

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

*You should read the following management discussion in conjunction with our audited consolidated financial statements as of and for the year ended December 31, 2006 prepared in accordance with International Financial Reporting Standards ("IFRS").*

### OVERVIEW

We are the world's largest 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 gas 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 sale 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 activities 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 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>Years ended December 31,</b>	
	<b>2006</b>	<b>2005</b>
Sales (net of excise tax, VAT and customs duties)	2,152,111	1,383,545
Operating expenses	<u>(1,363,923)</u>	<u>(929,561)</u>
<b>Operating profit</b>	<b>788,188</b>	<b>453,984</b>
Finance income	97,923	53,890
Finance expense	(65,220)	(69,926)
Share of net income of associated undertakings and jointly controlled entities	26,363	11,782
Gains on disposal of available-for-sale financial assets	<u>8,811</u>	<u>385</u>
<b>Profit before profit tax</b>	<b>856,065</b>	<b>450,115</b>
Current profit tax expense	(213,844)	(118,028)
Deferred profit tax expense	<u>(5,760)</u>	<u>(16,156)</u>
Total profit tax expense	(219,604)	(134,184)
<b>Profit for the period</b>	<b>636,461</b>	<b>315,931</b>
<b>Attributable to:</b>		
Equity holders of OAO Gazprom	613,345	311,125
Minority interest	<u>23,116</u>	<u>4,806</u>
	<b>636,461</b>	<b>315,931</b>

## Sales

The following table sets out our volumes and realized prices for the years ended December 31, 2006 and 2005.

(RR million unless indicated otherwise)	Years ended	
	December 31, 2006	2005
<b>Sales of gas</b>		
<i>Europe</i>		
Gross sales <sup>(1)</sup>	1,149,582	850,017
Excise tax	(1,396)	(133)
Customs duties	(302,319)	(230,785)
Net sales	845,867	619,099
Volumes in billion cubic meters (bcm)	161.5	156.1
Gross average price, U.S.\$ per mcm <sup>(2)</sup> (including excise tax and customs duties) <sup>(3)</sup>	261.9	192.4
Gross average price, RR per mcm <sup>(2)</sup> (including excise tax and customs duties)	7,119.4	5,443.6
<i>FSU</i>		
Gross sales (net of value added tax (VAT))	243,133	131,393
Excise tax	-	(2,975)
Customs duties	(33,414)	(20,027)
Net sales	209,719	108,391
Volumes in bcm	101.0	76.6
Gross average price, U.S.\$ per mcm <sup>(2)</sup> (including excise tax and customs duties, net of VAT) <sup>(3)</sup>	88.6	60.7
Gross average price, RR per mcm <sup>(2)</sup> (including excise tax and customs duties, net of VAT)	2,408.4	1,716.1
<i>Russia</i>		
Gross sales (net of VAT)	357,274	311,336
Excise tax	(1,241)	(1,351)
Net sales	356,033	309,985
Volumes in bcm	316.3	307.0
Gross average price, RR per mcm <sup>(2)</sup> (including excise tax, net of VAT)	1,129.4	1,014.1
<i>Total sales of gas</i>		
Gross sales (net of VAT)	1,749,989	1,292,746
Excise tax	(2,637)	(4,459)
Customs duties	(335,733)	(250,812)
Net sales	1,411,619	1,037,475
Volumes in bcm	578.8	539.7
Net sales of refined products (net of excise tax, VAT and customs duties)	434,985	202,870
Net sales of crude oil and gas condensate (net of excise tax, VAT and customs duties)	171,709	52,591
Gas transportation sales (net of VAT)	34,500	25,050
Other revenues (net of VAT)	<u>99,298</u>	<u>65,559</u>
<b>Total sales (net of excise tax, VAT and customs duties)</b>	<b><u>2,152,111</u></b>	<b><u>1,383,545</u></b>

### Notes:

- <sup>(1)</sup> VAT is not charged on sales to Europe.
- <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 RR768,566 million, or 56%, to RR2,152,111 million in 2006 compared to 2005.

Net sales of gas accounted for 66% of total net sales in 2006 (75% in 2005). The changes in sales mix were caused by an increase in sales of crude oil and refined products subsequent to the acquisition of a controlling interest in October 2005 in OAO Siberian Oil Company (OAO Sibneft), renamed to OAO Gazprom neft in June 2006.

Net sales of gas increased from RR1,037,475 million in 2005 to RR1,411,619 million in 2006, or by 36%.

Net sales of gas to Europe increased in 2006 compared to 2005 by RR226,768 million, or 37%. This increase resulted primarily from a 36% increase in gross average realized U.S. dollar export gas prices, as well as a 3% increase in sales volumes. 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. The increase in sales volumes was primarily due to increased volumes sold to customers in the United Kingdom, Romania, the Netherlands and Turkey.

Net sales of gas to FSU countries increased compared to 2005 by RR101,328 million, or 93%, to RR209,719 million in 2006. This increase was due to a 47% increase in prices in RR terms (net of excise tax, customs duties and VAT) and a 32%, or 24.4 bcm, increase in sales volumes. The increase in prices in RR terms was primarily due to the increase in sales prices to customers in the Ukraine.

Net sales of gas in the domestic market increased by RR46,048 million, or 15%, to RR356,033 million in 2006 compared to 2005. This increase was primarily due to the increase in domestic gas tariffs set by the Federal Tariffs Service and increase in sales volumes by 3% or 9.3 bcm.

Sales of refined products increased by RR232,115 million, or 114%, to RR434,985 million in 2006 compared to RR202,870 million in 2005. The increase was primarily due to the consolidation of OAO Gazprom neft and its subsidiaries (Gazprom neft) from October 2005. Gazprom neft contributed revenue of RR260,372 million, or 60% of the total net sales of refined products for 2006. The growth in price of refined products also contributed to the increase. Sibur and its controlled petrochemical companies accounted for 25% and 46% of the total sales of refined products in 2006 and 2005, respectively. Sales of refined products (net of excise tax, VAT and customs duties) accounted for 20% and 15% of our total sales (net of excise tax, VAT and customs duties) in 2006 and 2005, respectively.

Subsequent to the acquisition of OAO Sibneft in the year 2005 the Group's crude oil production significantly increased. Sales of crude oil (net of VAT and customs duties), included in sales of crude oil and gas condensate, amounted to RR151,489 million and RR38,500 million in 2006 and 2005, respectively.

Gas transportation sales increased by RR9,450 million, or 38%, to RR34,500 million in 2006 from RR25,050 million in 2005. This increase was primarily due to an increase in volumes of gas transported for RosUkrEnergO AG and an increase in transportation tariffs.

Other revenues increased by RR33,739 million, or 51%, to RR99,298 million in 2006 compared to RR65,559 million in 2005. Other revenues represent activities including media, construction works and sales of other services and goods.

### Operating expenses

Operating expenses increased by 47% in the year ended December 31, 2006 to RR1,363,923 million from RR929,561 million in the year ended December 31, 2005. Operating expenses as a percentage of sales decreased from 67% in the year ended December 31, 2005 to 63% in the year ended December 31, 2006. The table below presents a breakdown of operating expenses in each period:

(RR million)	Years ended	
	2006	2005
Purchased oil and gas	280,062	87,723
Staff costs	199,588	168,076
Taxes other than on income	187,245	113,966
Depreciation	167,446	124,783
Transit of gas, oil and refined products	156,489	110,863
Repairs and maintenance	82,305	55,266
Materials	81,810	73,779
Cost of goods for resale, including refined products	51,041	24,540
Electricity and heating expenses	45,062	33,031
Social expenses	18,563	15,674
Impairment provisions	14,384	8,774
Research and development	13,123	6,544
Equipment maintenance	12,885	11,564
Insurance expenses	10,448	11,800
Other	43,472	83,178
<b>Total operating expenses</b>	<b>1,363,923</b>	<b>929,561</b>

### *Purchased oil and gas*

Cost of purchased oil and gas increased to RR280,062 million in the year ended December 31, 2006 from RR87,723 million in the year ended December 31, 2005. The increase primarily relates to the increase in gas purchases in Middle Asia for further reselling to RosUkrEnergo AG. The consolidation of Gazprom neft increased the cost of oil and gas purchases by RR66,801 million in the year ended December 31, 2006.

### *Staff costs*

Staff costs increased by 19% to RR199,588 million in the year ended December 31, 2006 from RR168,076 million in the year ended December 31, 2005. The increase primarily resulted from acquisition of OAO Sibneft in the year 2005, an increase in expenses associated with pension obligations and growth in average base salaries.

### *Taxes other than on income*

Taxes other than on income consist of:

(RR million)	Years ended December 31,	
	2006	2005
Natural resources production tax	158,480	87,229
Property tax	21,825	15,269
Other taxes	<u>6,940</u>	<u>11,468</u>
<b>Taxes other than on income</b>	<b>187,245</b>	<b>113,966</b>

Natural resources production tax increased by 82% to RR158,480 million in the year ended December 31, 2006 from RR87,229 million in the year ended December 31, 2005 due to the consolidation of Gazprom neft by RR59,612 million and due to the change in tax legislation. From January 1, 2006, the natural resources production tax rate for natural gas increased from RR135 per mcm to RR147 per mcm. The increase in property tax can be explained by the increase of the tax base due to the revaluation of fixed assets for statutory reporting purposes, which we performed as of January 1, 2006.

### *Depreciation*

Depreciation increased by 34% to RR167,446 million in the year ended December 31, 2006 from RR124,783 million in the year ended December 31, 2005. The increase primarily resulted from our growing fixed assets base and consolidation of Gazprom neft, which accounts for RR35,413 million of the increase.

### *Transit costs*

Transit of gas, oil and refined products increased by 41% to RR156,489 million in the year ended December 31, 2006 from RR110,863 million in the year ended December 31, 2005. The increase is explained by the increase in oil and refined products transit costs by RR34,946 million due to the consolidation of Gazprom neft and increase in gas transportation volumes and tariffs.

### *Repairs and maintenance*

Cost of repairs and maintenance increased by 49% to RR82,305 million in the year ended December 31, 2006 from RR55,266 million in the year ended December 31, 2005. The increase was primarily due to an increase in the volume of repairs and maintenance services rendered by third-party providers mainly in the Transportation segment.

### *Materials*

Cost of materials increased by 11% to RR81,810 million in the year ended December 31, 2006 from RR73,779 million in the year ended December 31, 2005. The increase was primarily related to increased volumes of purchases by the Transportation and Refining segments and higher prices of materials.

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

Cost of goods for resale, including refined products increased to RR51,041 million in the year ended December 31, 2006 from RR24,540 million in the year ended December 31, 2005. The increase was primarily due to Gazprom neft consolidation, which represented RR13,706 million of the increase.

### *Other operating expenses*

Other expenses decreased by 48% to RR43,472 million in the year ended December 31, 2006 from RR83,178 million in the year ended December 31, 2005. Other 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 increased by RR334,204 million, or 74%, from RR453,984 million in the year ended December 31, 2005 to RR788,188 million in the year ended December 31, 2006. Our operating profit margin increased from 33% in the year ended December 31, 2005 to 37% in the year ended December 31, 2006.

### **Finance income and expense**

(RR million)	Years ended December 31,	
	2006	2005
Exchange gain	60,497	27,530
Exchange loss	(21,449)	(33,724)
Interest income	36,460	25,202
Interest expense	(43,771)	(36,202)
Gains on and extinguishment of restructured liabilities	<u>966</u>	<u>1,158</u>
<b>Net finance income/(expense)</b>	<b>32,703</b>	<b>(16,036)</b>

Exchange gain increased by 120% to RR60,497 million in the year ended December 31, 2006, compared to RR27,530 million in the year ended December 31, 2005. Exchange loss decreased by 36% to RR21,449 million in the year ended December 31, 2006 from RR33,724 million in the year ended December 31, 2005. The changes reflect the impact of the 8.5% appreciation of the RR against the U.S. dollar (in which a major part of our borrowings is denominated) and the 1.5% devaluation of the RR against the euro in the year ended December 31, 2006 compared to the 3.7% depreciation of the RR against the U.S. dollar and the 9.7% appreciation of the RR against euro in the year ended December 31, 2005.

Interest income increased by 45% to RR36,460 million in the year ended December 31, 2006 from RR25,202 million in the year ended December 31, 2005 mainly due to an increase in our loans issued by AB Gazprombank (ZAO) and bank current accounts. Interest expense increased by 21% from RR36,202 million in the year ended December 31, 2005 to RR43,771 million in the year ended December 31, 2006 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 RR14,581 million to RR26,363 million in the year ended December 31, 2006 compared to RR11,782 million in the year ended December 31, 2005. The increase was primarily due to share in net profit of OAO NGK Slavneft which became an associate with the acquisition of OAO Sibneft in 2005.

### **Profit tax**

Total profit tax expense increased by RR85,420 million, or 64%, to RR219,604 million in the year ended December 31, 2006 compared to RR134,184 million in the year ended December 31, 2005 primarily due to increased profit before tax.

Our effective profit tax rate in the year ended December 31, 2006 compared to year ended December 31, 2005 decreased from 30% to 26%.

### **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 RR302,220 million, or 97%, from RR311,125 million in the year ended December 31, 2005 to RR613,345 million in the year ended December 31, 2006.

### Profit for the period attributable to minority interest

Minority interest increased by 381% to RR23,116 million in the year ended December 31, 2006 compared to RR4,806 million in the year ended December 31, 2005. The increase was primarily due to the earnings of OAO Gazprom neft, as a result of acquisition of the 75.68% interest in OAO Sibneft in 2005.

### LIQUIDITY AND CAPITAL RESOURCES

The following table summarizes our statements of cash flows for year ended December 31, 2006 and 2005:

(RR million)	Years ended December 31,	
	2006	2005
Net cash provided by operating activities	544,088	272,617
Net cash used for investing activities	(512,251)	(653,410)
Net cash provided by financing activities	94,414	422,706

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

Net cash provided by operating activities amounted to RR544,088 million in the year ended December 31, 2006 compared to RR272,617 million in the year ended December 31, 2005. This was primarily due to higher sales and operating profit, which rose mainly due to the upward trend in gas prices and partially offset by an increase in operating expenses and profit tax.

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

Net cash used for investing activities amounted to RR512,251 million in the year ended December 31, 2006 compared to RR653,410 million in the year ended December 31, 2005. Net cash, used for investing activities for 2005 include RR381,769 million for OAO Sibneft acquisition. Cash, used for investing activities for 2006 includes investments in OAO Novatek shares in the amount of RR63,431. The 2006 amount was affected by higher capital expenditures on field development and transportation infrastructure.

#### *Net cash provided by financing activities*

Net cash provided by financing activities amounted to RR94,414 million in the year ended December 31, 2006 compared to RR422,706 million in the year ended December 31, 2005. This change was primarily due to the fact, that in 2005 we obtained the loan from Dresdner Bank AG, to finance the purchase of OAO Sibneft and higher net repayments of borrowings in 2006, compared to 2005.

### CAPITAL EXPENDITURES

Total capital expenditures (excluding the effect of acquisitions of subsidiaries and reclassifications) by segment for the years ended December 31, 2006 and 2005 in nominal RR terms, amounted to the following:

(RR million)	Years ended December 31,	
	2006	2005
Transport	242,305	184,496
Production of gas	130,751	100,316
Production of crude oil and gas condensate	56,261	17,348
Distribution	22,546	19,042
Refining	20,646	16,379
Other <sup>(1)</sup>	<u>13,131</u>	<u>15,039</u>
<b>Total</b>	<b>485,640</b>	<b>352,620</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 RR133,020 million, or 38%, from RR352,620 million in the year ended December 31, 2005 to RR485,640 million in the year ended December 31, 2006. The increase of our capital expenditures in the Transportation segment was primarily due to increased capital expenditure on the construction of major transportation projects, including SRTO – Torzhok pipeline, Nord Stream, Arkhangelsk-Severodvinsk gas pipeline. Capital expenditures in the Production of crude oil and gas condensate segment have increased following the consolidation of Gazprom neft.

## **DEBT OBLIGATIONS**

Total debt balance (defined as the sum of short-term borrowings and current portion of long-term borrowings, short-term promissory notes payable, long-term borrowings, long-term promissory notes payable and restructured tax liabilities), increased by RR 124,630 million from RR 955,285 million as of 31 December 2005 to RR 1,079,915 million as of 31 December 2006. AK Gazprombank (ZAO) accounted for 31% and 21% of the total debt as of 31 December 2006 and 2005 respectively. The increased total debt attributable to AB Gazprombank (ZAO) resulted from the bank's expanded operations related to provision of loans to legal entities and individuals, project finance and investment activities. In the framework of these activities the scope of loans provided by the bank and of purchased securities has increased significantly. To finance these operations the bank uses funds of its clients held on current and deposit accounts and to minimize the liquidity risk Gazprombank raises additional funds by issuing debt securities (promissory notes, bonds).

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 RR10,349 million, or 1%, from RR797,465 million as of 31 December 2005 to RR807,814 million as of 31 December 2006.