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 as of December 31, 2003, 2002 and 2001 and the years then ended in conjunction with our audited financial statements as of and for the years ended December 31, 2003 and 2002. All RR amounts related to financial information for periods prior to 2003 are expressed in constant RR as of December 31, 2002 purchasing power, unless otherwise noted. As the characteristics of the economic environment of the Russian Federation indicate that hyperinflation has ceased, effective from January 1, 2003, we no longer apply the provisions of IAS 29, "Financial Reporting in Hyperinflationary Economies." Accordingly, no adjustment for the effects of changes in general purchasing power have been made for periods starting from January 1, 2003. The U.S. dollar amounts, except as indicated, have been translated from the RR amounts at the rate of RR29.45 = U.S.$1.00, which is the rate published by the Central Bank of Russia on December 31, 2003.

Overview

We are the world's largest natural gas company, and the world's largest publicly-traded hydrocarbons company, in terms of reserves, transportation and production volumes. Our revenues are primarily derived from sales of natural gas to western and central Europe, Russia and other former Soviet Union countries.

We divide our operations into the following four main business segments:

- Production: exploration, development and production operations relating to natural gas and other hydrocarbons. These activities are primarily located within Russia.
- Refining: processing and refining of natural gas, gas condensate and other hydrocarbons (including crude oil), and sale of hydrocarbon products. Operations relating to refining of natural gas, gas condensate and oil increased during 2001 due to our acquisition of OAO AK Sibur ("Sibur") (see "—Certain Acquisitions and Dispositions"). Sibur's operations significantly increased in the year ended December 31, 2003 following the completion of bankruptcy procedures in September 2002.
- Transportation: transportation of natural gas through the world's largest high-pressure trunk pipeline system (151,600 km). We own and operate a single centrally controlled system for natural gas production, processing, transportation, storage and deliveries. Beginning in the late 1990s, we began acquiring interests in gas distribution companies that own and operate medium-and low-pressure pipelines.
- Distribution: domestic and export sale of natural gas. We are the world's largest exporter of natural gas.

Other businesses primarily comprise banking, insurance, construction and media. These businesses are not separately reflected in our financial statements because they do not represent individually material segments.

Our four main business segments are mutually dependent, with a significant portion of the revenues of one segment comprising a part of the costs of another segment. In particular, our Distribution and Refining segments purchase natural gas from our Production segment and transportation services from our Transportation segment. We establish internal transfer prices to provide for the funding requirements of our individual subsidiaries within each segment. Accordingly, the results of operations of these segments on a stand-alone basis do not necessarily represent that segment's underlying financial position and results of operations as if it were a stand-alone business. For this reason, we do not analyze any of our main segments separately in the discussion that follows.

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 condition and results of operations.

Gas and oil exploration and production activities

Gas and oil exploration and production activities are accounted for in accordance with the successful efforts method as it provides timely accounting of the success or failure of our exploration and production activities. Under the successful efforts method, costs of successful development and exploratory wells are capitalized. Costs of unsuccessful exploratory wells are expensed upon determination that the well does not justify commercial development. Other exploration costs are expensed as incurred.

Assets associated with exploration and production activities are depreciated on a straight-line basis calculated on the basis of cost. International Financial Reporting Standards ("IFRS") do not specifically require the use of the units-of-production method for the depreciation, depletion and amortization of gas production assets, primarily because there is no specific accounting standard for oil and gas producing companies. In making our estimates of depreciation, and considering the corresponding asset lives, we include in proved reserves those reserves that relate to quantities that will be produced beyond the initial license period date in circumstances where we have both the right to request and the intent to renew the license. A significant increase or decrease in reserves or the terms of our licenses could result in shorter or longer estimated useful lives for depreciation of assets.

Impairment provision for accounts receivable

The impairment provision for accounts receivable is based on our assessment of the collectibility of specific customer accounts. If there is deterioration in a major customer's creditworthiness or actual defaults are higher than our estimates, the actual results could differ from these estimates.

Impairment of other assets and accounting for provisions

At each balance sheet date we assess whether there is any indication that the recoverable amount of our assets has declined below the carrying value. The recoverable amount is the higher of an asset's net selling price and its value in use. When such a decline is identified, the carrying amount is reduced to the recoverable amount. The amount of the reduction is recorded in the consolidated statement of operations in the period in which the reduction is identified. If conditions change and management determines that the asset value has increased, the impairment provision will be fully or partially reversed.

Our accounting for impairment includes provisions against capital construction projects, investments, other long-term assets and inventory obsolescence. The provisions for liabilities and charges primarily include provisions for guarantees, environmental and pension liabilities. We record impairment or accrue these provisions when our assessments indicate that it is probable that a liability has been incurred or an asset will not be recovered, and an amount can be reasonably estimated. Our estimates for provisions for liabilities and charges are based on currently available facts and our estimates of the ultimate outcome or resolution of the liability in the future. Actual results may differ from our estimates, and our estimates can be revised in the future, either negatively or positively, depending upon the outcome or expectations based on the facts surrounding each exposure.

Because of our operating cycle, certain significant decisions about capital construction projects are made after the end of our fiscal year. Accordingly, we typically have larger impairment charges or releases in the fourth quarter of our fiscal year as compared to other quarters. For example, in 2003 we recorded a fourth quarter impairment provision release of RR5,701 million related to assets under construction compared to a RR3,923 million impairment provision for the first nine months of 2003. In 2002 we recorded a fourth quarter impairment provision release of RR6,883 million related to assets under construction compared to a nil impairment provision for the first nine months of 2002.

Interest costs on borrowings

We capitalize interest costs on borrowings as part of the cost of assets under construction during the period required to prepare the assets for their intended use. All other borrowing costs are expensed. IFRS permits but does not require the capitalization of borrowing costs for qualifying assets. We capitalize borrowing costs that relate to funds borrowed specifically for, and funds borrowed generally and deemed to be used for, the purpose of assets under construction. For general borrowings, the borrowing costs eligible for capitalization are determined by applying a capitalization rate to the cumulative expenditures on assets under construction. This rate represents the weighted average of the borrowing costs applicable to the general borrowings. The amount of interest costs capitalized is primarily affected by the level of capital expenditures for assets under construction, interest rates and total borrowings.

Profit tax and other taxes

Tax legislation in the Russian Federation is subject to varying interpretations and frequent changes.

Deferred tax assets and liabilities are calculated in respect of temporary differences using a balance sheet liability method. Deferred tax is recorded for all temporary differences arising between the tax basis of assets and liabilities and their carrying values for financial reporting purposes. A deferred tax asset is recorded only to the extent that it is probable that future taxable profit will be available against which the deductible temporary differences can be utilized. Deferred tax assets and liabilities are measured at tax rates that are expected to apply to the period when the asset is realized or the liability is settled, based on tax rates that have been enacted or substantively enacted at the balance sheet date.

Site restoration and environmental costs

Site restoration costs that may be incurred by us at the end of the operating life of certain of our facilities and properties are recognized when we have a present legal or constructive obligation as a result of past events, and it is probable that an outflow of resources will be required to settle the obligation, and a reliable estimate of the amount of the obligation can be made. The cost is depreciated through our statement of income on a straight-line basis over the asset's productive life.

IFRS prescribes the recording of liabilities for these costs. Estimating the amounts and timing of those obligations that should be recorded requires significant judgment. This judgment is based on cost and engineering studies using currently available technology and is based on current environmental regulations. Liabilities for site restoration are subject to change because of change in laws and regulations, and their interpretation.

Certain Factors Affecting our Results of Operations

The primary factor that affects our results of operations is the price for which we can sell our natural gas and other hydrocarbon products, both internationally and in Russia. Other factors affecting our results are:

- the impact of fluctuations in RR exchange rates against the U.S. dollar and euro and, prior to 2003, of changes in the purchasing power of the RR resulting from inflation in Russia;
- our high tax burden;
- interest rates and discounts on promissory notes;
- non-cash settlements; and
- impairment of assets.

The export price of natural gas

Our results of operations are heavily reliant on natural gas export prices. Prices for the natural gas we export increased considerably in 2001 in U.S. dollar terms (although they declined in constant RR terms in 2001), and then declined during the first six months of 2002, and increased for the last six months of 2002 and the year ended December 31, 2003. Export gas prices to European countries are indexed mainly to oil product prices as stipulated in long-term contracts and, therefore, fluctuate based on world oil prices. Due to the formulae underlying our long-term contracts, our prices are not as volatile on a short-term basis as spot oil prices and tend to lag upward and downward movements in oil prices by approximately six to nine months.

Our business requires significant ongoing capital expenditures in order to maintain our production and transportation systems. An extended period of low gas prices would limit our ability to maintain an adequate level of capital expenditures, which in turn could limit our ability to maintain current levels of production and deliveries of gas, adversely affecting our results.

The European Union Gas Directive of June 22, 1998, and the new Gas Directive of June 26, 2003 that replaced it, have established common rules for the transmission, distribution, supply and storage of natural gas in the European market and may cause substantial changes to existing European market structures and to the overall level and volatility of prices.

Natural gas export prices for sales to FSU countries are generally based on one-year fixed price contracts. Average natural gas export prices to FSU countries are more than 50% below the level of those for European countries. This is partly due to lower transportation costs and excise tax burdens but is principally due to the impact of intergovernmental agreements, which effectively limit the prices we can charge to FSU countries.

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 do not enter into any significant hedging arrangements to mitigate the price risk of our sales activities.

The following table shows our average natural gas export price to Europe and FSU countries (including excise tax and net of VAT) for the years ended December 31, 2003, 2002 and 2001:

	Year ended December 31,		
	2003	**2002**	**2001**
	(including excise tax, net of VAT and customs duties)		
Our natural gas export price to Europe (average actual realized U.S.$ per mcm)(1)	123.9	102.5	122.6
Our natural gas export price to Europe (average actual realized U.S.$ per mcf)(1)	3.5	2.9	3.5
Our natural gas export price to Europe (average constant RR per mcm, except for 2003 amount which is in nominal RR)	3,782.3	3,369.0	4,100.0
Our natural gas export price to FSU countries (average actual realized U.S.$ per mcm)(2)	40.9	45.4	41.5
Our natural gas export price to FSU countries (average actual realized U.S.$ per mcf)(2)	1.2	1.5	1.2
Our natural gas export price to FSU countries (average constant RR per mcm, except for 2003 amount which is in nominal RR)	1,256.6	1,444.2	1,417.5

Notes:

(1) Average actual realized nominal prices and not convenience translations of constant RR prices.

(2) Average actual realized nominal prices and not convenience translations of constant RR prices, except sales to Belarus, which are made in RR and for the purposes hereof converted to dollars at the end of each month at the exchange rate then in effect.

Regulation of domestic natural gas prices and transportation tariffs

Natural gas prices and transportation tariffs in Russia are regulated by the Natural Monopoly Law and the Gas Supply Law, as well as by a number of supplemental Government resolutions, and do not currently fluctuate based on supply and demand. The Federal Energy Commission of the Russian Federation ("FEC") regulates natural monopolies, including the establishment and regulation of natural gas prices and transportation tariffs. From March 2004 the FEC was reorganized into the Federal Tariffs Service ("FTS").

Natural gas prices in Russia have remained significantly below export prices (even after netting back export tariffs and transportation costs) primarily due to Governmental regulation, by the FEC (and now the FTS). Over the last five years the FEC reset domestic gas tariffs at rates that, on a cumulative basis, failed to recover fully the effects of inflation. As of December 31, 2003 the domestic natural gas price was 198% higher in nominal RR terms than in 1997, whereas cumulative inflation over the period from December 31, 1997 to December 31, 2002 was 314%, and 363% over the period from December 31, 1997 to December 31, 2003.

Since 2000, however, domestic natural gas prices have increased at a rate greater than inflation. Our average domestic natural gas sales prices were equivalent to RR668.7 per mcm in 2003, RR535.7 per mcm in 2002 and RR442.8 per mcm in 2001, all expressed in constant RR, except for 2003 data which is in nominal RR.

The following table shows our average domestic natural gas price (including excise tax and net of VAT) for the years ended December 31, 2003, 2002 and 2001:

	Year ended December 31,		
	2003	2002	2001
	(including excise tax, net of VAT)		
Our domestic natural gas price (average actual realized RR per mcm)	668.7	505.0	357.9
Our domestic natural gas price (average actual realized RR per mcf)	18.9	14.3	10.1
Our domestic natural gas price (average constant RR per mcm, except for 2003 amount which is in nominal RR)(1)	668.7	535.7	442.8
Our domestic natural gas price (average constant RR per mcf, except for 2003 amount which is in nominal RR)(1)	18.9	15.2	12.5
Our domestic natural gas price (average U.S.$ per mcm)(2)	21.8	16.0	11.9
Our domestic natural gas price (average U.S.$ per mcf)(2)	0.6	0.5	0.3

Notes:

(1) Constant RR price in terms of the equivalent purchasing power of the RR as of December 31, 2002.

(2) Translated from average actual realized RR price for convenience only using period-end exchange rates.

The Government has allowed domestic gas prices to increase and may continue to do so in the foreseeable future. The Government is considering the introduction of an unregulated wholesale domestic market where some natural gas can be sold at prices determined by market forces. Concerns about inflation and political considerations constrain the Government's ability to move rapidly in this direction, however. For example, we proposed that natural gas prices should increase by 38% on average in 2003 (40% for industrial consumers and 20% for household consumers), but the Government approved an average increase of only 20% (a 20% increase for industrial consumers commencing January 1, 2003 and a 23% increase for household consumers commencing February 1, 2003). Prices for both industrial and household consumers were increased by a further 20% with effect from January 1, 2004.

During the years ended December 31, 2003, 2002 and 2001, our sales revenues derived from the transport of gas produced by third parties were relatively small, though increasing.

Impact of fluctuations in RR exchange rates against the U.S. dollar and the euro and of change in purchasing power of the RR

Impact of inflation and changes in exchange rates on export sales and operating margins. 63%, 64% and 67% of our gross sales (including excise tax and net of VAT and customs duties) for the years ended December 31, 2003, 2002 and 2001, respectively were denominated in U.S. dollars or euros, while most of our costs were denominated in RR. The relative movements of inflation and exchange rates therefore significantly affect our results of operations. In particular, our operating margins are generally adversely affected by a real appreciation of the RR against the U.S. dollar or euro, because this will generally cause our costs to increase in real terms relative to our sales revenues. Conversely, our operating margins are generally positively affected by a real depreciation of the RR against the U.S. dollar or euro, because this will generally cause our costs to decrease in real terms relative to our sales revenues.

The following table sets forth the rates of inflation in Russia, the rates of nominal appreciation or depreciation of the RR against the U.S. dollar and euro and the rates of real change in the value of the RR against the U.S. dollar and euro for the periods shown.

	Year ended December 31,		
	2003	2002	2001
Inflation (CPI)	12.0%	15.1%	18.8%
Nominal (appreciation) depreciation of the RR against the U.S.$	(7.3)%	5.4%	7.0%
Real appreciation of the RR against the U.S.$	20.9%	9.2%	11.0%
Nominal depreciation of the RR against the euro	11.2%	25.0%	1.3%
Real appreciation (depreciation) of the RR against the euro	0.7%	(7.9)%	17.2%

Period to period comparisons of our export sales revenues, as restated in constant RR for periods prior to 2003, have been significantly affected by the real change in the value of the RR against the U.S. dollar and the euro. If our actual realized U.S. dollar or euro prices and the related sales for any periods before 2003 being compared were the same, but between the periods the RR appreciated in real terms against the U.S. dollar or the euro, the related sales expressed in constant RR would have declined from one period to the next. If the real appreciation of the RR were great enough, our export prices and sales expressed in constant RR would have declined from one period to the next even in circumstances where our actual realized U.S. dollar prices and the related sales would have increased. Conversely, if the RR depreciated in real terms against the U.S. dollar or the euro, our prices and the related sales expressed in constant RR would have increased from one period to the next even if our actual realized U.S. dollar or euro prices and related sales remained unchanged, and could have increased even if our U.S. dollar or euro prices and related sales declined.

Impact of inflation accounting and presentation in our financial statements of constant RR. Until December 31, 2002, our financial results, including comparatives, include a restatement for changes in the general purchasing power of the RR in accordance with IAS 29. IAS 29 requires that financial statements prepared in the currency of a hyperinflationary economy be stated in terms of the measuring unit current at the balance sheet date. The restatement is calculated from the conversion factors derived from the Russian Federation Consumer Price Index, published by the Russian State Committee on Statistics ("Goskomstat"), and from indices obtained from other published sources for years prior to 1992. As the Russian economy is no longer considered to be hyperinflationary, from January 1, 2003 we no longer apply IAS 29.

The impact of stating our financial information in terms of the measuring unit current at the balance sheet dates, prior to and as of December 31, 2002, was to:

- inflate the current period transactions recorded in the statement of operations of the local statutory books by the average rate of inflation for the period in order to state them in terms of the purchasing power of the RR as of the balance sheet date (i.e., using the average inflation factor of 1.0638 for all relevant transactions in the year ended December 31, 2002);
- restate the period end non-monetary assets and liabilities and shareholders' equity, including share capital, in terms of the measuring unit current as of the period-end; and
- restate all comparatives, monetary and non-monetary items, in terms of the purchasing power of the RR as of December 31, 2002 (i.e., for the information included herein, to inflate the comparatives in terms of the purchasing power of the RR as of December 31, 2002).

The restatement of all comparatives, in particular, had a significant impact on our reported sales and operating profit. For example, domestic sales expressed in constant RR decreased when increases in nominal prices were lower than inflation and increased less than might otherwise be expected even when increases in nominal prices were higher than inflation. Our ability to increase the prices we charge for our natural gas sales in the domestic market is constrained by Government regulations. Moreover, as we discuss more fully below, the impact of U.S. dollar and euro price increases for our export sales was offset in recent periods, and the impact of U.S. dollar and euro price decreases was magnified in recent periods, by the real appreciation of the RR (i.e., by a rate of inflation that is higher than the rate at which the RR is depreciating against the U.S. dollar or euro). As a result, our reported sales lagged behind the changes in our average actual realized prices in nominal terms. On the other hand, our costs, which are mainly in RR and are generally not regulated, tended to increase in line with or above inflation in recent periods.

In addition, the restatement of all comparatives had a significant impact on our debt balances. For example, even though we borrowed more than we repaid during the years ended December 31, 2003, 2002 and 2001, the restatement of our comparatives into current purchasing power resulted in our reported debt balances having declined at each period end until December 31, 2002. For a discussion of our debt obligations, see "—Liquidity and Capital Resources—Debt obligations."

Impact of Monetary Effects. Our results of operations were also substantially affected prior to 2003 by the impact of nominal devaluation and inflation on the value of our monetary assets and liabilities. Nominal devaluation of the RR generally resulted in foreign exchange gains on monetary assets denominated in foreign currencies and foreign exchange losses on monetary liabilities denominated in foreign currencies. These gains and losses were recorded on a net basis in our statements of operations under the caption "Exchange gain (loss)." Inflation resulted in purchasing-power gains on monetary liabilities and purchasing power losses on monetary assets; because our financial statements for periods and as of dates prior to 2003 are price-level restated, these gains and losses are recorded on a net basis in our statements of operations for periods prior to 2003 under the caption "Monetary gain." There was no monetary gain for the year ended December 31, 2003 as the characteristics of the economic environment of the Russian Federation indicated that hyperinflation had ceased, and effective from January 1, 2003 we no longer apply the provisions of IAS 29. Accordingly, no adjustments for the effects of changes in general purchasing power are recorded in the financial statements beginning January 1, 2003.

Our historically high tax burden

We are subject to a wide range of taxes imposed at federal, regional, and local levels and are one of the largest sources of tax revenue to the federal authorities in Russia, as well as to the regional and local authorities in those regions and localities in which we operate. The combination of political pressure on the federal, regional and local authorities to address social and economic issues and the difficulties associated with collecting taxes from companies and enterprises in financial difficulties, all increase the risk that the Government, as well as regional and local governments, will seek to mitigate these problems by increasing our already substantial tax burden.

Given the relative size of our activities in Russia, our tax burden is largely determined by the taxes payable in Russia.

In addition to profits tax, we are subject to a number of other taxes in Russia, many of which are based on revenue or volumetric measures. Royalty taxes, mineral extraction taxes and road users tax are calculated based on the revenue generated from exploration and production activities. Social taxes and contributions are a function of salaries and wages. Significant taxes to which we are subject include:

- excise tax (abolished effective January 1, 2004 for gas produced after January 1, 2004);
- VAT (reduced from 20% to 18% effective January 1, 2004) and sales tax (abolished effective January 1, 2004);
- natural resources production tax, which replaced royalty taxes and mineral extraction taxes effective January 1, 2002 (effective January 1, 2004 natural resources production tax for gas changed from 16.5% of the value of gas produced to a fixed rate of RR107/mcm, and for gas condensate from 16.5% of the value of gas condensate produced from gas condensate fields and RR340 per ton of gas condensate produced from oil and gas condensate fields (the latter rate being subject to adjustments depending on fluctuations of oil prices and the RR exchange rate) to a single rate of 17.5% of the value of gas condensate produced);
- gas export duty (increased from 5% to 30% effective January 1, 2004);
- property tax (increased from 2% to 2.2% effective January 1, 2004);
- road users tax (abolished effective January, 1 2003); and
- social taxes and contributions.

Our overall effective profit tax rates (current and deferred tax expense as a percentage of IFRS profit before profit tax and minority interest) for the years ended December 31, 2003, 2002 and 2001 were 31.6%, 82.1% and 92.0%, respectively, while the statutory income tax rates in Russia were 24%, 24% and 35% in 2003, 2002 and 2001, respectively. The significant difference between our effective profit tax rates and the statutory rates and the volatility of those rates since 2000 has been the result of:

- significant non-deductible expenses, primarily relating to social expenses;

- significant deferred tax benefits and expenses. In each period, temporary differences related to property, plant and equipment affected deferred taxes due to the fact that a significant proportion of the tax basis is based on values determined by independent appraisals while the financial reporting basis is historical cost restated for changes in the general purchasing power of the RR;
- the impact of accounting for inflation, which had been increasing our effective tax rate during the periods ending before 2003; and
- changes in Russian tax legislation.

Current profit tax expense for the years ended December 31, 2003, 2002 and 2001 was RR42,368 million, RR54,187 million and RR94,957 million, respectively. This represents effective current profit tax rates (current profit tax expense as a percentage of IFRS profit before tax and minority interest) for the years ended December 31, 2003, 2002 and 2001 of 17.9%, 32.7% and 41.0%, respectively. The general reduction of the current profit tax rate in the years ended December 31, 2003 and 2002 was primarily due to the shorter depreciation lives of fixed assets for tax purposes effective January 1, 2002, which increased depreciation for tax purposes and consequently reduced our current tax expense in those periods. The reduction of the current profit tax rate from the year ended December 31, 2002 to the year ended December 31, 2003 was primarily due to the effect of "transition period" profit tax charged as a one time expense in 2002 resulting from changes in tax legislation. See "—Results of Operations—Year ended December 31, 2003 versus year ended December 31, 2002—Profit tax."

Effective January 1, 2002, the Russian Government adopted new tax legislation. This tax legislation included a number of changes, the most significant of which for the profit tax were:

- a decrease in the statutory profit tax rate from 35% to 24%;
- the elimination of upper limits on the deductibility of expenses considered to be in the normal course of business;
- a general decrease in the useful lives of property, plant and equipment for tax accounting purposes;
- the elimination of independent appraisals or use of indices to increase the tax base of property, plant and equipment (capped to 30% of any increase associated with a revaluation as of January 1, 2002 and eliminated entirely thereafter). No independent appraisal was undertaken or revaluation recorded for tax purposes as of January 1, 2002 as we projected tax losses at our parent company, which holds most of our property, plant and equipment, in light of the decrease in the tax depreciation lives of property, plant and equipment and did not want to increase the taxable base for property tax purposes;
- the elimination of investment tax credits, although this has had and will have no significant impact because since June 1999 we have been unable to claim such credits due to the structure of our capital funding programs with subsidiaries. Our capital funding program is structured in such a way to maximize management control over capital expenditures throughout our consolidated Group. We believe that the advantages of tighter control outweigh the additional tax costs associated with the inability to claim the investment tax credits;
- the ability to deduct interest on business loans regardless of the source and use; and
- the ability to offset exploration expenditure against profit tax instead of against mineral restoration taxes.

We expect that our overall effective profit tax rate as a percentage of IFRS profit will continue to be higher than the statutory profit tax rate for the foreseeable future.

On September 3, 1999 the Government issued regulation #1002 allowing certain companies to restructure over ten years various overdue taxes, interest and fines due to the federal government authorities. During the years ended December 31, 2000, 2001 and 2002 certain of our subsidiaries signed such restructuring agreements. This resulted in the recognition of a gain in each of the respective periods based on the difference between the estimated fair value of the new agreements (based on discounted future cash flows) and the carrying amount of the old payables. This gain is reflected as gain on restructured taxes. Following the restructurings, we recognize the amortization of the discount (representing the difference between the nominal and discounted value of the restructured taxes) as interest expense on taxes payable. Interest accrues on the restructured tax payables (excluding interest and fines) at a rate of 5.5% per annum, representing 1/10 of the Central Bank's annual financing rate (55%) as specified in the regulation, and is paid quarterly. This interest is also included in interest expense on taxes payable. If the terms of the restructuring are violated, the original nominal value of the tax payable (including interest and fines) becomes due with additional interest of 1/300 of the Central Bank refinancing rate accruing daily. In the years ended December 31, 2003 and 2002 a number of our subsidiaries were able to extinguish part of the restructured interest and fines, having complied with the terms of the accelerated repayment schedules of such payables provided for by the regulation.

Interest rates

We have significant short-term and long-term debt obligations with both fixed and variable interest rates. Fluctuations in interest rates therefore affect our financial results. We do not have any significant hedging arrangements to mitigate interest rate risks resulting from our financing activities.

Non-cash settlements

Historically, in common with other Russian companies, we have entered into agreements to settle a number of transactions by the transfer of goods and services, or promissory notes, instead of cash. This practice has resulted principally from the following factors:

- high inflation in Russia;
- unreliable banking services;
- gas that we produce is required for the day-to-day operations of a number of our key suppliers; and
- contractual arrangements.

As the general economic climate in Russia has improved, the volume and value of these transactions has decreased significantly.

While the use of barter transactions and illiquid promissory notes to settle commercial transactions continues to be prevalent in Russia, our reliance on such non-cash transactions has decreased as a proportion of the value of our transactions. As can be seen in the table below, the percentage of non-cash settlements (i) related to total sales decreased from approximately 18% in the year ended December 31, 2001 to approximately 17% in the year ended December 31, 2003; (ii) related to domestic sales decreased from approximately 23% in the year ended December 31, 2001 to approximately 21% in the year ended December 31, 2003; and (iii) related to capital expenditures decreased from approximately 31% in the year ended December 31, 2001 to approximately 23% in the year ended December 31, 2003.

	Year ended December 31,		
	2003	2002	2001
% of non-cash settlements related to total gross sales .	17%	18%	18%
% of non-cash settlements related to gross domestic sales	21%	21%	23%
% of non-cash settlements related to total capital expenditures	23%	15%	31%

Barter transactions have been substantially reduced and now non-cash settlements primarily represent mutual cancellations using promissory notes. We receive promissory notes from our customers (both issued by customers and third parties) as settlement of receivables. Promissory notes issued by customers are recorded in the same manner as accounts receivable we originate (i.e., at estimated fair value). Promissory notes issued by other third parties are recorded as available-for-sale investments. We give promissory notes, mainly those of OAO Gazprom, to our suppliers in exchange for services or products. Such promissory notes are relatively liquid in the Russian market and are commonly traded by other Russian companies. The difference between the carrying value of the payables being settled and the face value of the promissory notes is recorded as interest expense within net finance costs. Promissory notes are shown separately in our balance sheet. See "—Liquidity and Capital Resources—Debt Obligations."

Impairment of assets

Historically, our results have been affected by impairment provisions on accounts receivable, inventory, property, plant and equipment (including assets under construction), investments and other long-term assets. Expenses for such impairment provisions were RR15,298 million, RR7,104 million and RR42,863 million for the years ended December 31, 2003, 2002 and 2001, respectively.

Our provisions for accounts receivable have been significant. As of December 31, 2003, the aggregate balance sheet provision for accounts receivable and prepayments was RR140,837 million or 32% of the gross receivable balance. Provisions for accounts receivable have related mainly to non-payment for natural gas sold to Ukraine, Moldova, Serbia and Montenegro and certain domestic consumers.

Our provisions for property, plant and equipment have also been significant. As of December 31, 2003, the aggregate balance sheet provision related to property, plant and equipment was RR93,466 million or 5% of gross property, plant and equipment. RR91,481 million of this aggregate balance sheet provision relates specifically to assets under construction, representing 30% of gross assets under construction. The impairment provision for assets under construction primarily relates to the following projects: RR19,190 million for part of the Obskaya-Bovanenkovo railroad construction; RR15,665 million for certain development projects in the Bovanenkovskoye and Kharasaveiskoye fields; and RR20,857 million for the Novy Urengoi Chemical Complex. Although these projects have not been abandoned, under the current investment program we do not believe they will generate positive cash flows in the future.

From 2002, the cumulative balance sheet provision against assets under construction has decreased. The decrease, generally caused by release of impairment provisions, primarily reflects the strategy of current management to focus on priority projects in a systematic way and begin to fund certain projects which had previously been frozen. As a result, the release of impairment provisions related to assets under construction generated income totalling RR1,788 million and RR6,883 million in 2003 and 2002, respectively. Because of our operating cycle, certain significant decisions about capital construction projects are made after the end of our fiscal year. Accordingly, we typically have larger charges (releases) in the fourth quarter of our fiscal year as compared to other quarters. For a discussion of our impairment provisions in the year ended December 31, 2003 and 2002, see "—Results of Operations—Year ended December 31, 2003 versus year ended December 31, 2002."

Certain Acquisitions and Dispositions

Since January 1, 2001, we have made a number of acquisitions and dispositions.

In 1999 we began participating in the creation of regional trade houses involved in the trading of gas in Russia. In 2002 our interest in the majority of such companies increased from 20% to 51% of their share capital and these companies were consolidated as subsidiaries.

In January 2001, we exchanged a 57% interest in Lebedinsky GOK ("LGOK"), a mining and ore enrichment company operating in the Russian Federation, and a 17% interest in the Oskolsky EMK for a 48% interest in ZAO Gazmetall ("Gazmetall"). Gazmetall is a metallurgical holding company with controlling interests in LGOK and the Oskolsky EMK. In March 2002, we sold our 48% interest in Gazmetall for U.S.$70 million to OAO Oskolsky Metallurgical Plant, a subsidiary of Gazmetall. The financial effect of these transactions was not material to our financial position or results of operations.

In January 2001, we acquired 50.7% of the voting shares of Sibur, a leading marketer of petrochemical products in Russia. The consideration of RR3,015 million consisted of a combination of cash, promissory notes issued by companies in our Group and other securities. Sibur was consolidated as a subsidiary effective from January 1, 2001. In the first quarter of 2002 external supervision was introduced, at our initiative, in respect of Sibur pursuant to a decision of the arbitration court. On September 10, 2002 a creditors' meeting approved an amicable settlement agreement, which was subsequently approved by the court. The agreement provided for the restructuring and rescheduling of Sibur debts generally over a period of eight years with first payments due in 2004. In the third quarter of 2002 we signed agreements to acquire additional interests in a number of Russian petrochemical companies, the majority of which were already affiliated with Sibur. In April 2003, following the completion of legal procedures we established control over majority of these companies and thereby increased our controlling interest in the share capital of Sibur from 50.7% to 75.7%. In respect of this acquisition the Group has issued the long-term promissory notes with a nominal value of RR 17,587 and an estimated fair value of approximately RR6,770 million. In September 2003 we acquired an additional 2.4% interest in Sibur for RR102 million. Fair values of the identifiable assets and liabilities of these companies have been determined on a provisional basis and might be subject to subsequent adjustments over the period to December 31, 2004. Any adjustments are not expected to be material to the Group's consolidated financial statements.

In 2000 OAO Zapsibgazprom ("Zapsibgazprom") issued additional shares, thereby decreasing our interest in its share capital from 51.1% to 34%. In April 2002, the Federal Commission for the Securities Market cancelled the registration of additional stock issued to third parties by Zapsibgazprom. As a result, we increased our interest in the ordinary share capital of Zapsibgazprom back from 34% to 51.1%. In December 2002, we sold our 12% interest in OAO Arcticgas with a carrying value of RR1 million to OAO NK Yukos in exchange for 25.6% of the shares of Zapsibgazprom with a nominal value of RR300,000 and additional cash consideration of U.S.$2.95 million. We thereby increased our interest in the share capital of Zapsibgazprom from 51.1% to 76.7%.

In April 2002 we acquired an additional 32.8% of the voting shares in our production subsidiary OAO Vostokgazprom for RR2 million, increasing our interest from 51.0% to 83.8%. We hold these additional shares through our subsidiary Gazprom UK Ltd.

During 2000, ZAO Media-Most ("Media-Most") defaulted on its payment obligation under certain loans, which we had guaranteed. We fulfilled our obligations under the guarantee, and in November 2000, signed agreements with Media-Most to change the collateral under the guarantees to obtain a 46% interest in OAO TV Company NTV ("NTV") and 25% plus one share interests in various other Media-Most operating companies. In July 2001 Media-Most defaulted on another loan, which we had guaranteed. After fulfilling our obligation under this loan guarantee, we obtained a further 19% interest in NTV and additional 25% interests in the other Media-Most operating companies. In July 2002, we acquired additional interests in Media-Most, in NTV and in certain of our other media subsidiaries, as well as payables and promissory notes to third parties due by these companies. The consideration was paid partly in cash and partly through the forgiveness of debt owed to OAO Gazprom. As a result of this transaction we increased our interest in NTV from 65.0% to 95.6% and in Media-Most from 14.3% to 38.6%. In October 2002, we signed a framework agreement to sell non-controlling interests in certain media companies, including NTV, to Evrofinance Group (as nominee), the consideration for which was partially settled in cash and partially through the settlement of certain debt obligations of Media-Most and its media companies to us. The interests to be sold primarily comprised those acquired in July 2002. As a result, our interest in NTV was reduced to 65.0%. Under the framework agreement, Evrofinance Group is to contribute cash and these acquired interests into a new media holding company, which will be controlled and majority-owned by us. Our contribution into the new holding company will comprise the remaining interests in certain of our media subsidiaries. We expect to complete these transactions in 2004.

In January 2003 in accordance with an option provided for by the NTV global depositary receipts ("GDRs") purchase agreement dated April 1, 2001, we acquired the GDRs from the SmallCap World Fund Inc. for U.S.$32.0 million paid in cash. In February 2003 the GDRs were exchanged for common shares of NTV and OAO TNT-Teleset. As a result of this transaction the Group increased its interest in NTV from 65.0% to 69.4% and in OAO TNT-Teleset from 50.0% to 51.7%.

In September 2002 we entered into an agreement with OAO Stroytransgaz to establish a joint activity which was formally established in October 2002. We contributed promissory notes of OAO Gazprom with a fair value of RR4,759 million (face value RR5,719 million) payable in January 2004 and OAO Stroytransgaz contributed 1,144 million of ordinary shares of OAO Gazprom (4.83% of our shares). In March 2003 OAO Stroytransgaz terminated its participation in the joint activity agreement in return for promissory notes contributed by us into the joint activity. In April 2003 we acquired 25.9% of the ordinary shares of OAO Stroytransgaz for consideration with a fair value of RR3,336 million, including primarily promissory notes and cash. In August 2003 we acquired 15.54% of preferred shares and an additional 0.2% of ordinary shares in OAO Stroytransgaz for RR152 million.

Initially, we and ZAO Rosshelf, our 53% owned subsidiary, had 99.1% and 0.9% direct interests, respectively, in a joint activity established to develop the Arctic shelf (Shtokmanovskoye and Prirazlomnoye fields) in the Barents and Pechora Seas. In October 2002, we signed an amendment to the joint activity agreement that provided for the addition of ZAO Sevmorneftegaz to our joint activity agreement. ZAO Sevmorneftegaz is jointly controlled by ZAO Rosshelf and OAO NK Rosneft-Purneftegaz, a subsidiary of OAO NK Rosneft ("Rosneft"). Under the agreement, in February 2003 ZAO Sevmorneftegaz made a non-cash contribution valued at RR4,334 million, thereby obtaining a 48.9% interest in the assets of the joint activity. As a result of the transaction we and ZAO Rosshelf held 48.7% and 2.4% direct interests in the joint activity, respectively, and our total effective interest decreased from 99.6% to 62.9%. In July 2003 Rosneft signed an agreement to acquire a 49.95% direct interest in the joint activity as recognition of is prior investment into the joint activity. The effect of this transaction was to decrease our total effective interest in the joint activity from 62.9% to 48.85% and to establish joint control over the assets of the joint activity with Rosneft.

In May 2003, Gazprombank acquired a 15.76% interest in OAO Mosenergo for RR10,900 million.

Recent developments

In January 2004, Gazprombank acquired a 5.3% interest in RAO UES for RR19,800 million.

In March 2004, we acquired a 34% interest in AO Lietuvos Dujos from the State Property Fund of Lithuanian Republic for RR1,020 million. Lietuvos Dujos engages primarily in the distribution and transportation of natural gas in Lithuania.

In March 2004, ZMB, our subsidiary in Germany, acquired a 40.0% interest in Bosphorus Gas Corporation AS for U.S.$0.6 million paid in cash. Bosphorus Gas Corporation AS distributes natural gas in Turkey.

In March 2004 we acquired a 20% interest in Odex Exploration Ltd. (Cyprus) for U.S.$10.5 million. The company is involved in the exploration and development of oil and gas fields in North Africa.

In March 2004 our production subsidiary OAO Vostokgazprom issued 2,275,000 additional ordinary shares. All of the new shares were purchased by us for RR2,275 million for cash. The issue was registered by the Federal Service for Financial Markets in May 2004. As a result the ownership interest of Gazprom in OAO Vostokgazprom increased from 83.8% to 99.9%.

In April 2004 we acquired a further 14.23% interest in Sibur pursuant to an agreement with ZAO "Gazoneftekhimicheskaya compania." The nominal value of the long-term promissory note issued by the Group in connection with this transaction was RR669 million as of December 31, 2003. As a result of this transaction we increased our controlling interest in the charter capital of Sibur from 78.1% to 92.3%.

In June 2004 we acquired an additional 12.8% interest in ZAO Stimul. As a result of this transaction the Group increased its interest in the charter capital of ZAO Stimul from 38.2% to 51.0%. ZAO Stimul, a production company, holds a license for the development of the Eastern part of the Orenburg oil and gas condensate deposit.

Our asset reacquisition program

Our senior management has carried out an asset reacquisition program, through which we have reacquired certain assets from various entities.

In April 2002, we completed the repurchase of 32% of the shares in ZAO Purgaz ("Purgaz") from the Itera International Energy group of companies ("Itera") pursuant to a repurchase option provided by the 1999 share purchase agreement under which we had sold the shares to Itera for their nominal value. As a result, our interest in Purgaz rose from 19% to 51%. Purgaz holds a license for the development of the Gubkinskoye gas field in western Siberia. In connection with the acquisition of these Purgaz shares, we paid Itera RR33,000 in cash (the nominal value of the shares) and financed Purgaz's repayment of RR6,594 million of financing originally provided by Itera to Purgaz to finance development work, thereby satisfying all of Purgaz's outstanding liabilities to Itera. Subsequent to its consolidation in April 2002, Purgaz contributed 11.2 bcm to our natural gas production volumes in 2002, and 15.2 bcm in 2003.

In February 2003 the management of our wholly-owned subsidiary OOO Mezhregiongaz ("Mezhregiongaz"), acting in violation of our internal procedures, sold 40.1% (out of our total 46.4% interest) of the share capital of ZAO Agrochemical Corporation Azot ("Azot") at its carrying value of RR394 million for cash, reducing our interest to 6.3%. The shares were sold to the other shareholders of Azot as a result of the latter taking advantage of their pre-emptive purchase rights. In April 2003, a part of this transaction was cancelled by an agreement of the shareholders. As a result, we received back a 33.9% interest in Azot and returned RR333 million of the cash received in February 2003. In July 2003 we acquired an additional 7.2% interest in Azot at par value from the existing shareholders of Azot for RR71 million in cash. Accordingly, as of December 31, 2003 we had a 47.4% interest in Azot. In an action we brought to recover the remaining 6.2% of our prior interest, the Moscow Region Arbitration Court has ruled in our favor, and the process for the execution of this decision have been initiated.

In February 2003 we acquired a 51.0% additional interest in OAO Severneftegazprom ("Severneftegazprom") from Itera at the nominal value of the shares (RR102,000) for cash and thereby increased our interest in the share capital of Severneftegazprom to 100%. In connection with the acquisition of this interest, we paid RR369 million in cash to Itera to settle the amount owed by Severneftegazprom to finance development work. Severneftegazprom, a production company, holds a license for the development of the Yuzhno-Russkoye field. At the same time we sold to Itera a 10.0% interest in OAO Sibirsky Oil and Gas Company at its carrying value of RR2.55 million plus a 7.8% interest in OAO Tarkosaleneftegaz at its carrying value of RR356 million for cash.

ZAO Achimneftegaz ("Achimneftegaz") was created as a wholly-owned subsidiary of our subsidiary, OOO Urengoigazprom ("Urengoigazprom"), to accelerate development of the Achimov layer gas condensate deposit in the Urengoiskoye field. Achimneftegaz is currently working on the second section of the Achimov layer of the field. Several years ago, ZAO CTI-Sigma, an Itera affiliate, acquired a 49% stake in Achimneftegaz. We are currently taking measures to reacquire a 48% stake in Achimneftegaz from the 49% previously acquired by ZAO CTI-Sigma.

We initially held a 51% stake in ZAO Nortgaz ("Nortgaz"), a company that holds licenses for the development of the North Urengoiskoye field. Our initial stake was reduced to 0.5% in 2001 as a result of a court decision invalidating our participation in a share issuance by Nortgaz in 1999 on the basis that the value of the property that we contributed to Nortgaz had not been approved by its Board of Directors. We are currently attempting to reacquire the Nortgaz shares we lost as a result of this prior decision through further court actions. According to published reports, Nortgaz has gas reserves of approximately 325 bcm.

RESULTS OF OPERATIONS

The following table and discussion is a summary of our consolidated results of operations for the years ended December 31, 2003, 2002 and 2001. Each line-item is also shown as a percentage of our total sales. All RR amounts related to financial information for periods prior to January 1, 2003 are expressed in constant RR as of December 31, 2002 purchasing power, unless otherwise noted. No adjustment for the effects of changes in general purchasing power have been made for period starting from January 1, 2003.

	Year ended December 31,					
	2003		2002		2001	
	(RR million)	(% of sales)	(RR million)	(% of sales)	(RR million)	(% of sales)
Sales (net of excise tax, VAT and customs duties)	819,753	100%	644,687	100%	712,967	100%
Operating expenses	(593,415)	(72)%	(496,713)	(77)%	(506,843)	(71)%
Operating profit	**226,338**	**28%**	**147,974**	**23%**	**206,124**	**29%**
Net monetary effects and financing items	2,141	0%	17,224	3%	22,511	3%
Share of net income of associated undertakings	3,478	0%	4,285	1%	4,087	1%
Gains (losses) on available-for-sale investments	5,017	1%	(3,729)	(1)%	(993)	(0)%
Profit before profit tax and minority interest	**236,974**	**29%**	**165,754**	**26%**	**231,729**	**33%**
Current profit tax expense	(42,368)	(5)%	(54,187)	(8)%	(94,957)	(13)%
Deferred profit tax (expense) benefit	(32,449)	(4)%	(81,945)	(13)%	(118,234)	(17)%
Total profit tax (expense) benefit	(74,817)	(9)%	(136,132)	(21)%	(213,191)	(30)%
Profit before minority interest	**162,157**	**20%**	**29,622**	**5%**	**18,538**	**3%**
Minority interest	(3,062)	(0)%	(667)	(0)%	(5,339)	(1)%
Net profit	**159,095**	**19%**	**28,955**	**4%**	**13,199**	**2%**

Year ended December 31, 2003 versus year ended December 31, 2002

Sales

The following table sets out our volumes and realized prices for the year ended December 31, 2003 and 2002.

	Year ended December 31, 2003	Year ended December 31, 2002
	(RR million, unless otherwise indicated)	
Sales of gas		
Europe		
Gross sales (including excise tax)[1]	547,381	433,085
Excise tax	(125,065)	(97,970)
Net sales	422,316	335,115
Excise tax as a percentage of sales	23%	23%
Volumes in bcm	144.7	128.6
Average price, US$ per mcm[2] (including excise tax and net of customs duties)[3]	123.9	102.5
Average price, constant RR per mcm[2] as of December 31, 2002 purchasing power, except for 2003 amount which is in nominal RR (including excise tax and net of customs duties)	3,782.3	3,369.0
FSU		
Gross sales (including excise, net of VAT)	53,591	61,506
Excise tax	(9,542)	(10,437)
Net sales	44,049	51,069
Excise tax as a percentage of sales	18%	17%
Volumes in bcm	42.6	42.6
Average price, US$ per mcm[2] (including excise tax and net of VAT and customs duties)[3]	40.9	45.4
Average price, constant RR per mcm[2] as of December 31, 2002 purchasing power, except for 2003 amount which is in nominal RR (including excise tax and net of VAT and customs duties)	1,256.6	1,444.2
Russia		
Gross sales (including excise, net of VAT)	206,094	159,642
Excise tax	(19,444)	(16,788)
Net sales	186,650	142,854
Excise tax as a percentage of sales	9%	11%
Volumes in bcm	308.2	298.0
Average price, nominal RR per mcm[2] (including excise tax and net of VAT)	668.7	505.0
Average price, constant RR per mcm[2] as of December 31, 2002 purchasing power, except for 2003 amount which is in nominal RR (including excise tax and net of VAT)	668.7	535.7
Total sales of gas		
Gross sales (including excise, net of VAT and customs duties)	807,066	654,233
Excise tax	(154,051)	(125,195)
Net sales	653,015	529,038
Excise tax as a percentage of sales	19%	19%
Volumes in bcm	495.5	469.2
Sales of gas condensate and other oil and gas products (net of excise tax and VAT)	92,180	56,647
Gas transportation sales (net of VAT)	28,226	18,028
Other sales (net of VAT)	46,332	40,974
Total sales (net of excise tax, VAT and customs duties)	**819,753**	**644,687**

Notes:

(1) VAT is not charged on sales to Europe.

(2) One mcm is equivalent to 35,316 cubic feet.

(3) Average actual prices and not a convenience translation.

Net sales revenues increased by RR175,066 million, or 27%, to RR819,753 million in 2003 compared to 2002. Net sales of gas accounted for 80% of total sales in 2003 (82% in 2002) and were RR653,015 million or 23% higher than in 2002.

Net sales of natural gas to Europe increased by RR87,201 million, or 26%, to RR422,316 million in 2003 compared to 2002. This was primarily due to a 12% increase in prices (comparing nominal prices for the year ended December 31, 2003 to prices in constant RR terms as of December 31, 2002 purchasing power for the year ended December 31, 2002), and a 13%, or 16 bcm, increase in sales volumes. Following the increase in U.S. dollar oil prices, average U.S. dollar export gas prices increased by 21% in 2003 to U.S.$123.9 per mcm compared to 2002. Nevertheless, our reported average RR export gas prices to Europe increased by only 12% to RR3,782.3 per mcm as a result of a 7.3% nominal appreciation of the RR against the U.S. dollar for 2003 compared to 2002. The increase in sales volumes was primarily due to increased volumes sold to Germany, Hungary, Turkey and Holland under existing long-term contracts.

Net sales of natural gas to FSU countries decreased by RR7,020 million, or 14%, to RR44,049 million in 2003 compared to 2002. This was due to a 13% decrease in the average prices of natural gas (comparing nominal prices for 2003 to prices in constant RR terms as of December 31, 2002 purchasing power for 2002). Sales volumes remained approximately the same. The 13% decrease in our reported average RR price to RR1,256.6 per mcm resulted from a 10% decrease in the average realized U.S. dollar price to U.S.$40.9 per mcm, which was primarily due to lower prices in the Ukraine set by intergovernmental agreements and to the nominal appreciation of the RR against the U.S. dollar. In 2003 we continued to restrict our shipments to Ukraine to those required to cover transportation services, so-called "transit-gas," which mitigates our collection risk. Shipments to Ukraine in 2003 were 26.0 bcm compared to 26.1 bcm in 2002.

Net sales of natural gas in the domestic market increased by RR43,796 million, or 31%, to RR186,650 million in 2003 compared to 2002. This was due to the increase in domestic gas tariffs set by the Federal Energy Commission and a 3%, or 10.2 bcm, increase in sales volumes. The nominal average domestic price increased by 32% from RR505.0 per mcm in 2002 to RR668.7 per mcm in 2003. The 3% increase in domestic sales volumes reflects increased sales by Sibur (from 3.7 bcm in 2002 to 8.3 bcm in 2003), sales to Itera (from 8.1 bcm in 2002 to 15.5 bcm in 2003) and gas sales through an electronic terminal by our subsidiary Mezhregiongaz, which commenced at the end of 2002 (from 0.5 bcm in 2002 to 1.3 bcm in 2003). Sales volumes by Sibur increased in 2003 due to the fact that Sibur increased its level of operations following the completion of bankruptcy procedures in September 2002. Sales volumes to Itera increased because following our reacquisition of a controlling interest in Purgaz, Itera was no longer able to fulfill certain of its long-term supply obligations and thus reached an agreement with us to purchase additional natural gas.

Total excise taxes on natural gas sales increased by 23%, to RR154,051 million, in 2003 from RR125,195 million in 2002, representing 19% and 19% of gross sales of natural gas, respectively. The increase was primarily due to higher natural gas sales to customers in Europe and Russia.

Sales of gas condensate and oil and gas products increased by RR35,533 million, or 63%, to RR92,180 million in 2003 compared to RR56,647 million in 2002. This increase was primarily due to higher oil and gas product prices, the increased level of operations at Sibur following the completion of bankruptcy procedures in September 2002, and the consolidation by Sibur of additional petrochemicals in 2003. Sibur and these petrochemical companies accounted for 63% of sales of gas condensate and oil and gas products in 2003, compared to 48% in 2002.

Gas transportation sales increased by RR10,198 million, or 57%, to RR28,226 million, in 2003 from RR18,028 million in 2002. This was primarily due to the commencement of transportation sales to Eural Trans Gas starting from January 2003, which amounted to RR14,759 million in 2003 and more than offset the RR6,458 million reduction in transportation sales to Itera. Eural Trans Gas is engaged in purchasing gas from Central Asia for resale to customers in Europe. The volume of gas transported under the contract with Eural Trans Gas in 2003 was 34.9 bcm.

Other sales increased by RR5,360 million, or 13%, to RR46,332 million in 2003 compared to RR40,974 million in 2002. Other sales represent activities such as construction work, gas storage services, refining services, sales by our media subsidiaries and sales of other services and goods.

Operating Expenses

Operating expenses increased by 19%, to RR593,415 million, in 2003 from RR496,713 million in 2002. Operating expenses decreased as a percentage of sales from 77% in 2002 to 72% in 2003. The table below presents a breakdown of operating expenses in each year:

	Year ended December 31,			
	2003		2002	
	RR million	% of net sales	RR million	% of net sales
Transit costs	108,711	13%	102,632	16%
Staff costs	100,122	12%	65,717	10%
Depreciation	99,648	12%	93,454	14%
Materials	44,395	5%	47,310	7%
Repairs and maintenance	42,955	5%	24,218	4%
Taxes other than on income	35,088	4%	43,975	7%
Purchased gas	29,650	4%	9,957	2%
Electricity	24,300	3%	13,449	2%
Processing services	16,243	2%	13,226	2%
Provisions for impairment of assets	15,298	2%	7,104	1%
Provisions for liabilities and charges	13,528	2%	6,804	1%
Cost of goods for resale, including refined products	11,870	1%	17,900	3%
Social expenses	11,724	1%	7,013	1%
Research and development	6,083	1%	4,464	1%
Transportation services	5,684	1%	3,423	1%
Other	28,116	4%	36,067	5%
Total operating expenses	**593,415**	**72%**	**496,713**	**77%**

Transit costs

Transit costs increased by 6%, to RR108,711 million, in 2003 from RR102,632 million in 2002. Transit costs relate principally to fees charged by Ukraine, Poland and other Eastern Europe and Central Asian countries for the transit of gas to markets in Europe. The increase was primarily due to the increased volume of gas sales to Europe, new transit contracts in Central Asia and higher transportation tariffs in Poland. These increases more than offset the RR6,226 million decrease in transit costs in Ukraine, following the decrease in transportation tariffs in line with the decrease in gas prices to Ukraine.

In 2003, ZGG, our wholly owned subsidiary in Germany, started to purchase gas for resale to customers in Western Europe and incur transit costs primarily in the Ukraine. Also, in January 2003 we began to provide gas transportation services to Eural Trans Gas relating to the transportation of gas from fields in Central Asia to the Russian border with Ukraine, resulting in increased transit costs payable by us to third parties for the transportation of gas across Kazakhstan and Uzbekistan. Our increased transit cost in Poland resulted from an increase in the U.S. dollar denominated gas transportation tariff by U.S.$1.35, to U.S.$2.68, per mcm per 100 km in January 2003. The effect of the increased tariffs, largely U.S. dollar denominated, was partially offset by the nominal appreciation of the RR against the U.S. dollar in 2003 compared to 2002.

Staff costs

Staff costs increased by 52%, to RR100,122 million, in 2003 from RR65,717 million in 2002. The increase was primarily due to the rise in the average base salaries in January 2003 and June 2003, the bonus paid for the 10th anniversary of OAO Gazprom in February 2003 and the increase in the number of employees following the acquisition of controlling interests in a number of Russian petrochemical companies, which accounted for RR6,862 million of the increase.

Depreciation

Depreciation increased by 7%, to RR99,648 million, in 2003 from RR93,454 million in 2002. The increase primarily resulted from our growing fixed asset base.

Materials

Cost of materials decreased by 6%, to RR44,395 million, in 2003 from RR47,310 million in 2002. The decrease was primarily related to lower prices for material purchases as we reduced the use of non-cash settlements, which are generally made at higher prices relative to purchases for cash.

Repairs and maintenance

Cost of repairs and maintenance increased by 77%, to RR42,955 million, in 2003 from RR24,218 million in 2002. The increase was primarily related to increased volume and higher cost of repair and maintenance activities in the transportation segment due to the ageing of the pipeline assets.

Taxes other than on income

Taxes other than on income consist of:

	Year ended December 31,	
	2003	**2002**
	(RR million)	
Natural resources production tax	19,644	20,485
Property tax	10,646	9,371
Road users tax	—	10,369
Other taxes	4,798	3,750
Taxes other than on income	**35,088**	**43,975**

Taxes other than on income decreased by 20% to RR35,088 million in 2003 from RR43,975 million in 2002. The decrease was primarily attributable to road users tax, which was abolished effective January 1, 2003.

Purchased gas

Cost of purchased gas increased by 198%, to RR29,650 million, in 2003 from RR9,957 million in 2002. The increase was primarily related to purchases of gas from Central Asia for resale to customers in Western Europe, which commenced in January 2003. Purchases of gas from Naftogaz Ukraine and Eural Trans Gas in Europe accounted for approximately RR9,150 million and RR2,400 million, respectively, of the total increase of RR19,693 million.

Electricity

Electricity expense increased by 81%, to RR24,300 million, in 2003 from RR13,449 million in 2002. The increase resulted primarily from increased usage due to the increased volume of gas transported in Russia, in line with the increased volume of gas sales, the impact of the acquisition of controlling interests in petrochemical companies, an increase in electricity tariffs set by the FEC, and increased electricity consumption due to the higher proportion of electricity-driven equipment used for gas transportation. The proportion of electricity-driven equipment increased from approximately 15% of the total capacity of the equipment used for gas transportation in 2002 to approximately 23% in 2003. The increase in electricity tariffs incurred by us exceeded the average increase in electricity tariffs set by the FEC for the whole of Russia, which was 18% for 2003, as the tariffs differ by region and increases in tariffs set by the FEC in different regions ranged from 15% to 80%. For our five subsidiaries incurring the highest amount of electricity expense in 2003, which accounted for 47% of total electricity expense in 2003 and 57% in 2002, tariffs increased between 15% and 47%.

Processing services

Processing services for refined products increased by 23%, to RR16,243 million, in 2003 from RR13,226 million in 2002. These processing services, which are provided by third parties, primarily pertain to the operations of Sibur, which increased its level of operations following the completion of bankruptcy procedures in September 2002.

Provisions for impairment of assets

Provision expense for the impairment of assets increased by 115%, to RR15,298 million, in 2003 compared to RR7,104 million in 2002. The increase was primarily a result of a charge in respect of property, plant and equipment in 2003 compared to a net release in 2002, and higher impairment provisions for investments and other long-term assets. These adverse changes were partly offset by a decrease in the impairment provision expense for accounts receivable and prepayments.

The impairment provision for property, plant and equipment resulted in a net charge of RR207 million in 2003 compared to a net release of RR6,883 million for 2002. The charge for 2003 consists of a RR1,778 million net release for assets under construction and a RR1,985 million charge against production assets on the Severo-Vasyuganskoe gas condensate field following a decrease in recoverable reserves. Releases in the impairment provision primarily reflects the strategy of management to focus on priority projects in a systematic way and once again fund projects, which had previously been frozen. In 2003, the release primarily relates to the Long-Yugan-Labytnangi-Salekhard-Kharp pipeline, which was put into operation in the fourth quarter of 2003.

The impairment provision expense for investments and other long-term assets increased by RR3,382 million from a provision release of RR224 million in 2002 to a provision expense of RR3,158 million in 2003. The provision expense in 2003 primarily relates to equity investments in petrochemical companies acquired in the fourth quarter of 2003 and investments in a number of small joint ventures, which had minimal activity and low returns.

The impairment provision expense for accounts receivable and prepayments decreased by RR1,252 million, or 7%, to RR16,159 million in 2003 from RR17,411 million in 2002. The decrease was primarily a result of lower provisions for non-recurring items mainly related to other debtors, which offset increased provisions against older domestic gas receivables. As of December 31, 2003, the aggregate provision related to accounts receivable and prepayments was RR140,837 million or 32% of the gross accounts receivable and prepayments balance.

Provisions for liabilities and charges

Provision expense for liabilities and charges increased by 99%, to RR13,528 million, in 2003 compared to RR6,804 million in 2002. The increase was primarily a result of a higher expense for pension liabilities, which increased by RR5,994 million, or 103%, to RR11,807 million in 2003 from RR5,813 million in 2002. Pension liabilities represent our obligations under our defined benefit plan, which is administered by our subsidiary, NPF Gazfund. The increase was primarily due to a decrease in the assumed discount rate, which resulted from the decline in corporate and government debt yields in Russia, and a voluntary increase by us in vested pensions to provide an inflationary increase in pensions for our current pensioners.

Other operating expenses

Other operating expenses decreased by RR7,951 million, or 22%, to RR28,116 million, in 2003 compared to RR36,067 million in 2002. Other operating expenses include costs related to rental of equipment and vehicles, telecommunications, advertising, and other expenses attributable to the newly consolidated petrochemical subsidiaries.

Operating profit

As a result of the factors discussed above, our operating profit increased by RR78,364 million, or 53%, from RR147,974 million in 2002 to RR226,338 million in 2003. Our operating profit margin increased from 23% in 2002 to 28% in 2003.

Net monetary effects and financing items

	Year ended December 31,	
	2003	2002
	(RR million)	
Net exchange gain (loss)	15,140	(9,435)
Interest income	15,295	10,636
Interest expense	(32,301)	(29,265)
Monetary gain	—	31,380
Gains on and extinguishment of restructured liabilities	4,007	13,908
Net monetary effects and financing items	**2,141**	**17,224**

We incurred a net exchange gain of RR15,140 million in 2003 compared to a net exchange loss of RR9,435 million in 2002. The change reflects primarily the impact on foreign currency denominated borrowings of a 7.3% appreciation of the RR against the U.S. dollar in 2003 compared to a 5.4% depreciation in 2002.

Interest expense increased by RR3,036 million in 2003 compared to 2002 primarily due to interest incurred on the debt restructured by Sibur in September 2002 and increase in interest paid by Gazprombank in line with growth in deposits, which more than offset the increased capitalized interest resulting from increased capital expenditures.

Gains on and extinguishment of restructured liabilities decreased by RR9,901 million to RR4,007 million in 2003. This was primarily due to the fact that there were no tax payables eligible for restructuring in 2003, and there was a RR3,124 million gain on the restructuring of Sibur's debts, following the approval of the settlement agreement with Sibur's creditors in 2002. We recognized RR4,007 million of gains in 2003 due to the forgiveness by certain tax authorities of penalties relating to overdue taxes that had previously been restructured.

There was no monetary gain in 2003 as the characteristics of the economic environment of the Russian Federation indicated that hyperinflation had ceased; effective from January 1, 2003 we no longer apply the provisions of IAS 29. Accordingly, no adjustments for the effects of changes in general purchasing power are recorded in the financial statements subsequent to December 31, 2002.

Share of net income of associated undertakings

Share in net income of associated undertakings decreased by RR807 million to RR3,478 million in 2003 compared to 2002. The decrease was primarily due to lower net profits recorded by WINGAS, due to changes in German tax regulations, increased provisions against non-core associated undertakings and the loss of net income following the sale of our 37% interest in OAO AKB National Reserve Bank in July 2002. These decreases offset higher net profits recorded by EuRoPol GAZ S.A. and the impact of the consolidation as a subsidiary of Sibur-Tyumen in 2003 with respect to which we had recorded losses in 2002 when it was an associated undertaking.

Gains (losses) on available-for-sale investments

In 2003 we recognized gains on available-for-sale investments of RR5,017 million compared to losses of RR3,729 million in 2002. The gains in 2003 were primarily due to the reduction in provisions made in prior years against long-term available-for-sale equity investments. In 2002 we incurred losses primarily due to decreases in the estimated fair value of third party promissory notes held by Sibur and its subsidiaries.

Profit tax

Profit tax expense decreased by RR61,315 million, or 45%, to RR74,817 million in 2003 compared to RR136,132 million in 2002.

Our overall effective profit tax rate decreased from 82% in 2002 to 32% in 2003. The decrease primarily resulted from the fact that from January 1, 2003 we no longer apply the provisions of IAS 29, which eliminated the inflationary increase of the financial reporting base for fixed assets and therefore, reduced the deferred tax expense related to fixed assets. The deferred tax expense resulting from the effect of inflation on our fixed assets for 2002 totaled RR59,160 million.

Our current profit tax expense decreased by RR11,819 million, to RR42,368 million, in 2003 from RR54,187 million in 2002. Our effective current profit tax rate decreased to 18% in 2003 compared to 33% for 2002, primarily resulting from the effect of a "transition period" profit tax in the year ended December 31, 2002 and the impact of increased tax depreciation and the utilization of tax losses at OAO Gazprom in 2003. The transition period profit tax was a one time current tax charge of RR22,637 million resulting from the change in tax legislation, effective January 1, 2002, to recognize profit tax on an accrual rather than a cash basis. Transition period profit tax is payable over a period of up to five years.

Minority interest

Minority interest deducted from results from operations increased by RR2,395 million to RR3,062 million in 2003 compared to RR667 million in 2002. The increase was primarily due to increased earnings of consolidated subsidiaries Purgaz and Sibur.

Net profit

As a result of the factors discussed above, our net profit increased by RR130,140 million, or 449%, from RR28,955 million in 2002 to RR159,095 million in 2003.

Year ended December 31, 2002 versus year ended December 31, 2001

Sales

The following tables set out our volumes and realized prices for the years ended December 31, 2002 and 2001.

	Year ended December 31, 2002	Year ended December 31, 2001
	(RR million, unless otherwise indicated)	
Sales of gas		
Europe		
Gross sales (including excise tax)[1]	433,085	520,647
Excise tax	(97,970)	(113,449)
Net sales	335,115	407,198
Excise tax as a percentage of sales	23%	22%
Volumes in bcm	128.6	127.0
Average price, U.S.$ per mcm[2] (including excise tax and net of customs duties)[3]	102.5	122.6
Average price, constant RR per mcm[2] (including excise tax and net of customs duties)	3,369.0	4,100.0
FSU		
Gross sales (including excise, net of VAT)	61,506	56,221
Excise tax	(10,437)	(7,048)
Net sales	51,069	49,173
Excise tax as a percentage of sales	17%	13%
Volumes in bcm	42.6	39.6
Average price, U.S.$ per mcm[2] (including excise tax and net of VAT and customs duties)[3]	45.4	41.5
Average price, constant RR per mcm[2] (including excise tax and net of VAT and customs duties)	1,444.2	1,417.5
Russia		
Gross sales (including excise, net of VAT)	159,642	133,187
Excise tax	(16,788)	(2,716)
Net sales	142,854	130,471
Excise tax as a percentage of sales	11%	2%
Volumes in bcm	298.0	300.8
Average price, nominal RR per mcm[2] (including excise tax and net of VAT)	505.0	357.9
Average price, constant RR per mcm[2] (including excise tax and net of VAT)	535.7	442.8
Total sales of gas		
Gross sales (including excise, net of VAT and customs duties)	654,233	710,055
Excise tax	(125,195)	(123,213)
Net sales	529,038	586,842
Excise tax as a percentage of sales	19%	17%
Volumes in bcm	469.2	467.4
Sales of gas condensate and other oil and gas products (net of excise tax and VAT)	56,647	74,640
Gas transportation sales (net of VAT)	18,028	18,226
Other sales (net of VAT)	40,974	33,259
Total sales (net of excise tax, VAT and customs duties)	**644,687**	**712,967**

Notes:

(1) VAT is not charged on sales to Europe.

(2) One mcm is equivalent to 35,316 cubic feet.

(3) Average actual prices and not a convenience translation.

Net sales revenues fell by RR68,280 million, or 10%, to RR644,687 million in 2002 compared to 2001. Net sales of gas accounted for 82% of total sales in 2002 (82% in 2001) but were RR57,804 million, or 10%, lower than in 2001.

Net sales of natural gas to Europe decreased by RR72,083 million, or 18%, in 2002 compared to 2001. This was primarily due to an 18% decrease in the average price of gas exported to Europe expressed in constant RR from RR4,100.0 per mcm in 2001 to RR3,369.0 per mcm in 2002, reflecting a 16% decrease in the average actual U.S. dollar gas export price per mcm from U.S.$122.6 in 2001 to U.S.$102.5 in 2002 following the decrease in U.S. dollar oil prices in the second half of 2001, and the fact that devaluation of the RR against the U.S. dollar continued to lag behind inflation for the comparable periods. The cumulative inflation index for the period from the beginning of 2001 to the end of 2002 was 36.8% while the RR devaluation against the U.S. dollar for the same period was only 12.9%. The decrease in export gas prices was partially offset by a 1.6 bcm, or 1%, increase in export sales volumes, primarily due to increased volumes sold to Germany and Turkey under existing long-term contracts.

Net sales of natural gas to FSU countries increased by RR1,896 million, or 4%, to RR51,069 million in 2002 compared to 2001. This was primarily due to a 2% increase in the average constant RR price of gas and an 8% increase in FSU sales volumes. The main reason for the increase in FSU sales volumes was a 19% or 4.2 bcm increase in sales volumes to Ukraine from 21.9 bcm in 2001 to 26.1 bcm in 2002, which more than offset the decreased shipments of gas shipped to Belarus and Moldova; shipments to Baltic countries remained at the same level. Sales volumes to Ukraine increased as they represent transit gas—i.e., consideration for transportation services provided in Ukraine, which eliminates our collection risk—and our Ukrainian transit costs increased. See "—Operating expenses—Transit costs" below. The average U.S. dollar price for FSU natural gas sales increased by 9%, to U.S.$45.4 per mcm, in 2002, primarily due to a 34% increase in the contract price of transit gas sales to Ukraine from U.S.$50 per mcm to U.S.$67 per mcm in the third quarter of 2002. Despite the 9% increase in the average U.S. dollar price for FSU gas sales the constant RR gas price increased only 2%, reflecting the fact that devaluation of the RR against the U.S. dollar continued to lag behind inflation for the comparable periods. Excise tax increased by 48% or RR3,389 million, primarily due to a change in excise tax legislation effective October 1, 2001, whereby sales of dry gas became subject to excise tax whereas previously such sales had been exempt. The majority of our natural gas sales to the Baltic countries are shipments of dry gas.

Net sales of natural gas in the domestic market increased by RR12,383 million, or 9%, to RR142,854 million in 2002 compared to 2001. This increase was primarily due to a 21% increase in average constant RR domestic prices, which more than offset the 1% decrease in domestic sales volumes, which fell 2.8 bcm to 298.0 bcm in 2002. The decrease in domestic sales volumes was primarily due to a 3.5 bcm decrease in gas sales volumes by Sibur, which substantially reduced its operations at the end of 2001 and during the first six months of 2002. Sibur increased its activity at the end of the third quarter of 2002 after reaching an amicable agreement with its creditors, but this increase was insufficient to offset the decrease in the first six months of 2002. Nominal average domestic natural gas sales prices increased 41% from RR357.9 per mcm in 2001 to RR505.0 per mcm in 2002 following the 20% and a further 15% increase in domestic prices to industrial consumers effective March 1, 2002 and July 1, 2002, respectively, and a 15% increase in domestic prices to the general population effective August 1, 2002. Average constant RR domestic natural gas price increased only 21%, as the increase in nominal prices was partly eroded due to 15.1% inflation in the year ended December 31, 2002. Excise tax on domestic sales increased by RR14,072 million, or 518%, in 2002 compared to 2001, primarily due to the acquisition of controlling interests in many regional trade houses and their subsequent consolidation in 2002. The consolidation of regional trade houses resulted in an increase in our excise tax liability, as the liability to pay excise tax lies with the entity selling gas to the final customer.

Total excise taxes on natural gas sales increased 2%, or RR1,982 million, to RR125,195 million in 2002 from RR123,213 million in 2001, representing 19% and 17% of gross sales of natural gas in 2002 and 2001, respectively.

Sales of gas condensate and oil and gas products decreased by RR17,993 million, or 24%, to RR56,647 million in 2002 compared to RR74,640 million in 2001. This decrease was primarily due to the reduction in operations at Sibur at the end of 2001 and during the first six months of 2002. Sibur's level of operations began to increase beginning at the end of the third quarter of 2002, but this increase was insufficient to offset the decrease in the first six months of 2002. Sibur accounted for 37% and 64% of sales of gas condensate and oil and gas products in 2002 and 2001, respectively.

Gas transportation sales decreased by RR198 million, or 1%, to RR18,028 million in 2002 from RR18,226 million in 2001 due to lower prices in constant RR terms and lower volumes. Approximately

73% of third-party transportation sales were to Itera under U.S. dollar denominated contracts. A 7% increase in the average tariffs we charged Itera (in nominal RR terms after conversion of the U.S. dollar tariffs into RR) was insufficient to offset inflation of 15.1% for the year ended December 31, 2002 and in addition was largely offset by a 6% decrease in the volume of gas we transported for third parties.

Other sales increased by RR7,715 million, or 23%, to RR40,974 million in 2002 compared to RR33,259 million in 2001. Other sales represent activities such as construction work, gas storage services, drilling work and sales of other services and goods.

Operating expenses

Operating expenses decreased by RR10,130 million, or 2%, to RR496,713 million in 2002 compared to RR506,843 million in 2001. Operating expenses increased as a percentage of sales from 71% in 2001 to 77% in 2002. The table below presents a breakdown of operating expenses in each period:

	Year ended December 31,			
	2002		2001	
	RR million	% of net sales	RR million	% of net sales
Transit costs	102,632	16%	95,105	13%
Depreciation	93,454	14%	99,868	14%
Staff costs	65,717	10%	59,456	8%
Materials	47,310	7%	59,602	8%
Taxes other than on income	43,975	7%	46,289	6%
Repairs and maintenance	24,218	4%	21,552	3%
Cost of goods for resale, including refined products	17,900	3%	21,085	3%
Impairment and other provisions	13,908	2%	41,083	6%
Electricity	13,449	2%	11,430	2%
Processing services	13,226	2%	12,595	2%
Purchased gas	9,957	2%	7,466	1%
Social expenses	7,013	1%	6,088	1%
Losses on disposal of property, plant and equipment	6,405	1%	5,849	1%
Insurance	5,825	1%	4,147	1%
Research and development	4,464	1%	4,360	1%
Other	27,260	4%	10,868	2%
Total operating expenses	**496,713**	**77%**	**506,843**	**71%**

Transit costs

Transit costs increased by RR7,527 million, or by 8%, from RR95,105 million in 2001 to RR102,632 million in 2002. Transit costs relate principally to fees charged by Ukraine, Poland and other Eastern European and Central Asian countries for the transit of gas to markets in Europe. The increase was primarily due to higher transportation tariffs in Ukraine and Poland and an increased volume of transit services. U.S. dollar denominated gas transportation tariffs through the Ukraine increased by 34% from July 1, 2002, from U.S.$1.09 per mcm per 100 km to U.S.$1.46 per mcm per 100 km. U.S. dollar denominated gas transportation tariffs through Poland increased by 99% in the fourth quarter of 2002 from approximately U.S.$1.35 per mcm per 100 km to approximately U.S.$2.68 per mcm per 100 km. The effect of increased tariffs was partially offset by the fact that transit costs are largely U.S. dollar denominated and the rate of devaluation of the RR against the U.S. dollar in 2002 compared to 2001 was below the rate of inflation for the respective periods.

Depreciation

Depreciation decreased by RR6,414 million, or 6%, to RR93,454 million in 2002 from RR99,868 million in 2001. This decrease was primarily due to an increase in the amount of depreciation included in the cost of gas in storage from RR2,048 million in 2001 to RR5,228 million in 2002. The depreciation associated with those volumes will be expensed in future periods when the gas is sold.

Staff costs

Staff costs increased by RR6,261 million, or 11%, to RR65,717 million in 2002 from RR59,456 million in 2001. There was no significant change in the number of employees, and the increase was primarily due to an increase in staff salaries above inflation.

Materials

The cost of materials used in our activities decreased by RR12,292 million, or 21%, from RR59,602 million in 2001 to RR47,310 million in 2002. The decrease was primarily related to lower prices for material purchases as we reduced the use of non-cash settlements.

Taxes other than on income

Taxes other than on income consist of:

	Year ended December 31,	
	2002	**2001**
	(RR million)	
Natural resources production tax	20,485	—
Road users tax	10,369	9,924
Property tax	9,371	9,563
Royalty tax	—	12,633
Mineral restoration tax	—	9,090
Other taxes	3,750	5,079
Taxes other than on income	**43,975**	**46,289**

Taxes other than on income decreased by RR2,314 million, or 5%, from RR46,289 million in 2001 to RR43,975 million in 2002. This resulted mainly from the replacement of the royalty and mineral restoration taxes payable by production entities with the natural resources production tax effective January 1, 2002. The rate of natural resources production tax was 16.5% of the value of gas produced and of the value of gas condensate produced from gas condensate fields and RR340 per ton of oil and gas condensate produced from oil and gas condensate fields. The latter rate was subject to adjustment depending on fluctuations of oil prices and the RR exchange rate. The rates of this tax have now changed, as described above under "—Certain Factors Affecting our Results of Operations—Our high tax burden."

Repairs and maintenance

Repairs and maintenance increased by RR2,666 million, or 12%, from RR21,552 million in 2001 to RR24,218 million in 2002 primarily due to the ageing of our production and transportation facilities.

Cost of goods for resale, including refined products

Cost of goods for resale, including refined products, decreased by RR3,185 million, or 15%, from RR21,085 million in 2001 to RR17,900 million in 2002 primarily as a result of the reduction in operations at Sibur in 2002.

Provisions

Provision expenses decreased by RR27,175 million, or 66%, to RR13,908 million in 2002 compared to RR41,083 million in 2001. The decrease primarily resulted from lower provisions in respect of accounts receivable and prepayments, which fell 50%, from RR35,070 million in 2001 to RR17,411 million in 2002, and for impairment of assets under construction, which changed from a RR6,503 charge in 2001 to a RR6,883 million release in 2002.

As of December 31, 2002, the balance of provisions related to accounts receivable and prepayments was RR130,267 million, or 38% of the gross receivable balance, both short-term and long-term.

Provision expense in respect of accounts receivable and prepayments for 2001 includes a RR11,861 million charge as a result of changes in tax legislation effective from January 1, 2001 which required a provision for VAT to be recorded for accounts receivable balances that were provided for (including those provided for in prior periods). Absent this charge, provisions decreased by RR5,798 million in 2002. The decrease was primarily attributable to lower provision expense against trade receivables of Ukraine, which fell from RR18,284 million in 2001 to RR1,081 million in 2002, partially offset by additional provision expenses against trade receivables and prepayments and other receivables.

Provision expense related to impairment of assets under construction decreased by 206% from a RR6,503 million charge in 2001 to a RR6,883 million release in 2002, primarily as a result of our efforts to focus our capital program on priority projects and thereby reduce our total number of projects, and our allocating funds to projects that had previously been frozen or lacked financing under investment programs for prior years.

Other operating expenses

Other operating expenses increased by RR16,392 million, or 151%, from RR10,868 million in 2001 to RR27,260 million in 2002 primarily due to the impact of the release of the RR9,340 million provision on forward foreign exchange contracts in 2001, and lower gains on trading investments in 2002 as a result of the de-consolidation of National Reserve Bank. See "—Share of net income of associated undertakings."

Operating Profit

As a result of the factors discussed above, our operating profit decreased by RR58,150 million, or 28%, from RR206,124 million in 2001 to RR147,974 million in 2002. Our operating profit margin decreased from 29% in 2001 to 23% in 2002.

Net monetary effects and financing items

	Year ended December 31,	
	2002	2001
	(RR million)	
Net exchange loss	(9,435)	(5,406)
Interest income	10,636	14,184
Interest expense	(29,265)	(42,902)
Monetary gain	31,380	33,513
Gains on and extinguishment of restructured liabilities	13,908	23,122
Net Monetary Effects and Financing Items	**17,224**	**22,511**

Our net exchange loss increased by RR4,029 million, or 75%, to RR9,435 million in 2002, reflecting the impact of (i) a 5.4% devaluation of the RR against the U.S. dollar and a 25.0% devaluation of the RR against the euro in 2002 on our U.S. dollar and euro denominated borrowings (offset in part by the impact of these devaluations on our U.S. dollar and euro denominated receivables) and (ii) an increase in our net foreign currency liability position.

Interest expense decreased by RR13,637 million, or 32%, to RR29,265 million in 2002 compared to 2001 primarily due to a RR6,296 million decrease in interest expense on taxes payable, following a reduction in overdue taxes payable, and a reduction in our borrowing costs resulting from the improved interest rate environment.

Monetary gain decreased by RR2,133 million, or 6%, to RR31,380 million in 2002 compared to 2001 due to the decrease in the rate of inflation and our lower net monetary liability position.

Gains on and extinguishment of restructured liabilities decreased by RR9,214 million, or 40%, to RR13,908 million in 2002. This was primarily due to a significant reduction in tax payables eligible for restructuring in 2002, offset by RR3,124 million of gain on the restructuring of Sibur's debts, following the approval of the settlement agreement with Sibur's creditors on September 10, 2002. We also recognized gains due to the forgiveness by certain tax authorities of fines relating to overdue taxes that had previously been restructured.

Share of net income of associated undertakings

Share of net income of associated undertakings increased by RR198 million, or 5%, to RR4,285 million in 2002 primarily due to an increase in our share of the net income recorded by EuRoPol GAZ S.A. from RR223 million in 2001 to RR2,367 million in 2002, and the inclusion of RR667 million of equity income from National Reserve Bank, offset by our share of the net loss recorded by Sibur-Tyumen of RR1,529 million and of a loss of Moldovagas of RR526 million in 2002 compared to RR487 million of income in 2001. We ceased to exercise control over the activities of National Reserve Bank from January 1, 2002. Accordingly, effective January 1, 2002 we de-consolidated our investment in National Reserve Bank and recorded it as an associated undertaking until we disposed of 37% of our ordinary shares and all of our preference shares of the bank in July 2002. We currently own 3% of the ordinary shares of National Reserve Bank and account for this investment at cost.

Losses on available for sale investments

Losses on available for sale investments increased by RR2,736 million, or 276%, to RR3,729 million in 2002, primarily due to the effect of the de-consolidation of National Reserve Bank. In 2001 National Reserve Bank recognized a gain of RR1,510 million in available-for-sale investments. Our losses on available-for-sale investments also increased due to an increase in provisions against promissory notes of RR580 million related to certain short-term promissory notes held by Sibur and its subsidiaries and a decrease in realized gains on promissory notes of RR629 million following reduction in the scope of transactions with promissory notes.

Profit tax

	Year ended December 31,	
	2002	2001
	(RR million)	
Profit before profit tax and minority interest	165,754	231,729
Theoretical tax charge at the statutory rate thereon	(39,781)	(81,105)
Tax effect of items which are not deductible or assessable for taxation purposes:		
Inflationary effects	(63,278)	(101,338)
Non-deductible expenses	(31,644)	(40,535)
Statutory tax concessions	—	13,721
Other non-temporary differences	(1,429)	8,167
Effect of change in tax rate	—	(12,101)
Profit tax expense	**(136,132)**	**(213,191)**

Profit tax expense decreased RR77,059 million, or 36%, to RR136,132 million in 2002 compared to RR213,191 million in 2001.

Our current profit tax expense decreased by RR40,770 million, or 43%, to RR54,187 million in 2002 from RR94,957 million in 2001. Our effective current profit tax rate decreased from 41% in 2001 to 33% in 2002. Our high current profit tax rate for 2001 resulted in part from Russian tax regulations that limited the deductibility of some of our operating expenses. The decrease in our current tax rate was primarily due to the application of revised tax depreciation lives for property, plant and equipment following the enactment of Chapter 25 "Profit tax" of the Russian Federation Tax Code on January 1, 2002. The revised tax depreciation tax lives, which became generally shorter, gave rise to current period tax losses in the statutory books of OAO Gazprom. We recognized the results of the assessment of the revised tax depreciation lives for property, plant and equipment in the three months ended September 30, 2002 when such an assessment was completed. Revised tax returns were then filed for the nine months ended September 30, 2002. The current tax benefit as a result of changing depreciation lives was partially offset by RR22,637 million of current profit tax expense in 2002 related to a "transition period" profit tax, which is a one time current tax charge resulting from the change in tax legislation, effective January 1, 2002, to recognize profit tax on an accrual rather than a cash basis. Transition period profit tax is payable over a period of up to five years.

Our high overall effective tax rate of 82% and 92% for 2002 and 2001, respectively, primarily resulted from the impact of non-deductible expenses as described above, as well as from inflation accounting, which among other things, was increasing the book value of our fixed assets compared to their tax basis, resulting in a deferred tax expense. The magnitude of our overall effective tax rate in 2001 also resulted from the impact of the reduction in Russian tax rates from 35% to 24%, which reduced our net deferred tax asset, resulting in a deferred tax expense. Our deferred tax expense was RR81,945 million and RR118,234 million for the years ended December 31, 2002 and 2001, respectively. The depreciation adjustment and transition period profit tax charge referred to in the preceding paragraph did not affect our overall tax rate in 2002 because they were offset by corresponding deferred tax expense and benefit, respectively.

Minority interest

Minority interest deducted from results from operations decreased by RR4,672 million to RR667 million in 2002 compared to RR5,339 million in 2001. This was primarily due to the effect of the de-consolidation of National Reserve Bank effective January 1, 2002 which contributed RR4,235 million to the minority share in equity earnings in 2001.

Net profit

As a result of the factors discussed above, our net profit increased by RR15,756 million, or by 119%, from RR13,199 million in 2001 to RR28,955 million in 2002.

Liquidity and Capital Resources

We make significant capital expenditures to explore for natural gas, to develop our natural gas fields and to produce our natural gas, gas condensate and crude oil, and to maintain and expand the UGSS and international pipelines. Our capital expenditures (including cash advances to contractors and suppliers, which are recorded within long-term accounts receivable and prepayments, and excluding the effect of acquisitions of subsidiaries and reclassifications) were RR204,235 million in 2003, RR180,268 million in 2002 and RR180,815 million in 2001.

We make a significant portion of our capital expenditures using consideration other than cash. See "—Capital expenditures." For the years ended December 31, 2002 and 2001, our operating cash flows exceeded our cash capital expenditures by significant margins, but were not sufficient to cover our combined cash and non-cash capital expenditures. For the year ended December 31, 2003, however, our operating cash flows were insufficient to cover our cash capital expenditures.

Our business requires significant ongoing capital expenditures in order to maintain our production and transportation systems. An extended period of low gas prices would limit our ability to maintain an adequate level of capital expenditures, which in turn could limit our ability to maintain current levels of production and deliveries of gas, adversely affecting our results.

Other significant uses of our cash flows include servicing our debt and paying dividends. Interest paid and expensed was RR19,204 million, RR22,379 million and RR27,389 million in 2003, 2002 and 2001, respectively. Interest paid and capitalized was RR13,807 million, RR12,998 million and RR16,711 million in 2003, 2002 and 2001, respectively. Total interest paid, both expensed and capitalized, was RR33,011 million, RR35,377 million and RR44,100 million for 2003, 2002 and 2001, respectively. We paid dividends of RR8,479 million, RR10,328 million and RR6,736 million in 2003, 2002 and 2001, respectively.

In 2003, 2002 and 2001, our borrowings exceeded our repayments of debt. Our borrowings net of repayments (including bonds and promissory notes) were RR43,308 million, RR41,803 million and RR25,429 million for 2003, 2002 and 2001, respectively. However, as a result of the inflation of our prior period debt balances due to the application of inflation accounting under IAS 29 prior to January 1, 2003, our debt balances until December 31, 2002 reported in our financial statements have declined despite these net borrowings. See "—Debt Obligations." Our cash and cash equivalents increased in 2003, 2002 and 2001.

Our plan for 2004 is to finance our budgeted capital expenditures, interest and dividends mainly out of operating cash flows, which we expect to increase through higher domestic tariffs for sales of natural gas and higher prices for, and increased volumes of, the natural gas we export. At the same time, we intend to improve our debt profile by retiring a portion of our short-term RR denominated debt (in particular our short-term RR denominated promissory notes) and by refinancing other RR denominated debt with long-term borrowings in convertible currencies.

Cash flows

The following table summarizes the statements of cash flows for the years ended December 31, 2003, 2002 and 2001.

	Year ended December 31,		
	2003	2002	2001
		(RR million)	
Net cash provided by operating activities	141,846	160,111	163,544
Net cash used for investing activities.	(145,163)	(160,688)	(117,603)
Net cash provided by (used for) financing activities	17,555	3,017	(9,076)

Net cash provided by operating activities

Net cash provided by operating activities decreased to RR141,846 million in 2003 from RR160,111 million in 2002, despite the significantly higher operating income generated by our gas sales during 2003.

The positive impact of higher gas prices on our cash flow was more than offset by negative changes in our net working capital position and higher profit tax paid compared to 2002. The negative change in our working capital position reflected an increase in accounts receivable and prepayments, inventories and other current assets and an increase in available-for-sale and trading investments. See "—Working Capital."

Net cash provided by operating activities decreased to RR160,111 million in 2002 from RR163,544 million in 2001. The decrease was primarily due to lower margins generated by our sales in 2002, which followed the 18% reduction in the average realized constant RR prices on our gas sales to Europe, and negative changes in our working capital position, reflecting a decrease in accounts payable and taxes payable and increased available-for-sale and trading investments. These two factors more than offset the decrease in profit taxes paid.

Net cash used for investing activities

Net cash used for investing activities decreased to RR145,163 million in 2003 from RR160,688 million in 2002. This 10% decrease was primarily due to the net change in long-term loans and reduced net outflows related to the acquisition and disposal of subsidiaries.

Net cash used for investing activities increased to RR160,688 million in 2002 from RR117,603 million in 2001. Net cash used for investing activities in 2002 includes the effect of the deconsolidation of OAO AKB National Reserve Bank, which resulted in a net cash outflow of RR4,058 million in 2002 as OAO AKB National Reserve Bank previously contributed to the consolidated cash and cash equivalents balance. Absent this change, net cash used for investing activities increased by RR39,027 million in 2002. The 36.6% increase was primarily due to the RR32,671 million increase in cash capital expenditures to RR141,124 million in 2002.

Net cash provided by (used for) financing activities

Net cash provided by financing activities increased to RR17,555 million in 2003 from RR3,017 million in 2002. The increase was primarily due to an increase in net long-term borrowings and reduction in restricted cash, which more than offset the net cash outflow from the net redemption of promissory notes and repayment of short-term borrowings.

Net cash provided by financing activities amounted to RR3,017 million in 2002 compared to net cash used of RR9,076 million in 2001. The 133% increase was mainly the result of an increase in net proceeds from long-term borrowings, which exceeded the net outflows from the redemption of promissory notes, and a reduction in interest paid.

Working capital

Our working capital surplus (current assets less current liabilities) was RR174,335 million as of December 31, 2003 and RR56,221 million as of December 31, 2002. The RR118,114 million increase in our working capital in 2003 was primarily due to an increase in short-term investments, accounts receivable and prepayments and inventory, and a decrease in short-term promissory notes payable, which more than offset the increase in accounts payable and accrued charges. Short-term investments increased by RR28,174 million, primarily due to higher purchases of trading investments by our subsidiary, Gazprombank, and higher purchases of third party promissory notes. Accounts receivable and prepayments increased by RR42,887 million, primarily due to an increase in advances for equipment purchases and higher loans provided by Gazprombank. Inventory increased by RR22,769 million, primarily due to higher volumes and unit costs of gas in storage, higher cost of materials and supplies to be used for operations, partially due to a release of the inventory provision, and higher goods for resale as we follow a program to sell off our excess of unused inventories. Short-term borrowings and short-term promissory notes payable decreased by RR14,201 million and RR13,951 million, respectively, in line with our strategy of refinancing short-term debt with long-term borrowings and eliminating the issuance of promissory notes. We believe that we have sufficient working capital to meet our requirements for at least the next twelve months; however, we are dependent on the short-term credit markets to finance our working capital. We depend on regular access to the domestic rouble bank loan and rouble debt markets to meet a significant portion of our financing requirements.

As of December 31, 2002, our working capital surplus amounted to RR56,221 million compared to RR45,041 million as of December 31, 2001. The RR11,180 million increase in working capital was primarily due to a decrease in accounts payable and accrued charges by RR27,717 million, a decrease in short-term promissory notes payable by RR29,018 million, a decrease in taxes payable by RR21,896 million, partially offset by a decrease in accounts receivable and prepayments by RR65,729 million and a change in other working capital components by RR1,722 million.

Capital expenditures

Total capital expenditures (including cash advances to contractors and suppliers, which are recorded within long-term accounts receivable and prepayments, and excluding the effect of acquisitions of subsidiaries and reclassifications) by segment for the years ended December 31, 2003, 2002 and 2001 in constant RR terms, except for data as of December 31, 2003 which is in nominal RR, amounted to the following:

	Year Ended December 31,					
	2003		2002		2001	
	(RR million)	(% of total)	(RR million)	(% of total)	(RR million)	(% of total)
Transportation	81,819	40%	86,176	48%	81,631	45%
Production	100,541	49%	76,985	43%	74,890	42%
Refining	4,899	2%	7,125	4%	5,371	3%
Distribution	9,762	5%	1,663	0%	378	0%
Other [(1)]	7,214	4%	8,319	5%	18,545	10%
Total	**204,235**	**100%**	**180,268**	**100%**	**180,815**	**100%**

Note:

(1) Primarily includes expenditures for service activities such as drilling, transportation equipment and repair.

The reduction in capital expenditures on transportation and the significant increase in capital expenditures on production in 2003 compared to 2002, represented a temporary change in the trend over the two years ended December 31, 2002. Our budgeted future capital expenditures are discussed below, and indicate our renewed focus on investing in our transportation network.

Total capital expenditures (including cash advances to contractors and suppliers, which are recorded within long-term accounts receivable and prepayments, and excluding the effect of acquisitions of subsidiaries and reclassifications) increased from RR180,268 million in 2002 to RR204,235 million in 2003. The increase was primarily due to increased funding of new production projects including the development of the Yamburgskoye, Pestsovoye, Vyngayakhinskoye and Yen-Yakhinskoe fields and the Aneryakhinskoe area of the Yamburgskoye field.

Following is a table of our cash and non-cash capital expenditures (including cash advances to contractors and suppliers, which are recorded within long-term accounts receivable and prepayments, and excluding the effect of acquisitions of subsidiaries and reclassifications):

	Year ended December 31,		
	2003	2002	2001
		(RR million)	
Cash capital expenditures	144,370	141,124	108,453
Interest paid and capitalized	13,807	12,998	16,711
Mutual cancellations and barter settlements	42,469	42,639	49,133
Other[(1)]	3,589	(16,493)	6,518
Total capital expenditures	**204,235**	**180,268**	**180,815**

Notes:

(1) Includes changes in accounts payable related to capital construction, changes in promissory notes related to capital construction.

Budgeted total capital expenditures by segment for the year ending December 31, 2004 is, as follows (excluding expenditures for Sibur, Vostokgazprom and Purgaz):

	Year ended December 31, 2004
	(RR million)
Production	71,600
Transportation	111,600
Refining	2,380
Distribution	—[1]
Other [2]	6,760
Total	**192,340**

Notes:

(1) For 2004, included within other segments.

(2) Primarily includes expenditures for service activities such as drilling and automobile transport and repair.

Our capital expenditures in the six months ended June 30, 2004 were approximately RR87 billion out of the RR192 billion budgeted for the year ending December 31, 2004.

The actual amount and timing of capital expenditures made are subject to adjustment.

Debt obligations

Our borrowings net of repayments (including bonds and promissory notes) were RR43,308 million, RR41,803 and RR25,429 million, for the years ended December 31, 2003, 2002 and 2001, respectively. However, as a result of the inflation of our prior period debt balances due to the application inflation accounting under IAS 29 prior to January 1, 2003, our debt balances in such periods are reported to have declined until December 31, 2002 despite these net borrowings.

Our total borrowings decreased as of December 31, 2002 compared to December 31, 2001 and then increased as of December 31, 2003 compared to December 31, 2002. In spite of the opposite movements in our total borrowings, there have been consistent movements in our long-term and short-term borrowings, reflecting in part our strategy of refinancing short-term debt with long-term borrowings. Our long-term borrowings (including the current portion of long-term borrowings and long-term promissory notes payable), which are predominantly denominated in convertible currencies (mainly the U.S. dollar and the euro), increased in constant RR terms from December 31, 2001 to December 31, 2002 and in nominal RR terms from December 31, 2002 to December 31, 2003. Our short-term borrowings (excluding the current portion of long-term borrowings but including short-term promissory notes payable) decreased in constant RR terms from December 31, 2001 to December 31, 2002 and in nominal RR terms from December 31, 2002 to December 31, 2003.

The following table shows our borrowings at December 31, 2003, 2002 and 2001 expressed in constant RR terms, except for data as of December 31, 2003 which is in nominal RR:

	As of December 31,		
	2003	2002	2001
	(RR million)		
Long-term borrowings			
Fixed interest rate borrowings	247,763	138,612	107,516
Weighted average interest rates for fixed rate borrowings	8.8%	9.2%	9.1%
Variable interest rate borrowings	150,759	207,754	220,910
Weighted average interest rates for variable rate borrowings	4.2%	4.7%	6.4%
Total long-term borrowings	**398,522**	**346,366**	**328,426**
RR denominated borrowings	34,285	33,191	39,767
Foreign currency denominated borrowings	364,237	313,175	288,659
Total long-term borrowings	**398,522**	**346,366**	**328,426**
Less: current portion of long-term borrowings	(94,767)	(97,763)	(91,013)
Add: long-term promissory notes, net of discount	13,715	20,218	14,259
Average discount on promissory notes	12.8%	18.7%	26.5%
Total long-term debt obligations	**317,470**	**268,821**	**251,672**
Short-term debt borrowings			
Fixed interest rate borrowings	61,982	85,421	102,077
Weighted average interest rates for fixed rate borrowings	8.2%	10.1%	16.8%
Variable interest rate borrowings	13,873	1,639	—
Weighted average interest rates for variable rate borrowings	5.3%	6.8%	—
Total short-term borrowings	**75,855**	**87,060**	**102,077**
RR denominated borrowings	25,905	11,134	38,581
Foreign currency denominated borrowings	49,950	75,926	63,496
Total short-term borrowings	**75,855**	**87,060**	**102,077**
Plus: Current portion of long-term borrowings	94,767	97,763	91,013
Short-term promissory notes, net of discount	27,433	41,384	70,402
Average discount on promissory notes	8.9%	16.3%	20.0%
Total short-term debt borrowings	**198,055**	**226,207**	**263,492**
Total borrowings	**515,525**	**495,028**	**515,164**

The following table shows our actual U.S. dollar and euro denominated long-term borrowings (expressed in U.S. dollars) as of December 31, 2003, 2002 and 2001 as well as the same balances expressed in constant RR terms, except for data as of December 31, 2003 which is in nominal RR.

	As of December 31,		
	2003	2002	2001
	(RR million)		
U.S. dollar denominated (expressed in U.S. dollars)	9,690	8,280	6,088
Euro denominated (expressed in U.S. dollars) (1)	2,676	1,625	2,275
Total long-term convertible-currency-denominated borrowings expressed in U.S. dollars	**12,366**	**9,905**	**8,363**
Total long-term convertible-currency-denominated borrowings expressed in constant RR, except for data as of December 31, 2003 which is in nominal RR	**364,237**	**314,818**	**288,659**

Note:

(1) Converted at the euro to U.S. dollar exchange rate of 1.25, 1.04 and 0.88 as of December 31, 2003, 2002 and 2001, respectively.

From December 31, 2000 to December 31, 2003, our actual long-term borrowings denominated in convertible currencies grew, as we increasingly met our financing requirements with long-term borrowings in the capital markets and began to refinance our short-term obligations.

A significant portion of our long-term borrowings denominated in convertible currencies are collateralized by receivables under certain of our export contracts. As of December 31, 2003, 2002 and 2001 borrowings of RR154,858 million, RR219,700 million and RR210,807 million, respectively, inclusive of current portion of long-term borrowings, were secured by revenues from export supplies of gas to Europe. We have not increased our borrowings secured by revenues from export supplies of natural gas to Europe since December 31, 2003.

The following table shows our schedule of repayments for long-term borrowings (excluding long-term promissory notes) as of December 31, 2003 and 2002, expressed in constant RR terms:

	As of December 31,	
	2003	2002
	(RR million)	
Between one and two years	68,253	92,378
Between two and five years	109,521	132,010
After five years	125,981	24,215
	303,755	248,603

Contractual obligations and other commitments

The amount of outstanding guarantees issued to third parties increased by RR2,057 million to RR89,764 million as of December 31, 2003 as compared to December 31, 2002 primarily as a result of guarantees issued to Eural Trans Gas in the amount of RR6,274 million and to NAK Naftogaz Ukraine in the amount of RR2,945 million, which more than offset decreases in the oustanding amounts of existing guarantees.

The amount of outstanding guarantees issued to third parties increased by RR7,423 million to RR87,707 million as of December 31, 2002 as compared to December 31, 2001. RR15,368 million of the increase was due to guarantees issued to banks for the construction of the offshore portion of the Blue Stream pipeline. As of December 31, 2002 our guarantees balance included RR6,213 million of guarantees issued by subsidiaries under contracts for purchases of equipment, construction and installation works.

We have significant obligations to supply gas under long-term contract with European customers.

Qualitative and Quantitative Disclosures and Market Risks

We are exposed to market risk from changes in commodity prices, foreign currency exchange rates, interest rates and prices of marketable securities. We are exposed to commodity risk as we are a commodity business and our natural gas export sales are linked to oil product prices. We are exposed to foreign exchange risk to the extent that our sales revenues, costs, receivables for gas sales and debt are denominated in currencies other than RR. We are subject to market risk from changes in interest rates that may affect the cost of our financing. Other than in our banking subsidiaries, we do not 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 RR relative to the U.S. dollar and euro. At December 31, 2003, approximately RR326,930 million and RR87,257 million of our borrowings were denominated in U.S. dollars and euros, respectively (out of approximately RR474,377 million of our total borrowings, excluding promissory notes, at that date). Decreases in the value of the RR relative to the U.S. dollar or euro will increase our foreign currency denominated costs and expenses and our debt service obligations for foreign currency denominated borrowings in RR terms. A depreciation of the RR relative to the U.S. dollar or euro will also result in a decrease in the value of our foreign currency borrowings in RR terms. We believe that the risks associated with our foreign currency exposure are mitigated by the fact that a significant portion of our revenues, approximately 63% in 2003, are U.S. dollar or euro denominated. As of December 31, 2003 the RR had appreciated against the U.S. dollar by approximately 7.3% and depreciated against the euro by approximately 11.2% since January 1, 2003.

A hypothetical, instantaneous and unfavorable 10% change in currency exchange rates on December 31, 2003 and 2002 would have resulted in additional interest expense, including default interest, of approximately RR3,183 million and RR2,549 million (nominal) in 2003 and 2002, respectively, reflecting the increased costs in RR of servicing our foreign currency denominated borrowings held as of December 31, 2003 and 2002. A hypothetical, instantaneous and unfavorable 10% change in currency exchange rates as of December 31, 2003 and 2002 would have resulted in an estimated foreign exchange loss of approximately RR41,419 million and RR41,567 million (nominal) on foreign currency denominated borrowings held as of December 31, 2003 and 2002, respectively.

Interest Rate Risk

We are exposed to interest rate risk in our borrowings that bear interest at floating rates. As of December 31, 2003 and 2002, we had approximately RR474,377 million and RR433,426 million in total borrowings (excluding promissory notes), of which approximately RR309,745 million and RR224,033 million bore interest at fixed rates and approximately RR164,632 million and RR209,393 million bore interest at floating rates determined by reference to the London inter-bank offered rate ("LIBOR") for U.S.$ and euro deposits, respectively.

A hypothetical, instantaneous and unfavorable change of 100 basis points in the interest rate applicable to floating rate financial liabilities held as of December 31, 2003 and 2002 would have resulted in additional net interest expense of approximately RR1,860 million and RR2,050 million (nominal) in 2003 and 2002, respectively. This sensitivity analysis is based on the assumption of an unfavorable 100 basis point movement of the interest rate applicable to each homogenous category of financial liabilities. A homogeneous category is defined according to the currency in which financial liabilities are denominated and assumes the same interest rate movement within each homogeneous category (e.g., U.S.$ and euro).

A hypothetical, instantaneous and unfavorable change (decrease) of 100 basis points in the interest rate would have resulted in an increase of fair value of fixed rate financial liabilities held as of December 31, 2003 and 2002 to RR10,773 million and RR1,545 million, respectively.

Derivatives

For the purpose of reducing currency risk, our banking subsidiaries use a number of derivative instruments. These comprise forward foreign exchange contracts and written foreign currency option contracts. The objective, when using any derivative instrument, is to ensure that the risk to reward profile of any transaction is optimized. The normal policy is to measure these instruments at their fair value, using the spot rate at the year end as the basis for the fair value measurement with resultant gains or losses being reported within gains less losses arising from dealing in foreign currencies within the statement of operations. These derivatives are not material to the Group.

Commodity risk

Substantially all of our natural gas, gas condensate and other hydrocarbon export sales to Europe are sold under long-term contracts. Our natural gas export prices to Europe are based on a formula linked to world oil product prices, which in turn are linked to world crude oil prices. Worldwide political developments and the actions of the Organization of Petroleum Exporting Countries affect crude oil prices and thus our natural gas export prices. We do not use any derivative instruments to hedge our production in order to decrease our price risk exposure.

Securities price risk

We are exposed to movements in the prices of marketable securities that we hold in our investment portfolio. Specifically, as of December 31, 2003, we held RR22,109 million of corporate shares and bonds and RR7,775 million of state and municipal securities. A change in Russia's sovereign credit rating, or an external event that impacts Russian debt and equity prices, could have an impact on the market value of our trading securities.