

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

*You should read the following management's discussion in conjunction with our audited consolidated financial information as of and for the year ended December 31, 2007 prepared in accordance with International Financial Reporting Standards ("IFRS").*

### OVERVIEW

We are one of the world's largest oil and gas companies in terms of reserves, production and market capitalization. Our revenues are primarily derived from sales of natural gas, crude oil and other hydrocarbon products to western and central Europe, Russia and other former Soviet Union countries.

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

- Production of gas – exploration and production of gas;
- Transport – transportation of gas;
- Distribution – domestic and export sales of gas;
- Production of crude oil and gas condensate – exploration of oil and gas condensate, sales of crude oil and gas condensate; and
- Refining – processing of oil, gas condensate and other hydrocarbons, and sales of refined products.

Other businesses primarily comprise banking, electricity and media.

Our five 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 segment purchases natural gas from our Production of gas segment and transportation services from our Transport segment. Our Refining segment purchases crude oil and gas condensate from the Production of crude oil and gas condensate segment. We establish internal transfer prices with reference to the specific funding requirements of the individual subsidiaries within each segment. Accordingly, the results of operations of these segments on a stand-alone basis do not necessarily represent each 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.

### RESULTS OF OPERATIONS

(RR million)

	<b>Year ended December 31</b>	
	<b>2007</b>	<b>2006</b>
Sales (net of excise tax, VAT and customs duties)	2,390,467	2,152,111
Operating expenses	(1,688,689)	(1,363,923)
<b>Operating profit</b>	<b>701,778</b>	<b>788,188</b>
Gain from sale of interest in subsidiary	50,853	-
Gain from change in fair value of call option	50,738	-
Deconsolidation of NPF Gazfund	44,692	-
Finance income	159,380	97,923
Finance expenses	(132,573)	(65,220)
Share of net income of associated undertakings and jointly controlled entities	24,234	26,363
Gains on disposal of available-for-sale financial assets	25,102	8,811
<b>Profit before profit tax</b>	<b>924,204</b>	<b>856,065</b>
Current profit tax expense	(218,266)	(213,844)
Deferred profit tax expense	(10,953)	(5,760)
Total profit tax expense	(229,219)	(219,604)
<b>Profit for the year</b>	<b>694,985</b>	<b>636,461</b>
<b>Attributable to:</b>		
Equity holders of OAO Gazprom	658,038	613,345
Minority interest	36,947	23,116
	<b>694,985</b>	<b>636,461</b>

## Sales

The following table sets out our volumes and realized prices for the year ended December 31, 2007 and 2006.

(RR million unless indicated otherwise)	Year ended December 31	
	2007	2006
<b>Sales of gas</b>		
<i>Far Abroad</i>		
Gross sales <sup>(1)</sup>	1,161,549	1,149,582
Excise tax	(96)	(1,396)
Customs duties	(288,043)	(302,319)
Net sales	873,410	845,867
Volumes in billion cubic meters (bcm)	168.5	161.5
Gross average price, U.S.\$ per mcm <sup>(2)</sup> (including excise tax and customs duties) <sup>(3)</sup>	269.4	261.9
Gross average price, RR per mcm <sup>(2)</sup> (including excise tax and customs duties)	6,891.4	7,119.4
<i>FSU (Former Soviet Union)</i>		
Gross sales (net of value added tax (VAT))	273,550	243,133
Excise tax	-	-
Customs duties	(18,709)	(33,414)
Net sales	254,841	209,719
Volumes in bcm	96.5	101.0
Gross average price, U.S.\$ per mcm <sup>(2)</sup> (including excise tax and customs duties, net of VAT) <sup>(3)</sup>	110.9	88.6
Gross average price, RR per mcm <sup>(2)</sup> (including excise tax and customs duties, net of VAT)	2,835.3	2,408.4
<i>Russia</i>		
Gross sales (net of VAT)	399,452	357,274
Excise tax	-	(1,241)
Net sales	399,452	356,033
Volumes in bcm	307.0	316.3
Gross average price, RR per mcm <sup>(2)</sup> (including excise tax, net of VAT)	1,301.1	1,129.4
<i>Total sales of gas</i>		
Gross sales (net of VAT)	1,834,551	1,749,989
Excise tax	(96)	(2,637)
Customs duties	(306,752)	(335,733)
Net sales	1,527,703	1,411,619
Volumes in bcm	572.0	578.8
Net sales of refined products (net of excise tax, VAT and customs duties)	492,438	434,985
Net sales of crude oil and gas condensate (net of excise tax, VAT and customs duties)	167,758	171,709
Gas transportation sales (net of VAT)	41,740	34,500
Other revenues (net of VAT)	<u>160,828</u>	<u>99,298</u>
<b>Total sales (net of excise tax, VAT and customs duties)</b>	<b>2,390,467</b>	<b>2,152,111</b>

Notes:

<sup>(1)</sup> VAT is not charged on sales to Far Abroad countries.

<sup>(2)</sup> One mcm is equivalent to 35,316 cubic feet.

<sup>(3)</sup> Calculated on the basis of average rate.

Total sales (net of excise tax, VAT and customs duties) increased by RR 238,356 million, or 11%, to RR 2,390,467 million in the year ended December 31, 2007 compared to the year ended December 31, 2006.

Net sales of gas accounted for 64% and 66% of total net sales in the year ended December 31, 2007 and 2006, respectively.

Net sales of gas increased from RR 1,411,619 million in the year ended December 31, 2006 to RR 1,527,703 million in the year ended December 31, 2007, or by 8%.

Net sales of gas to Far Abroad countries increased in the year ended December 31, 2007 compared to the year ended December 31, 2006 by RR 27,543 million, or 3%. The increase resulted primarily from a 4% increase in sales volumes. The 3% decrease in the gross average price nominated in RR (including excise tax and customs duties) was offset by the decrease in effective rate of customs duties. This decrease in the effective rate of customs duties was caused by an increase in sales from gas purchased outside Russia. Such sales are not subject to customs duties. The increase in sales volumes to Far Abroad countries was primarily due to increased sales to customers in Great Britain, Turkey, Holland and Belgium.

Net sales of gas to FSU countries increased in the year ended December 31, 2007 compared to the year ended December 31, 2006 by RR 45,122 million, or 22%, to RR 254,841 million. This increase was mainly due to a 27%

increase in the net average price in RR terms (net of excise tax, customs duties and VAT), which was partly offset by 4% decrease in sales volumes. The increase in the net average price in RR terms was primarily due to the increase in sales prices to customers in Belarus, Kazakhstan, Lithuania, and Moldova. The increase in net average prices (excluding excise tax and customs duties, net of VAT) was affected by the decrease in effective rate of customs duties. This decrease was primarily caused by the increased sales of gas from Middle Asia. Such sales are not subject to customs duties.

Net sales of gas in the domestic market increased by RR 43,419 million, or 12%, to RR 399,452 million in the year ended December 31, 2007 compared to the year ended December 31, 2006. This increase was mainly due to the increase in domestic gas tariffs set by the Federal Tariffs Service by 15%, which was partly offset by decrease in sales volumes by 3%, or 9.3 bcm.

Sales of refined products (net of excise tax, VAT and customs duties) increased by RR 57,453 million, or 13%, to RR 492,438 million in the year ended December 31, 2007 compared to RR 434,985 million in the year ended December 31, 2006. The increase mainly relates to the sales of OAO Gazprom Neft and its consolidated subsidiaries, which accounted for 59% and 60% of the total sales of refined products for the year ended December 31, 2007 and 2006, respectively. Sales of refined products (net of excise tax, VAT and customs duties) accounted for 21% and 20% of our total sales (net of excise tax, VAT and customs duties) in the years ended December 31, 2007 and 2006, respectively.

Sales of crude oil and gas condensate (net of excise tax, VAT and customs duties) decreased by RR 3,951 million, or 2%, to RR 167,758 million in the year ended December 31, 2007 compared to RR 171,709 million in the year ended December 31, 2006. Sales of crude oil (net of VAT and customs duties) included in net sales of crude oil and gas condensate, amounted to RR 147,552 million and RR 151,613 million in the years ended December 31, 2007 and 2006, respectively. The decrease mainly related to Gazprom Neft activities and was caused by the fact, that more own oil was used to produce refined products.

Gas transportation sales (net of VAT) increased by RR 7,240 million, or 21%, to RR 41,740 million in the year ended December 31, 2007 from RR 34,500 million in the year ended December 31, 2006. This increase was mainly due to an increase in both transportation tariffs and volumes of gas transported.

Other revenues (net of VAT) increased by RR 61,530 million, or 62%, to RR 160,828 million in the year ended December 31, 2007 compared to RR 99,298 million in the year ended December 31, 2006. Other revenues represent activities including media, and sales of other goods and services, including electricity.

### Operating expenses

Operating expenses increased by 24% in the year ended December 31, 2007 to RR 1,688,689 million from RR 1,363,923 million in the year ended December 31, 2006. Operating expenses as a percentage of sales increased from 63% in the year ended December 31, 2006 to 71% in the year ended December 31, 2007. The table below presents a breakdown of operating expenses in each period:

(RR million)	Year ended December 31	
	2007	2006
Purchased oil and gas	382,054	280,062
Staff costs	248,894	199,588
Taxes other than on income	196,993	187,245
Depreciation	183,577	167,446
Transit of gas, oil and refined products	152,093	156,489
Repairs and maintenance	118,058	95,190
Materials	94,520	81,810
Cost of goods for resale, including refined products	56,643	51,041
Electricity and heating expenses	44,901	42,559
Social expenses	16,343	18,563
Research and development	15,486	13,123
Rental expenses	13,568	8,890
Insurance expenses	12,950	10,448
Processing services	10,090	8,363
Impairment provisions	7,708	14,384
Transportation services	6,675	6,130
Other operating expenses	<u>128,136</u>	<u>22,592</u>
<b>Total operating expenses</b>	<b>1,688,689</b>	<b>1,363,923</b>

*Purchased oil and gas*

Cost of purchased oil and gas increased by 36% to RR 382,054 million in the year ended December 31, 2007, from RR 280,062 million in the year ended December 31, 2006. The cost of purchased gas included in the cost of purchased oil and gas amounted to RR 299,465 million and RR 202,975 million in the year ended December 31, 2007 and 2006, respectively. The increase primarily relates to the increase in prices of gas purchased in Middle Asia, mainly for further reselling.

#### *Staff costs*

Staff costs increased by 25% to RR 248,894 million in the year ended December 31, 2007 from RR 199,588 million in the year ended December 31, 2006. The increase mainly resulted from the growth of average base salaries and an increase in expenses associated with pension obligations.

#### *Taxes other than on income*

Taxes other than on income consist of:

(RR million)	Year ended December 31	
	2007	2006
Natural resources production tax	165,097	158,480
Property tax	21,638	21,825
Other taxes	<u>10,258</u>	<u>6,940</u>
<b>Taxes other than on income</b>	<b>196,993</b>	<b>187,245</b>

#### *Depreciation*

Depreciation increased by 10% to RR 183,577 million in the year ended December 31, 2007 from RR 167,446 million in the year ended December 31, 2006. The increase primarily relates to the growth in our fixed asset base.

#### *Transit of gas, oil and refined products*

Transit of gas, oil and refined products decreased by 3% to RR 152,093 million in the year ended December 31, 2007 from RR 156,489 million in the year ended December 31, 2006. This decrease mainly relates to the decrease in volumes of gas transported through Ukraine and Eastern Europe countries and depreciation of U.S. dollar against the RR in the year 2007 compared to the year 2006.

#### *Repairs and maintenance*

Cost of repairs and maintenance increased by 24% to RR 118,058 million in the year ended December 31, 2007 from RR 95,190 million in the year ended December 31, 2006. The increase was primarily due to an increase in volume of repairs and maintenance services rendered by third party providers mainly in the Transport segment.

#### *Materials*

Cost of materials increased by 16% to RR 94,520 million in the year ended December 31, 2007 from RR 81,810 million in the year ended December 31, 2006. The increase was primarily related to higher prices of materials and increased volumes of purchases by the Transport and Refining segments.

#### *Cost of goods for resale, including refined products*

Cost of goods for resale, including refined products increased by 11% to RR 56,643 million in the year ended December 31, 2007 from RR 51,041 million in the year ended December 31, 2006. The increase was mostly due to the higher cost of electricity purchased for resale.

#### *Electricity and heating expenses*

Electricity and heating expenses increased by 6% to RR 44,901 million in the year ended December 31, 2007 from RR 42,559 million in the year ended December 31, 2006, mainly due to increased electricity consumption and higher electricity tariffs, which are set by the FTS.

#### *Other operating expenses*

Other operating expenses increased to RR 128,136 million in the year ended December 31, 2007 from RR 22,592 million in the year ended December 31, 2006. Other operating expenses include bank charges, security services, legal and consulting services and advertising.

## Operating profit

As a result of the factors discussed above, our operating profit decreased by RR 86,410 million, or 11%, from RR 788,188 million in the year ended December 31, 2006 to RR 701,778 million in the year ended December 31, 2007. Our operating profit margin decreased from 37% in the year ended December 31, 2006 to 29% in the year ended December 31, 2007.

## Gain from sale of interest in subsidiary

In accordance with the agreement with BASF AG to swap certain assets on December 17, 2007 we received 15% less one share in Wintershall Gas GmbH (WINGAS GmbH), increasing our share in the entity from 35% to 50% less one share and 49% in Wintershall AG, the license holder for the development of certain Libyan oil concessions (C96 C97). These investments are shown within Investments in associated undertakings and jointly controlled entities on the consolidated balance sheet in the amount of RR 19,620 million (Euro 546 million) and RR 10,259 million (Euro 286 million), respectively. We also received Euro 598 million in cash. BASF AG received 25% less one ordinary share and one non voting share, which is equal to 10% of income from the project, in OAO Severneftegazprom. Income obtained from this transaction was shown in separate line in the consolidated statement of income in the amount of RR 50,853 million.

## Gain from change in fair value of call option

In April 2007, ENI S.P.a. (Eni) offered to us an option to acquire a 20% interest in OAO Gazprom Neft by April 2009, at a price of USD 3.7 billion plus certain financial expenses. From the date of the signing of the agreement until 31 December 2007, the change of the option's fair value amounted to RR 50,738 million. In accordance with IAS 39, the related financial asset is recorded in other non-current assets and recognized as income in the consolidated statement of income.

## Deconsolidation of NPF Gazfund

In 1994, Gazprom founded the Non-State pension fund NPF Gazfund. Historically, Gazprom consolidated NPF Gazfund primarily due to Gazprom management having control over the financial and investment decisions of NPF Gazfund. Gazprom used NPF Gazfund as the Group's primary investment vehicle for purchasing strategic investments and NPF Gazfund did not have any other significant operations or investments.

During the first quarter of 2007, there were changes in legislation relating to pension funds, specifically Regulation No. 63 dated 1 February 2007, which introduced stringent requirements on pension fund's investment policies and on the composition of investment portfolios. After evaluating and assessing the specific provisions of the new legal requirements, executive management met in March 2007 and decided to discontinue the use of Gazfund as the Group's primary investment vehicle.

Based on the new legislation and management's decisions, NPF Gazfund was deconsolidated from the consolidated financial information of OAO Gazprom in first quarter 2007. As a result of this deconsolidation, the Gazfund investment assets are now accounted for as plan assets under IAS 19. The principal balance sheet line items affected are short term financial assets, other non-current assets, provisions for liabilities and charges, minority interest and equity including treasury shares. In addition, where NPF Gazfund continues to hold ownership interests in OAO Gazprom subsidiaries (for example, OAO Gazprombank, OAO Sibur-Holding and their subsidiaries), those interests are reflected as minority interest in the accompanying financial information.

This transaction resulted in the recognition of income in the amount of RR 44,692 million and increase in retained earnings in the amount of RR 111,015 million due to recognition of fair value of the pension assets on the balance sheet of the Group.

## Finance income and expenses

(RR million)	Year ended December 31	
	2007	2006
Exchange gain	82,936	60,497
Exchange loss	(55,598)	(21,449)
Interest income	75,394	36,460
Interest expense	(76,975)	(43,771)
Gain on and extinguishment of restructured liabilities	<u>1,050</u>	<u>966</u>
<b>Net finance income</b>	<b>26,807</b>	<b>32,703</b>

Exchange gain increased by 37% to RR 82,936 million in the year ended December 31, 2007, compared to RR 60,497 million in the year ended December 31, 2006. This increase is primarily due to the increase in the

volume of loans and borrowings nominated in U.S. dollar and appreciation of the Russian Rouble against the US dollar during the year ended December 31, 2007 compared to the year ended December 31, 2006.

Exchange loss increased by 159% to RR 55,598 million in the year ended December 31, 2007 from RR 21,449 million in the year ended December 31, 2006. The changes reflect the impact of the increase of volume of loans and borrowings nominated in euro and appreciation of the euro against the RR in the year ended December 31, 2007 compared to the year ended December 31, 2006.

Interest income increased by 107% to RR 75,394 million in the year ended December 31, 2007 from RR 36,460 million in the year ended December 31, 2006 mainly due to an increase in loans issued by OAO Gazprombank and bank current accounts. Interest expense increased by 76% from RR 43,771 million in the year ended December 31, 2006 to RR 76,975 million in the year ended December 31, 2007 mainly due to increased borrowings related to OAO Gazprombank activity.

#### **Share of net income of associated undertakings and jointly controlled entities**

Share of net income of associated undertakings and jointly controlled entities decreased by RR 2,129 million, or 8%, to RR 24,234 million in the year ended December 31, 2007 compared to RR 26,363 million in the year ended December 31, 2006. The decrease was primarily due to the exclusion of our share of net profit of OAO Mosenergo in amount of RR 2,696 million due to its consolidation in 2007 as well as due to the decrease of our share of OAO NGK Slavneft net profit in the amount of RR 3,655 million for the year ended December 31, 2007 compared to the year ended December 31, 2006. These effects were partly offset by the increase in our share of net profit of OAO Novatek and TOO KazRosGaz by RR 3,093 million and RR 1,406 million, respectively.

#### **Profit tax**

Total profit tax expense increased by RR 9,615 million, or 4%, to RR 229,219 million in the year ended December 31, 2007 compared to RR 219,604 million in the year ended December 31, 2006. Our effective profit tax rate in the year ended December 31, 2007 compared to the year ended December 31, 2006 decreased by 1% from 26% to 25%.

#### **Profit for the period attributable to equity holders of OAO Gazprom**

As a result of the factors discussed above, our profit for the period attributable to equity holders of OAO Gazprom increased by RR 44,693 million, or 7%, from RR 613,345 million in the year ended December 31, 2006 to RR 658,038 million in the year ended December 31, 2007.

#### **Profit for the period attributable to minority interest**

Minority interest increased by 60% to RR 36,947 million in the year ended December 31, 2007 compared to RR 23,116 million in the year ended December 31, 2006 due to the increase in the extent of minority interest in OAO Gazprombank, OAO Sibur-Holding and its subsidiaries, caused by the deconsolidation of NPF Gazfund.

### **LIQUIDITY AND CAPITAL RESOURCES**

The following table summarizes our statements of cash flows for the years ended December 31, 2007 and 2006:

(RR million)	<b>Year ended December 31</b>	
	<b>2007</b>	<b>2006</b>
Net cash provided by operating activities	598,508	544,088
Net cash used for investing activities	(892,241)	(512,251)
Net cash provided by financing activities	309,706	94,414

#### *Net cash provided by operating activities*

Net cash provided by operating activities amounted to RR 598,508 million in the year ended December 31, 2007 compared to RR 544,088 million in the year ended December 31, 2006. This was primarily due to favourable effects of the working capital changes in 2007 compared to 2006.

*Net cash used for investing activities*

Net cash used for investing activities amounted to RR 892,241 million in the year ended December 31, 2007 compared to RR 512,251 million in the year ended December 31, 2006. The increase was primarily due to the acquisition of an interest in Sakhalin Energy Investment Company Ltd. and OAO Tomskneft and higher capital expenditures on field development and gas transportation infrastructure.

*Net cash provided by financing activities*

Net cash provided by financing activities amounted to RR 309,706 million in the year ended December 31, 2007 compared to net cash provided by financing activities in the amount of RR 94,414 million in the the year ended December 31, 2006. This change was primarily due to increase in proceeds from new short-term and long-term borrowings received in the year ended December 31, 2007.

## CAPITAL EXPENDITURES

Total capital expenditures (excluding the effect of acquisitions of subsidiaries and reclassifications) by segment for the year ended December 31, 2007 and 2006 in nominal RR terms, amounted to the following:

(RR million)	Year ended December 31	
	2007	2006
Transport	197,849	242,305
Production of gas	185,722	130,751
Production of crude oil and gas condensate	66,237	56,261
Distribution	39,088	22,546
Refining	38,671	20,646
Other	49,318	13,131
<b>Total</b>	<b>576,885</b>	<b>485,640</b>

Total capital expenditures (excluding the effect of acquisitions of subsidiaries and reclassifications) increased by RR 91,245 million, or 19%, from RR 485,640 million in the year ended December 31, 2006 to RR 576,885 million in the year ended December 31, 2007. The increase of our capital expenditures in the Production of gas segment was primarily due to increased capital expenditures on the construction of new wells and associated gas preparation units at the Bovanenkovskoe, Kharasaveiskoye, Kharvutinskoye and Yuzhno-Russkoye fields. The increase in capital expenditures in the Other segment was mainly caused by capital expenditures of OAO Mosenergo in the second half of 2007.

## DEBT OBLIGATIONS

Our net debt balance (defined as the sum of short-term borrowings, current portion of long-term borrowings, short-term promissory notes payable, long-term borrowings, long-term promissory notes payable and restructured tax liabilities, net of cash and cash equivalents and balances of cash and cash equivalents restricted as to withdrawal under the terms of certain borrowings and other contractual obligations) increased by RR 420,769 million, or 52%, from RR 807,814 million as of 31 December 2006 to RR 1,228,583 million as of 31 December 2007. This increase was primarily caused by higher borrowings in 2007. The proceeds from these borrowings were used to finance new acquisitions.