffs. We generally realize higher prices and net margins for natural gas volumes sold directly to the end-customer, as the gas transportation tariff is included in the contract price and no retail margin is lost to wholesale gas traders. Sales to wholesale traders allow us to diversify our gas sales without incurring additional commercial expenses. In 2005, the margin between the end-customer netback price and the ex-field price decreased by RR 29 per mcm, or 29.3%, compared to 2004.

The following table shows our average natural gas sales prices for the years ended 31 December 2005 and 2004:

Average natural gas prices [(1)]	**Year ended 31 December**		**Change**
	2005	**2004**	**%**
Average natural gas price to end-customers[(2)]	1,121	958	17%
Gas transportation expense for sales to end-customers	434	331	31%
Average natural gas netback on end-customer sales	687	627	10%
Average natural gas price ex-field (wholesale traders)	617	528	17%

(1) Net of VAT and excise tax. Average RR realized per mcm.
(2) Includes cost of transportation.

Crude oil, stable gas condensate, liquefied petroleum gas (LPG) and oil products prices

Crude oil, stable gas condensate, LPG and oil products prices on international markets have historically been volatile depending on, among other things, the balance between supply and demand fundamentals, the ability of the OPEC countries to sustain production levels to meet increasing global demand and potential disruptions in global crude oil supplies due to war, terrorist activities or natural disasters. Crude oil prices in Russia have remained below prices in the international market primarily due to constraints on the ability of Russian oil companies to transport their crude oil, whereas certain oil products and LPG prices in Russia have more closely followed prices on international markets. This has occasionally led to crude oil surpluses in key consuming regions in Russia driving down the price in the domestic market. Moreover, there is no independent or uniform benchmark price for crude oil in Russia because the majority of all crude oil destined for sale in Russia is produced and refined by the same vertically integrated Russian oil companies. Crude oil that is not exported from Russia or refined by the producer is offered for sale in the domestic market at prices determined on a transaction-by-transaction basis. Crude oil that we sell bound for international markets is transported through the Transneft pipeline system where it is blended with other crude oil of varying qualities to produce an export blend commonly referred to as "Urals blend", which normally trades at a discount to the international benchmark Brent crude oil.

Our crude oil, stable gas condensate, LPG and oil products export prices include transportation expenses in accordance with the terms of delivery while prices for domestic and CIS sales do not. Our crude oil export price terms are generally free on board (FOB) or delivery at frontier (DAF) at the border of the Russian Federation. Historically, the majority of our sales volumes sold for export are transported by pipeline to Germany or through the shipping ports at Butinge, Lithuania. In 2005, our average crude oil contract price for export sales, including export duties, was approximately USD 319 per ton compared to approximately USD 223 per ton in 2004.

The majority of our stable gas condensate export price terms are carriage paid to (CPT) the Port of Vitino while a small portion are priced at free carrier (FCA) Purovsk railroad station. In 2005, our average stable gas condensate contract price for export sales, including export duties, was approximately USD 450 per ton. Our stable gas condensate domestic sales are priced FCA Purovsk railroad station. Under these agreements, the buyer takes ownership at the named place and responsibility for further transportation of the product to its final destination.

Average crude oil and stable gas condensate prices	**Year ended 31 December**		**Change**
	2005	**2004**	**%**
Crude oil			
Export price, RR per ton [1] [2]	6,102	4,743	29%
Export price, $ per ton [3]	215.7	175.0	23%
Domestic price, RR per ton [1]	4,100	3,353	22%
Stable gas condensate			
Export price, RR per ton [1] [2]	8,339	-	100%
Export price, $ per ton [3]	294.8	-	100%
Domestic price, RR per ton [1]	6,268	-	100%

[1] Net of VAT, excise tax and export duties. Average RR realized per ton.
[2] Includes cost of transportation.
[3] Converted from the average RR realized price using average exchange rates for the period.

Our LPG export and CIS terms of delivery are DAF at the Belarusian-Polish and Russian-Latvian borders. In 2005, our average LPG contract price for export sales, including export duties, was approximately USD 450 per ton. Our domestic sales of LPG are delivered FCA at Purovsk railroad station. Domestic sales of oil products from Surgutsky refinery are priced FCA Surgut railroad station. In 2004, our average oil products contract price for export sales, including export duties, was approximately USD 202 per ton. Under these agreements, the buyer takes ownership at the named place and responsibility for further transportation of the product to its final destination.

Average LPG and oil products prices	**Year ended 31 December**		**Change**
	2005	**2004**	**%**
LPG			
Export price, RR per ton [1] [2]	9,515	-	100%
Export price, $ per ton [3]	336.4	-	100%
Domestic price, RR per ton [1]	5,647	-	100%
Oil products			
Export price, RR per ton [1] [2]	-	4,900	(100%)
Export price, $ per ton [3]	-	170.1	(100%)
Domestic price, RR per ton [1]	4,704	3,879	21%

[1] Net of VAT, excise tax and export duties. Average RR realized per ton.
[2] Includes cost of transportation.
[3] Converted from the average RR realized price using average exchange rates for the period.

Transportation tariffs

Transportation tariffs established by the FTS from 1 October 2005 for the transport of natural gas produced in Russia for shipments to consumers located within the customs territory of the Russian Federation and the member states of the Customs Union Agreement (Belarus, Kazakhstan, Kyrgyzstan, and Tajikistan) are set at RR 23.84 (excluding VAT) per mcm per 100 km. This represents a 23% increase from the tariffs of RR 19.37 (excluding VAT) per mcm per 100 km set on the 1 October 2004 and a 44% increase from the tariffs of RR 16.56 (excluding VAT) per mcm per 100 km effective 1 August 2003. The increases in regulated transportation tariffs may be passed on to end-customers pursuant to contract terms. There is no set timetable for reviews or changes in transportation tariffs set by the FTS, and thus changes in transportation tariffs occur on an irregular basis.

We transport most of our crude oil through the pipeline network owned and operated by Transneft, Russia's monopoly crude oil pipeline operator. Our transportation tariffs for transportation of crude oil through Transneft's pipeline network are also set by the FTS. The overall expense per ton for the transport of crude oil depends on the length of the transport route from the producing field to the ultimate destination.

Our stable gas condensate, LPG and oil products are transported by rail which is owned and operated by the state-owned company, Russian Railways (RZD). Our tariffs for transportation by rail are set by FTS and vary depending on product and length of transport route. We deliver our stable gas condensate to international

markets using the recently commissioned storage and loading facilities at the Port of Vitino on the White Sea. The majority of our LPG and oil products are sold in Russia and the CIS.

Commencement of Purovsky Plant

Our unstable gas condensate has historically been transported through our own pipeline network and pipelines owned by Gazprom to the Surgutsky refinery, where it is processed into stabilized gas condensate and oil products (including diesel fuel, light distillate and naphtha). With the commissioning of our Purovsky Plant in June 2005, we began transporting our unstable gas condensate production volumes from our East-Tarkosalinskoye and Khancheyskoye fields through our own pipeline network directly to the Purovsky Plant. We have an agreement with Gazprom to access its gas condensate pipeline network to deliver the unstable gas condensate produced at our Yurkharovskoye field to the Purovsky Plant through 2006. The crude oil and oil products mix that we receive from the Surgutsky refinery has historically been transported to market using a combination of the Transneft crude oil pipeline network and the Russian Railways system. The commissioning of our Purovsky Plant has changed our distribution channel for delivery of stable gas condensate to the market. We now export the majority of our stable gas condensate to international markets.

We expect our gas condensate revenues and margins to increase since prices for stable gas condensate in international markets have historically exceeded prices for Urals blend crude oil.

Our tax burden

We are subject to a wide range of taxes imposed at the federal, regional, and local levels, many of which are based on revenue or volumetric measures. In addition to income tax, significant taxes to which we are subject include VAT, Unified Natural Resources Production Tax (UPT), export duties, property tax, social taxes and contributions.

In practice the Russian tax authorities often have their own interpretation of tax laws that rarely favors taxpayers, who often have to resort to court proceedings to defend their position against the tax authorities. Differing interpretations of tax regulations exist both among and within government ministries and organizations at the federal, regional and local levels, creating uncertainties and inconsistent enforcement. Tax declarations, together with related documentation such as customs declarations, are subject to review and investigation by a number of authorities, each of which may impose fines, penalties and interest charges. Generally, taxpayers are subject to an inspection of their activities for a period of three calendar years which immediately precede the year in which the audit is conducted. Previous audits do not exclude subsequent claims relating to the audited period. In addition, in some instances, new tax regulations have been given retroactive effect. While under the Russian Federation tax code only laws benefiting the tax payers may have retroactive effect, tax risks in Russia nevertheless remain more significant than those typically found in countries with more developed tax systems.

We have not employed any tax minimization schemes using offshore or domestic tax zones in the Russian Federation.

OPERATIONAL HIGHLIGHTS

Oil and gas production costs

Our oil and gas production costs are derived from our results of operations for oil and gas producing activities as reported in the unaudited supplemental oil and gas disclosures for the periods ended 31 December 2005 and 2004. Oil and gas production costs do not include general corporate overheads or its associated tax effects. The following tables set forth certain operating information with respect to our oil and gas production costs during the periods presented in Russian roubles and in US dollars per boe:

	Year ended 31 December		Change
	2005	2004	%
	(millions of RR)		
Production costs:			
Lifting cost	2,552	1,147	122%
Long-term supply purchases	2,065	5,632	(63%)
Taxes other than on income	4,336	1,393	211%
Transportation costs	6,581	3,672	79%
Total production costs before DD&A	**15,534**	**11,844**	**31%**
Depreciation, depletion and amortization (DD&A)	3,255	584	457%
Total production costs	**18,789**	**12,428**	**51%**

	Year ended 31 December		Change
	2005	2004	%
	($/boe)		
Production costs:			
Lifting cost	0.50	0.61	(18%)
Long-term supply purchases	3.76	2.94	28%
Taxes other than on income	0.85	0.74	14%
Transportation costs	1.16	0.97	20%
Total production costs before DD&A	**2.74**	**3.12**	**(12%)**
Depreciation, depletion and amortization (DD&A)	0.63	0.31	105%
Total production costs	**3.31**	**3.27**	**1%**

Production costs consist of amounts directly related to the operation and maintenance of our producing oil and gas wells, related equipment and facilities, purchases of natural gas and crude oil and gas condensate from our affiliates and other third parties, and transportation cost to end-customers. The average production costs per boe reflect the crude oil equivalent of natural gas and gas condensate at our prospective producing fields converted based on the relative energy content of each field's hydrocarbons.

Hydrocarbon sales volumes

In 2005, we increased our natural gas and liquids (crude oil, stable gas condensate, LPG and oil products) sales volumes due to significant increases in our production of these hydrocarbons in the 2005 period compared to the corresponding period in 2004. Our growth in production was achieved through the efficient exploitation of our existing producing asset base, together with increases in our holdings of core assets such that we could consolidate the production from these assets rather than report them as purchases. As discussed in the section on "Acquisitions" above, in December 2004, we began consolidating the production volumes from core fields licensed to Tarkosaleneftegas and Khancheyneftegas into our results.

We expect our total production volumes to continue growing, primarily as a result of the development activities at our existing producing fields and by exploring and developing other oil and gas fields in our asset portfolio.

Natural gas sales volumes

millions of cubic meters	Year ended 31 December 2005	2004	Change %
Production from: [1]			
Yurkharovskoye field	8,916	6,673	34%
East-Tarkosalinskoye field	13,327	-	100%
Khancheyskoye field	2,767	-	100%
Other fields	26	2,309	(99%)
Total natural gas production	**25,036**	**8,982**	**179%**
Purchases from:			
Tarkosaleneftegas [2]	-	5,738	(100%)
Khancheyneftegas [3]	-	2,297	(100%)
Other	2,518	523	381%
Total natural gas purchases	**2,518**	**8,558**	**(71%)**
Total production and purchases	**27,554**	**17,540**	**57%**
Changes in pipeline and underground storage	(224)	(263)	(15%)
Total natural gas sales volumes	**27,330**	**17,277**	**58%**
Natural gas volumes sold to end-customers	*11,650*	*8,889*	*31%*
Natural gas volumes sold ex-field	*15,680*	*8,388*	*87%*

[1] Net of technical losses

[2] Represents purchases of gas production at our combined interest of 56%

[3] Represents purchases of natural gas at our agreed upon contractual rate of 100%

In 2005, our total consolidated natural gas production, net of technical losses, increased by 16,054 mmcm, or 178.7%, compared to 2004 and accounted for 91.6% of total natural gas sales volumes. The increase in natural gas production was primarily due to the consolidation of production from the East-Tarkosalinskoye and Khancheyskoye fields and organic growth at both the Yurkharovskoye and Khancheyskoye fields. In 2005, natural gas production from the East-Tarkosalinskoye and Khancheyskoye fields was 16,094 mmcm; two times more than the volumes we purchased from these fields in 2004, while organic growth at the Yurkharovskoye field was 2,243 mmcm, or 33.6%.

The decrease in “Other” natural gas production was primarily attributable to the sale of our subsidiary holding the license to the West-Tarkosalinskoye field to Gazprom, after which, we began purchasing our share of natural gas production from the West-Tarkosalinskoye field in accordance with contractual terms and conditions.

In 2005, total natural gas purchases decreased by 6,040 mmcm, or 70.6%, to 2,518 mmcm, compared to 8,558 mmcm in 2004, primarily due to the full consolidation of Tarkosaleneftegas and Khancheyneftegas in December 2004. Purchases from “Other” increased by 1,995 mmcm, or 381.4%, in 2005, compared to 2004, primarily due to the divestiture of the West Tarkosalinskoye license. In 2005, we purchased 2,191 mmcm of natural gas from Gazprom under the terms and conditions of the West Tarkosalinskoye agreement.

Liquids sales volumes

thousands of tons	Year ended 31 December 2005	2004	Change %
Production from: [1]			
Yurkharovskoye field	662	554	20%
East-Tarkosalinskoye field	742	-	100%
Khancheyskoye field	644	-	100%
Other fields	83	239	(65%)
Total liquids production	**2,131**	**793**	**169%**
Purchases from:			
Tarkosaleneftegas [2]	-	348	(100%)
Khancheyneftegas [3]	-	520	(100%)
Geoilbent	240	358	(33%)
Other	140	99	41%
Total liquids purchases	**380**	**1,325**	**(71%)**
Total production and purchases	**2,511**	**2,118**	**19%**
Changes in inventory	(51)	(6)	(750%)
Total liquids sales volumes	**2,460**	**2,112**	**17%**
Crude oil export sales volumes	*183*	*502*	*(64%)*
Crude oil domestic sales volumes	*679*	*1,087*	*(38%)*
Stable gas condensate export sales volumes	*760*	-	*100%*
Stable gas condensate domestic sales volumes	*2*	-	*100%*
LPG export sales volumes	*28*	-	*100%*
LPG domestic sales volumes	*213*	-	*100%*
Oil products export sales volumes	-	*20*	*(100%)*
Oil products domestic sales volumes	*595*	*503*	*18%*

(1) Net of technical losses

(2) Represents purchases of production at our combined interest of 56%

(2) Represents purchases of production at our agreed upon contractual rate of 100%

In 2005, crude oil and gas condensate production, net of technical losses, increased by 1,338 thousand tons, or 168.7% to 2,131 thousand tons, compared to 793 thousand tons in 2004. The increase was largely attributable to continued development at our fields and full consolidation of production from the East-Tarkosalinskoye and Khancheyskoye fields. The increase was slightly offset by a decrease in production from “Other” of 156 thousand tons, or 65.3%, due to our divestiture of the West-Tarkosalinskoye license.

In 2005, purchases decreased by 945 thousand tons, or 71.3%, compared to the same period in 2004, primarily due to the consolidation of Tarkosaleneftegas and Khancheyneftegas in December 2004 and the divestiture of Geiolbent in June 2005. Following our disposal of Geoilbent we have ceased purchasing its crude oil volumes which amounted to 240 thousand tons in 2005 and 358 thousand tons in 2004.

In 2005, we delivered 1,031 thousand tons and 1,052 thousand tons of unstable de-ethanized gas condensate to the Purovsky Plant and Surgutsky refinery, respectively, compared to nil and 1,333 thousand tons, respectively, in 2004. In 2005, stable gas condensate output comprised 41.7% of the total yield from the Surgutsky refinery compared with 57.9% in 2004. Processed products from the Purovsky Plant are sold separately from the processed products we receive from the Surgutsky refinery. After processing gas condensate at the Surgutsky refinery we receive crude oil and a slate of oil products. The crude oil is sold as Ural’s blend crude oil and delivered by the Transneft pipeline network.

RESULTS OF OPERATIONS FOR THE YEAR ENDED 31 DECEMBER 2005 COMPARED TO THE YEAR ENDED 31 DECEMBER 2004

The following table and discussion is a summary of our consolidated results of operations (in millions of Russian roubles) for the year ended 31 December 2005 and 2004. Each line item is also shown as a percentage of our total revenues.

millions of Russian roubles	Year ended 31 December			
	2005	***% of Total revenues***	**2004**	***% of Total revenues***
Total revenues [(1)]	**38,523**	***100%***	**24,144**	***100%***
Other income	3,664	*9%*	583	*2%*
Total revenues and other income	42,187	*109%*	24,727	*102%*
Operating expenses	**(22,861)**	***(59%)***	**(17,113)**	***(71%)***
Income from operations	**19,326**	***50%***	**7,614**	***32%***
Finance expense	(729)	*(2%)*	(292)	*(1%)*
Share of income from associates	143	*0%*	764	*3%*
Income before income tax and minority interest	18,740	*49%*	8,086	*34%*
Total income tax expense	(5,078)	*(13%)*	(2,118)	*(9%)*
Profit for the period	13,662	*36%*	5,968	*25%*
Minority interest	(35)	*0%*	274	*(1%)*
Profit attributable to NOVATEK shareholders	13,697	*36%*	5,694	*24%*

[(1)] Net of VAT, excise tax and export duties.

Total revenues and other income

Our total revenues and other income comprise oil and gas sales, sales of polymer and insulation tape, other revenues, disposals and other income. Total revenues increased by RR 14,379 million, or 59.6%, to RR 38,523 million in 2005 compared to RR 24,144 million in 2004 while disposals and other income increased by RR 3,081 million, or 528%, to RR 3,664 million compared to RR 583 million in 2004.

The increase in total revenues was primarily the result of our success in expanding our natural gas production volumes and diversifying our liquid hydrocarbon marketing channels as well as favorable pricing environments in both the export and domestic markets. Our continued efforts in funding exploration and development activities have allowed us to expand our sales volumes annually since our inception. In 2005, our sales volumes of natural gas increased to 27,330 mmcm from 17,277 mmcm in 2004, or 58.2%. Our combined sales volumes of crude oil, stable gas condensate, LPG and oil products increased to 2,460 thousand tons in 2005 from 2,112 thousand tons in 2004, or 16.5%. We expect to continue increasing our sales volumes, but at a more measured pace, due to production growth at our subsidiaries.

The increase in other income was primarily driven by asset disposals of RR 3,631 million in 2005 compared to RR 198 million in 2004. The increase in 2005 was primarily due to the disposals in Geoilbent, Selkupneftegas and Tambeyneftegas.

The following table sets forth our net sales (in millions of Russian roubles, net of VAT, excise tax and export duties), and other income for the year ended 31 December 2005 and 2004:

	Year ended 31 December		Change
	2005	2004	%
Sales of natural gas			
Net sales	**22,729**	**12,943**	**76%**
Net End-customer sales	*13,056*	*8,515*	*53%*
Net Ex-field sales	*9,673*	*4,429*	*118%*
Sales of stable gas condensate			
Net sales	**6,349**	**-**	**100%**
Net export sales	*6,336*	*-*	*100%*
Net domestic sales	*13*	*-*	*100%*
Sales of liquefied petroleum gas			
Net sales	**1,472**	**-**	**100%**
Net export sales	*271*	*-*	*100%*
Net domestic sales	*1,201*	*-*	*100%*
Sales of oil products			
Net sales	**2,797**	**2,050**	**37%**
Net export sales	*-*	*99*	*(100%)*
Net domestic sales	*2,797*	*1,951*	*43%*
Sales of crude oil			
Net sales	**3,899**	**6,025**	**(35%)**
Net export sales	*1,114*	*2,381*	*(53%)*
Net domestic sales	*2,785*	*3,644*	*(24%)*
Total oil and gas sales	**37,246**	**21,018**	**77%**
Oil and gas construction services	-	2,053	(100%)
Sales of polymer and insulation tape	964	617	56%
Other revenues	313	456	(33%)
Total revenues	**38,523**	**24,144**	**60%**
Net gain (loss) on disposals	**3,631**	**198**	**1,734%**
Net other income (expense)	**33**	**385**	**(91%)**
Total revenues and other income	**42,187**	**24,727**	**71%**

Natural gas sales

In 2005, our revenues from the sale of natural gas increased by RR 9,786 million, or 75.6%, compared to 2004. Revenues from the sale of natural gas accounted for 59.0% and 53.6% of our total revenues in 2005 and 2004, respectively. The increase in natural gas revenues was primarily attributable to an increase in sales volumes and subsequently an increase in new customers. Almost half of our sales in 2005 were made to new customers mainly in power generation and other industries. We sell our natural gas volumes exclusively in the Russian domestic market.

In 2005, our average realized price per mcm increased by RR 83 per mcm, or 11.0%, compared to 2004, due to an overall increase in natural gas prices and an increase in sales volumes to end-customers. The average realized prices of our natural gas sold to end-customers and natural gas sold ex-field were higher by 17.0% and by 16.9%, respectively, in 2005 compared to 2004. The netback margin we received on end-customer sales compared to ex-field sales decreased by RR 29 per mcm, or 29.3%, in 2005 compared to 2004 due to an increase in the transportation tariff per mcm in 2005.

Crude oil sales

In 2005, our revenues from the sales of crude oil decreased by RR 2,126 million, or 35.3%, compared to 2004, due to a reduction in the overall volumes of crude oil sold during the 2005 period, which was offset by higher prices in 2005 for both the export and domestic markets.

Total sales volumes of crude oil decreased in 2005 by 727 thousand tons, or 45.8%, compared to 2004. The decrease in sales volumes of crude oil in 2005 was due to the migration of processing of our unstable de-ethanized gas condensate from the Surgutsky refinery to the Purovsky Plant (stable gas condensate from the Surgutsky refinery is sold as crude oil), lower percentage of stable gas condensate in the product mix received from the Surgutsky refinery in the 2005 period and the divestiture of our participation interest in Geoilbent in June 2005.

Our average realized sales price translated into US dollars for crude oil exported to international markets increased by USD 40.7 per ton, or 23.3%, to USD 215.7 per ton in 2005 compared to USD 175.0 per ton in 2004, primarily due to the higher pricing environment in the international crude oil markets during 2005. Our

average realized crude oil domestic sales price increased by RR 747 per ton, or 22.3%, to RR 4,100 per ton in 2005, compared to RR 3,353 per ton in 2004, due to the strengthening of domestic crude oil prices in 2005.

Stable gas condensate sales

In 2005, our revenues from sales of stable gas condensate were RR 6,349 million compared to nil in 2004, and are directly related to the launch of our Purovsky Plant in June 2005. The volumes of stable gas condensate received from the Purovsky Plant are sold separately from the volumes received from the Surgutsky refinery and, as such, are not included in revenues from crude oil sales.

In 2005, we exported substantially all of our stable gas condensate volumes, 760 thousand tons, from the Purovsky Plant to markets in the United States and Europe using the loading and storage facilities at the Port of Vitino on the White Sea. In 2005, our average realized price translated into US dollars for stable gas condensate sold on the export market was USD 294.8 per ton, while prices on the domestic market were RR 6,268 per ton.

Liquefied petroleum gas sales

In 2005, our revenues from the sales of LPG were RR 1,472 million, compared to nil in 2004, and are directly related to the launch of our Purovsky Plant in June 2005. In 2005, we sold 241 thousand tons of LPG, of which, 88.3% was sold domestically for an average price of RR 5,647 per ton and the remaining volumes were sold to the export market for an average price of USD 336.4 per ton.

Oil products sales

In 2005, our revenue from the sales of oil products increased by RR 747 million, or 36.4%, compared to 2004. The increase in oil products revenues was primarily due to an increase in the average domestic price of RR 825 per ton, or 21.2%, to RR 4,704 per ton in 2005, compared to RR 3,879 per ton in 2004, and to a lesser extent a 13.7% increase in sales volumes in 2005 compared to 2004. In 2005, sales volumes from the Surgutsky refinery amounted to 595 thousand tons compared to 523 thousand tons in 2004. The main oil products sold were diesel fuel, light distillate and naphtha. We sold 100% of our oil products' volumes to the domestic market in 2005 as we were able to realize better margins for light distillate and diesel fuel. The domestic market for oil products in 2004 was characterized by generally lower prices across all oil products categories and we received a lower proportion of higher margin processed volumes from the Surgutsky refinery in 2004 compared to 2005.

Sales of polymer and insulation tape

In 2005, our revenues from the sales of polymer and insulation tape increased to RR 964 million compared to RR 617 million in 2004, due to higher sales volumes and prices. In 2005, we commenced production of BOPP film wrap at our subsidiary NOVATEK-Polimer which generated RR 88 million in revenue. In 2005, other polymers sales contributed an additional RR 876 million in revenues compared to RR 617 million in 2004.

Other revenues

Other revenues include rent, polymer tolling, telecommunication and other services. In 2005, other revenues decreased by RR 143 million, or 31.4%, from RR 313 million compared to RR 456 million in 2004. The decrease was due to the divestiture of certain non-core businesses in 2005 and 2004.

Operating expenses

In 2005, operating expenses increased by RR 5,748 million, or 33.6%, to RR 22,861 million compared to RR 17,113 million in 2004. Operating expenses decreased as a percentage of total revenues to 59.3% in 2005 compared to 70.9% in 2004, as shown in the table below.

Categories	Year ended 31 December 2005 (RR million)	2005 (& of total revenues)	2004 (RR million)	2004 (& of total revenues)
Materials, services and other expense	3,473	*9%*	3,795	*16%*
Purchases of natural gas, gas condensate and crude oil	2,065	*5%*	5,708	*24%*
Transportation expenses	6,605	*17%*	3,690	*15%*
Taxes other than income tax	4,494	*12%*	1,569	*6%*
General and administrative expenses	2,417	*6%*	1,605	*7%*
Depreciation, depletion and amortization	3,372	*9%*	681	*3%*
Net impairment expense (benefit)	87	*0%*	(118)	*(1%)*
Exploration expenses	348	*1%*	183	*1%*
Total operating expenses	**22,861**	***59%***	**17,113**	***71%***

Materials, services and other expense

In 2005, our materials, services and other expense decreased by RR 322 million, or 8.5%, to RR 3,473 million compared to RR 3,795 million in 2004. The change in the expense was primarily due to the acquisition of Tarkosaleneftegas and Khancheyneftegas in December 2004 and the launch of the Purovsky Plant in June 2005, which accounted for RR 1,193 million, or 34.3%, and RR 142 million, or 4.1%, of total materials, services and other expense in 2005 compared to nil in 2004. These additional expenses were offset by the divestiture of SNP Nova and Novafininvest in 2004 and a decrease in their expense of RR 3,496 million.

The main components of this expense in 2005 were materials and payroll expenses. Materials expense decreased by RR 382 million, or 24.0%, in 2005 compared to 2004. The divestiture of SNP Nova and Novafininvest resulted in a decrease of RR 1,504 million whereas the consolidation of Tarkosaleneftegas and Khancheyneftegas added RR 237 million and production growth at Novatek-Polimer resulted in an additional increase of RR 441 million.

In 2005, payroll expense increased by RR 486 million mainly due to the consolidation of Tarkosaleneftegas and Khancheyneftegas which added RR 518 million and payroll increases at Yurkharovneftegas and Nova ZPK, operator of the Purovsky Plant, of RR 109 million and RR 107 million, respectively. The increases in 2005 were offset by the divestiture of SNP Nova and Novafininvest in 2004 and a reduction in employees at Purneftegasgeologiya in 2005, resulting in a decrease of RR 152 million and RR 97 million, respectively.

Other factors responsible for the decrease in materials, services and other expense in 2005 compared to 2004 were decreases in construction and extraction services of RR 555 million which were offset by increases to repair and maintenance expense of RR 158 million.

Purchases of natural gas, gas condensate and crude oil

In 2005, our purchases of hydrocarbons decreased significantly due to the acquisition and subsequent consolidation of production from the East-Tarkosalinskoye and Khancheyskoye fields and the sale of Geoilbent in June 2005. In 2005, our purchases of natural gas included production from the West-Tarkosalinskoye field in the amount of 2,191 mmcm. This field was previously owned by us (See "Divestitures" above) and our net production of natural gas from this field in 2004 was 454 mmcm.

Transportation expense

Our total transportation expense in 2005 increased by RR 2,915 million, or 79.0%, compared to 2004. In 2005, transportation expense for natural gas increased by RR 2,114 million, or 72.0%, to RR 5,052 million compared to RR 2,938 million in 2004. The increase was due to a 31.1% increase in our sales volumes of natural gas sold to end-customers, for whom the cost of transportation is included in the sales price, and a 31.2% increase in our average natural gas transportation expense per mcm. The average tariff for transportation of natural gas in 2005 was RR 20.49 per mcm per 100 km compared to RR 17.26 per mcm per 100 km in 2004. The increase in volumes and transportation expense per mcm contributed roughly equally to the increase in natural gas transportation expense.

Transportation expenses for liquids by pipeline and by rail contained only export volumes delivered to customers while domestic transportation expense is recorded on a net basis with the respective revenue.

In 2005, our expense for transportation of crude oil to export markets decreased by RR 144 million, or 52.0%, compared to 2004. The decrease in crude oil transportation expense was primarily due to a reduction in export volumes delivered which was slightly offset by an increase in the expense per ton due to increases in the transportation tariff in 2005.

In 2005, our total expense for transportation of oil products, stable gas condensate and LPG by rail to export markets increased by RR 934 million compared to 2004, primarily due to a 788 thousand ton increase in combined export volumes of stable gas condensate and LPG in 2005.

In 2005, our expense for stable gas condensate and LPG transported by rail to export markets amounted to RR 800 million and RR 96 million, respectively, or approximately RR 1,052 per ton, and RR 3,373 per ton, respectively. The remaining RR 47 million was related to railway infrastructure maintenance and was not allocated between products. Transportation expenses for stable gas condensate and LPG was nil in 2004.

In 2005, we did not have any export sales of oil products whereas, in 2004, we transported 20 thousand tons of oil products at an expense of RR 9 million, or RR 450 per ton.

Taxes other than income tax

Taxes other than income tax expense are comprised of the following: “unified natural resources production tax” (UPT), property tax, excise tax, social taxes and other taxes and contributions. In 2005, taxes other than income tax increased by RR 2,925 million, or 186.4%, compared to 2004. The increase was primarily due to the consolidation of Tarkosaleneftegas and Khancheyneftegas in December 2004. Prior to the consolidation, taxes other than income tax attributable to these companies were not included as part of our expenses due to the fact that, as associates, these companies were accounted for under the equity method.

The increase in taxes other than income tax resulted primarily from a RR 3,074 million, or 237.7%, increase in the UPT due to increased hydrocarbon production volumes in 2005 compared to 2004 and an increase in the UPT rate for natural gas from RR 107 per mcm in 2004 to RR 135 per mcm in 2005. The consolidation of Tarkosaleneftegas and Khancheyneftegas in December 2004 and the subsequent increase in consolidated production accounted for RR 2,766 million, or 90.0%, of our UPT tax increase and 94.6% of the total increase in taxes other than income in 2005.

Effective 1 January 2005, the base rate for the UPT relating to crude oil increased from RR 347 per metric ton to RR 419 per metric ton.

In 2005, property tax expense increased by RR 221 million, or 208.5%, to RR 327 million compared to RR 106 million in 2004. The increase is related to significant additions of property, plant and equipment at the Yurkharovskoye field combined with the impact of the consolidation of property, plant and equipment of Tarkosaleneftegas and Khancheyneftegas in December 2004.

General and administrative expenses

In 2005, general and administrative expenses increased by RR 812 million, or 50.6%, to RR 2,417 million compared to RR 1,605 million in 2004. The main contributors to the change in the 2005 expense were the consolidation of Tarkosaleneftegas and Khancheyneftegas in December 2004 and the divestiture of SNP Nova and Novafininvest, also in 2004. The main components of this expense, comprising 77.9% of the 2005 expense, were payroll, insurance, social and charity and legal, audit and consulting expenses.

In 2005, payroll expenses increased by RR 372 million, or 58.8%, to RR 1,004 million compared to RR 632 million in 2004. The acquisition of Tarkosaleneftegas and Khancheyneftegas, in December 2004, contributed RR 119 million while increases in basic compensation and administrative staff at NOVATEK contributed RR 272 million to the increase in this expense. The launch of the Purovsky Plant and the related payroll expense for an additional 249 employees resulted in an additional increase of RR 36 million. The increases were offset by a reduction in payroll expenses of RR 77 million due to the divestiture of SNP Nova and Novafininvest in 2004.

In 2005, insurance expenses increased by RR 231 million, or 170.8%, to RR 367 million compared to RR 135 million in 2004. The increase was primarily due to the acquisition of Tarkosaleneftegas and Khancheyneftegas, in December 2004, which added RR 155 million, or 67.1%, to the overall increase for insurance on production assets. Additional increases in insurance expenses in 2005 were related to insurance on liquid inventories stored at the Surgutsky refinery, insurance on production assets (primarily Purovsky Plant) and Directors’ and Officers’ insurance resulting from the IPO in July 2005.

In 2005, social and charity expenses increased by RR 61 million, or 28.1%, compared to 2004, primarily due to continued support of education and other social programs. The acquisition of Tarkosaleneftegas and Khancheyneftegas resulted in an additional RR 23 million in social and charity expense in 2005.

In 2005, legal, audit and consulting services expenses increased by RR 37 million, or 18.8%, to RR 233 million compared to RR 196 million in 2004. The increase was primarily related to expenses incurred to undertake the IPO in July 2005.

In 2005, other general and administrative expenses increased by RR 110 million, or 26.5%, compared to 2004, due to increases in business trip, fire safety and security, rent and other administrative expenses.

Depreciation, depletion and amortization

Depreciation, depletion and amortization expense increased by RR 2,691 million in 2005, or 395.2%, compared to 2004. The increase was primarily due to our calculation of depreciation and depletion on a unit-of-production basis for our oil and gas properties, which increased by RR 2,671 million, or 457.4%. The increase was, largely attributable to growth in our production volumes combined with additions to property, plant and equipment at the Yurkharovskoye field and the impact of the consolidation of Tarkosaleneftegas and Khancheyneftegas in December 2004. The effect of the consolidation of Tarkosaleneftegas and Khancheyneftegas increased our depreciation expense by RR 2,417 million in 2005 while continued development at Yurkharovneftegas added RR 243 million..

Income from operations

As a result of the factors discussed above, our profit from operations increased by RR 11,712 million, or 153.8%, to RR 19,326 million in 2005 from RR 7,614 million in 2004. In 2005, our income from operations as a percentage of our total revenues increased to 50.2% compared to 31.5% in 2004.

Finance income (expense)

Finance expense increased from a net expense of RR 292 million in 2004 to a net expense of RR 729 million in 2005. The increase was the result of higher interest expense of RR 258 million primarily related to the Credit Linked Notes issued in June and December of 2004, which was partly offset by the early repayment of other loans. Foreign exchange loss increased from a net gain of RR 109 million in 2004 to a net loss of RR 280 million in 2005. The increase in foreign exchange loss was primarily due to US dollar denominated debt and the general strengthening of the US dollar in 2005 compared to 2004. The increase in interest expense and foreign exchange loss was partly offset by an increase in interest income of RR 210 million in 2005, compared to 2004, due to the provision of loans to related parties.

Share of income of associated companies

In 2005, our share of the net income of Tarkosaleneftegas and Khancheyneftegas was nil compared to RR 181 million in 2004, as we now consolidate these entities and no longer account for them as associated companies under the equity method of accounting due to the acquisition of the additional interests in these entities in December 2004. Our share of the net income of other associated companies decreased by RR 440 million to RR 143 million in 2005 compared to 2004 primarily due to the divestiture of our participation interest in Geoilbent in June 2005.

Income tax expense

Our overall effective income tax rates (total tax expense calculated as a percentage of our reported IFRS profit before income tax and share of net income from associates) were 27.3% and 28.9% for the years ended 31 December 2005 and 2004, respectively. Our effective income tax rate of 27.3% for the year ended 31 December 2005 is higher than our statutory income tax rate of 24% primarily due to an increase in non-deductible expenses and other non-temporary differences.

Profit for the period and earnings per share

As a result of the factors discussed above, our profit for the period increased by RR 7,694 million, or 128.9%, to RR 13,662 million in 2005 from RR 5,968 million in 2004. The profit attributable to NOVATEK shareholders increased by RR 8,003 million, or 140.6%, to RR 13,697 in 2005 from RR 5,694 million in 2004.

Our weighted average basic and diluted earnings per share increased to RR 4,511 per share in 2005 from RR 2,510 per share in 2004. The weighted average number of ordinary shares outstanding in 2005 and 2004 were 3,036,306 and 2,268,654, respectively. The increase was mainly due to a 140.6% increase in net profit attributable to shareholders of NOVATEK which was partly offset by an increase in the weighted average number of ordinary shares outstanding in 2005 compared to 2004. The weighted average number of shares was higher in the 2005 period due to the issuance of 789,276 new ordinary shares in connection with the acquisitions in December 2004 of the remaining interests in Tarkosaleneftegas and Khancheyneftegas (see “Acquisitions” above).

LIQUIDITY AND CAPITAL RESOURCES

Our primary sources of liquidity are the cash provided from operating activities, debt financing, and access to capital markets. Our plan going forward is to finance our budgeted capital expenditures, interest and dividend payments mainly out of operating cash flows supplemented by additional borrowings and equity, if needed. In addition, we intend to improve our debt profile by retiring a portion of our short-term rouble denominated debt and by refinancing our debt portfolio with long-term borrowings in roubles and other currencies.

Cash flows

The following table shows our net cash flows from operating, investing and financing activities for the year ended 31 December 2005 and 2004:

	Year ended 31 December		Change
millions of Russian roubles except ratios	**2005**	**2004**	**%**
Net cash provided by operating activities	10,246	4,817	113%
Net cash provided by (used for) investing activities	8,983	(12,892)	170%
Net cash provided by (used for) financing activities	(19,280)	9,433	(304%)
Current ratio	114%	64%	78%
Total debt to equity	16%	54%	(70%)
Long-term debt to long term debt and equity	2%	23%	(91%)

Net cash provided by operating activities

Net cash provided by operating activities increased by RR 5,429 million, or 112.7%, to RR 10,246 million in 2005 compared to RR 4,817 million in 2004. The increase was mainly attributable to significantly higher operating income from our oil and gas sales as a result of increases in our sales volumes and realized prices in 2005 compared to 2004. The positive impact on our cash flows due to higher sales volumes and realized prices was partially offset by an increase in income tax payments.

Net cash from investing activities

Net cash from investing activities increased by RR 21,875 million, or 170%, to RR 8,983 million in 2005 compared to net cash used in investing activities of RR 12,892 million in 2004. The increase in 2005 was primarily due to proceeds received from the disposals of Geoilbent, Selkupneftegas and Tambeyneftegas and repayment of a loan made to a related party. In 2005, the net cash used for investment in purchases of property plant and equipment, primarily associated with the continued development of our oil and gas activities, was slightly lower than in 2004 and the provision of short- and long-term loans was significantly lower in 2005 compared to 2004. In 2004, we provided short- and long-term loans to our associates, Tarkosaleneftegas and Khancheyneftegas, for the continued development of their oil and gas activities.

Net cash from financing activities

Net cash from financing activities decreased by RR 28,713 million, or 304%, to net cash used for financing activities of RR 19,280 million in 2005 compared to net cash provided by financing activities of RR 9,433 million in 2004. The decrease was primarily due to repayments of short- and long-term borrowings of RR 21,212 million in 2005 (See “Debt obligations” below).

Working capital

At 31 December 2005, our working capital surplus (current assets less current liabilities) was RR 1,490 million compared to a deficit of RR 5,105 million at 31 December 2004. In 2005, current assets increased by RR 2,788 million compared to 2004 primarily due to increases in prepayments and advances and trade and other receivables of RR 2,780 million, which was partially offset by a decrease in short-term loans receivable of RR 540 million and cash and cash equivalents of RR 47 million. In 2005, current liabilities decreased by RR 3,807 million compared to 2004 primarily due to a reduction in short-term debt of RR 2,566 million and a reduction in other taxes, income tax and accounts payable of RR 1,241 million in 2005.

Capital expenditures

Total capital expenditures on property, plant and equipment for 2005 and 2004 are as follows:

	Year ended 31 December		Change
millions of Russian roubles	**2005**	**2004**	**%**
Exploration and production	5,183	7,212	(28%)
Other	1,277	200	539%
Total	**6,460**	**7,412**	**(13%)**

Exploration and production expenditures represent our investments in developing our oil and gas properties. During 2005 and 2004, capital expenditures in exploration and production were mainly attributable to the construction of the Purovsky Plant and the storage and loading facilities at the Port of Vitino as well as further development at our three core fields. During 2005, we accrued and capitalized expenditures aggregating to approximately RR 1,200 million on the construction of the Purovsky Plant and the loading facilities at the Port of Vitino. In 2005, we also capitalized approximately RR 1,047 million for equipment relating to our BOPP facilities at Novatek-Polimer.

Capitalized interest of RR 608 million and RR 446 million was included within capital expenditures for the year ended 31 December 2005 and 2004, respectively.

Debt obligations

Our total debt obligations decreased by RR 14,906 million, or 62.1%, to RR 9,094 million at 31 December 2005 from RR 24,000 million at 31 December 2004. Our borrowings have been used primarily for the financing of capital expenditures related to development of our three core oil and gas fields and investment in related assets such as the construction of the Purovsky Plant and the loading facilities at the Port of Vitino.

Short-term debt

Our short-term debt obligations decreased by RR 4,188 million, or 77.8%, to RR 1,192 million at 31 December 2005 from RR 5,380 million at 31 December 2004.

Long-term debt

In 2005, we were able to repay a major portion of our long-term borrowings ahead of their respective maturity schedules due to an increase in operating cash flow, resulting from our 2005 financial performance, Geoilbent divestiture and the early repayment of a loan made to a related party in the amount of RR 7,755 million (USD 270 million). In 2005, loans repaid ahead of maturity consisted of rouble denominated loans from Sberbank, RR 3,354 million, Finance Department of YNAO, RR 1,130 million, Yamal Regional Fund of Development, RR 1,208 million, and a US dollar denominated loan to Vneshtorgbank, RR 2,834 million (USD 100 million). Also, in 2005, we repaid a US dollar denominated loan to C.R.R.B.V. in the amount of RR 2,856 (USD 100 million) in line with its scheduled maturity.

Our long-term debt at 31 December 2005 included loans from C.R.R.B.V., in the amount of RR 5,757 million (USD 200 million), repayable in June 2006 and bearing interest of 7.75% per annum and Russian rouble denominated bonds in the amount of RR 1,000 million, repayable in November 2006 and bearing interest of 9.4%.

QUALITATIVE AND QUANTITATIVE DISCLOSURES AND MARKET RISKS

We are exposed to market risk from changes in commodity prices, foreign currency exchange rates, and interest rates. We are exposed to commodity price risk as our crude oil destined for export sales are linked to oil product prices. We are exposed to foreign exchange risk to the extent that our sales revenues, costs, receivables, loans and debt are denominated in currencies other than Russian roubles. We are subject to market risk from changes in interest rates that may affect the cost of our financing. We do not currently use financial instruments, such as foreign exchange forward contracts, foreign currency options, interest rate swaps and forward rate agreements, to manage these market risks and we do not hold or issue derivative or other financial instruments for trading purposes.

Foreign currency risk

Our principal exchange rate risk involves changes in the value of the Russian rouble relative to the US dollar. At 31 December 2005, RR 6,116 million, or 67.3%, of our long-term debt was denominated in US dollars (out of approximately RR 9,094 million of our total borrowings, excluding promissory notes, at that date). Decreases in the value of the Russian rouble relative to the US dollar will increase our foreign currency denominated costs and expenses and our debt service obligations for foreign currency denominated borrowings in Russian rouble terms. A depreciation of the Russian rouble relative to the US dollar will also result in an increase in the value of our foreign currency borrowings in Russian rouble terms. We believe that the risks associated with our foreign currency exposure are partially mitigated by the fact that a portion of our total revenues, approximately 20% in 2005, is denominated in US dollars. As of 31 December 2005, the Russian rouble had depreciated against the US dollar by approximately 3.7% since 1 January 2005.

A hypothetical, instantaneous and unfavorable 10% change in currency exchange rates as of 31 December 2005 would have resulted in an estimated foreign exchange loss of approximately RR 680 million on foreign currency denominated borrowings held as of 31 December 2005. A hypothetical, instantaneous and unfavorable 10% change on the average currency exchange rate for 2005 would have resulted in additional interest expense of approximately RR 112 million in 2005, reflecting the hypothetical increased costs in rouble terms of servicing our foreign currency denominated borrowings held during 2005.

Commodity risk

Substantially all of our crude oil, stable gas condensate and LPG export sales are sold under spot contracts. Our export prices are linked to world crude oil prices. Worldwide political developments, natural disasters and the actions of the Organization of Petroleum Exporting Countries affect crude oil prices and thus our export prices.

We currently do not use any derivative instruments to hedge our production in order to decrease our price risk exposure.

The weather is another factor affecting demand for and, therefore, the price of natural gas. Changes in weather conditions from year to year can influence demand for natural gas and to some extent gas condensate and oil products. We currently do not enter into any significant hedging arrangements to mitigate the price risk of our sales activities.

Pipeline access

We transport substantially all of our natural gas through the Gazprom owned unified gas supply system (UGSS). Gazprom is responsible for gathering, transporting, dispatching and delivering substantially all natural gas supplies in Russia. Under existing legislation, Gazprom must provide access to the UGSS to all independent suppliers on a non-discriminatory basis provided there is capacity not being used by Gazprom. In practice, however, Gazprom exercises considerable discretion over access to the UGSS because it is the sole owner of information relating to capacity. There can be no assurance that Gazprom will continue to provide us with access to the UGSS, however, we have not been denied access in prior periods.

Ability to reinvest

Our business requires significant ongoing capital expenditures in order to grow our production. An extended period of low natural gas prices or high transportation tariffs would limit our ability to maintain an adequate level of capital expenditures, which in turn could limit our ability to increase current levels of production and deliveries of natural gas, gas condensate and crude oil, adversely affecting our results.

Off balance sheet activities

A 31 December 2005, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which are typically established for the purpose of facilitating off-balance sheet arrangements.

Critical accounting policies

Our financial statements reflect the selection and application of accounting policies that require management to make significant estimates and assumptions. We believe that the following are some of the most critical accounting policies that currently affect our financial position and results of operations.

Oil and gas exploration and production activities

We follow the successful efforts method of accounting for oil and gas properties which we believe is the most prudent and conservative accounting treatment for our oil and gas operations. Under the successful efforts method property acquisitions, successful exploratory wells, all development costs and support equipment and facilities are capitalized. Unsuccessful exploratory wells are charged to expense at the time the wells are determined to be non-productive. Production costs, overhead and all exploration costs other than exploratory drilling are charged to expense as incurred. Acquisition costs of unproved properties are evaluated periodically and any impairment assessed is charged to expense.

We calculate our depreciation, depletion and amortization of capitalized costs of oil and gas properties using the unit-of-production method for each field based upon proved developed reserves for exploration and development costs, and total proved reserves for acquisitions of proved properties. For this purpose, the oil and gas reserves of our fields have been determined based on estimates of mineral reserves prepared by us, and for our three core and newly appraised fields, reserves have been determined in accordance with internationally recognized definitions and were independently appraised by internationally recognized petroleum engineers. The present value of the estimated costs of dismantling oil and gas production facilities, including abandonment and site restoration costs, are recognized when the obligation is incurred and are included within the carrying value of property, plant and equipment, and therefore are subject to amortization thereon using the unit-of-production method.

Revenue recognition

Revenues from oil and gas sales and sales of polymer and insulation tape are recognized when such products are delivered to customers and title has transferred. Revenues are stated net of value-added tax, excise tax and export duties.

Revenues from rendering construction services were based on the stage of completion determined by reference to services performed to date as a percentage of total services to be performed.

Related party transactions

The following are considered to be our related parties:

- our associates are entities we do not control but over which we exercise significant influence and therefore we account for them in accordance with IAS No. 28, *Investments in Associates* (IAS 28);
- our major shareholders and their immediate relatives;
- our directors and officers and their immediate relatives;
- enterprises in which principal shareholders, officers and directors and their immediate relatives have control or significant influence; and
- other parties with which we deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests.

In considering each possible related party relationship, attention is directed to the nature and substance of the relationship, and not merely to its legal form. Our reported statements of income, balance sheets and statements of cash flows would be different had such transactions been carried out amongst unrelated parties. Related parties may enter into transactions that unrelated parties might not, and transactions between related parties may not be executed on the same terms, conditions and amounts as transactions between unrelated parties.

Business combinations

On 31 March 2004, the International Accounting Standards Board (IASB) issued IFRS No. 3, *Business Combinations* (IFRS 3), on accounting for business combinations and revised Standard IAS No. 36, *Impairment of Assets* (IAS 36) and IAS No. 38, *Intangible Assets* (IAS 38). The main features of the new and revised standards are that all business combinations within the scope of IFRS 3 must be accounted for using the purchase method. The previously permitted pooling-of-interest method is prohibited. Identifiable assets acquired, liabilities, and contingent liabilities incurred or assumed must be initially measured at fair value. Intangible items

acquired in a business combination must be recognized as assets separately from goodwill if they meet the definition of an asset, are either separable or arise from contractual or other legal rights, and their fair value can be measured reliably. Amortization of goodwill and intangible assets with indefinite useful lives is prohibited. Instead, they must be tested for impairment annually or more frequently if events or changes in circumstances indicate a possible impairment. IFRS 3 allows for the use of provisional values in the initial accounting for a business combination if the fair values of assets and liabilities purchased or the cost of the combination can only be determined provisionally. Adjustments to the provisional values are expected to be finalized within 12 months of the acquisition date. These standards apply to business combinations commencing on or after 31 March 2004. We have accounted for our December 2004 acquisitions of the remaining equity interests in Tarkosaleneftegas and Khancheyneftegas that we did not previously own in accordance with provisions promulgated in IFRS 3, IAS 36 and IAS 38.

We applied the transitional rules of IFRS 3. *Business Combinations*, in respect of goodwill and negative goodwill arising from business combinations for which the agreement date was before 31 March 2004. Consequently, beginning 1 January 2005, previously recognized goodwill was no longer amortized and will be tested for impairment in accordance with IAS 36, *Impairment of Assets*, and on 1 January 2005, previously recognized negative goodwill of RR 762 million was reversed with a corresponding adjustment to the opening balance of retained earnings.

New accounting developments

We prepare our financial statements in accordance with IFRS. As discussed within the Business Combinations section above, we were required to adopt the provisions of IFRS 3, *Business Combinations*, for all business combinations within the scope of IFRS 3 from 31 March 2004.

In December 2003, the International Accounting Standards Board issued amendments to 15 existing IFRS standards that became effective 1 January 2005. The application of these 15 revised IFRS standards has not had a material effect on our financial position, statements of income or cash flows. In 2004, the IASB published five new standards, two revisions and two amendments to existing standards. In addition, the IFRIC issued six new interpretations in 2004. Significant changes relevant to us are discussed below.

The revisions to IAS 1, *Presentation of Financial Statements*, clarify certain presentation requirements. Most significantly, the revised standard requires that minority interest be presented within equity.

IAS 24, *Related Party Disclosures*, as revised, requires the disclosure of compensation of key management personnel and clarifies that such personnel include non-executive directors.

Other revised and amended standards effective on 1 January 2005 are as follows: IAS 2, *Inventories*; IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors; IAS 10, *Events after the Balance Sheet Date*; IAS 16, *Property, Plant and Equipment*; IAS 17, *Leases*; IAS 19, *Employee Benefits*; IAS 21, *The Effects of Changes in Foreign Exchange Rates*; IAS 27, *Consolidated and Separate Financial Statements*; IAS 28, *Investments in Associates*; IAS 31, *Investments in Joint Ventures*; IAS 32, *Financial Instruments: Disclosure and Presentation*; IAS 33, *Earnings per Share*; IAS 36, *Impairment of Assets*; IAS 38, *Intangible Assets*; and IAS 39, *Financial Instruments: Recognition and Measurement*. The adoption of these revised and amended standards has not had a material effect on our financial position, statements of income or of cash flows.

Other new standards and interpretations that we early adopted on 1 January 2005 are as follows: IAS 19 (amended), *Employee Benefits*, IFRS 4, *Insurance Contracts*; IFRIC 3, *Emission Rights*; IFRIC 4, *Determining whether an Arrangement contains a Lease*; IFRIC 5, *Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds* and IFRIC Amendment to SIC-12. The adoption of these standards did not have a material impact on our financial position, statements of income or of cash flows.

Accounting policies significant to us that were adopted or modified on 1 January 2005 are discussed below.

Share based payments. We account for share-based payments in accordance with IFRS 2, *Share-based Payment* (IFRS 2). The fair value of the employee services received in exchange for the grant of the equity instruments is recognized as an expense. The total amount to be expensed over the vesting period is determined by reference to the fair value of the instruments granted. The proceeds received net of any directly attributable transaction costs are credited to share capital (nominal value) and share premium when the options are exercised. For transactions with parties other than employees, we account for the transaction based upon the fair value of goods or services provided, unless the fair values are not reliably estimable. The adoption of IFRS 2 did not have a material effect on us as we had no outstanding share-based awards at 1 January 2005.

For share-based payments made to employees by shareholders, an increase to additional paid in capital is recorded equal to the associated compensation expense each period.

Business combinations. See ''Critical accounting policies'' above. We account for business combinations in accordance with the provisions of IFRS 3, *Business Combinations* (IFRS 3).

Non-current assets held for sale and discontinued operations. We account for non-current assets held for sale and discontinued operations in accordance with IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*. IFRS 5 replaced IAS 35, *Discontinuing Operations*. Assets or disposal groups that are classified as held for sale are presented separately on the balance sheet and are carried at the lower of the carrying amount and fair value less costs to sell. Additionally, the results of discontinued operations are shown separately on the face of the income statement. The adoption of IFRS 5 did not have a material effect on us.

On 1 January 2005, we early adopted IFRS 6, *Exploration for and Evaluation of Mineral Resources*. This standard provides guidance on accounting for costs incurred in the exploration for and evaluation of mineral resources. Adoption of the standard did not have a material effect on us and did not result in changes to our accounting policies.