

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 six months ended June 30, 2006. 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, 2005 prepared in accordance with International Financial Reporting Standards ("IFRS").

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 five main business segments:

- Production of natural gas – exploration and production of natural gas;
- Transportation – 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 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 natural gas from our Production of natural gas segment and transportation services from our Transportation 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)	Six months ended June 30	
	2006	2005
Sales (net of excise tax, VAT and customs duties)	1,091,424	611,233
Operating expenses	(686,425)	(402,178)
Operating profit	404,999	209,055
Finance income	61,845	25,788
Finance expense	(39,354)	(33,568)
Share of net income of associated undertakings and jointly controlled entities	16,968	8,943
Gains on disposal of available-for-sale financial assets	3,144	1,427
Profit before profit tax	447,602	211,645
Current profit tax expense	(112,355)	(51,081)
Deferred profit tax expense	(3,011)	(6,565)
Total profit tax expense	(115,366)	(57,646)
Profit for the period	332,236	153,999
Attributable to:		
Equity holders of OAO Gazprom	321,491	152,810
Minority interest	10,745	1,189

Sales

The following table sets out our volumes and realized prices for the six months ended June 30, 2006 and 2005.

(RR million unless indicated otherwise)	Six months ended June 30	
	2006	2005
Sales of gas		
<i>Europe</i>		
Gross sales ⁽¹⁾	589,353	396,911
Excise tax	(484)	(90)
Customs duties	(160,607)	(109,678)
Net sales	428,262	287,143
Volumes in billion cubic meters (bcm)	84.9	81.4
Gross average price, U.S.\$ per mcm ⁽²⁾ (including excise tax and customs duties) ⁽³⁾	250.9	174.4
Gross average price, RR per mcm ⁽²⁾ (including excise tax and customs duties)	6,944.2	4,876.1
<i>FSU</i>		
Gross sales (net of value added tax (VAT))	118,242	54,257
Excise tax	-	(87)
Customs duties	(15,683)	(8,373)
Net sales	102,559	45,797
Volumes in bcm	51.1	36.4
Gross average price, U.S.\$ per mcm ⁽²⁾ (including excise tax and customs duties, net of VAT) ⁽³⁾	83.5	53.3
Gross average price, RR per mcm ⁽²⁾ (including excise tax and customs duties, net of VAT)	2,312.4	1,490.6
<i>Russia</i>		
Gross sales (net of VAT)	191,909	164,181
Excise tax	(845)	(1,165)
Net sales	191,064	163,016
Volumes in bcm	170.8	162.1
Gross average price, RR per mcm ⁽²⁾ (including excise tax, net of VAT)	1,123.5	1,012.8
<i>Total sales of gas</i>		
Gross sales (net of VAT)	899,504	615,349
Excise tax	(1,329)	(1,342)
Customs duties	(176,290)	(118,051)
Net sales	721,885	495,956
Volumes in bcm	306.8	279.9
Net sales of refined products (net of excise tax, VAT and customs duties)	209,737	67,686
Net sales of crude oil and gas condensate (net of excise tax, VAT and customs duties)	95,470	6,422
Gas transportation sales (net of VAT)	16,976	12,181
Other revenues (net of VAT)	<u>47,356</u>	<u>28,988</u>
Total sales (net of excise tax, VAT and customs duties)	<u>1,091,424</u>	<u>611,233</u>

Notes:

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

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

⁽³⁾ Calculated on the basis of average rate.

Total sales (net of excise tax, VAT and customs duties) increased by RR480,191 million, or 79%, to RR1,091,424 million in the six months ended June 30, 2006 compared to the six months ended June 30, 2005.

Net sales of gas accounted for 66% of total net sales in the six months ended June 30, 2006 (81% in the six months ended June 30, 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 RR495,956 million in the six months, ended June 30, 2005 to RR721,885 million in the six months, ended June 30, 2006, or by 46%.

Net sales of natural gas to Europe increased in the six months, ended June 30, 2006 compared to the six months ended June 30, 2005 by RR141,119 million, or 49%. This increase resulted primarily from a 44% increase in gross average realized U.S. dollar export gas prices, as well as a 4% 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, Holland and Turkey.

Net sales of natural gas to FSU countries increased in the six months, ended June 30, 2006 compared to the six months ended June 30, 2005 by RR56,762 million, or 124%, to RR102,559 million. This increase was due to a 59% increase in prices in RR terms (net of excise tax, customs duties and VAT) and a 40%, or 14.7 bcm, increase in sales volumes. The increase in prices in RR terms was primarily due to the increase in sales prices to Ukraine.

Net sales of natural gas in the domestic market increased by RR28,048 million, or 17%, to RR191,064 million in the six months ended June 30, 2006 compared to the six months ended June 30, 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 5% or 8.7 bcm.

Sales of refined products increased by RR142,051 million, or 210%, to RR209,737 million in the six months ended June 30, 2006 compared to RR67,686 million in the six months ended June 30, 2005. The increase was primarily due to the consolidation of OAO Gazprom neft and its subsidiaries (Gazprom neft) from October 2005. The acquired subsidiary contributed revenue of RR126,412 million, or 60% of the total net sales of refined products for the six months ended June 30, 2006. The growth in the domestic and export prices of refined products also contributed to the increase. Sibur and its affiliated petrochemical companies accounted for 24% and 64% of the total sales of refined products for the six months ended June 30, 2006 and 2005, respectively. Sales of refined products (net of excise tax, VAT and customs duties) accounted for 19% and 11% of our total sales (net of excise tax, VAT and customs duties) in the six months ended June 30, 2006 and 2005, respectively.

Subsequent to the acquisition of OAO Sibneft in the year 2005 the Group's crude oil production significantly increased and became one of its principal activities. Sales of crude oil (net of VAT and customs duties), included in sales of crude oil and gas condensate, for the six months, ended June 30, 2006 amounted to RR85,493 million.

Gas transportation sales increased by RR4,795 million, or 39%, to RR16,976 million in the six months ended June 30, 2006 from RR12,181 million in the six months ended June 30, 2005. This increase was primarily due to an increase in volumes of gas transported for RosUkrEnergO AG and an increase in prices.

Other revenues increased by RR18,368 million, or 63%, to RR47,356 million in the six months ended June 30, 2006 compared to RR28,988 million in the six months ended June 30, 2005. Other revenues represent activities including media, construction works and sales of other services and goods.

Operating expenses

Operating expenses increased by 71% in the six months ended June 30, 2006 to RR686,425 million from RR402,178 million in the six months ended June 30, 2005. Operating expenses as a percentage of sales decreased from 66% in the six months, ended June 30, 2005 to 63% in the six months, ended June 30, 2006. The table below presents a breakdown of operating expenses in each period:

(RR million)	Six months ended June 30	
	2006	2005
Purchased oil and gas	131,127	32,903
Taxes other than on income	99,120	48,381
Staff costs	91,205	74,597
Transit of gas, oil and refined products	83,827	53,206
Depreciation	80,524	61,403
Materials	37,682	29,994
Repairs and maintenance	34,341	24,656

(RR million)	Six months ended June 30	
	2006	2005
Cost of goods for resale, including refined products	25,852	5,923
Electricity and heating expenses	20,499	15,837
Social expenses	8,081	7,041
Charge for/(release of) impairment provisions	6,118	(761)
Insurance expenses	5,079	6,942
Other	<u>62,970</u>	<u>42,056</u>
	686,425	402,178

Purchased oil and gas

Cost of purchased oil and gas increased by 299% to RR131,127 million in the six months ended June 30, 2006 from RR32,903 million in the six months ended June 30, 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 RR38,571 million in the six months ended June 30, 2006.

Taxes other than on income

Taxes other than on income consist of:

(RR million)	Six months ended June 30	
	2006	2005
Natural resources production tax	78,035	38,654
Property tax	10,657	7,429
Other taxes	<u>10,428</u>	<u>2,298</u>
Taxes other than on income	<u>99,120</u>	<u>48,381</u>

Natural resources production tax increased by 102% to RR78,035 million in the six months ended June 30, 2006 from RR38,654 million in the six months ended June 30, 2005 due to the consolidation of Gazprom neft by RR35,251 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 (except for the revaluation of trunk pipelines, which are exempted from the property tax base).

Staff costs

Staff costs increased by 22% to RR91,205 million in the six months ended June 30, 2006 from RR74,597 million in the six months ended June 30, 2005. The increase primarily resulted from an increase in average base salaries by 10% effective from April 1, 2005 and October 1, 2005. Staff costs, related to Gazprom neft, amounted to RR6,646 million in the six months ended June 30, 2006.

Depreciation

Depreciation increased by 31% to RR80,524 million in the six months ended June 30, 2006 from RR61,403 million in the six months, ended June 30, 2005. The increase primarily resulted from our growing fixed assets base and consolidation of Gazprom neft, that stands for RR18,612 million of the increase.

Transit of gas, oil and refined products

Transit of gas, oil and refined products increased by 58% to RR83,827 million in the six months ended June 30, 2006 from RR53,206 million in the six months ended June 30, 2005. The increase is explained by the increase in oil and refined products transit costs by RR22,699 million due to the consolidation of Gazprom neft and increase in gas transportation volumes and tariffs.

Materials

Cost of materials increased by 26% to RR37,682 million in the six months ended June 30, 2006 from RR29,994 million in the six months ended June 30, 2005. The increase was primarily related to increased volumes of purchases by the Transportation and Refining segments and higher prices of materials.

Repairs and maintenance

Cost of repairs and maintenance increased by 39% to RR34,341 million in the six months ended June 30, 2006 from RR24,656 million in the six months ended June 30, 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.

Cost of goods for resale, including refined products

Cost of goods for resale, including refined products increased by 336% to RR25,852 million in the six months ended June 30, 2006 from RR5,923 million in the six months ended June 30, 2005. The increase was primarily due to Gazprom neft consolidation, that represented RR16,367 million of the increase.

Other operating expenses

Other expenses increased by 50% to RR62,970 million in the six months ended June 30, 2006 from RR42,056 million in the six months ended June 30, 2005. Other expenses include bank charges, security services, legal and consulting services and advertising. The increase in these expenses was primarily caused by the increase in our overall business activities.

Operating profit

As a result of the factors discussed above, our operating profit increased by RR195,944 million, or 94%, from RR209,055 million in the six months ended June 30, 2005 to RR404,999 million in the six months ended June 30, 2006. Our operating profit margin increased from 34% in the six months ended June 30, 2005 to 37% in the six months ended June 30, 2006.

Finance income and expense

(RR million)	Six months ended June 30	
	2006	2005
Exchange gain	44,702	15,343
Exchange loss	(16,639)	(20,326)
Interest income	16,612	9,456
Interest expense	(22,715)	(13,242)
Gains on and extinguishment of restructured liabilities	<u>531</u>	<u>989</u>
Net finance income/(expense)	22,491	(7,780)

Exchange gain increased by 191% to RR44,702 million in the six months ended June 30, 2006, compared to RR15,343 million in the six months ended June 30, 2005. Exchange loss decreased by 18% to RR16,639 million in the six months ended June 30, 2006 from RR20,326 million in the six months ended June 30, 2005. The change reflects the impact of the 5.9% appreciation of the RR against the U.S. dollar (in which a major part of our borrowings is denominated) and the 0.6% appreciation of the RR against the euro in the six months ended June 30, 2006 compared to the 3.3% depreciation of the RR against the U.S. dollar and the 8.7% appreciation of the RR against euro in the six months ended June 30, 2005.

Interest income increased by 76% to RR16,612 million in the six months ended June 30, 2006 from RR9,456 million in the six months ended June 30, 2005 mainly due to an increase in our loans issued by AB Gazprombank (ZAO) and bank current accounts. Interest expense increased by 72% from RR13,242 million in the six months ended June 30, 2005 to RR22,715 million in the six months ended June 30, 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 RR8,025 million to RR16,968 million in the six months ended 30 June, 2006 compared to RR8,943 million in the six months ended

30 June, 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 RR57,720 million, or 100%, to RR115,366 million in the six months ended June 30, 2006 compared to RR57,646 million in the six months ended June 30, 2005 primarily due to increased profit before tax.

Our overall effective profit tax rate in the six months ended June 30, 2006 compared to the six months ended June 30, 2005 decreased from 27% 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 RR168,681 million, or 110%, from RR152,810 million in the six months ended June 30, 2005 to RR321,491 million in the six months ended June 30, 2006.

Profit for the period attributable to minority interest

Minority interest increased by 804% to RR10,745 million in the six months ended June 30, 2006 compared to RR1,189 million in the six months ended June 30, 2005. The increase was primarily due to consolidation of 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 the six months ended June 30, 2006 and 2005:

(RR million)	Six months ended June 30	
	2006	2005
Net cash provided by operating activities	244,255	163,357
Net cash used for investing activities	(137,118)	(104,439)
Net cash (used for) provided by financing activities	(84,604)	7,763

Net cash provided by operating activities

Net cash provided by operating activities amounted to RR244,255 million in the six months ended June 30, 2006 compared to RR163,357 million in the six months ended June 30, 2005. This was primarily due to higher sales and operating profit, which rose mainly due to the upward trend in gas prices, 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 RR137,118 million in the six months ended June 30, 2006 compared to RR104,439 million in the six months ended June 30, 2005. Investing activities increased due to higher capital expenditures on field development and transportation infrastructure.

Net cash (used for) provided by financing activities

Net cash used for financing activities amounted to RR84,604 million in the six months ended June 30, 2006 compared to net cash provided by financing activities in the amount of RR7,763 million in the the six months ended June 30, 2005. This increase was primarily due to early repayment of a portion of the loan from Dresdner Bank AG, that was received to finance the purchase of OAO Sibneft and higher net repayments of borrowings.

CAPITAL EXPENDITURES

Total capital expenditures (excluding the effect of acquisitions of subsidiaries and reclassifications) by segment for the six months ended June 30, 2006 and 2005 in nominal RR terms, amounted to the following:

(RR million)	Six months ended June 30	
	2006	2005
Transportation	79,186	55,335
Production of natural gas	37,720	31,742
Production of crude oil and gas condensate	20,452	6,312
Distribution	7,371	2,245
Refining	7,068	4,176
Other ⁽¹⁾	4,894	7,828
Total	156,691	107,638

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 RR49,053 million, or 46%, from RR107,638 million in the six months ended June 30, 2005 to RR156,691 million in the six months ended June 30, 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 the pipeline from the northern region of the Tyumen Oblast to Torzhok, North-European gas pipeline, Arkhangelsk-Severodvinsk gas pipeline. Capital expenditures in the Production of crude oil and gas condensate segment have increased following the consolidation of OAO Gazprom нефт.

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 RR 126,716 million, or 16%, from RR 797,465 million as of 31 December 2005 to RR 670,749 million as of 30 June 2006.