

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

*You should read the following management's discussion in conjunction with our unaudited consolidated interim condensed financial information as of and for the three months ended March 31, 2007. The interim condensed financial information has been prepared in accordance with International Accounting Standard 34 "Interim financial reporting" ("IAS 34"). This financial information should be read together with the consolidated financial statements for the year ended December 31, 2006 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 natural gas – exploration and production of natural gas;
- Transport – transportation of natural gas;
- Distribution – domestic and export sales of natural 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, construction 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 natural 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>Three months ended March 31</b>	
	<b>2007</b>	<b>2006</b>
Sales (net of excise tax, VAT and customs duties)	611,528	585,777
Operating expenses	<u>(401,733)</u>	<u>(355,267)</u>
<b>Operating profit</b>	<b>209,795</b>	<b>230,510</b>
Deconsolidation of NPF Gazfund	44,692	-
Finance income	25,415	36,569
Finance expenses	(20,036)	(18,552)
Share of net income of associated undertakings and jointly controlled entities	11,046	5,988
Gains on disposal of available-for-sale financial assets	<u>8,593</u>	<u>1,215</u>
<b>Profit before profit tax</b>	<b>279,505</b>	<b>255,730</b>
Current profit tax expense	(56,334)	(62,788)
Deferred profit tax expense	<u>(6,034)</u>	<u>(2,043)</u>
Total profit tax expense	<u>(62,368)</u>	<u>(64,831)</u>
<b>Profit for the period</b>	<b>217,137</b>	<b>190,899</b>
<b>Attributable to:</b>		
Equity holders of OAO Gazprom	210,312	185,157
Minority interest	<u>6,825</u>	<u>5,742</u>
	<b>217,137</b>	<b>190,899</b>

## Sales

The following table sets out our volumes and realized prices for the three months ended March 31, 2007 and 2006.

(RR million unless indicated otherwise)	Three months ended March 31	
	2007	2006
<b>Sales of gas</b>		
<i>Far Abroad</i>		
Gross sales <sup>(1)</sup>	282,661	315,257
Excise tax	-	(481)
Customs duties	(64,221)	(86,436)
Net sales	218,440	228,340
Volumes in billion cubic meters (bcm)	39.9	45.6
Gross average price, U.S.\$ per mcm <sup>(2)</sup> (including excise tax and customs duties) <sup>(3)</sup>	269.6	242.5
Gross average price, RR per mcm <sup>(2)</sup> (including excise tax and customs duties)	7,091.4	6,906.8
<i>FSU (Former Soviet Union)</i>		
Gross sales (net of value added tax (VAT))	82,714	72,722
Excise tax	-	-
Customs duties	(8,636)	(11,486)
Net sales	74,078	61,236
Volumes in bcm	28.1	28.8
Gross average price, U.S.\$ per mcm <sup>(2)</sup> (including excise tax and customs duties, net of VAT) <sup>(3)</sup>	111.8	88.8
Gross average price, RR per mcm <sup>(2)</sup> (including excise tax and customs duties, net of VAT)	2,942.1	2,528.1
<i>Russia</i>		
Gross sales (net of VAT)	135,915	124,909
Excise tax	-	(845)
Net sales	135,915	124,064
Volumes in bcm	105.6	111.5
Gross average price, RR per mcm <sup>(2)</sup> (including excise tax, net of VAT)	1,286.9	1,120.7
<i>Total sales of gas</i>		
Gross sales (net of VAT)	501,290	512,888
Excise tax	-	(1,326)
Customs duties	(72,857)	(97,922)
Net sales	428,433	413,640
Volumes in bcm	173.6	185.9
Net sales of refined products (net of excise tax, VAT and customs duties)	105,767	98,623
Net sales of crude oil and gas condensate (net of excise tax, VAT and customs duties)	32,348	45,121
Gas transportation sales (net of VAT)	10,799	8,905
Other revenues (net of VAT)	<u>34,181</u>	<u>19,488</u>
<b>Total sales (net of excise tax, VAT and customs duties)</b>	<b><u>611,528</u></b>	<b><u>585,777</u></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 RR25,751 million, or 4%, to RR611,528 million in the three months ended March 31, 2007 compared to the three months ended March 31, 2006.

Net sales of gas accounted for 70% of total net sales in the three months ended March 31, 2007 (71% in the three months ended March 31, 2006).

Net sales of gas increased from RR413,640 million in the three months ended March 31, 2006 to RR428,433 million in the three months ended March 31, 2007, or by 4%.

Net sales of natural gas to Far Abroad countries decreased in the three months, ended March 31, 2007 compared to the three months ended March 31, 2006 by RR9,900 million, or 4%. The decrease resulted primarily from a 13% decrease in sales volumes, which was partly compensated by 11% increase in gross average realized U.S. dollar export gas prices. The decrease in sales volumes was primarily due to a warmer winter in 2007 compared to 2006, and related decline in volumes sold to customers in Germany, Slovakia, France, Poland, Romania and the Czech Republic. The increase in export gas prices was caused by an increase in world prices for hydrocarbons that are used as price-determinants in gas supply contracts. In the majority of contracts hydrocarbons prices of prior periods are used as price determinants.

Net sales of natural gas to FSU countries increased in the three months ended March 31, 2007 compared to the three months ended March 31, 2006 by RR12,842 million, or 21%, to RR74,078 million. This increase was mainly due to a 24% increase in prices in RR terms (net of excise tax, customs duties and VAT), which was partly offset by 2% decrease in sales volumes. The increase in prices in RR terms was primarily due to the increase in sales prices to customers in Belarus, Kazakhstan, Lithuania, Moldova, Armenia, and Latvia.

Net sales of natural gas in the domestic market increased by RR11,851 million, or 10%, to RR135,915 million in the three months ended March 31, 2007 compared to the three months ended March 31, 2006. This increase was mainly due to the increase in domestic gas tariffs set by the Federal Tariffs Service, which was partly offset by decrease in sales volumes by 5%, or 5.9 bcm.

Sales of refined products increased by RR7,144 million, or 7%, to RR105,767 million in the three months ended March 31, 2007 compared to RR98,623 million in the three months ended March 31, 2006. The increase mainly relates to the sales of OAO Sibur Holding and its consolidated subsidiaries, which accounted for 28% and 24% of the total sales of refined products for the three months ended March 31, 2007 and 2006, respectively, and is due to the growth in both volumes and domestic prices of refined products. Sales of refined products (net of excise tax, VAT and customs duties) accounted for 17% of our total sales (net of excise tax, VAT and customs duties) in the three months ended March 31, 2007 and 2006.

Sales of crude oil and gas condensate (net of excise tax, VAT and customs duties) decreased by RR12,773 million, or 28%, to RR32,348 million in the three months ended March 31, 2007 compared to RR45,121 million in the three months ended March 31, 2006. Sales of crude oil included in net sales of crude oil and gas condensate, amounted to RR28,558 million and RR40,604 million in the three months ended March 31, 2007 and 2006, respectively.

Gas transportation sales increased by RR1,894 million, or 21%, to RR10,799 million in the three months ended March 31, 2007 from RR8,905 million in the three months ended March 31, 2006. This increase was due to an increase in both transportation tariffs and volumes of gas transported.

Other revenues increased by RR14,693 million, or 75%, to RR34,181 million in the three months ended March 31, 2007 compared to RR19,488 million in the three months ended March 31, 2006. Other revenues represent activities including media, construction works and sales of other services and goods.

### Operating expenses

Operating expenses increased by 13% in the three months ended March 31, 2007 to RR401,733 million from RR355,267 million in the three months ended March 31, 2006. Operating expenses as a percentage of sales increased from 61% in the three months ended March 31, 2006 to 66% in the three months ended March 31, 2007. The table below presents a breakdown of operating expenses in each period:

(RR million)	Three months ended	
	March 31	
	2007	2006
Purchased oil and gas	104,272	59,895
Staff costs	55,311	49,288
Taxes other than on income	50,509	53,891
Depreciation	50,090	46,487
Transit of gas, oil and refined products	37,747	42,447
Materials	22,592	17,247
Repairs and maintenance	16,476	17,129
Cost of goods for resale, including refined products	13,734	14,663
Electricity and heating expenses	12,322	12,065
Research and development	3,852	1,928
Social expenses	3,384	4,569
Insurance expenses	3,204	3,019
Charge for impairment provisions	996	5,450
Other	<u>27,244</u>	<u>27,189</u>
<b>Total operating expenses</b>	<b>401,733</b>	<b>355,267</b>

#### *Purchased oil and gas*

Cost of purchased oil and gas increased by 74% to RR104,272 million in the three months ended March 31, 2007 from RR59,895 million in the three months ended March 31, 2006. The increase primarily relates to the increase in both volumes and prices of gas purchased in Middle Asia, mainly for further reselling. One of the major consumers of this gas is RosUkrEnergO AG. The cost of purchased oil included in the cost of purchased oil and gas amounted to RR16,436 million and RR15,482 million in the three months ended March 31, 2007 and 2006, respectively.

### *Staff costs*

Staff costs increased by 12% to RR55,311 million in the three months ended March 31, 2007 from RR49,288 million in the three months ended March 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)	<b>Three months ended March 31</b>	
	<b>2007</b>	<b>2006</b>
Natural resources production tax	40,324	43,799
Property tax	5,758	5,333
Other taxes	<u>4,427</u>	<u>4,759</u>
<b>Taxes other than on income</b>	<b>50,509</b>	<b>53,891</b>

Natural resources production tax decreased by 8% to RR40,324 million in the three months ended March 31, 2007 from RR43,799 million in the three months ended March 31, 2006. The decrease mainly relates to production of oil and is due the decline in world oil prices and depreciation of U.S. dollar against the RR.

### *Depreciation*

Depreciation increased by 8% to RR50,090 million in the three months ended March 31, 2007 from RR46,487 million in the three months ended March 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 11% to RR37,747 million in the three months ended March 31, 2007 from RR42,447 million in the three months ended March 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 first quarter 2007 compared to the respective period of 2006.

### *Materials*

Cost of materials increased by 31% to RR22,592 million in the three months ended March 31, 2007 from RR17,247 million in the three months ended March 31, 2006. The increase was primarily related to higher prices of materials and increased volumes of purchases by the Transport and Refining segments.

### *Repairs and maintenance*

Cost of repairs and maintenance decreased by 4% to RR16,476 million in the three months ended March 31, 2007 from RR17,129 million in the three months ended March 31, 2006. This decrease mostly resulted from reduction of repairs and maintenance services rendered by third-party providers, mainly in Gazprom Neft.

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

Cost of goods for resale, including refined products decreased by 6% to RR13,734 million in the three months ended March 31, 2007 from RR14,663 million in the three months ended March 31, 2006. The decrease is mostly due to decrease in cost of purchased refined products in Gazprom Neft, which was partly offset by increase in cost of goods for resale, mainly in Gazprom Germania.

### *Other operating expenses*

Other operating expenses increased to RR27,244 million in the three months ended March 31, 2007 from RR27,189 million in the three months ended March 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 RR20,715 million, or 9%, from RR230,510 million in the three months ended March 31, 2006 to RR209,795 million in the three months ended March 31, 2007. Our operating profit margin decreased from 39% in the three months ended March 31, 2006 to 34% in the three months ended March 31, 2007.

### Deconsolidation of NPF Gazfund

In 1994, Gazprom founded the Non-State pension fund NPF Gazfund. Historically, Gazprom consolidated NPF Gazfund primarily due to the fact that NPF Gazprom management exhibited 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 on the OAO Gazprom consolidated interim condensed balance sheet 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, AB Gazprombank (ZAO), OAO Sibur-Holding), 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)	Three months ended	
	March 31	
	2007	2006
Exchange gain	10,374	28,673
Exchange loss	(4,988)	(6,289)
Interest income	14,166	7,840
Interest expense	(15,048)	(12,263)
Gain on and extinguishment of restructured liabilities	875	56
<b>Net finance income/(expense)</b>	<b>5,379</b>	<b>18,017</b>

Exchange gain decreased by 64% to RR10,374 million in the three months ended March 31, 2007, compared to RR28,673 million in the three months ended March 31, 2006. Exchange loss decreased by 21% to RR4,988 million in the three months ended March 31, 2007 from RR6,289 million in the three months ended March 31, 2006. The changes reflect the impact of the 1.2% appreciation of the RR against the U.S. dollar (in which a major part of our borrowings is denominated) and the 0.03% appreciation of the RR against the euro in the three months ended March 31, 2007 compared to the 3.5% appreciation of the RR against the U.S. dollar and the 2.1% appreciation of the RR against euro in the three months ended March 31, 2006.

Interest income increased by 81% to RR14,166 million in the three months ended March 31, 2007 from RR7,840 million in the three months ended March 31, 2006 mainly due to an increase in our loans issued by AB Gazprombank (ZAO) and bank current accounts. Interest expense increased by 23% from RR12,263 million in the three months ended March 31, 2006 to RR15,048 million in the three months ended March 31, 2007 mainly due to increased borrowings.

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

Share of net income of associated undertakings and jointly controlled entities increased by RR5,058 million, or 84%, to RR11,046 million in the three months ended March 31, 2007 compared to RR5,988 million in the three months ended March 31, 2006. The increase was primarily due to share in net loss of RosUkrEnergo AG recognized in three months ended March 31, 2006, share of net profit of OAO Novatek, which became associate in September 2006, and increase in share of net profit in WIEE, WIEH, and WINGAS GmbH for the three months ended March 31, 2007 compared to three months ended March 31, 2006.

### **Profit tax**

Total profit tax expense decreased by RR2,463 million, or 4%, to RR62,368 million in the three months ended March 31, 2007 compared to RR64,831 million in the three months ended March 31, 2006. Our effective profit tax rate in the three months ended March 31, 2007 compared to the three months ended March 31, 2006 decreased from 25% to 22% due to the one-time recognition of non-taxable income related to the NPF Gazfund deconsolidation discussed above.

### **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 RR25,155 million, or 14%, from RR185,157 million in the three months ended March 31, 2006 to RR210,312 million in the three months ended March 31, 2007.

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

Minority interest increased by 19% to RR6,825 million in the three months ended March 31, 2007 compared to RR5,742 million in the three months ended March 31, 2006.

## **LIQUIDITY AND CAPITAL RESOURCES**

The following table summarizes our statements of cash flows for the three months ended March 31, 2007 and 2006:

(RR million)	Three months ended March 31	
	2007	2006
Net cash provided by operating activities	461,468	194,310
Net cash used for investing activities	(116,386)	(56,038)
Net cash provided by (used for) financing activities	53,121	(109,143)

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

Net cash provided by operating activities amounted to RR461,468 million in the three months ended March 31, 2007 compared to RR194,310 million in the three months ended March 31, 2006. This was primarily due to cash on bank accounts of AB Gazprombank (ZAO) in amount RR275,345 million, including cash on bank accounts representing AB Gazprombank (ZAO) temporary cash deposits from participants of the auctions in the amount of RR 157,166 million.

#### *Net cash used for investing activities*

Net cash used for investing activities amounted to RR116,386 million in the three months ended March 31, 2007 compared to RR56,038 million in the three months ended March 31, 2006. The increase was primarily due to higher capital expenditures on field development and gas transportation infrastructure and deconsolidation of cash and cash equivalents held in NPF Gazfund.

#### *Net cash provided by (used for) financing activities*

Net cash provided by financing activities amounted to RR53,121 million in the three months ended March 31, 2007 compared to net cash used for financing activities in the amount of RR109,143 million in the the three months ended March 31, 2006. This change was primarily due to early repayment of a portion of the loan from Dresdner Bank AG, that was received to finance the purchase of Gazprom Neft in the three months ended March 31, 2006, and proceeds from new borrowings received in the three months ended March 31, 2007.

## CAPITAL EXPENDITURES

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

(RR million)	Three months ended March 31	
	2007	2006
Transport	36,018	29,263
Production of natural gas	29,215	16,225
Production of crude oil and gas condensate	9,905	9,301
Refining	6,011	2,171
Distribution	4,541	2,856
Other <sup>(1)</sup>	<u>1,557</u>	<u>2,028</u>
<b>Total</b>	<b>87,247</b>	<b>61,844</b>

Note:

- (1) Primarily includes expenditures for service activities such as drilling, transportation services (other than transportation of gas, oil and refined products) and repair.

Total capital expenditures (excluding the effect of acquisitions of subsidiaries and reclassifications) increased by RR25,403 million, or 41%, from RR61,844 million in the three months ended March 31, 2006 to RR87,247 million in the three months ended March 31, 2007. The increase of our capital expenditures in the Production of natural gas segment was primarily due to increased capital expenditure on the construction of new wells and associated gas preparation units at Bovanenkovskoye, Kharasaveiskoye, Kharvutinskoye and Yuzhno-Russkoye fields.

## 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) decreased by RR340,009 million, or 42%, from RR807,814 million as of 31 December 2006 to RR467,805 million as of 31 March 2007. This decrease can be explained by a significant increase of our cash and cash equivalents in bank accounts primarily due to temporary placement of funds in AB Gazprombank (ZAO) from third parties.