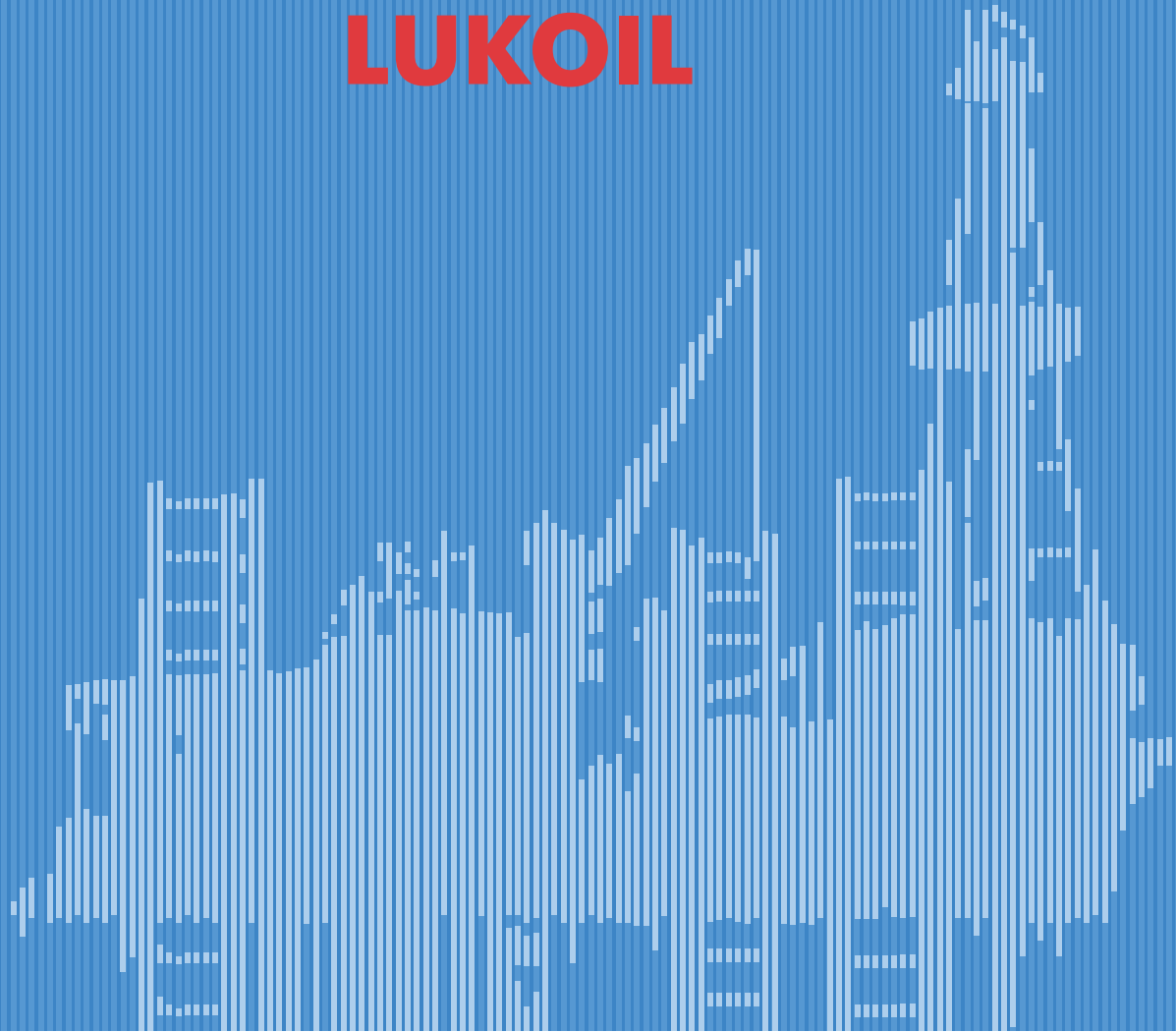


**LUKOIL**



**2011**

ANNUAL REPORT





Annual Report  
2011

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# Letter to Shareholders

Dear Shareholders,

In 2011 LUKOIL crossed the threshold into its third decade of operations, and in September our Company celebrated **1,500 million tonnes of oil produced since the Company's foundation 20 years ago**. For us this is not mere statistics. It stands for an outstanding labour of generations of oil workers.

In 2011 we managed to reach record levels of a few financial indicators. Group's net income reached \$10,357 million, net income per share grew by 21.4% to \$13.3. Free cash flow reached a record level of \$7,240 million in the reporting year. Return on capital employed amounted to 14%. Company's net debt decreased by 28% or by \$2.5 billion. LUKOIL enjoys the highest level of financial stability among Russian peers.

Growth of shareholders income is a key priority for us. Dividend payouts for 2010 were 13% higher than for 2009 and the Board of Directors has recommended the Annual General Meeting of Shareholders to approve dividends for 2011 at a level of 75 rubles per share, offering yield of 4.2%.

Last year was one of reassessment of the road travelled by our Company and choice of directions for the future. Many of our fields are at late stages of development, and this was reflected by a decline

in our overall output of hydrocarbons by 4.4% in 2011, the first such decline in the last 10 years.

We have responded by developing a new **Strategic Program for 2012-2021**, which makes sustainable production growth into our key priority. Our hydrocarbon production growth rate should be no less than 3.5% per annum in the next 10 years. Most of the growth will come from promising new projects in Iraq, Central Asia, the Caspian and Yamal-Nenets Autonomous District. But we will also achieve growth of production in other, established regions through substantial increase in the amount of reserves that are brought into development.

The main goal of the new Program is to increase income to shareholders. The next decade will see a major redistribution of the value created by LUKOIL in favour of its shareholders, increasing the income which the Company provides to them by several times.

In order to attain the targets, which the Program sets, we need to make fundamental improvements to the efficiency of our business. This is not just a matter of addressing external factors, such as ageing of fields, shortage of large-scale oil and gas deposits and legal barriers to acquisition of new licenses. These are all elements of extensive growth, i.e. of business expansion. Certainly, we will do everything we can in this direction, acquiring and entering



**Valery Grayfer**

*Chairman of the Board of Directors  
of LUKOIL*



**Vagit Alekperov**

*President of LUKOIL*

new projects, and working with the Government to lift restrictions on development of large fields, including offshore fields. But the resources for such development are ultimately just as exhaustible as natural resources themselves.

We have reached a turning point, at which **our Company must take the path of intensive growth**. In the first place this implies greater use of new technologies. Throughout its history LUKOIL has always invested large amounts in the development of its technology base and has achieved notable successes in this direction.

The high standard of Company technologies enables us to work in the severest of climates beyond the Arctic circle and at huge sea and ocean depths. We have carried out offshore projects independently in the Baltic, the Barents Sea, the Caspian, Ghana, and Côte d'Ivoire. At present limitations imposed by law make it impossible for LUKOIL to apply its unique capabilities – its technological and financial potential – inside Russia. But we are optimistic that **LUKOIL, as a Russian national private company, will obtain equal rights with Government-owned companies** in development of the country's oil and gas resources, including those located offshore.

However, intensive development is not only a matter of technology applications. Continued improvements are also needed in business process

management, work with sub-contractors and suppliers, energy efficiency, more sparing use of expendable materials, and lowering of production and non-production expenses.

The largest part of **investment spending** associated with the new Program will be carried out in the next three to five years. This spending is essential in order to bring new and promising Company projects to the development stage. Such projects will be brought into production in Iraq (West Qurna-2), the Caspian (the V. Filanovskiy field), Western Siberia (the Pyakyakhinskoye field), Uzbekistan (the Kandym group of fields) and in other regions. This will create a basis for sustainable growth of production in the coming decade.

In the **Exploration & Production** segment LUKOIL made substantial progress in 2011 with preparation for development launches at a number of new fields, and a total of 170 million boe of contingent resources were transformed into proved reserves as a result. Replacement of production by new proved reserves was more than 100% in 2011. LUKOIL remains among the Russian and international industry leaders by volume of proved hydrocarbon reserves.

Production of hydrocarbons in 2011 was 781 million boe, which is 4.4% less than in 2010. However, Company production levels should stabilize in 2012,

including production levels in our main operating region of Western Siberia, and growth of hydrocarbon production is expected to resume beyond 2013. LUKOIL already has everything in place to ensure that this will happen, including a number of large and promising projects, unique experience of working in varied climate zones, and accurate geological and hydrodynamic models of practically all of our fields.

LUKOIL and Bashneft Oil Company created a joint venture during the reporting year for development of the R. Trebs and A. Titov fields in Timan-Pechora. The fields fit well into the infrastructure, which LUKOIL has already created in that region. This synergy will give our partners and us the opportunity to develop these major fields in the most economically efficient way possible.

LUKOIL is continuing rapid development of its **Refining & Marketing** business segment, with a focus on growth of operating efficiency, greater refining depth and high levels of conversion. Crude oil refining volumes at Company refineries in 2011 were 1,073 barrels per day. The volume was 3.1% less than in 2010 due to scheduled shut-down of the Odessa Refinery and reduced loading of Company refineries in Bulgaria and Romania as part of a plan to minimize operating losses.

There was a huge increase in consumption of gasoline in Russia during 2011 as a result of growth in car purchases. The Russian Government took various measures to address this situation, including introduction of the '60-66' system, which unifies export duties for light and dark oil products at 66% of the duty level for crude oil while keeping a higher rate of 90% for exports of gasoline. The new system encourages deeper refining of crude oil, which we have been working to achieve for a number of years and will continue to work towards in the future. The Company is planning to reduce output of dark petroleum products at its Russian refineries by 2.5 times in the next decade. Implementation of modernization projects should boost output of automotive gasoline at LUKOIL's Russian refineries by almost 1.5 times in the period to 2021 and refining depth at Russian facilities will approach 95%.

Work began in 2011 on construction of the first section of a gas-processing plant, which will be part of the new gas-chemical complex to be built at the site of LUKOIL's chemical subsidiary, Stavrolen. The complex will have an important role in achieving the task of maximum utilization of associated oil gas, as well as creating thousands of jobs and supporting growth of the entire economy in the surrounding region.

Much was also done during the reporting year in LUKOIL's **Power Generating business sector**. New generating capacities were brought into operation using high-tech equipment. **The Group also began implementation of projects in the renewable energy sector**. LUKOIL's plans in this sector include construction and operation of solar and wind generating stations in Bulgaria, Romania and Uzbekistan. In Bulgaria LUKOIL has already begun construction of its first large photovoltaic (solar energy) station with 1.25 megawatt capacity and with scheduled annual output of 1,500 megawatt-hours. A joint venture has also been set up with the company ERG for construction of wind farms in European countries where incentives for their construction have been established by law. If Russia passes a law to encourage development of renewable sources of energy, we are ready to implement similar projects in our own country.

As always, **personal, environmental, industrial and social security** remains high in the Company's list of priorities, and this is reflected in the Strategy, which has been prepared for the coming decade. Planned measures include R&D work in the sphere of industrial safety and employee health, as well as training, instruction and raising the qualifications of LUKOIL employees. Improvements will be achieved through application of the latest information technologies and creation of a system for compulsory personnel training. LUKOIL strives to raise the living standards of its workers year by year, fully understanding that people are our most valuable asset and the key to our success. In 2011 LUKOIL was the winner of the 'Best Corporate Project' nomination in the second national project competition, 'Healthy Russia'. The Competition was founded by the Russian Ministry of Health and Social

Development as part of a Government program for promotion of healthy lifestyles among the Russian general public.

For our Company the coming decade will be one of daily invention and application of original, ground-breaking solutions in all business segments, as well

as optimization of costs, new approaches to work with investors and shareholders, and fruitful cooperation with legislators in Russia and other countries where we do business. We ask you, our shareholders, to give your backing and support to LUKOIL as it scales new heights!

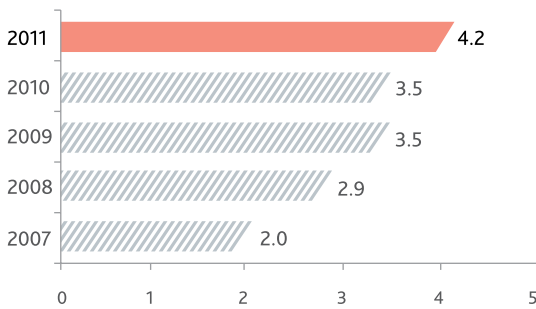
Chairman of the Board of Directors of LUKOIL  
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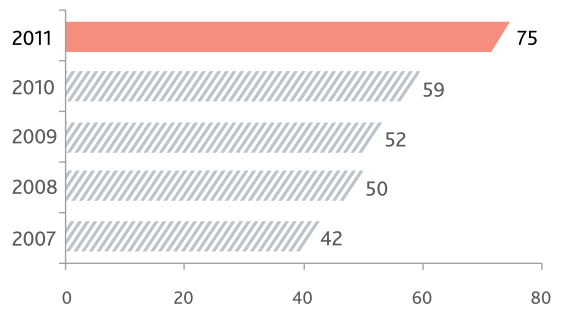
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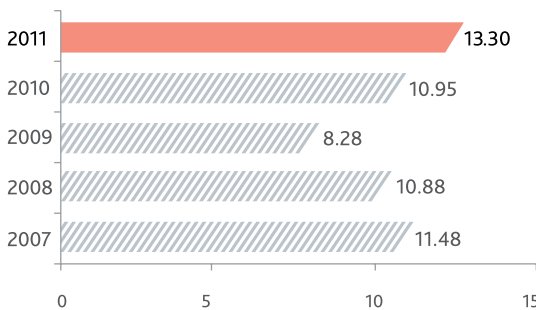
Dividend yield, %



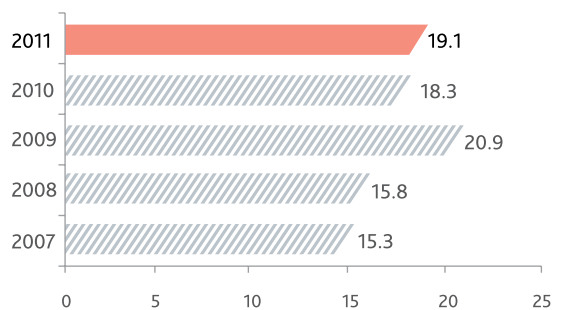
Dividend per share, rubles



Basic earnings per share, \$



Payout ratio, %



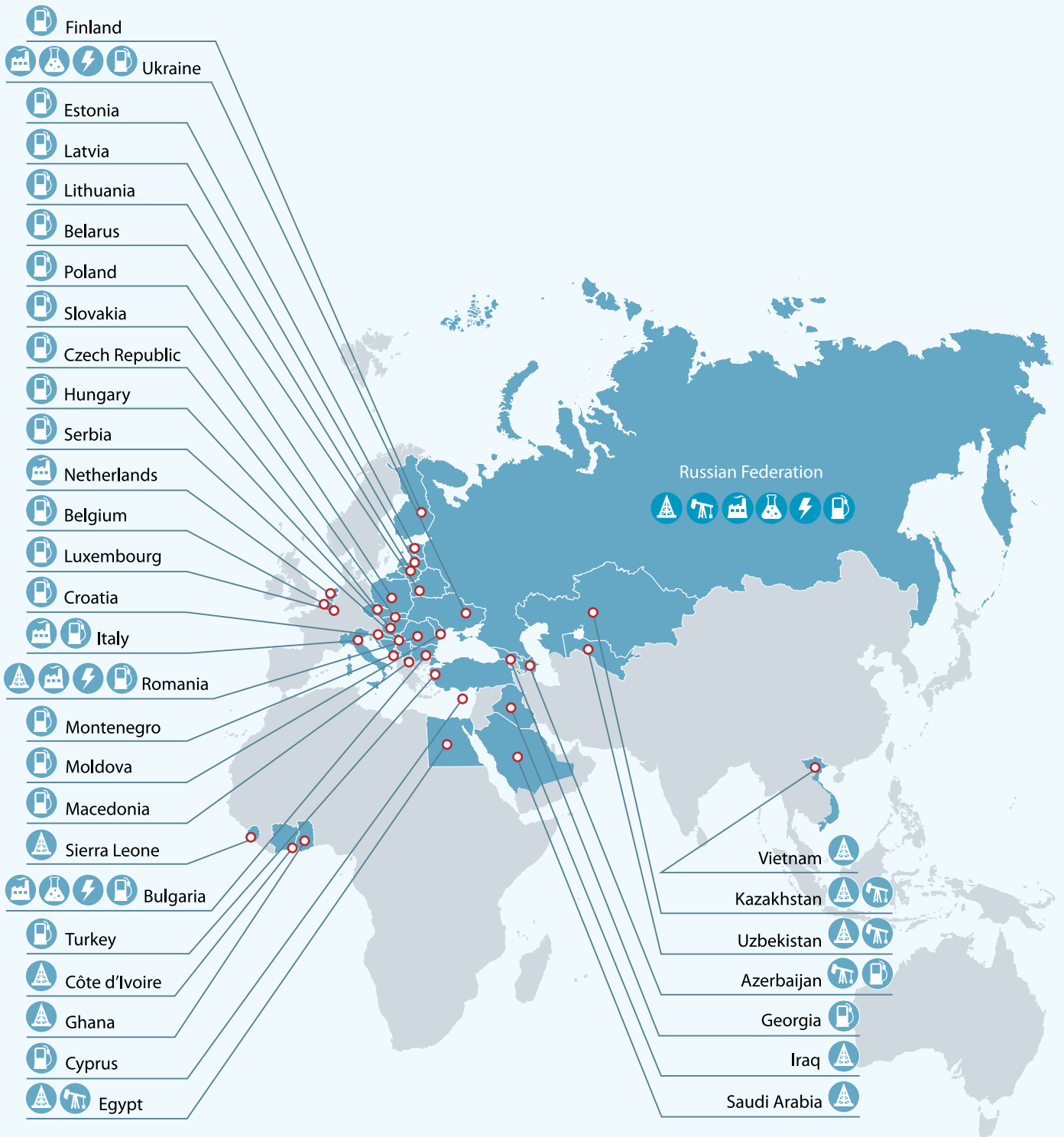


## LUKOIL in the World

LUKOIL is a major international vertically-integrated oil and gas company, accounting for 2.1% of global output of crude oil.

The strong position, which the Company enjoys today, is the fruit of 20 years work to expand the reserve base, increasing business scale by seeking out and executing strategic transactions.





## Main Operating and Financial Indicators

Main financial and market indicators	2011	2010	Change, %
Sales, \$ million	133,650	104,956	27.3
EBITDA, \$ million	18,606	16,049	15.9
Net income, \$ million	10,357	9,006	15.0
Basic EPS, \$	13.3	10.95	21.4
ROACE, %	14.0	14.0	–
Capital expenditures, \$ million	8,492	6,844	24.1
Investments (acquisition of subsidiaries) <sup>1</sup> , \$ million	2,860	932	206.9
Share price (MICEX, end of year), rubles	1,701.0	1,742.0	(2.4)
Dividend per share, rubles	75	59	27.1
<b>Main operating indicators</b>			
3P oil reserves, million barrels	23,602	22,573	4.6
3P gas reserves, billion cubic feet	36,125	37,821	(4.5)
3P hydrocarbon reserves, million boe	29,623	28,877	2.6
Crude oil production, million barrels	671.4	708.1	(5.2)
Production of marketable natural gas, million cubic meters	12,761	12,770	(0.1)
Production of marketable associated gas, million cubic meters	5,860	5,784	(1.3)
Production of marketable hydrocarbons, thousand boe per day	2,140	2,239	(4.4)
Throughputs at own refineries and at ISAB and TRN, million tonnes	64.9	66.2	(2.0)
Gas processing, million cubic meters	3,189	3,178	0.3
Production of petrochemicals, million tonnes	1.466	1.036	41.5
Crude oil exports, million tonnes	34.70	40.59	(14.5)
Petroleum product exports, million tonnes	24.00	25.82	(6.9)
Crude oil sales, million tonnes	48.26	51.38	(6.1)
Wholesale sales of petroleum products, million tonnes	87.34	91.02	(4.0)
Retail sales of petroleum products, million tonnes	15.25	14.34	6.3
Number of filling stations (owned, leased and franchises)	5,994	6,508	(7.9)
Average number of employees, thousand	120.3	130.0	(7.5)

Hydrocarbon reserves and production data include Group share in equity affiliates.

<sup>1</sup> Including prepayments due to acquisition of subsidiaries and non-cash transactions.

## Events in 2011

### FEBRUARY



**LUKOIL and Russian Technologies State Corporation sign a cooperation agreement** by which LUKOIL will provide fuel resources to companies and divisions of Russian Technologies

in the defence sector and other sectors. The parties also plan to work together to enhance level of LUKOIL technology base by applying new designs and products of Russian Technologies State Corporation, including applications for field construction and generation of electricity using associated gas.

**A consortium of LUKOIL and the US company Vanco signs a concession agreement with Romania's National Agency for Mineral Resources for exploration and production at two blocks in the Black Sea: Est Rapsodia and Trident.** The LUKOIL share in the project is 80% and the remaining 20% is held by Vanco. The consortium won the rights at a tendering competition in summer 2010. The blocks are located at sea depths between 90 and 1,000 m. Total area of the blocks is 2,000 km<sup>2</sup>.

**ConocoPhillips completes its withdrawal from share capital of LUKOIL, selling its remaining shares in the open market.** ConocoPhillips decided at the end of 2008 to sell its stake in LUKOIL in order to raise cash to cover debts and for repurchase of its own shares. In August 2010 LUKOIL bought about 8% of

its own shares from ConocoPhillips as part of a program for raising investment attractiveness and market capitalization, spending \$3.44 billion for the purpose. ConocoPhillips acquired 7.6% of LUKOIL shares in 2004 as part of the last stage of Company privatization. In 2006 ConocoPhillips increased its stake in LUKOIL share capital to a level of 20%.

**MARCH**



**LUKOIL and Gazprom sign an agreement on deliveries of gas from LUKOIL fields in the Bolshekhetskaya Depression (Yamal-Nenets Autonomous District) and the Northern Caspian.** Under the terms of the agreement LUKOIL will supply natural gas from fields in the Bolshekhetskaya Depression to Gazprom’s gas transport system in the period from 2012 to 2016, using the Yamburgskaya compression station as an access point. Delivery volumes may vary depending on commissioning of fields in the Bolshekhetskaya Depression and on available capacity in the Gazprom transport system. According to the signed document, Gazprom will do all in its power to accept gas from fields in the Northern Caspian after those fields are brought into operation by LUKOIL and will supply matching volumes of gas to LUKOIL enterprises under substitution agreements. Cooperation between LUKOIL and Gazprom is based on the general agreement on strategic partnership in 2005–2014, which was signed by the two companies in March 2005.

**LUKOIL reaches a long-term agreement with the petrochemical holding SIBUR on deliveries of associated gas.** Under the terms of the agreement, LUKOIL will deliver associated gas from the Company’s fields in Western Siberia to Nyagangazpererabotka, a processing enterprise owned by SIBUR. The purpose of the agreement is to achieve 95% use of associated gas extracted by LUKOIL companies.

**LUKOIL approves its Energy Saving Program for the period 2011–2013.** Key commitments of the Program include use of energy-efficient methods of enhanced oil recovery and measures to modernize pumping equipment, including large-scale use of inverterfed motors for centrifugal and submersible pumps, as well as reconstruction of pumps used for maintenance of strata pressure. The Program also includes plans for implementation of new energy-efficient technologies and equipment, as well as power supply production facilities based on cogeneration units and other energy-saving technologies. Savings of fuel and energy resources with value of \$350 million should be achieved in three years for investments of \$200 million.

**APRIL**

**LUKOIL completes acquisition of 11% in a joint venture for management of the ISAB oil refining complex, located in the town of Priolo (Sicily, Italy), from the company ERG.** The transaction increases LUKOIL’s stake in the JV from 49% to 60%. Price of the acquisition was \$342 million. The ERG board of directors decided to sell 11% of the JV to LUKOIL in January 2011 in partial exercise of a sell option held by ERG in accordance with the agreement on JV creation in 2008.

**A company within LUKOIL Group buys a 50% interest in the production sharing agreement for the Vietnam offshore block, Hanoi Trough-02, from the privately owned oil company Quad Energy S.A.** The HT-02 block is located on the shelf of the South China Sea. Geological exploration work has been underway at the block since 2007 and has discovered a number of prospects.

**LUKOIL becomes the first oil company in the world to use aluminium casing and pump-compression pipes in well construction at a field with high sulphur and CO<sub>2</sub> gas presence.** The technical solution was applied at the Bayandyskoye field in the Komi Republic, which has high level of these corrosive substances.



**LUKOIL enters the Italian fuel retail market** where it completed rebranding of 19 filling stations under sub-franchising agreements. In accordance with the agreements, LUKOIL will supply fuel and lubricants to the stations, including products made at LUKOIL facilities. The sub-franchising agreements are for five years with an option to automatically extend for a further three years.

**MAY**

**LUKOIL produces a first batch of Euro-5 automotive gasoline.** This has become possible by commissioning of a hydrofluoric alkylation unit as part of catalytic cracking complex at the Nizhny Novgorod Refinery. Euro-5 gasoline ensures so-called 'clean exhaust', reducing emission of sulphur oxides and the products of incomplete combustion of aromatics (including the particularly cancerogenic and mutagenic benzopyrene).



**A company in LUKOIL Group signs an agreement with the Italian company ERG Renew for creation of a parity-owned JV to work in the renewable energy sphere.** Activities by the JV will focus initially on Bulgaria and Romania, and will then expand to Ukraine and Russia.

**JUNE**

**LUKOIL holds its Annual General Meeting of Shareholders.** The Meeting approved the Annual Report for 2010 and accounts for the financial year. Shareholders approved payment of dividends from Company profit in 2010 in the amount of 59 rubles per ordinary share (\$1.94 at the exchange rate on December 31, 2010).

**JULY**

**LUKOIL reaches an agreement for purchase of a 49% interest in an exploration and development contract at the offshore deepwater block SL-5-11 in the territorial waters of Republic of Sierra Leone from the company Oranto Petroleum.** The obligatory geological exploration program under the contract implies drilling of one prospecting well before 2013. Block SL-5-11 has an area of 4,000 km<sup>2</sup> and is located on the Atlantic shelf in the territorial



waters of Sierra Leone. Water depth at the block varies from 100 to 3,300 m. 2D and 3D seismic works have already been carried out and have found a number of prospective structures with substantial amounts of crude oil, based on preliminary estimates.

**AUGUST**

A LUKOIL Group company signs a contract with Baker Hughes for production drilling and well launch at the Mishrif formation, part of the West Qurna-2 field in Iraq. The contract terms are for drilling and launch of 23 slanted production wells, which will ensure that commercial production of oil can begin at West-Qurna-2 as scheduled in conditions of the service contract for development of the field. The contract with Baker Hughes is on a turnkey basis, by which the contractor provides a full range of drilling and well-launch services and also supplies the equipment and materials needed for well construction.

**OCTOBER**

LUKOIL begins construction of the first stage of a gas-processing plant, which will be the core facility of a gas-chemical complex to be built at the site of the Company subsidiary, Stavrolen. The principal input for the gas-chemical complex will be associated oil gas from fields, which are being developed by LUKOIL in the Russian sector of the Caspian Sea.



**LUKOIL takes 5<sup>th</sup> place among energy companies in Europe, the Middle East and Africa and 10<sup>th</sup> place among global oil and gas leaders in the Platts Top 250 Global Energy Company Rankings for 2011.** Companies were appraised by four main criteria: asset size, revenue, level of profit and return on capital. LUKOIL's positions in the ranking in 2011 were unchanged from 2010.

## DECEMBER

**A LUKOIL company together with American Vanco and the Côte d'Ivoire state company PETROCI Holding made a discovery at the CI-401 block off the coast of Côte d'Ivoire.** The Independance-1X exploration well, which has been drilled at block CI-401, reached the target depth and discovered high-quality sandstones containing light oil and gas condensate. Independance-1X was drilled at sea depth of 1,689 m at a distance of 93 km to the south-east of Abidjan. Independance-1X is the second exploration well drilled at Block CI-401, which covers an area of 619 km<sup>2</sup> with sea depths between 950 and 2,100 m.

**A LUKOIL company begins supplies of electric power in Bulgaria at preferential tariff.** Setting of the tariff became possible after transfer of a LUKOIL power station in Bulgaria to cogeneration of heat and electricity (cogeneration is encouraged by Bulgarian law). The tariff set for electricity from LUKOIL's generating facility is twice higher than the average market level. The new arrangement is an important breakthrough in LUKOIL's efforts to win market share for its power generating business in foreign countries that offers incentives for use of efficient electricity and heat generating technologies.

**LUKOIL launches pilot operations at a photovoltaic generating facility in Bulgaria.** The facility is located close to the city of Burgas on a site of more than 2.5 hectares and has installed capacity of 1.25 megawatts. The produced electricity will be sold in the open market at a preferential tariff. Pollutant and greenhouse gas emissions from the photovoltaic facility are 1,600 tonnes per year less than from a traditional heat power station with the same capacity.

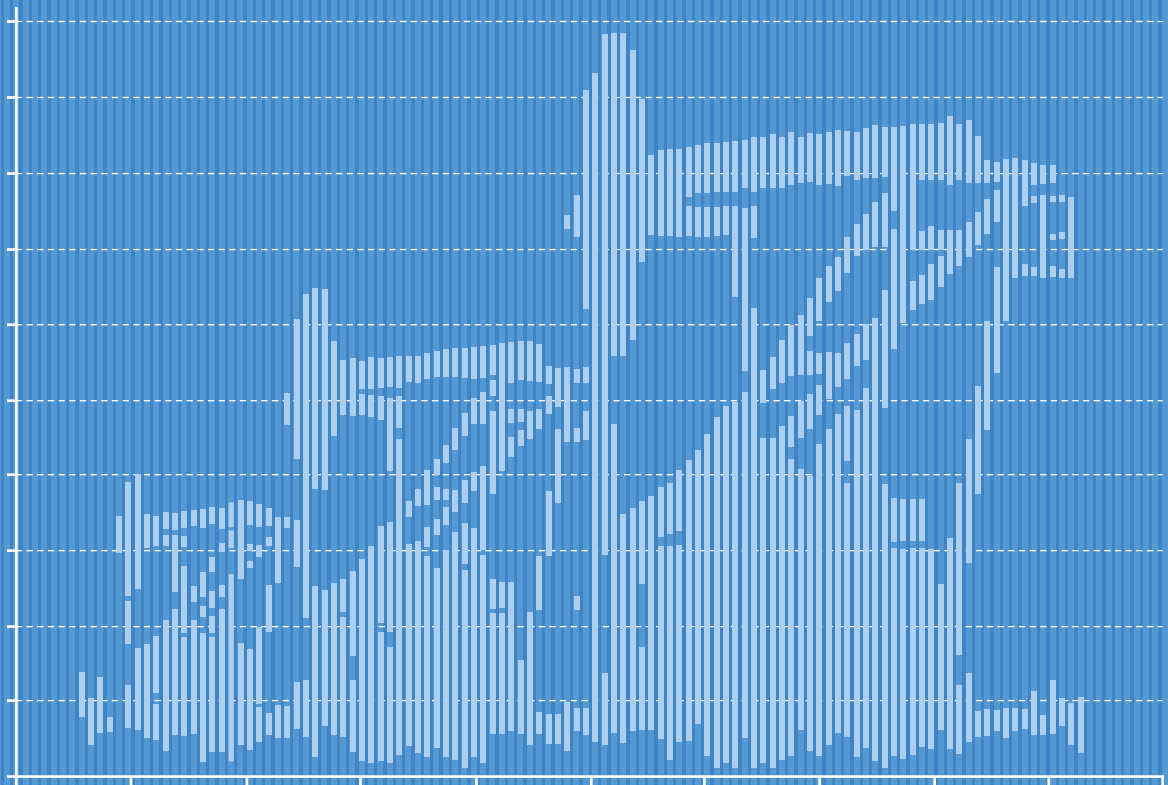


**LUKOIL and Bashneft Oil Company sign an agreement for acquisition by LUKOIL of a 25.1% stake in Bashneft-Polyus LLC, which owns licenses for mineral resources use including the Roman Trebs and Anatoly Titov oil fields. A joint venture agreement was also signed.** The acquisition was for a sum of \$153 million. The license area has 140.1 million tonnes of recoverable oil reserves in industrial categories (C1+C2), as recorded in the Russian State Register of Reserves.



# 1

## OIL & GAS EXPLORATION AND PRODUCTION



### 2012–2021 Strategy Program stipulates:

- At least 3.5% average annual growth of hydrocarbon production
- Stabilization of production in Western Siberia
- Increase of the oil recovery factor in Russia
- More than 80% of all investments to be spent on Exploration and Production
- Substantial increase of international projects share in total Group production
- Substantial increase of gas share in total Group hydrocarbon production



#### E&P segment indicators

Indicator, \$ million	2011	2010	Change, %
Revenue	44,858	36,523	28.2
EBITDA	12,125	10,848	11.8
Net income	6,665	6,139	8.6
Capital expenditures	6,629	4,908	35.1

The Exploration and Production segment is the main creator of value for the Company, generating more than 64% of net income.

The main achievement in 2011 was stabilization of crude oil production in Western Siberia. Output in the region ceased to decline at the end of the first half of the year and remained steady throughout the second half.

Another important event was the start of development work at the R. Trebs and A. Titov oil fields in a joint project with OJSC Bashneft Oil Company. The 2,151 km<sup>2</sup> license area is located in Nenets Autonomous District and has recoverable oil reserves of 140.1 million tonnes in industrial categories (C1+C2) recorded in the Government reserve register. All crude oil exports from the fields will be carried out by LUKOIL. Associated gas from the Trebs and Titov

fields can be sent to the energy center at the Yuzhno-Khylchuyuskoye field, where it will be turned into electricity to power field facilities at Trebs and Titov.

Main achievements in the Company's foreign projects during 2011 were associated with development of the West Qurna-2 field in Iraq. Several tendering competitions were held, the contract area was demined, and work started on construction of Pilot Camp (the shift camp for West Qurna-2). West Qurna-2 is one of the largest undeveloped fields in the world.

Another important step forward in LUKOIL's foreign business in 2011 was the start of early-gas production at the Dzharkuduk-Yangi Kyzylcha field as part of the Gissar project in Uzbekistan. Additional exploration (seismic and exploration drilling) led to increase of reserves, discovery of several prospective structures, the discovery of two new fields (South-East Kyzylbairak and Shamoltegmash), preparation of two structures for drilling, and confirmation of sizeable industrial gas reserves at a previously little studied sector of the large-scale Adamtash field.

## PRICE AND TAX ENVIRONMENT

### Crude oil market

Prices for crude oil were event-driven through most of 2011. The main factors with impact on oil prices were political instability in the Middle East, and debt problems in the USA and the eurozone. The wave of revolutions in Middle East countries, and particularly in Libya, during the first quarter of 2011 had major impact on world oil prices. The Brent price reached its highest point of the year (\$126.7 per barrel) in April, after increasing by 35% from the start of January. However, the Middle East events were already priced in by crude oil markets at the start of the second quarter and further events in that region had almost no impact on global supply volumes.

Reduction of supply in the first quarter gave way to demand-side issues as the main driver for oil price levels in the rest of the year. Debt problems in the eurozone, which had already been apparent in previous years, came to a head in the second quarter of

2011. Countries with particularly severe debt problems were forced to consider budget cuts, which had negative impact on expectations for levels of crude oil demand on international markets. A similar situation came to pass in August in the USA, where record debt levels led to lowering of the country's credit rating and fears of a second wave of the international financial crisis. These problems caused a sustained negative trend in world oil prices and by the end of the year the Brent price had fallen 16% from the April peak. However, the price at the end of 2011 was 14% higher than a year earlier (\$106.5 compared with \$93.7 per barrel) and the average price in 2011 was \$111.3 per barrel or 40% more than in 2010.

The Company's main operating areas, accounting for about 93% of oil production, are the Russian oil and gas provinces of Western Siberia, Southern and Central Russia, and Timan-Pechora. Prices for Russian Urals export blend therefore had direct impact on financial results. The Urals price rose by 39.4% compared with 2010 and averaged \$109.09 during the reporting year. The average discount of Urals to Brent in 2011 was \$2.2 per barrel compared with \$1.2 in 2010.

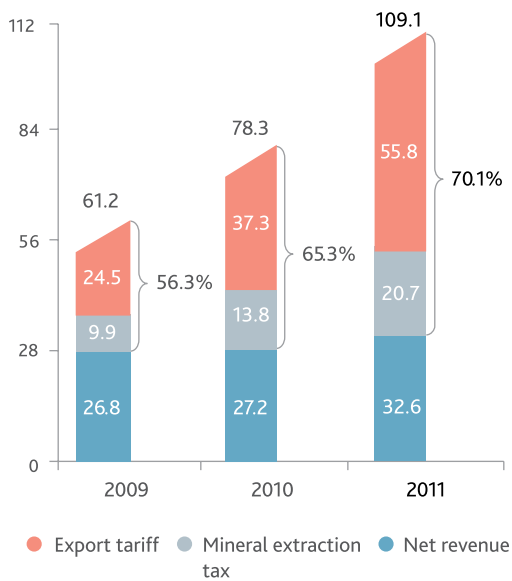
For an objective assessment of the Company's operating environment in 2011, it is important to take account of the tax burden on Russian oil exporters and changes in the burden compared with 2010. The main forms of taxation for oil companies in Russia including LUKOIL are mineral extraction tax (MET), excises and export duties. Applicable tax rates for oil companies in Russia are tied to world prices for crude oil and follow changes in world prices.

Growth of oil prices in 2011 caused the average MET rate (in dollar terms) to grow by 49.7% in comparison with 2010 to a level of \$20.69 per barrel.

The Company pays export duty on crude oil exports from Russia which is calculated by using a progressive scale based on the Urals crude price. Crude oil export duty rose by 49.6% in 2011 and the average duty rate during the year was \$55.8 per barrel. The Urals crude price net of tax for a Russian exporter (the international market price less export duty and MET) was \$32.6 per barrel in 2011. The share of MET and export duty in the average annual price of crude oil was 70.1%.

Taxes in projects that are governed by production sharing agreements continue to be paid in accordance with the terms of those agreements.

#### Revenue structure of a Russian crude oil exporter, \$ per barrel



#### Gas market

There was no clear trend in spot prices for gas in Europe during 2011. Prices saw volatility in the second half of the year as a result of abnormal weather, which affected levels of consumption in Europe. Gas prices fell by about 15% at various trading floors in Europe during 2011. However the average annual price in 2011 on various European markets was 30–50% higher than in 2010.

The opposite situation was observed in the USA, where prices for gas fell for most of the year. Supply in the USA continues to outrun demand due to excess production of shale gas, and the excess supply continued to have impact on gas prices in 2011, causing declines to a 10-year minimum. US spot prices fell by almost 30% in 2011, and the average annual price was 9% lower than in 2010.

Most of LUKOIL's gas production is in Russia and most of the Company's marketable gas output is sold to Gazprom and to other Russian consumers. The greater part of LUKOIL's Russian gas output is sold at the well and then transported through the Unified Gas Supply System, which is owned by Gazprom. LUKOIL cannot export gas, due to Gazprom's ownership of the Supply System and its monopoly on exports. The Company pays gas MET on its production of gas in Russia, and the rate of this tax increased by 61% during 2011 to a level of 237 rubles per thousand cubic meters.

Production of marketable gas in international projects was 4.8 billion cubic meters, of which more than 54% was produced at the Khauzak-Shady field in Uzbekistan. Gas from Khauzak-Shady is sold at an official price, fixed by agreements between Russia and Uzbekistan. A royalty is paid on production at a rate of 30% as part of the production sharing agreement (PSA). LUKOIL has a seven-year holiday from income tax, beginning from the start of production, at the end of which income tax will also be payable at the rate fixed in the PSA. The Uzbek Government share in profit production varies depending on the project's internal rate of return for LUKOIL Group.

Natural gas produced as part of the Karachaganak project in Kazakhstan is supplied to the Orenburg Gas-processing Plant. Taxation in this project is specified by terms of the PSA

Gas produced at the Shakh-Deniz field is supplied to the domestic market in Azerbaijan and also via the Southern Caucasus pipeline to Georgia and Turkey, where it is sold at market prices. Under terms of the PSA in Azerbaijan, LUKOIL is exempt from payment of taxes in cash on production and export of gas. The only significant tax paid by the Company is income tax at a fixed rate (the tax is withheld as a share of production).

#### INFLATION AND EXCHANGE RATES

LUKOIL Group produces most of its hydrocarbons inside Russia, so the largest part of Company costs is in rubles, while a significant share of revenues is expressed in US dollars or is tied to dollar oil prices

to a significant extent. So ruble inflation and fluctuation of the exchange rate can have substantial impact on Company results. Purchasing power of the US dollar in Russia, calculated from the \$/ruble exchange rate and the Russian inflation rate, declined by 12% in 2011 compared with 2010.

This development was one of the main causes of growth in unit lifting costs in Russia last year: unit costs rose from \$4.11 to \$4.7 per boe, or by 14.4%. Average unit lifting costs for the Group increased by 14.3% from \$4.12 to \$4.71 per boe in 2011. Capital expenditures in the Exploration and Production segment rose by 35.1% to \$6.6 billion.

#### ACQUISITION OF ASSETS

LUKOIL bought a 50% interest in a production sharing agreement at the offshore block, Hanoi Trough-02, in Vietnam from the privately owned oil company Quad Energy S.A. The HT-02 block is located on the shelf of the South China Sea. Geological exploration work has been underway at the block since 2007 and a number of prospects have been discovered.

The Company reached an agreement for purchase of a 49% interest in an exploration and development contract at the offshore deepwater block SL-5-11 in the territorial waters of the Republic of Sierra Leone

from the company Oranto Petroleum. The obligatory geological exploration program under the contract implies drilling of one prospecting well before 2013. Block SL-5-11 has area of 4,000 km<sup>2</sup> and is located on the Atlantic shelf in the territorial waters of Sierra Leone. Sea depth at the block varies between 100 and 3,300 m. 2D and 3D seismic works have already been carried out and have found a number of prospective structures with substantial crude oil resources, based on preliminary estimates.

LUKOIL and Bashneft Oil Company signed an agreement for acquisition by LUKOIL of a 25.1% stake in Bashneft-Polyus, which owns licenses for mineral resources use including the Roman Trebs and Anatoly Titov oil fields. A joint-venture agreement was also signed. The acquisition was for a sum of \$153 million. Bashneft-Polyus also signed an agreement to acquire 29 prospecting and exploration wells at the above-mentioned fields from LUKOIL for \$60 million. Bashneft and LUKOIL thus finalized the creation of a joint venture for development of the Trebs and Titov oil fields and advanced to the active stage of project implementation. The 2,151 km<sup>2</sup> license area is located in Nenets Autonomous District and has 140.1 million tonnes of recoverable oil reserves in industrial categories (C1+C2), as recorded in the Russian State Reserve Register.

## Licensing

The Group continued its work in 2011 to obtain new licenses for mineral use and to optimize its existing license portfolio in order to raise overall quality of the reserve base. LUKOIL obtained amendments and additions to conditions of its mineral use rights, extending the period of validity of its rights in some cases, as well as clarifying commitments of the Group companies to achieve specific output levels in accordance with project documentation.

**LUKOIL GROUP COMPANIES HAD 426 LICENSES ON THEIR BALANCE SHEETS AS OF JANUARY 1, 2012, OF WHICH 338 WERE FOR EXPLORATION & PRODUCTION OF HYDROCARBONS, 22 WERE FOR GEOLOGICAL STUDY, INCLUDING PROSPECTING AND EVALUATION OF MINERAL FIELDS, AND 66 WERE FOR GEOLOGICAL STUDY, EXPLORATION & PRODUCTION OF RAW HYDROCARBONS.**

The Company obtained 11 new licenses for use of mineral resources in 2011, of which five give rights for geological study, exploration & production of raw hydrocarbons, five are licenses for geological study of mineral areas in response to application by the mineral resources user, and one license is for geological study of a mineral area based on a Government contract.

During 2011 the Company took part in six auctions for mineral use rights, and won four of the auctions. Two auctions were declared invalid because only one bid was received, and the Company has submitted applications to obtain licenses for geological study of the relevant mineral fields in return for a direct payment by the mineral user. The licenses will be obtained in 2012.

LUKOIL surrendered six licenses for use of mineral resources during 2011, of which two were surrendered due to ending of the permitted period for geological study, and four were surrendered when it was found that development of the relevant areas would be economically inefficient.

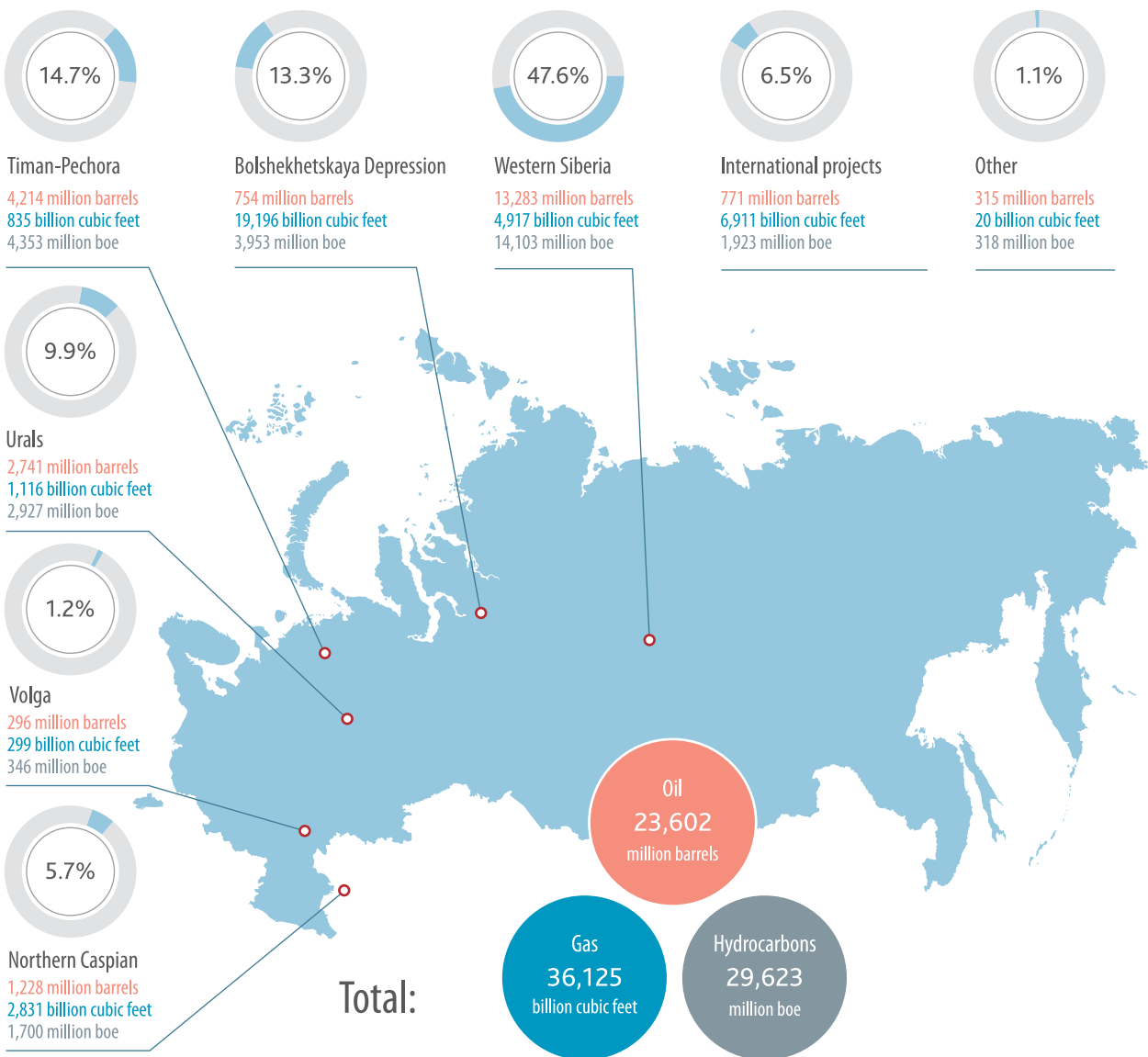
The Company obtained reissue of 91 licenses for mineral use during the reporting period in connection with further restructuring of its oil production subsidiaries.

Work continued in 2011 on amendments and additions to current license agreements concerning terms of mineral resource use at LUKOIL's license areas. A total of 34 amendments/additions were obtained, including 19 additions to licenses extending the period of their validity (13 of these licenses are for production and six are for study of mineral resources).



# Oil & Gas Reserves

## 3P OIL & GAS RESERVES OF LUKOIL GROUP BY REGIONS IN 2011



Reserve replacement is fundamental to long-term, sustainable development of the Company. LUKOIL Group carries out extensive geological exploration work in Russia and abroad in order to increase its reserves, and constantly monitors new projects and assets, which could represent acquisition targets.

ACCORDING TO DATA AUDITED BY MILLER AND LENTS (USA), THE COMPANY'S 3P RESERVES OF HYDROCARBONS AS OF JANUARY 1, 2012 WERE 29.623 BILLION BARRELS OF OIL EQUIVALENT (BOE), CONSISTING OF 23.602 BILLION BARRELS OF OIL AND 36.125 TRILLION CUBIC FEET OF GAS.

The audit was carried out to the standards of the US Securities and Exchange Commission (SEC). The Company decided in 2009 to adopt SEC standards for measurement of reserves in order to ensure greater transparency and comparability of Group reserve figures with those of competitors.

In accordance with SEC requirements, proved reserves that are not in development can only be recognized if there is an approved development plan. The plan must call for reserve development to begin within five years, unless specific circumstances justify a longer period before the start of development. Audit was carried out as prescribed by SEC standards up to attainment of profit production thresholds.

LUKOIL also completed an appraisal of contingent resources under PRMS. As of December 31, 2011 the Company had 3C contingent resources of 10.3 billion boe. The Company's 25.1% interest in Bashneft-Polyus was included in this figure for the first time (the LLC is a joint venture between LUKOIL and Bashneft Oil Company for development of the R. Trebs and A. Titov fields).

It is expected that prospective volumes of oil and gas, which are classified as contingent, will be transferred to reserves as the time for their development approaches, as the Company's associated gas utilization program moves forward, and as new technologies make production of hard-to-recover reserves commercially viable.

The greater part of the Company's proved reserves of oil are in Western Siberia, the Timan-Pechora oil and gas province and the Urals region. The main part of proved gas reserves are in the Bolshekhetskaya Depression (Western Siberia), Uzbekistan and the Caspian region. 60% of Company proved reserves are in development (65% of oil reserves and 41% of gas reserves). This reserve structure reflects large potential of the Company to increase production in the medium term, particularly production of gas.

Most of the Company's proved hydrocarbon reserves are conventional. Only about 4.3% of total proved hydrocarbon reserves (3.8% of 3P reserves) consist of high-viscosity oil and 4.7% (6.0% of 3P reserves) are at offshore fields. This reserve structure enables the Company to control development costs in an efficient manner and to bring new fields into production rapidly.

Replacement of production by proved reserves exceeded 100% in 2011. Growth of proved hydrocarbon reserves in 2011 as a result of geological exploration work, production drilling and acquisitions was 619 million boe, of which growth due to geological exploration work and production drilling was 612 million boe, and 7 million boe were added as a result of acquisitions. So organic growth of reserves compensated 76.3% of hydrocarbon production (77.5% for oil and 70.4% for gas). Organic growth of proved oil reserves in Russia was 516 million barrels (99% of the total growth) and 4 million barrels in the international projects (1% of the total growth). Organic growth of proved gas reserves in Russia was 310 billion cubic feet (56% of the total gas growth) and 240 billion cubic feet in the international projects (44% of the total gas growth).

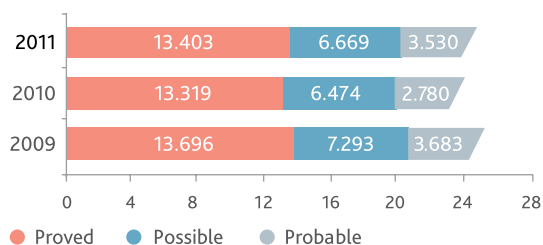
Proved reserves increased by 197 million boe due to revision of previous estimates.

There was substantial progress during 2011 in preparation for launch and development of a number of Company fields, enabling reclassification of 170 million boe of contingent resources as proved reserves. However, faster decline of production at the Yuzhno-Khylchuyuskoye field compared with earlier forecasts led to reduction of proved reserves by 147 million boe.

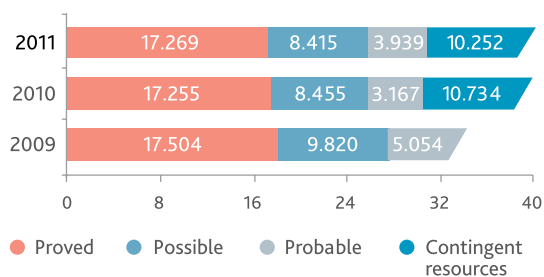


LUKOIL REMAINS AMONG RUSSIAN AND INTERNATIONAL LEADERS BY VOLUMES OF PROVED HYDROCARBON RESERVES. THE GROUP'S RATIO OF PROVED HYDROCARBON RESERVES TO PRODUCTION IS 22 YEARS (20 YEARS FOR OIL AND 30 YEARS FOR GAS).

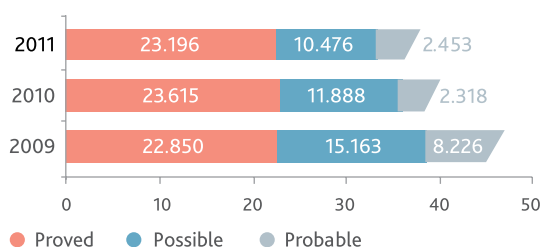
**3P crude oil reserves, billion boe**



**3P hydrocarbon reserves and contingent resources, billion boe**



**3P gas reserves, trillion cubic feet**



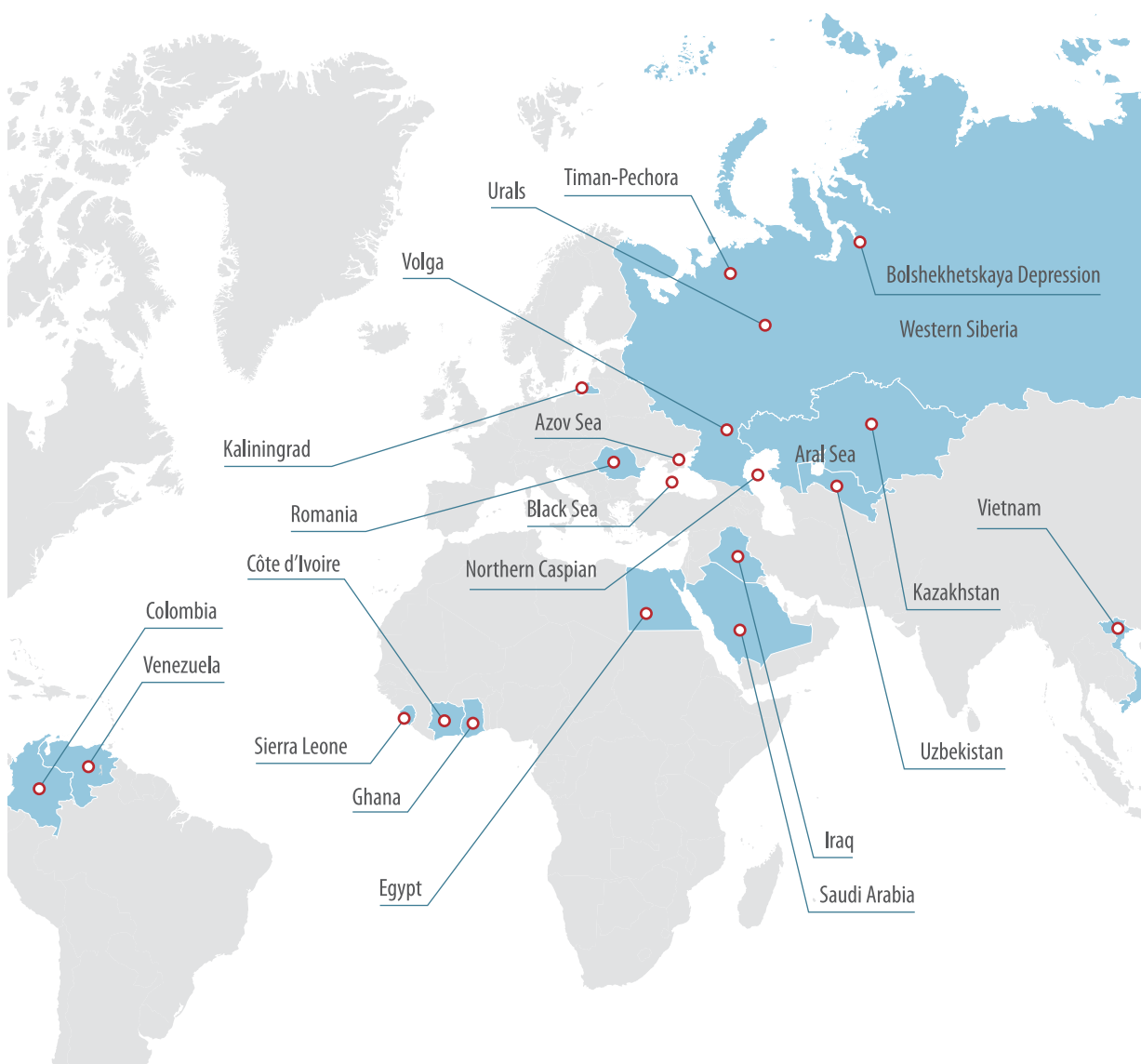
**Oil & gas reserves of LUKOIL Group**

January 1, 2012	Oil	Gas	Hydrocarbons <sup>1</sup>
	million barrels	billion cubic feet	million boe
Proved reserves	13,403	23,196	17,269
including:			
Developed	8,772	9,478	10,352
Undeveloped	4,631	13,718	6,917
Probable reserves	6,669	10,476	8,415
Possible reserves	3,530	2,453	3,939
<b>Total 3P reserves</b>	<b>23,602</b>	<b>36,125</b>	<b>29,623</b>

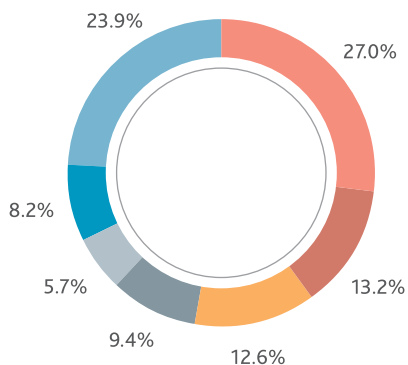
<sup>1</sup> Conversion ratio from cubic feet to barrels: 1 barrel = 6,000 cubic feet.

# Geological Exploration

## MAIN GEOLOGICAL EXPLORATION REGIONS OF LUKOIL GROUP



**Exploration drilling by regions (2011)**



- Western Siberia
- Timan-Pechora
- Volga
- Urals
- Bolshekhetskaya Depression
- Others
- International projects

Geological exploration work by companies of LUKOIL Group in 12 countries around the world is focused on replacement of production with new commercial reserves of hydrocarbons, and preparation of reserves for rapid launch and expansion of production in promising regions, both in Russia and abroad. The Company uses the latest technologies in order to maximize efficiency of its geological exploration work.

**Main prospecting projects 2011, carried out in fulfilment of earlier established tasks, were as follows:**

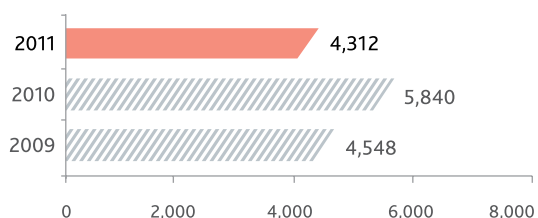
- Further exploration work at the Tsentralno-Astrakhanskoye gas and condensate field
- Continuation of prospecting and exploration work in the offshore Caspian to assess oil and gas prospects in Neocomian sediments
- Continuation of prospecting work to study geological structure and oil and gas potential at the Denisovskaya Depression in the Komi Republic
- Prospecting work for study of oil and gas prospects on the West African deep-water shelf and in the Aral region

The largest part of geological exploration work to discover oil and gas was in districts of Western Siberia, the Timan-Pechora oil and gas province, Perm Territory, the Volga, Astrakhan Regions, the offshore Caspian and as part of foreign projects.

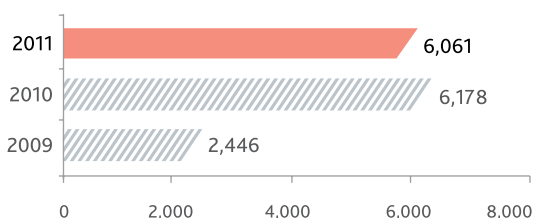
Geological exploration work in other regions was focused on preparation and reconnaissance of prospective new geological targets and additional exploration at fields, which were discovered earlier.

The Company carried out a substantial amount of 2D seismic work in 2011 to locate and detail geological

**3D seismic, km<sup>2</sup>**



**2D seismic, km**



structures and to prepare for drilling of prospecting and exploration wells, shooting a total of 6,061 km of 2D profiles. Volumes of 3D seismic were 4,312 km<sup>2</sup>. Quality of our seismic work and speed of processing and interpretation have improved in recent years, particularly due to application of new computer technologies. High standards of the Group's seismic work are demonstrated by success rates of about 70% in prospecting and exploration drilling.

LUKOIL completed 246.5 km of electrical exploration in 2011. Vertical seismic profiling, which enables detailing of geological structure around an existing well, was carried out at 15 wells. Total exploration drilling in 2011 amounted to 159,000 m, and efficiency was at a high level of 1,076 tonnes of conditional fuel per meter. A total of 48 prospecting and exploration wells were completed in 2011, of which 33 were productive.

Group companies discovered 6 fields in 2011 (Vostochno-Lambeishorskoye in the Komi Republic, Nikulinskoye in Perm Territory, Yuzhno-Eityanskoye in Western Siberia, Yuzhno-Stanovoye and Yurevskoye in Volgograd Region, and Independance in Côte d'Ivoire), as well as 20 new deposits at fields that are already in development.

Increase of proved reserves under SEC classification through geological exploration and additional information obtained in the course of production drilling amounted to 612 million boe. Organic growth of proved oil reserves was 516 million barrels (99% of the total growth) and 4 million barrels at the international projects (1%). Gas reserve growth in Russia amounted

to 310 billion cubic feet (56% of the total gas growth) and 240 billion cubic feet in the international projects (44%). Spending by LUKOIL Group on geological exploration work in 2011 was \$873 million including share in equity affiliates.

**RUSSIA**

Total 121,000 meters of exploration drilling was carried out in Russia during 2011, 2D seismic exploration was 5,463 km and 3D seismic was 4,309 km<sup>2</sup>. Spending on geological exploration in Russia was \$366 million.

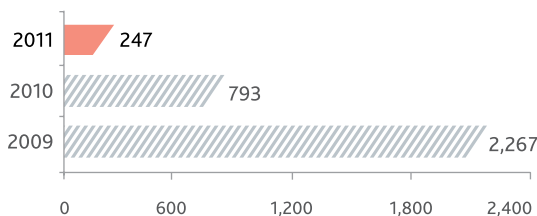
**WESTERN SIBERIA**

**Khanty-Mansiysk Autonomous District (Yugra)**

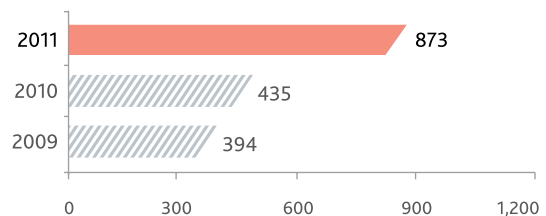
The Khanty-Mansiysk Autonomous District (Yugra) is the main oil production base of LUKOIL Group. The chief aim of geological exploration work there is replacement of reserves in order to maintain the Group's current production levels in the region. Although reserves in the region have been extensively explored, geological exploration work there is particularly efficient and productive.

Exploration drilling in the District totalled 42,700 meters in 2011 and 14 wells were completed, of which 12 were productive. The success rate of exploration drilling was 86%. The Company shot 907 km

Electric exploration, km



Spending on geological exploration, \$ million



of 2D seismic and 1,936 km<sup>2</sup> of 3D seismic in the course of the year. Most of the work was in peripheral areas of large fields, and was aimed at detailing oil and gas contours and identifying oil saturation in strata prior to production drilling.

LUKOIL identified 8 new deposits at previously discovered fields in the region during 2011. Largest growth of oil reserves was at the Kogalimskoye field (+1.8 million tonnes) and Nong-Eganskoye field (+1.4 million tonnes), thanks to 3D work and exploration drilling. Proved hydrocarbon reserves of the Company in the Khanty-Mansiysk Autonomous District to SEC standards were 7.3 billion boe (3P reserves were 13.6 billion boe). Significant oil inflows were obtained at a number of fields.

A prospecting well at the Svobodnoye field obtained oil inflows of 857 barrels per day from the Vasyugan suite at a dynamic level of 1,846 m. Testing of an exploration well at the Tevlinsko-Russkinskoye field gave free flow of oil of 392 barrels per day from Jurassic sediments using a 6-mm choke.

An exploration well was drilled at the Vostochno-Perevalnoye field, located on the territory of the Nadezhdinsky license area, and oil inflow of 400 barrels per day was obtained from achimian sediments. The well has been brought into production.

A new oil field was discovered in 2011 by drilling of a prospecting well at the Yuzhno-Eityanskoye elevation. Cased-hole testing of the T1 Tyumen suite gave an oil inflow of 138 barrels per day.

**YAMAL-NENETS AUTONOMOUS DISTRICT**

LUKOIL is developing gas reserves at the Bolshekhetskaya Depression in the Yamal-Nenets Autonomous District as part of its program for accelerated growth of gas production. The Company is also working at the Severo-Gubkinskoye, Prisklonovoye, and Yuzhno-Tarasovskoye oil and gas condensate fields, as well as the Urabor-Yakhinsky and Vansko-Namyssky areas.

Industrial inflows of gas and condensate have been obtained from testing of wells №304 and 2022 at the Pyakyakhinskoye field.

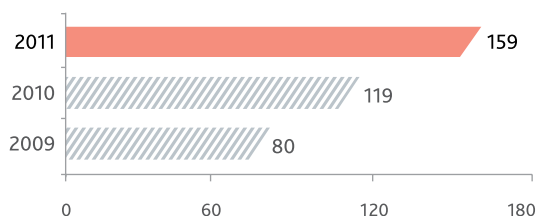
Testing of well №304 discovered 5 new gas condensate deposits at the Pyakyakhinskoye field. The strongest flow of separation gas was at a level of 123,000 cubic meters per day, with 124 barrels of stable condensate per day using a 12-mm choke.

Testing of well №2022 at the Pyakyakhinskoye field gave a free flow of gas condensate. In the course of studies a flow of separation gas at a rate of 169,800 cubic meters per day was obtained using a 10.2-mm choke. Flow of stable condensate was 122 barrels per day.

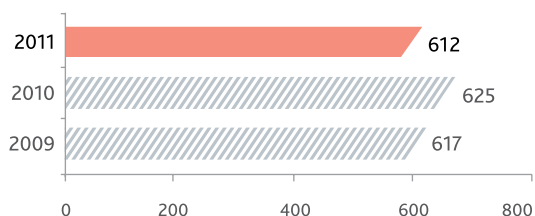
**TIMAN-PECHORA**

Timan-Pechora (the Nenets Autonomous District and Komi Republic) is a promising region for oil production by the Company. The region is little

Exploration drilling, thousand meters



Hydrocarbon reserve extensions and discoveries, million boe



studied, with high potential for new discoveries, and the Company carried out extensive geological exploration work there during 2011. Volumes of 2D and 3D seismic work during 2011, for clarification of geological models, were 627 km and 1,108 km<sup>2</sup>, respectively, and exploration drilling was 20,900 m.

Prospecting and exploration drilling in Komi Republic amounted to 17,000 m in 2011 and 3 wells were completed, all of which gave production. The drilling success rate was 100%.

The Vostochno-Lambeishorskoye field was discovered in the **Komi Republic**. Two wells that were drilled at the field confirmed the presence of industrial oil deposits in riphean limestones from the zadonsk era. Open-hole testing gave an inflow of pure light crude oil at a rate of 6,300 barrels per day. Recoverable C1+C2 reserves discovered at the field in the reporting year were 21.9 million tonnes, 3P reserves were 53 million barrels.

In the **Nenets Autonomous District** testing of an exploration well was completed at the Oshskoye field and free flowing oil was obtained at a rate of 1,057 barrels per day.

Geological exploration work and additional information obtained in the course of production drilling added 96 million barrels of proved reserves to international standards in Timan-Pechora during 2011.

## URALS

The Urals is a traditional production region for the Company, and reserves in the region have been extensively explored. LUKOIL carried out 590 km of 2D seismic and 341 km of 3D work in the region for geological purposes during 2011. Exploration drilling totalled 14,700 m. Exploration drilling to discover new fields and increase reserves was carried out mainly in the vicinity of sites with established commercial oil presence.

In **Perm Territory** construction of 5 wells was completed and all of them were productive. The success rate in exploration drilling was 100%. At the Yenapayevskaya and Zabrodovskaya areas two wells

were completed and testing was begun. In tests all of the wells gave flows from productive strata at daily rates between 22 and 435 barrels. One new field was discovered in 2011 – the Nikulinskoye field, – where testing gave maximum oil flow of 400 barrels per day.

## VOLGA (onshore)

The Volga is another traditional hydrocarbon production region for LUKOIL and its geology has been extensively studied. Exploration drilling in 2011 was 17,700 m. 2D seismic during 2011 amounted to 1,634 km, and 3D was 225 km<sup>2</sup>.

Drilling work was continued in **Volgograd Region** during 2011 at Avilovskaya well №10 and drilling of exploration well Avilovskaya №8 was begun. Well №44 at the Vysotskoye field was completed and cased-hole testing of Tula sediments gave inflows of gas at a maximum daily rate of 290,000 cubic meters. Construction of Levoberezhnaya well №6 was also completed and sampling of a Sennovian horizon gave sustained free flow of water-free oil and gas at a rate of 349 barrels per day, while testing of a Khovanian horizon gave an inflow of oil at a rate of 604 barrels per day. As a result the Yurievskoye field with C1+C2 reserves of 1 million tonnes was discovered.

Additional studies at the reopened Nizhnekorobkovskiy wells №23 and №27, which were drilled at the start of the 2000s at the Yuzhno-Stanovaya structure, led to discovery of the Yuzhno-Stanovoye field with C1+C2 recoverable reserves of 632,000 tonnes. Testing of Bobrikov and Yevlanovo-Livensk sediments gave pure oil inflows at rates of up to 250 barrels per day.

Construction work on Tsentralno-Astrakhanskaya well №3 continued at the **Tsentralno-Astrakhanskoye field**. Bottom-hole depth at the end of 2011 was 4,007 m. The well has been cased and is due to be developed in 2012. 3D seismic work at the field continued in 2011 when total 355 km<sup>2</sup> was carried out.

In **Tatarstan** oil inflow at a rate of 201 barrels per day was obtained from a well at the Olginskoye field, which is part of the Agryzsky license area. At the

Ozerny license area in-hole testing of the Bobrikov horizon gave a viscous oil inflow of 57 barrels per day.

## NORTHERN CASPIAN



The Northern Caspian is one of the key regions for increase of oil and gas production by LUKOIL in the medium term and the Company attaches great importance to development of resource potential in the region.

In the **offshore Caspian** two wells were completed and both were productive, so the success rate in prospecting and exploration drilling was 100%.

Rakushechnaya well №8 was completed with bottom-hole at a depth of 1,650 m and industrial oil inflow was obtained from testing of the oil-saturated part of a Neocomian reservoir with maximum daily inflow rate of 2,969 barrels per day. An Aptian oil deposit was tested and hydrofracturing of strata was used to enhance flow rates for the first time in offshore work. Maximum daily flow rate before hydrofracturing was 28 barrels per day, and the rate increased to 282 barrels per day after the operation. Well №2 at the Sarmatskaya structure was completed with bottom-hole at 3,330 m. Drilling results confirmed productivity and discovered expansion of the gas contour. The production string was tested in three productive strata of the Titon tier. Joint testing of strata II and III

gave daily gas inflows of 400,000 cubic meters per day and 618 barrels per day of condensate. Testing of stratum I gave a gas flow of 1,094,000 cubic meters per day and 209 barrels of condensate per day. The increase of C1 gas reserves at the Sarmatskoye gas field was 55.6 billion cubic meters.

## KALININGRAD REGION

LUKOIL companies carried out geological exploration work in 2011 in Kaliningrad Region, both onshore and offshore (in the Baltic Sea). Total 3,300 m of drilling was carried out. Specialists also completed 442 km of 2D seismic work at all license areas in preparation for deep drilling.

Drilling of a prospecting well at the D-41 structure was suspended at bottom-hole depth of 1,350 m pending alterations to the project plan in order to reduce risks associated with large step-out in directional drilling.

## INTERNATIONAL PROJECTS

LUKOIL's strategic development program implies intensive development of international operations in the Exploration and Production segment. The main task of geological exploration by the Company outside Russia is to prepare the resource base for rapid launch of production. Exploration drilling in international projects with LUKOIL participation was 37,855 meters in 2011. 2D seismic work in international projects in 2011 totalled 598 km and 3D work was 3.98 km<sup>2</sup>. Spending on geological exploration outside Russia was \$507 million. LUKOIL was involved in geological exploration drilling in 11 countries outside Russia by the end of 2011: Kazakhstan, Saudi Arabia, Egypt, Uzbekistan, Romania, Vietnam, Colombia, Venezuela, Côte d'Ivoire, Ghana and Sierra Leone. A total of 11 wells were completed during 2011 as part of these projects, of which three were productive.

Drilling of a third exploration well was finished in 2011 at the **Kungrad block** (part of the Shege structure) in **Uzbekistan**. Well studies in open borehole using an

MDT device obtained inflows of gas. Testing of well Shege-3 is scheduled for completion in 2012, after which a decision will be made on further work.

Drilling of wells Kuvachi-7 and Parsankul-9 was completed during 2011 at the **Kandym block**. Testing of Kuvachi-7 gave industrial inflows of gas and condensate at a daily rate of 165,000 cubic meters. Testing of Parsankul-9 will be carried out in 2012. Drilling of well Parsankul-10 has begun. A project for 2D and 3D seismic work has been prepared and a sub-contractor is being selected to carry it out.

In the **South-West Gissar** project in **Uzbekistan** drilling and testing of well Shamoltegmas-4 was completed during 2011. A total 598 km of 2D work has been carried out ahead of schedule. Gas inflows of up to 198,000 m<sup>3</sup> per day were obtained. Drilling work on prospecting well Shurdarye-2 began in December 2011 and will be completed in 2012, when well Navruz-1 will also be drilled. 3D seismic work will start in 2012 and recommendations will be prepared for appraisal drilling at the Shurdarye and Navruz structures.

Drilling of well Shagala-1 enabled complete evaluation of the eastern part of Aral prospects as part of the **Aral project in the Uzbek sector of the Aral Sea**. Testing gave no inflow of hydrocarbons. A program of further work was approved in August 2011, which includes the drilling of prospecting and appraisal wells. The first stage of the exploration period came to an end in April 2011 (the minimum work program has been carried in full and to schedule). Preparations are being made for drilling in 2012 of an appraisal well at the West Aral field and of a prospecting well at the Umid structure. Passports have been prepared for the Umid and Ak-Tepe structures. In 2011 LUKOIL increased its share in the project to 26.6%.

3D seismic field work and interpretation of results began in 2011 as part of the **West Qurna-2** project in **Iraq** (contracted work volumes are 540 km<sup>2</sup>). A number of studies have been carried out as well as work for creation of a petrophysical field model. WQ-11 was reopened and inflow of oil at a daily rate of 6,686 barrels was obtained. Scheduled tasks for 2012 include further reopening of wells, completion of 3D seismic work, logging of previously drilled

wells, preparation of a drilling pad and approach roads, and the start of drilling work on a prospecting well and the first production wells.



On the Western Africa shelf (projects in **Côte d'Ivoire and Republic of Ghana**) 5 exploration wells were drilled including 1 productive (Independance-1X) and 1 with non-industrial inflow (Buffalo-1X, **CI-205 block**).

Independance-1X well that was drilled at **CI-401 block** is 4,100 meters deep, while sea depth is 1,700 meters. The well established excellent sandstone reservoirs was established in Turonian sediments (3,799 – 3,815 meters). Proved net pay is 53 meters. Detection of oil deposits in Turonian sediments represents a pioneering discovery.

The exploration work plan for the **Riyadh (Block A)** project in **Saudi Arabia** implied drilling of five prospecting wells at the Tukhman and Mushaib fields and more than 1,500 km<sup>2</sup> of 3D seismic work. Studies were carried out in 2011 on economically viable technologies for extraction of difficult gas reserves in reservoirs with low permeability at the Tukhman field. Joint proposals with Saudi Aramco are being prepared for negotiations with the Saudi Arabian Government concerning changes in contract terms in order to continue economically viable work on the project. A decision on further work is expected during 2012.

Processing and interpretation of 3D seismic data from 2010 and previous years was completed as part of the **WEEM Extension** project in **Egypt**. The resource



base was clarified and passports were prepared for sidetrack drilling at wells WEEM-A2-ST2 and WEEME-A3. A tendering process was carried out, but drilling work had to be postponed until 2012 due to a lack of drilling capacities in 2011.

In February 2011 LUKOIL, Vanco International and the Romanian National Agency for Mineral Resources signed concession agreements for exploration and production at two blocks in the **Romanian sector of the Black Sea: Est Rapsodia and Trident**. The blocks are located at sea depths between 100 and 1,200 meters, and each block covers an area of 1,000 km<sup>2</sup>. The agreements came into force in November 2011. The minimum program in the obligatory first stage of work at each block includes conduct of 1,000 km<sup>2</sup> of 3D seismic exploration, AVO-analysis, basin modelling and drilling of one well. Regional 2D seismic data from previous years totalling 13,000 km were acquired in 2011, as well as materials from six offshore wells in Romania and Ukraine, nine geological reports and a seismic-study data base for the north-western part of the Black Sea. It is planned to carry out 2,000 km<sup>2</sup> of 3D seismic exploration work in 2012.

In April 2011 the Group acquired a 50% interest in the production sharing agreement for the **Vietnam** offshore block, **Hanoi Trough-02 (HT-02)**, from Quad Energy S.A. The HT-02 block covers an area of 1,185 km<sup>2</sup> and is located onshore and in coastal waters of the South China Sea, about 50 km away from the port of Haiphong and 1,500 km away from developed fields

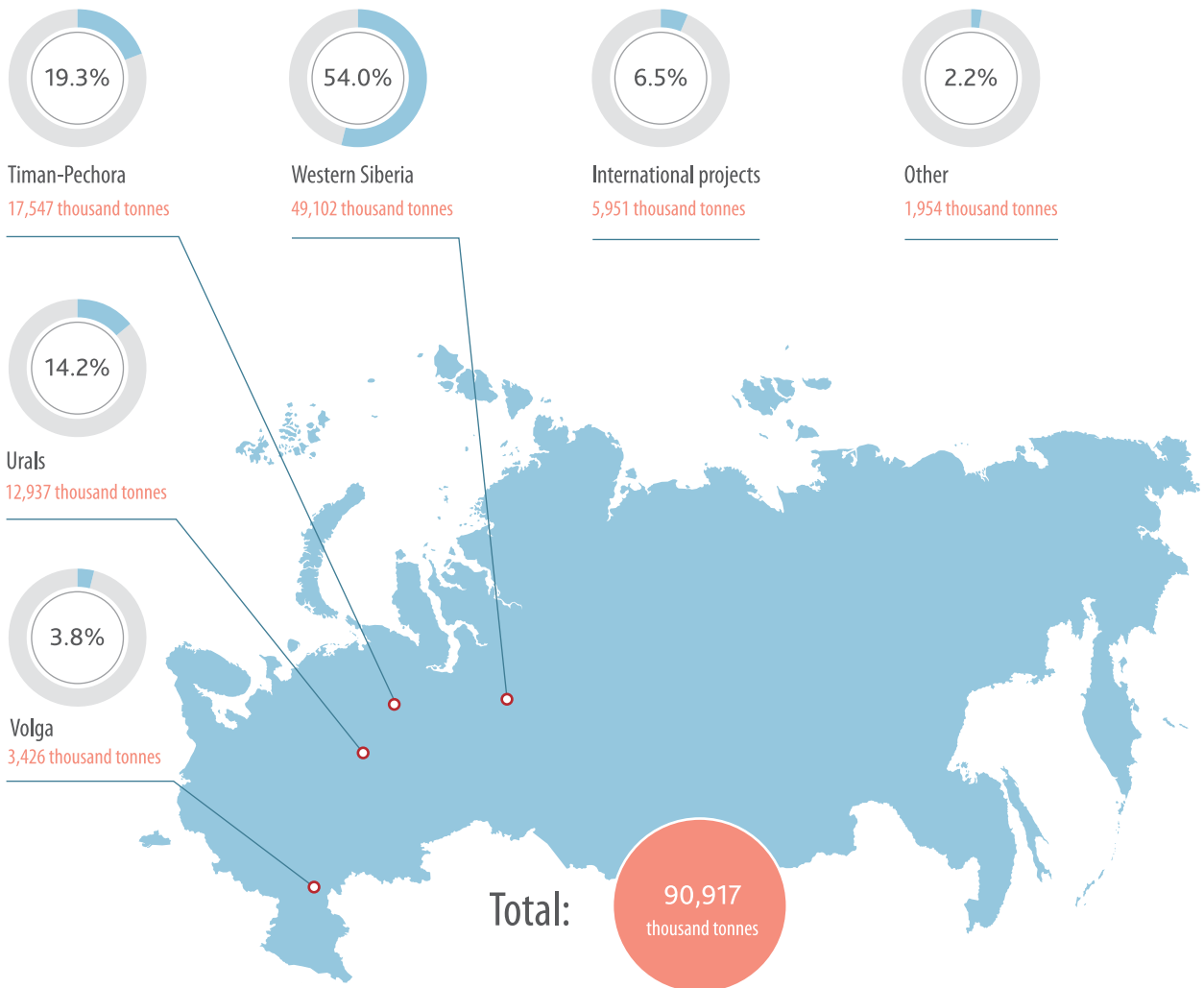
on the ocean shelf of South Vietnam. Water depth is up to 23 meters. Analysis of data from the block and from adjacent areas will be carried out in 2012, and recommendations will be prepared for further geological exploration. Depending on results, 3D or 2D seismic work may be carried out as well as drilling of a third well.

In July 2011 LUKOIL acquired a 49% interest in an exploration and development contract at the offshore deepwater **Block SL-5-11** in territorial waters of the **Republic of Sierra Leone** from the company Oranto Petroleum. Block SL-5-11 covers an area of 4,022 km<sup>2</sup> and is located on the continental slope of the Atlantic Ocean at sea depths between 100 and 3,300 m. 2D and 3D seismic studies were already carried out before acquisition on an area of 1,500 km<sup>2</sup> and a number of prospective structures were found, including the Leon and Savanna structures. The Block is part of the Sierra Leone – Liberia geological basin, where a number of large oil fields have been discovered in recent years. 2D electric exploration work is planned in 2012, as well as reprocessing of 3D seismic materials and preparations for prospecting drilling.

The Group has decided to abandon two projects in **Kazakhstan**: the **Tyub-Karagan** project (the second well Tyub-Karagan №2 was drilled in 2011 and did not discover industrial hydrocarbons deposits) and the **Zhambai-Zaburunye** (due to impossibility of finding a drilling sub-contractor capable of providing well-construction services in present conditions).

# Oil Field Development and Production

## LUKOIL OIL PRODUCTION BY REGIONS IN 2011



**Crude oil production by LUKOIL Group in 2011 (including the share of production by equity affiliates) was 90,917 million tonnes (1,840 million barrels per day).**

Lower oil output in 2011 reflects decline of production at fields in Western Siberia, where the Company produces 54% of its crude oil. The decline was due primarily to objective changes in the structure of recoverable reserves. **However, improvement to systems for maintaining strata pressure, use of the latest enhanced recovery technologies and horizontal drilling enabled LUKOIL to stabilize output levels in Western Siberia from the middle of the year (see 'Stabilization of production in Western Siberia').**

Production levels were also negatively affected by results in Timan-Pechora where rates of output at wells declined due to high-water cut and shrinkage of recoverable reserves. Parameters of the geological model for the Yuzhno-Khylchuyuskoye field were revised in the reporting year, and this was reflected in the Group's operating and financial results. Further measures have been designed and approved for stabilization of output levels at the Yuzhno-Khylchuyuskoye field and they will be implemented in 2012. They include drilling of side-tracks and use of 12 dual-injection systems.

LUKOIL subsidiaries and equity affiliates produced hydrocarbons at 358 fields in Russia and at 34 fields in 4 foreign countries during 2011. Production of hydrocarbons was begun at three new fields in the Russian Federation and at one field in Uzbekistan. Production levels at 18 Group fields rose by more than 50,000 tonnes in comparison with 2010. The largest increases (more than 200,000 tonnes) were achieved at 4 fields, which together gave overall annual increment of oil output by 1 million tonnes.

The Company had 30,840 oil production wells as of January 1, 2012, of which 26,970 were actually in use, and the number of injection wells was 10,960, of which 8,750 were under pressure. The number of oil production wells was 1.6% higher in 2011 than in 2010, and the number of injection wells increased by 6.0%, raising the efficiency of production. The share

of idle wells was almost unchanged from the end of 2010 at 12.5% of the total number. Average daily oil output at wells in projects with Group participation was 13.8 tonnes.

Volumes of production drilling were 2,953,000 m, which is 8% more than in 2010. The number of new production wells brought into operation was 1,006, of which 235 were horizontal. The Company plans to increase the number of horizontal wells in the medium term due to their high efficiency. Average daily flow from new wells in projects, in which the Group is a participant, was 32.4 tonnes, including 49.8 tonnes from horizontal wells.

The share of horizontal wells in the total number of new wells brought into operation in Russia increased from 11.5% in 2010 to 24.9% in 2011.

**A PROGRAM OF INDUSTRIAL TESTING ENABLED A TECHNOLOGY BREAKTHROUGH IN 2011, WHICH RAISES THE FORECAST FOR VIABLE DEVELOPMENT OF NEW RESERVES IN 2012–2021 BY 3.6 BILLION BARRELS OF OIL THANKS TO INCREASE OF OIL RECOVERY RATES AT FIELDS IN RUSSIA.**

LUKOIL made particularly rapid advances during 2011 in **drilling of horizontal wells that uses multi-zonal hydrofracturing of strata. A total of 96 wells with multi-zonal hydrofracturing were brought into operation in 2011 and gave 637,000 tonnes of oil production. Average daily oil flow from the wells was 56.3 tonnes.** Application of this technique at the Urevskoye and Tevlinsko-Russkinskoye fields led to significant adjustment of field development plans, increasing the target recovery factor and thereby raising rates of return on these investment projects. In another technology advance LUKOIL used an expanded logging-while-drilling (LWD) complex for construction of horizontal wells on an industrial scale, enabling real-time drilling of horizontal boreholes in productive strata, which ensures maximum contact with the reservoir.

**DRILLING OF HORIZONTAL WELLS IN THE DEPRESSION AT WELLS IN WESTERN SIBERIA GAVE AN INCREASE OF OIL FLOW RATES BY 2–4 TIMES COMPARED WITH PREVIOUSLY DRILLED**




**WELLS USING CLAY-POLYMER SOLUTIONS, WHILE REDUCING UNIT COSTS BY 30%.**

LUKOIL achieved some increase in the efficiency of sidetracks during the reporting year and drilling of sidetracks was increased. Consistently high efficiency was achieved by the use of scientifically prepared mini-projects with hydrodynamic modeling, as well as by more accurate forecasting of geological structure and the structure of reserves at areas where sidetracks were drilled. Sidetrack drilling is carried out mainly at wells, which have been taken out of operation, in order to extract residual oil reserves. Sidetracks were drilled at 241 wells in 2011 and gave average daily flow of 20.4 tonnes.

Efficiency of hydrofracturing operations at Company wells in 2011 was comparable with the result in 2010. The level of oil flow increase from hydrofracturing was maintained thanks to efforts to improve work planning, selection of wells using full-time hydrodynamic models, and tighter control over the quality of materials and reagents used by service companies.

A total of 4,894 operations were carried out on productive strata in 2011 using physical, chemical, hydrodynamic and heat techniques.<sup>1</sup> Additional oil output in Russia thanks to application of such enhanced oil recovery techniques was 22.3 million tonnes, or 26% of total oil production by the Group in Russia.

 <sup>1</sup> See 'Exploration and Production Technologies'



**RUSSIA**

Oil production by LUKOIL in Russia during 2011 was 84.966 million tonnes, of which 84.609 million tonnes were produced by Group subsidiaries.

Subsidiaries and equity affiliates of LUKOIL produced hydrocarbons at 358 fields in Russia in 2011. Production drilling in Russia grew by 9.1% to 2,493,000 m. The Group owned 28,930 production wells at the end of 2011, of which 25,240 were actually in use.

**WESTERN SIBERIA**

Fields in Western Siberia accounted for 54% of LUKOIL's oil production during the reporting year. Production in the region was somewhat lower than in 2010 at 49.1 million tonnes. Use of enhanced oil recovery methods and drilling of horizontal wells enabled LUKOIL to stabilize production rates in the

region from the middle of 2011. The Company will continue to focus on stabilization of production levels in main operating areas, stepping up capital expenditures for development of new technologies and improvement of field efficiency.

Despite long periods of exploitation, some of the Company's fields in Western Siberia are still achieving production increases. In particular, the Vostochno-Perevalnoye and Urevskoye fields showed strong oil production growth once again in 2011.

Oil production at the **Vostochno-Perevalnoye field**, commissioned in 2007, grew by 40% compared with 2010 to a level of 0.9 million tonnes. The growth was achieved by launch of new wells (39 wells with average daily oil flow rates of 36.6 tonnes) as well as operations at wells that were completed in the previous year (29 wells were brought into production in 2010 and gave average oil flow of 37 tonnes per day). The Company's development program calls for launch of 46 new wells in 2012–2013, of which four

will be horizontal. Water and gas treatment of strata is being used in test mode in order to raise the oil recovery at the Vostochno-Perevalnoye field. Peak production should be attained in 2013.

Oil production at the **Urevskoye field**, which was brought into production in 1978, rose by 8.1% to 3.1 million tonnes in 2011. The increase was achieved thanks to production drilling: 90 new wells were launched with average daily output of 38 tonnes, including 35 horizontal wells with daily flow of 61 tonnes. A total of 11 sidetracks were drilled at the

field in 2011 in order to maintain output levels at wells, and they gave average daily flow increases of 19.6 tonnes, producing 22,300 tonnes of additional oil in total. Work continued on a system for maintaining strata pressure, and 75 new injection wells were put under pressure in the reporting year.

The future drilling schedule for the Urevskoye field as of January 1, 2012, included 802 wells, of which 493 for production and 309 for injection. The Company's development program foresees completion of 117 new wells at the field in the period from 2012 to 2017.



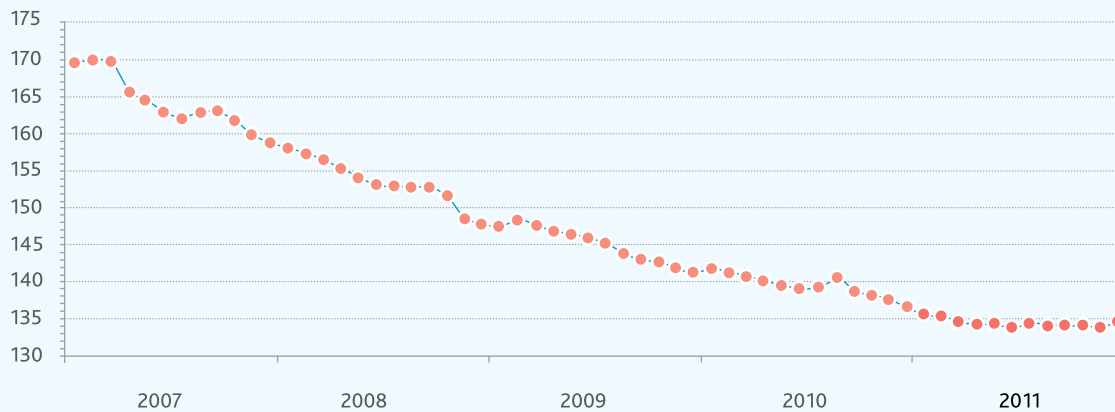
# Stabilizing Production in Western Siberia. The Urals Experience

Western Siberia is one of LUKOIL's key production regions. Crude oil production there in 2011 was 49.1 million tonnes or 54% of the total for the Group. However, most fields in the region have been in development for many years and their reserves are highly depleted. Output by LUKOIL in Western Siberia peaked in 2007 at a level of 59.9 million tonnes. Average annual decline of Group output in the region during 2008–2010 was 5.3%. In 2011 we succeeded in reducing the rate of production decline: levels of output were stable in the second half of the year.



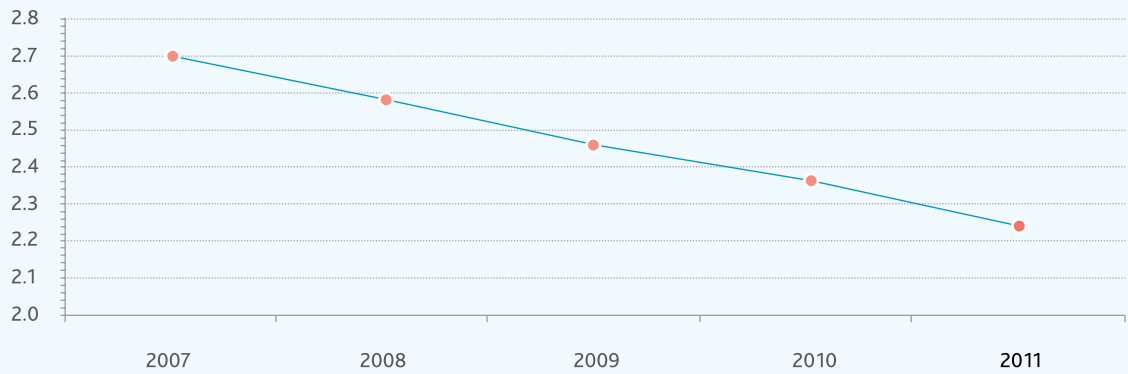
This result was achieved through implementation of several carefully planned measures:

Western Siberia: crude oil production, *thousand tonnes per day*

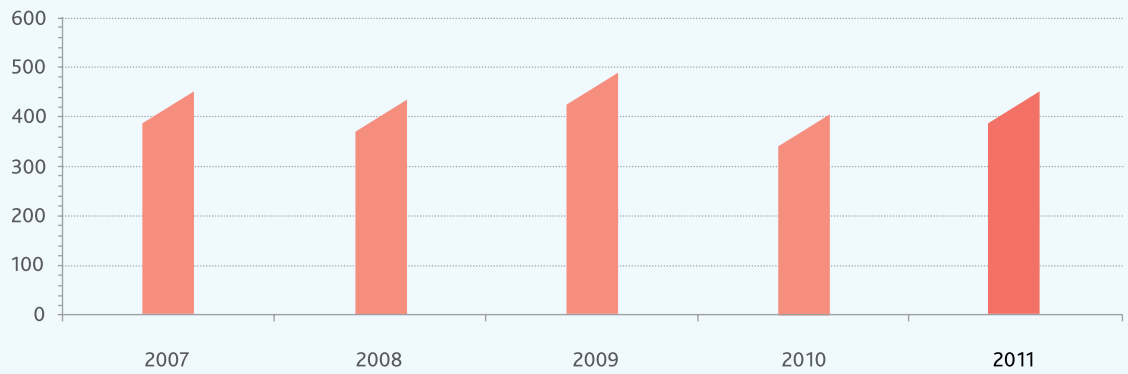


Major reinforcement of the system for maintenance of strata pressure. Average 450 injection wells have been brought into service each year, so that, while the number of production wells grew only insignificantly (by 4%) over five years, the number of injection wells rose by 20%. The ratio of production wells to injection wells was reduced, and this enabled lowering of production losses and optimization of reserve development reduced, and this enabled lowering of production losses and optimization of reserve development.

### Western Siberia: production wells to injection wells



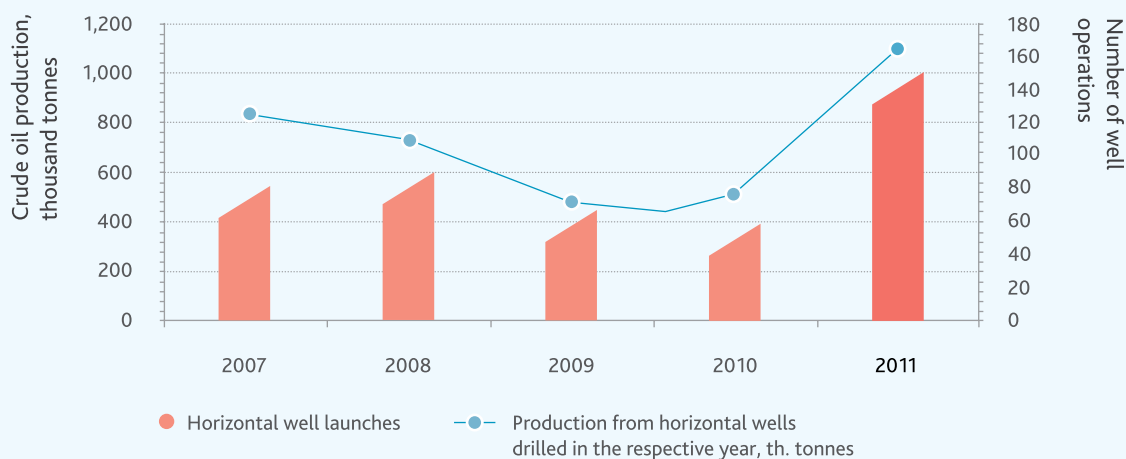
### Injection well launches in Western Siberia





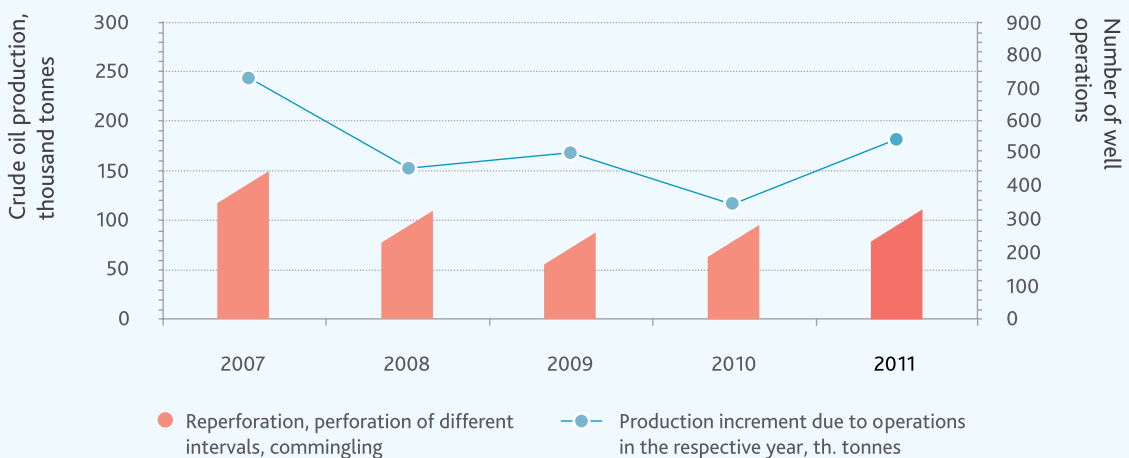
The quantity of horizontal drilling work in Western Siberia was greatly increased in 2011, when 153 highly efficient horizontal wells were commissioned in comparison with 59 in 2010. We also carried out 96 multizonal hydrofracturing operations on strata horizontal drilling during 2011. Average daily flow rates from the new wells were over 56 tonnes.

**Western Siberia: launches and production from horizontal wells**

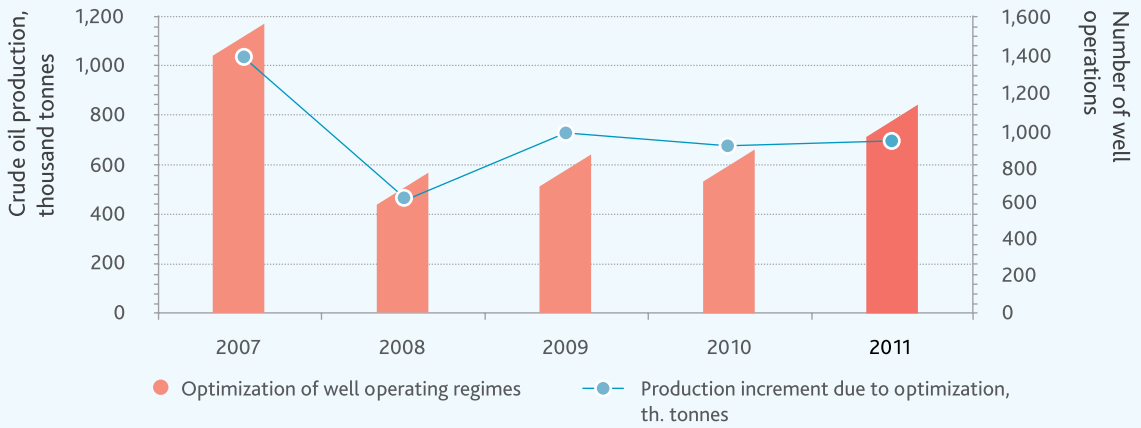


The number of low-cost well improvement operations (reperforation, perforation of different intervals, optimization of well operating regimes) increased in 2011 compared with 2010.

**Western Siberia: EOR operations**

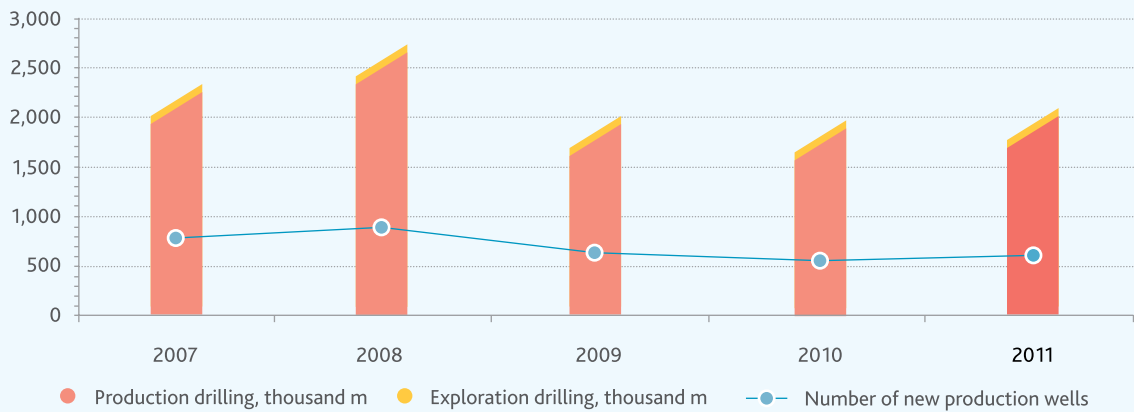


### Western Siberia: well optimization

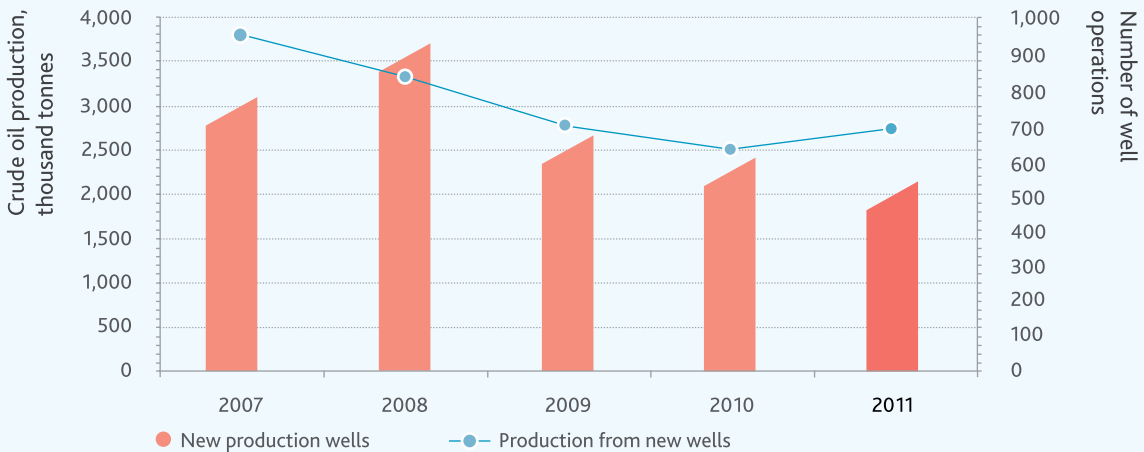


Use of new drilling technologies in 2011 gave an increase of crude oil output from new wells, despite a decline in the number of new wells.

### Western Siberia: drilling and well launches



### Western Siberia: production from new wells



LUKOIL Group plans to maintain its focus on stable levels of production in Western Siberia, increasing investments to create and apply the latest technologies, and to improve efficiency in exploration and development of fields. The Company's Strategic Development Program for 2012–2021 foresees a continuation of stable output levels in Western Siberia in coming years, and growth of production from 2016 thanks to the launching of new fields.

**URALS EXPERIENCE**

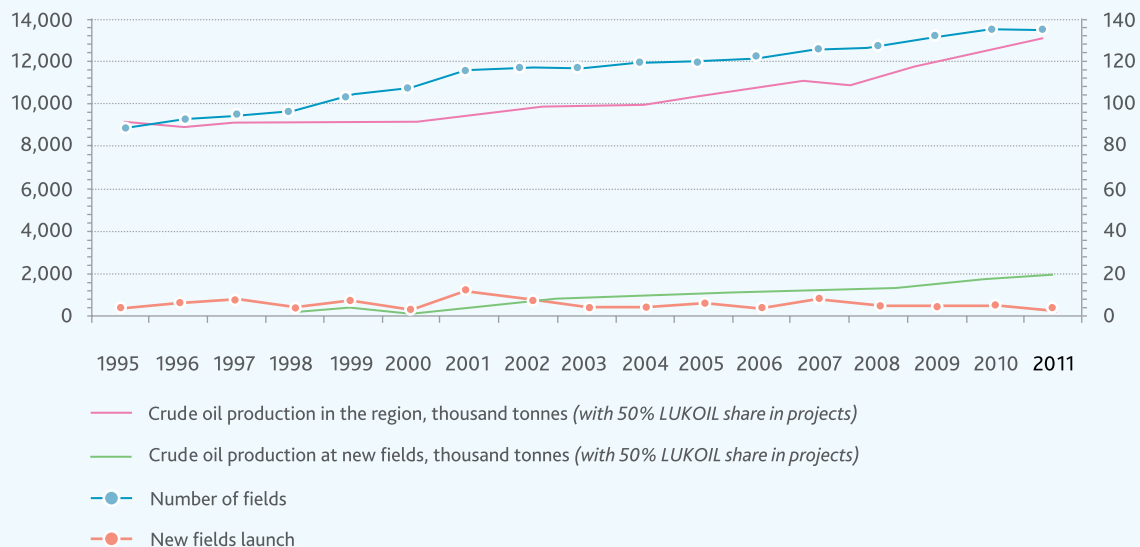
**LUKOIL has achieved steady growth of production over a number of years in the Urals, which is another traditional production region for the Company. Crude oil output in the Urals in 2011 was 12.9 million tonnes, representing 14.2% of total output by the Group.**

The Company brought 51 new fields into production in the Urals between 1995 and 2011, and a total of 133 fields were in operation as of January 1, 2012. There has been a steady increase of output levels from 9.3 million tonnes in 1995 to 12.9 million tonnes in 2011. These results were achieved thanks to:

- Annual launch of 2–3 new fields on average
- Increase of the share of crude oil produced at new fields, which were brought into production during the period (nearly 2 million tonnes in 2011)
- Implementation of efficient work on wells and formations (production drilling, drilling of sidetracks, hydrofracturing) as part of integrated programs for enhanced oil recovery, with coordination of decision-making for smaller and larger well groups

This enabled major increases of crude oil output at a number of large fields in the region (Unvinskoye, Sibirskoye, Gagarinskoye, Kurbatovskoye, Garyushkinskoye).

**Crude oil production and commissioning of new fields in the Urals**



## TIMAN-PECHORA

The Timan-Pechora oil province provided 19.3% of Company production in 2011. Output by LUKOIL in the province declined by 17.1% to 17.5 million tonnes, due to lower production levels at the Yuzhno-Khylchuyuskoye field, but Timan-Pechora still has great potential. In 2011 LUKOIL and Bashneft Oil Company set up a joint venture for development of the R. Trebs and A. Titov oil fields, which are located in the province. Timan-Pechora also has the largest share of LUKOIL's heavy oil reserves, which are located at the Yaregskoye and Usinskoye fields.

The **Yaregskoye field** has proved reserves of 318 million barrels of high-viscosity oil under SEC classification (3P reserves are 540 million barrels). Production at the field mainly uses a shaft technique. Work began in test mode during 2011 to improve heat treatment applications by use of a new drilling rig which enables wells to be drilled to a length of 800 m (2.5 times longer than traditional wells). Use of the new drilling rig, together with use of boring combines, will substantially reduce spending on preparation for development of slanted blocks and will raise productivity.

Five pairs of production and injection wells were drilled at the Lyaelskaya area of the Yaregskoye field in 2011 with horizontal completions and borehole length up to 1,100 m. The purpose of this test work is to obtain know-how in use of horizontal boreholes for injection and production purposes. The technology is similar to Steam Assisted Gravity Drainage (SAGD), which is being applied in production from oil sands in Canada, and the tests have confirmed its efficiency.

The **Permian-Carbonaceous deposit at the Usinskoye field** was brought into operation in 1977 and proved reserves in the deposit to SEC standards as of January 1, 2012 were 430 million barrels (3P reserves of the field were 680 million barrels). The deposit is characterized by highly varied structure of its carbonate reservoir, which contains high-viscosity oil, and thermal methods are being used to assist production. Most of the reserves at the deposit are

being extracted by natural means. Extensive steam injection is being carried out at steam-heat impact zones in order to increase the recovery factor as well as steam-cycle treatment at various wells located over the entire extent of the deposit (combined with injection of chemical reagents in some cases). Additional oil production since thermal methods began to be used at the deposit is in excess of 6.1 million tonnes.

Extensive thermal treatment of strata via a system of horizontal wells is being used at a sector of the deposit for the first time. In 2012 LUKOIL plans tests at the deposit using perpendicular gravitational drainage of strata.

Highest production growth rates in Timan-Pechora in 2011 were achieved at the **Yuzhno-Yuryakhinskoye field**, where the increase in output compared with 2010 was 214,400 tonnes (+233%). The production increase reflects well completions: six new wells were brought into production and gave average daily oil flows of 204.3 tonnes.

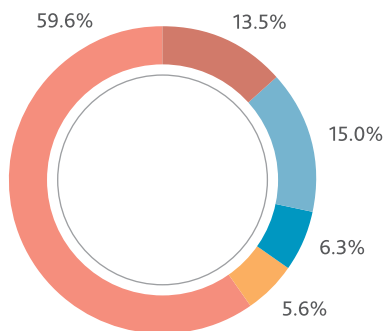
Five new wells are scheduled to enter production at the Yuzhno-Yuryakhinskoye field in 2012. The Company's development program for Exploration and Production business segment foresees rapid development of the field and further increase of oil production rates there.

## URALS

**Production of oil by LUKOIL in the Urals region increased to 12.9 million tonnes in 2011, or by 3.5%, thanks to use of new technologies, such as sidetracks, radial drilling and acid hydrofracturing.** The Urals accounted for 14.2% of total production by the Company during 2011, compared with a figure of 13.0% in 2010.

Production of oil at the **Unvinskoye field**, which has top priority for the Company in the region, grew by 9.8% in 2011 to 1.7 million tonnes, thanks mainly to extensive use of modern enhanced recovery technologies as well as production drilling. A total of 10 sidetracks were drilled, giving average daily oil

**Production drilling by regions (2011)**



- Western Siberia (including the Bolshekhetskaya Depression)
- Timan-Pechora
- Others
- International projects
- Volga

flow of 22 tonnes, and 17 operations for hydrofracturing of strata gave average daily production increments of 14.3 tonnes.

Radial drilling was used at six wells and gave average increments of 9.9 tonnes per day. Five new wells were completed and gave average oil flows of 33 tonnes per day, including one horizontal well with average daily flow of 60.5 tonnes. These actions raised overall oil flow rates at all operating production wells to a level of 17 tonnes per day, compared with 15 tonnes in 2010.

The Unvinskoye field is one of the Company's biggest investment projects in Perm Region by size of initial reserves. The field has been almost completely drilled over and only fringe zones of deposits remain to be drilled.

**VOLGA**

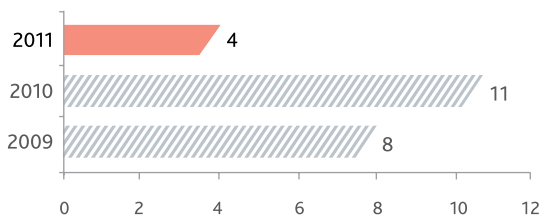
Crude oil production by LUKOIL in the Volga region increased by 9.2% in 2011 compared with 2010 to 3.4 million tonnes.

Growth of production in the region was driven mainly by development of the **Yury Korchagin field**, which was launched in 2010 and was the first launch in a series of new Company fields in the offshore Caspian, which will be the main source of oil production growth for LUKOIL in the medium term.

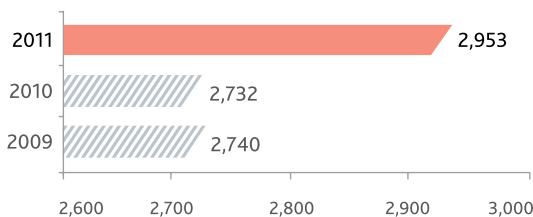
Total output from the Yury Korchagin field increased in 2011 to a level of 338,100 tonnes thanks to further drilling work, which enabled completion of three new wells. The total length of horizontal sections at wells rose above 1,000 m in the reporting year. Average daily oil flow from new wells was 432 tonnes and total production from new wells during the reporting year was 215,400 tonnes.

The circulation system for drilling fluid was modernized as part of technical re-equipment of the Yury Korchagin offshore platform. This has enabled operations using drilling fluid with an invert base, so that extra-long horizontal boreholes can now be drilled to lengths in excess of 5 km.

**Oil field launches, fields**



**Oil production drilling, thousand m**



Plans for 2012 include drilling and launch of one gas-suppression well and four production wells, with horizontal section length of up to 4,000 m. The project development plans call for drilling of 33 production wells in the period up to 2017. Peak oil production should be in excess of 2.4 million tonnes and peak gas production will be more than 1 billion cubic meters.

which enabled existing plant capacities for preparation of oil and gas to be fully loaded. Pre-FEED work was completed in the project for optimization of the second-generation plant, which will make facilities more dependable and raise daily capacity to 41,800 tonnes, and also in the project for management of well-head pressure, which will extend the period of full load of existing oil and gas preparation facilities through construction of a system for pressure increase (a pumping station).

## INTERNATIONAL PROJECTS

LUKOIL's share of production in international projects was 5.951 million tonnes in 2011, which is 4.4% less than in 2010. The decrease was mainly due to the Kumkol and KarakudukMunai projects in Kazakhstan, South-West Gissar in Uzbekistan, Meleiha in Egypt and Shakh-Deniz in Azerbaijan.

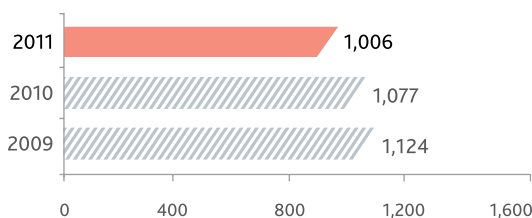
Production drilling in the Company's international projects increased by 3.0% in 2011 compared with 2010 to 459,800 meters. The number of oil production wells rose by 9.6% to 1,905, of which 1,728 were actually in use. A total of 267 new production wells were commissioned as part of international projects, in which the Company is a participant.

The Group share of production in the Tengiz project in Kazakhstan was nearly unchanged at 1.292 million tonnes. An utilization rate of 99.2% was achieved for associated gas at Tengiz in the reporting year. A total of 25 well interventions were carried out in 2011 and gave 1.5 million tonnes of additional output,

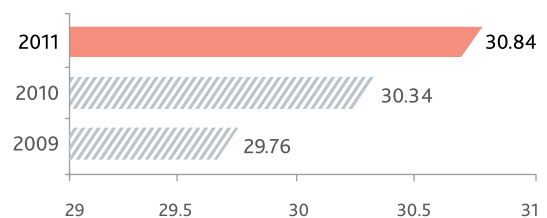
The Group's share of crude oil and gas condensate production in the Karachaganak project in Kazakhstan was 1.5 million tonnes in 2011, almost unchanged from the previous year. Drilling of three new horizontal wells was completed during the year as part of the field investment program and one of the new wells was brought into production. A fourth stabilization and purification line was brought into operation at the Karachaganak Processing Complex. Stabilization capacity at the end of 2011 was 27,400 tonnes of stable condensate and oil per day, and a record level of gas injection to strata (25.4 million cubic meters per day) was achieved.

There was a decline of output in the Kumkol project in Kazakhstan by nearly 15% to 1.25 million tonnes (the Group share) as the field is in a late stage of production. A total of 66 new production wells were brought into operation and gave average daily flows of 22.9 tonnes. Work was carried out to improve the system for utilization of associated gas, and proprietary rights to the technology scheme used in development of the Vostochny Kumkol field were obtained.

Oil production well launches, wells



Oil production wells, thousand wells



Share of the Group in production from the **Karakuduk-Munai** project in **Kazakhstan** was 696,000 thousand tonnes in 2010, down by 3% from the previous year due to natural ageing of the fields. Two new wells were brought into operation during 2011 and gave average daily flow of 26.9 tonnes. Seven sidetracks were drilled during the year.

Rapid development of the **North Buzachi** field in **Kazakhstan** was continued in 2011 and the LUKOIL share in output was almost unchanged at 493,000 tonnes. A total of 153 new production wells (including 50 horizontal wells) were brought into operation and the average daily flow rate per well was 10.3 tonnes. Five pumping stations were completed and launched during the year. Three horizontal wells and eight horizontal sidetracks were drilled. Work on the program for utilization of associated gas is continuing.

Production as part of the **Arman** project in **Kazakhstan** was 19,100 tonnes in 2011, which is 9.1% less than in 2010. One well was completed for gas production in 2011 in order to supply fuel for power generation at the field, overcoming electricity shortages.

Oil production grew by 16.9% at the **Alibekmola and Kozhasai** fields (**Kazakhoil Aktobe** project in **Kazakhstan**) to reach 285,200 tonnes in 2011. A total of 20 new wells were commissioned and their average flow rate was 52.9 tonnes. The oil preparation and pumping unit at the Alibekmola field was upgraded during the year and a workover of the oil production zone at the Kozhasai field was carried out. Work continued on the project for utilization of associated oil gas.

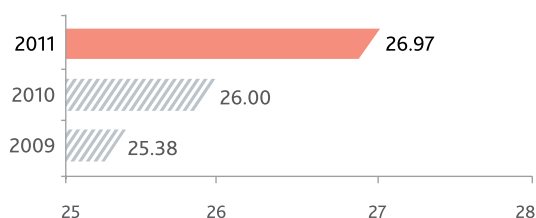
There was a decline in production of gas condensate as part of the **Shakh-Deniz** project in **Azerbaijan** by 9.3% to 135,400 tonnes due to limited capacity of consumers in Azerbaijan and Turkey to take the gas. One new well was brought to operation in 2011 and gave an average daily flow of 1,200 tonnes. Gas was delivered through the South-Caucasus pipeline to Azerbaijan, Georgia and Turkey. Condensate was shipped via the Baku – Tbilisi – Ceyhan export pipeline. On October 25, 2011, a package of documents on further development of Stage 2 of the project was signed by representatives of the Azerbaijani state oil company, SOCAR, and the Turkish state oil and gas pipeline company, BOTAS, in the presence of the Turkish Prime Minister. The documents must also be ratified by the Turkish and Azerbaijani parliaments. An accord between Azerbaijan and its partners on a five-year extension of the production sharing agreement for Shakh-Deniz depends on final approval of Stage 2.

LUKOIL's share of gas condensate production at the **Khauzak-Shady** area in Uzbekistan (developed as part of the **Kandym – Khauzak – Shady** project), which was commissioned in 2007, was 9,100 tonnes in 2011.

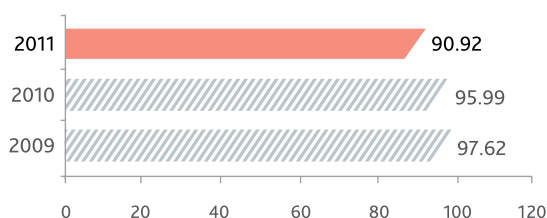
LUKOIL's share of production at the **South-West Gissar** project in **Uzbekistan**, which was acquired in 2008, declined by 11.9% in 2011 compared with 2010 to a level of 77,400 tonnes, due to natural exhaustion of the oil fields which are being developed in the project.

The Group's share in the **Meleiha** project in **Egypt** was 20.4% less in 2011 than in 2010 and amounted

Oil production wells in use, *thousand wells*



Oil production, *million tonnes*



to 54,900 tonnes. This was due to reduction of LUKOIL's share in the PSA due to growth of prices for hydrocarbons. A total of 24 new wells were brought into operation in 2011 and their average daily flow rate was 37.4 tonnes.

The Group share in production as part of the **WEEM** project was 136,800 tonnes (excluding WEEM extension). A system for maintenance of strata pressure was launched in test mode in the course of the year.

Preparations were carried out in the reporting year for the launch of production in the **West Qurna-2** project in **Iraq**. In 2009 a consortium of LUKOIL and the Norwegian company Statoil won a tender for

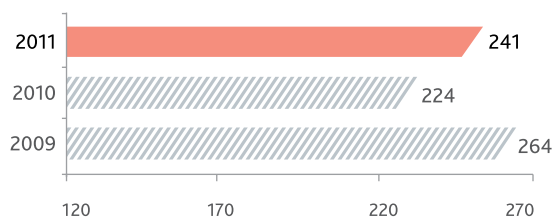
development rights at the West Qurna-2 field, which is among the largest in the Republic of Iraq.

The geological model of the field was brought up to date in 2011 to take account of new well-testing data, interpretation of fragments of geophysical studies and more accurate correlation of the geological section with sedimentation cycles. Drilling of 23 production wells is scheduled to begin in 2012 as part of the early oil development stage. Other plans for 2012 include construction of geological and hydrodynamic field models, completion of work to re-open old wells, core studies and 3D seismic work.

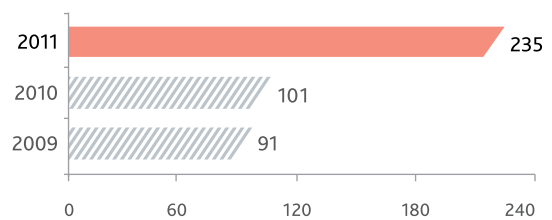
Oil production is scheduled to begin in 2013.



Drilling of sidetracks, *sidetracks*



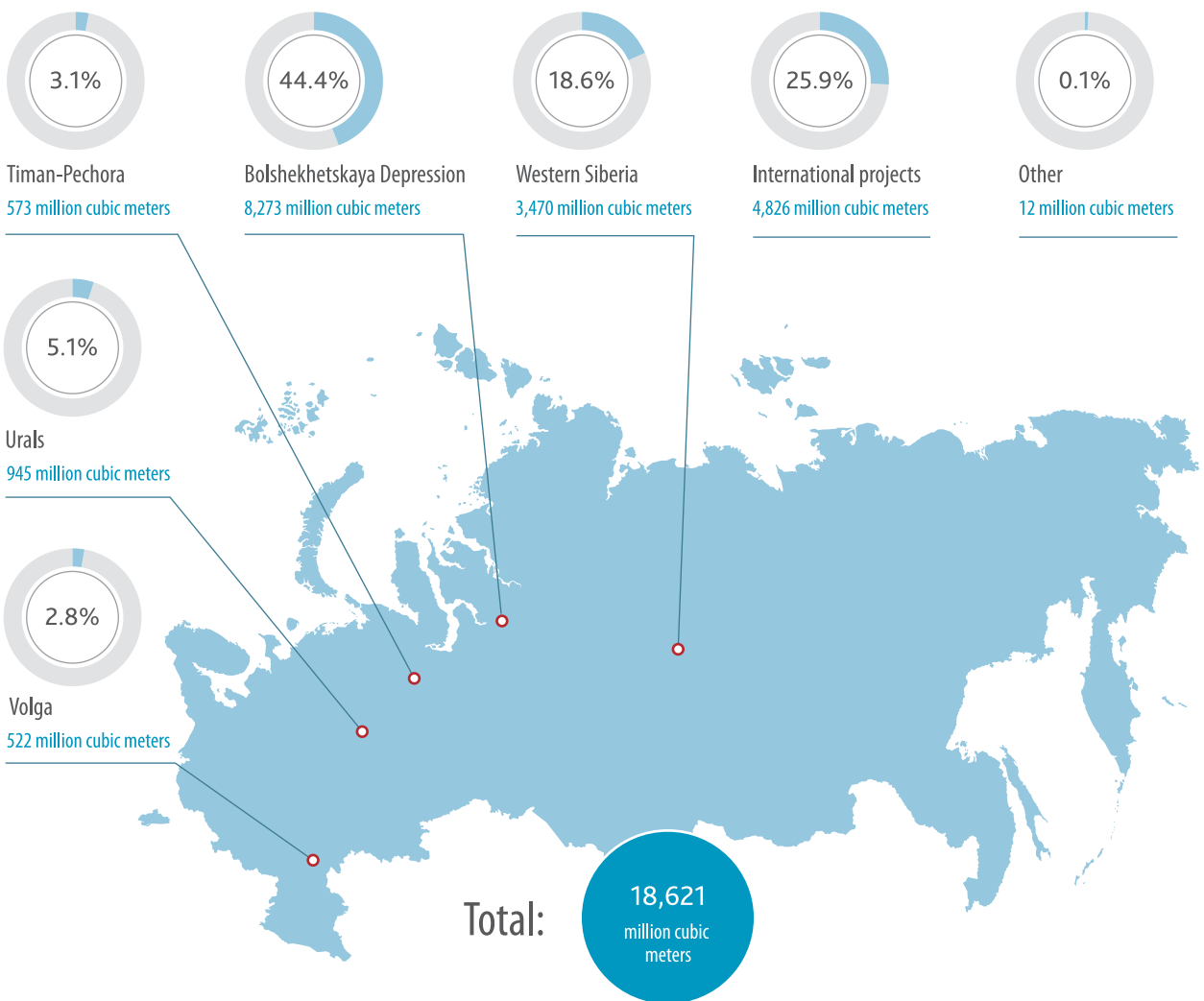
Drilling of horizontal wells, *wells*





# Gas Field Development and Gas Production

## LUKOIL PRODUCTION OF MARKETABLE GAS BY REGIONS IN 2011



LUKOIL's gas program is focused on accelerated growth of gas production both in Russia and abroad and increase in the share of gas to a third of total hydrocarbon production by the Group. The main aim of this strategy is to commercialize gas reserves and reduce the Company's exposure to major price volatility on the international oil market.

**Total gas production by LUKOIL Group in 2011 (including the share of production by equity affiliates) rose by 3.3% to 22.023 billion cubic meters.**

Output of marketable gas (net of own use, reinjection into reservoir formations and transport losses) rose by 0.4% to 18.621 billion cubic meters (300,000 boe per day), including increase of output by 1.2% in Russia and reduction of output by 1.9% in other countries. Company revenue from sales of natural gas was \$327 million in 2011, which is 4.8% more than in 2010, due to increase of demand and of prices for hydrocarbons.

**The main achievement in the Company's gas business during 2011 was the launch of gas production at the Dzharkuduk field as part of the South-West Gissar project in Uzbekistan.** Early gas was produced at the field towards the end of 2011 and attainment of large-scale production is scheduled in the first quarter of 2012. A complex gas preparation unit will be built at Dzharkuduk in 2013 when construction of the large Gumbulak and Adamtash fields will also be completed, with drilling of more than 40 production wells. An external power transmission line will also be provided, and other constructions will include a gas collection and preparation system, pipelines for marketable gas and condensate, a shift camp, a field base and various engineering infrastructure facilities.

The Company's main gas field remains the Nakhodkinskoye field, where natural gas production rose by 1.6% in 2011 to 8,273 million cubic meters. All of this gas was sold to Gazprom. **Net income of LUKOIL Group from gas projects in Russia was \$114 million in 2011.**

The Company had 404 gas production wells at the end of 2011, of which 296 were in use.

Output of natural gas increased by 1% in 2011 to a level of 14,082 million cubic meters, including 12,761 million cubic meters of marketable gas, production of which was almost unchanged from the previous year.

Production of associated gas grew by 7.4% to 7,941 million cubic meters, including 5,860 million cubic meters of marketable associated gas, production of which increased by 1.3%. Associated gas is used at Company fields, where it is injected in order to maintain strata pressure, for generation of electricity using gas-fired generating stations, and also for other production needs. Marketable associated gas is delivered to gas-processing plants and to local consumers.

The Company has been increasing the share of associated gas, which it puts to use<sup>1</sup>, year by year and the share reached 79.3% in 2011 compared with 76.8% in 2010, 71.1% in 2009 and 70.4% in 2008. The increase has been made possible by development of systems for utilization of associated gas at Company fields, including construction of compressor stations and gas pipelines. The level of utilization of associated gas at main Company fields in Western Siberia is now above 95%.

The Company is pursuing construction of gas-fired power stations at fields as part of a small-scale generating program in order to further increase utilization of associated gas. This reduces gas flaring and gives cost savings on electricity, lowering oil lifting costs. LUKOIL is implementing a program for the years 2011–2013, which aims to increase rates of associated gas utilization by organizations in the Group. The Company built or upgraded 52 facilities at 49 fields in 2011 as part of the gas utilization program.

<sup>1</sup> The share of produced gas in total gas extracted from strata. Remaining gas is flared off.



**RUSSIA**

Production of marketable gas in Russia in 2011 was 13,795 million cubic meters, which is 1.2% more than in 2010. The Company had 297 gas production wells in Russia at the end of 2011, of which 215 were actually in use.

Most of the Company's natural gas production in 2011 in Russia (more than 90%) came from the **Nakhodkinskoye field** in the **Bolshekhetskaya Depression**. Gas production there in 2011 was 8.3 billion

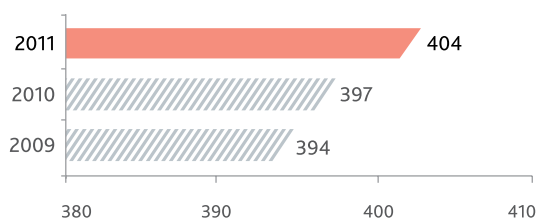
cubic meters, representing a slight increase in comparison with 2010.

A second exploration well was drilled in 2011 at the **Sarmatskoye field** and discovered substantial gas reserves. The increase in recoverable gas reserves amounted to 56 billion cubic meters.

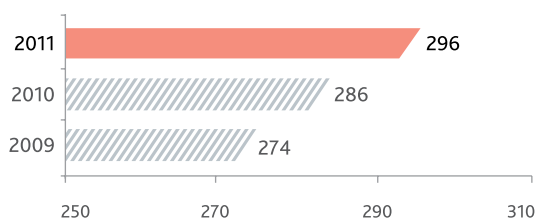
LUKOIL has an agreement with OJSC Rosneft Oil Company by which the Group will accept volumes of gas up to 5.6 billion cubic meters per year starting in 2013 from the Vankor group of fields for input to the LUKOIL gas transport system in the Bolshekhetskaya Depression, adjacent to the Khalmerpayutinskoye field, for delivery to the Gazprom gas transport system at the Yamburgskaya gas compression station. Construction of a pipeline system from the Khalmerpayutinskoye field to the Pyakyakhinskoye field, and from Pyakyakhinskoye to the Nakhodkinskoye field is scheduled for completion in 2013. Tenders have been carried out for purchases of pipes and valve systems, and subcontractors for construction of the pipeline system have been selected.

Rosneft's commitments under the agreement are to accept 3 million tonnes per year of stable oil and condensate mixture into its Vankor–Purpe pipeline for delivery to the Transneft trunk pipeline system. However, LUKOIL has decided not to use the Vankor route for transport of liquid hydrocarbons, but to use Transneft's Zapolyarye–Purpe trunk pipeline instead, so construction of the Pyakyakhinskoye field and the start of production there will be coordinated with the scheduled date for opening of that pipeline, which will pass across the field.

**Gas production wells, wells**



**Gas production wells in use, wells**



When all fields in the Bolshekhetskaya Depression reach planned output levels, total annual production of natural gas by the Company in the region will attain 20 billion cubic meters.

LUKOIL reached agreement with Gazprom in the reporting year on deliveries of 8.35–12.11 billion cubic meters of gas from fields in the Bolshekhetskaya Depression during 2012–2016 at prices set by the Federal Tariff Service less 15% for use by industry in Yamal-Nenets Autonomous District. The agreement also states that Gazprom will make every effort to accept all of LUKOIL's gas output from fields in the Northern Caspian into its gas transport system after LUKOIL begins production in that region and will deliver equivalent amounts to LUKOIL enterprises.

## INTERNATIONAL PROJECTS

Production of marketable gas as part of international projects decreased by 1.9% in 2011 to 4.826 million cubic meters. The share of natural gas was 86%, almost unchanged from the previous year. The Company had 107 gas production wells in international projects at the end of 2011, of which 81 were actually in use.

Early gas was produced at the end of 2011 at the Dzharkuduk field as part of the **South-West Gissar** project in **Uzbekistan**, and full-scale production should be achieved in the first quarter of 2012. A complex gas preparation unit will be built at Dzharkuduk in 2013 when construction of the large Gumbulak and Adamtash fields will also be completed, with drilling of more than 40 production wells. An external power transmission line will also be provided, and other construction work will include a gas collection and preparation system, pipelines for marketable gas and condensate, a shift settlement, a field base and various engineering infrastructure facilities.

Most of marketable gas production outside Russia (54%) was at the Khauzak-Shady area, which was brought into production at the end of 2007 and is being developed as part of the **Kandym – Khauzak – Shady** project in **Uzbekistan**. Production of market-

able gas at the Khauzak-Shady area was 2.63 billion cubic meters in 2011, which is almost unchanged from 2010.

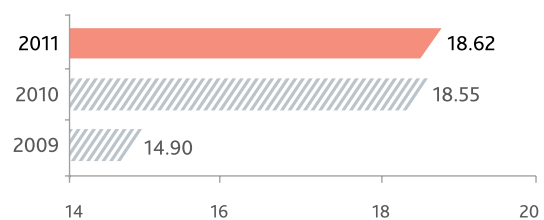
The Shady area (western part) of the Dengizskulsky field was brought into operation in November 2011. The total daily increment in field output was more than 5 million cubic meters. A contract has been signed for the design of project documents and delivery of equipment for the Khauzak booster compressor station.

A contract was signed in August 2011 for preparation of a pre-project study and general documentation for construction of a gas-processing complex at the Kandym group of fields. The Korean company Hyundai Engineering was selected as sub-contractor for the work on the basis of a tendering competition. Standard load of this unique gas-processing plant will be 8 billion cubic meters of gas per year, and the first set of facilities are scheduled for launch on August 1, 2016. The contract has been approved by the Government of Uzbekistan.

The Group share of marketable gas in the **Tengiz project** in 2011 was 560 million cubic meters. Completion of a special program has raised the utilization rate for associated gas to more than 99%.

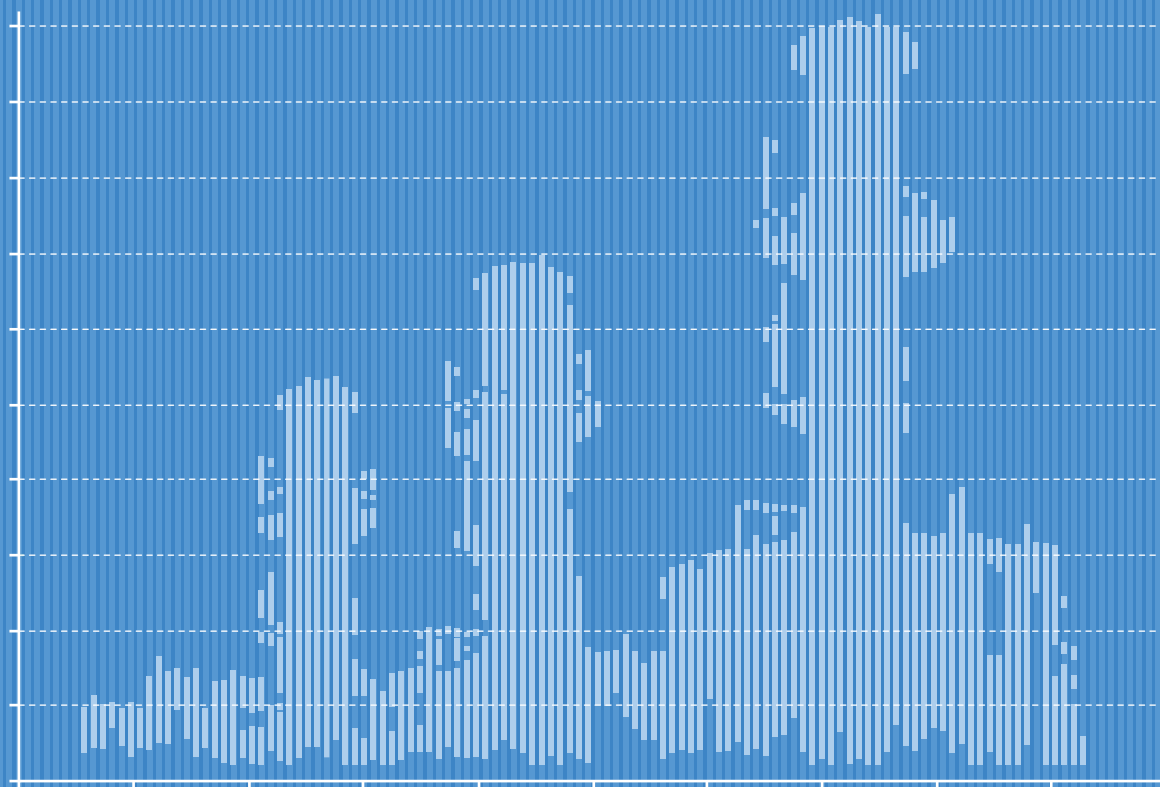
The Group share of marketable gas production in 2011 at the **Shakh-Deniz project in Azerbaijan**, which was brought into production in December 2006, was 513 million cubic meters in the reporting year, which is 5.9% less than in 2010. The reduction was due to limitation of volumes taken by Azerbaijan and Turkey.

### Marketable gas production, million cubic meters



# 2

## OIL REFINING, GAS PROCESSING AND PETROCHEMICALS



## STRATEGY 2012–2021:

- Significant increase of light products yield at Russian refineries
- Increase in gasoline production at Russian refineries by 50%
- Increase in average daily sales at Russian filling stations by 27%
- Installation of new secondary refining units at Russian refineries
- Bringing foreign refineries in line with the world standards



### Main indicators for LUKOIL's Refining & Marketing business segment

Indicator, \$ million	2011	2010	Growth, %
Revenue	128,549	100,246	28.2
EBITDA	5,795	5,124	13.1
Net income	3,687	3,330	10.7
Capital expenditures	1,354	1,320	2.6

**The Company achieved impressive results in the Refining & Marketing business segment in 2011: segment net income rose by 11% to \$3.687 billion.** The increase in net profit was achieved through ongoing optimization and installation of new conversion capacities, primarily in Russia, as well as favourable market conditions in Russia.

LUKOIL pursued work in 2011 to develop its oil refining business through modernization and expansion of refining capacities.

## PRICE AND TAX ENVIRONMENT

Growth of the world economy led to gradual recovery in demand for petroleum products during 2011, and there was substantial price growth on both domestic and export markets. The external price environment had a great influence on LUKOIL's revenue growth since the Company sold 81% of its petroleum products outside Russia. Average prices for fuel oil in Europe rose by 38% (FOB Rotterdam), and prices for high-octane gasoline were 34% higher. The domestic market for petroleum products also saw price growth: heating fuel oil prices rose by 30% and prices for AI-95 gasoline rose by 21%.

Volume of refining in 2011, including processing at third-party refineries, totalled 65.2 million tonnes, of which 64.9 million tonnes are attributed to the Company's own refineries (including the Company's share of refining at the ISAB and Zeeland complexes).

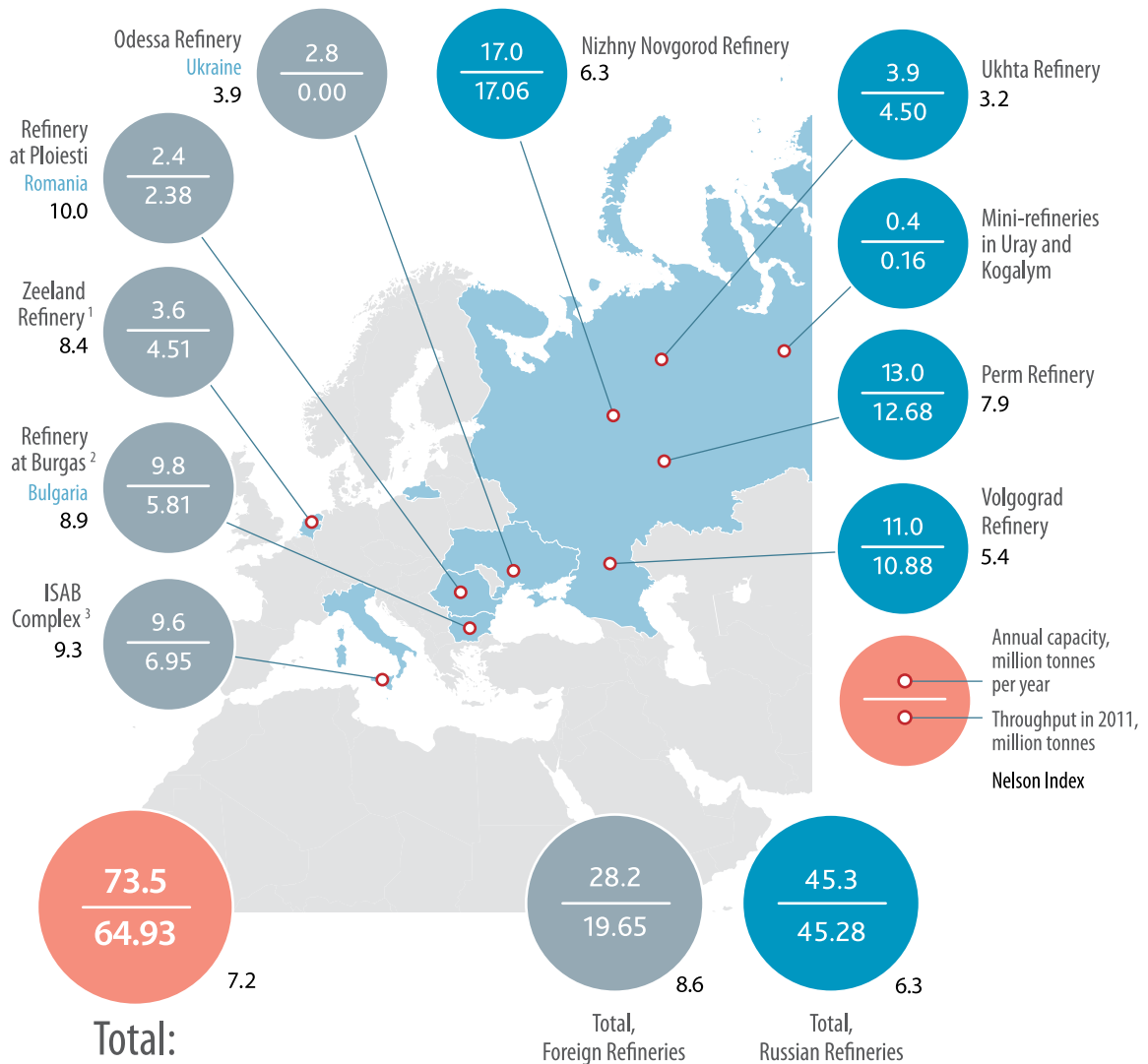
There was a significant increase of high-octane automotive gasoline consumption in Russia in 2011 due to increasing number of automobiles. The Government took a number of measures to address fuel shortages, including introduction of the '60-66' system, which unifies export duties for light and dark oil products at 66% of the duty level for crude oil while keeping a higher rate of 90% for exports of gasoline. The new system encourages deeper refining of crude oil, which the Group has been working on for a number of years and will continue this work in the future. The Company is planning to reduce output of dark petroleum products at its Russian refineries by more than 2.5 times in the next decade. Implementation of modernization projects should boost output of automotive gasoline at LUKOIL's Russian refineries by almost 1.5 times by 2021.

LUKOIL Group includes five oil refineries outside Russia, which lowers exposure to domestic risks and allows global optimization of commodity flows.



# Oil Refining

## LUKOIL GROUP REFINERIES



<sup>1</sup> Capacity and refining volumes at Zeeland (for oil) are shown as the Company's share (45%). In addition, 2.17 million tonnes of vacuum gasoil were processed at Zeeland in 2011.

<sup>2</sup> Including refining of 0.74 million tonnes of fuel oil in 2011.

<sup>3</sup> Capacity and refining volumes at ISAB (for oil and fuel oil) are shown as the Company's share (60%).





**LUKOIL GROUP CONTINUED RAPID DEVELOPMENT OF ITS OIL REFINING BUSINESS IN 2011 THROUGH MODERNIZATION AND EXPANSION OF REFINING CAPACITIES.**

The Group raised operating efficiency of its refineries in 2011 through measures to optimize production capacities, increase capacity load of refining units, raise energy efficiency and reliability of equipment (increasing the operation period between overhauls), as well as to optimize personnel numbers. Financial impact from these measures was about \$68.3 million.

**RUSSIAN REFINERIES**

Crude oil throughput at refineries in Russia owned by LUKOIL Group was 45.3 million tonnes in 2011, which is 0.1% more than in 2010.

The share of high-octane gasoline in total output of gasoline at Group refineries in Russia (not including mini-refineries) rose to 96.2% in 2011 (from 91.5% in 2010). Light-product yield was 52.0% (48.5% in 2010).

Scheduled work continued in 2011 at all of the Group's Russian refineries to re-equip and automate production processes, improve energy efficiency, and enhance industrial and environmental security. Capital expenditures at Company's refineries in Russia were \$586 million in the reporting year (against \$542 million in 2010).

A hydrogen fluoride alkylation unit was brought into operation in the first quarter of 2011 at the **Nizhny Novgorod Refinery**. The catalytic cracking complex for vacuum gasoil, construction of which was completed at the end of 2010, reached planned capacity levels in 2011. Increase of gasoline output compared with 2010 was 1.1 million tonnes.

The strategic development program for the Nizhny Novgorod Refinery, which was approved in 2011, calls for construction of a second catalytic cracking complex by 2015 using existing project documentation. Installation of the second complex will help to prevent repetition of the gasoline shortages, which were seen at the start of 2011, by ensuring that sufficient

supplies of high-quality automotive gasoline are available for the domestic market in the near future. Engineering studies and equipment orders for the project are already being carried out. The development program also includes installation of the second isomerisation unit, which will increase production of high-quality gasoline from low-octane fractions of straight-run gasoline. Construction of a facility for hydrocracking of residues is planned in the long term, and will substantially increase light product yield, as well as minimizing production of fuel oil and lowering sulphur content in fuel oil to 1%.

A new delayed coking unit with one million tonnes annual capacity was brought into operation in December 2011 at the **Volgograd Refinery**. Its launch will terminate the fuel oil production in 2012.

Construction and assembly works on a new diesel fuel hydrotreatment facility with 3 million tonnes annual capacity continued in 2011. Project completion will make all diesel fuel output from the Volgograd Refinery compliant with Euro-5 environmental standards. Commissioning of the unit is scheduled in the third quarter of 2012.

A new primary refining unit with 6 million tonnes annual capacity is being installed. It will replace two old units and its launch will reduce energy consumption in crude refining and raise the quality of product fractionation. Launch of the unit is scheduled in 2015.

Future plans include construction by 2016 of a deep refining complex for vacuum gasoil, which will

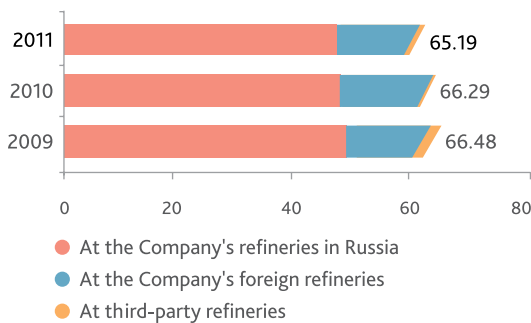
increase production of diesel fuel compliant with Euro-5 standards, as well as high-quality lubricants. The deep refining complex will consist of a vacuum gasoil hydrocracking unit with 3.5 million tonnes capacity, as well as hydrogen and sulphur units.

The delayed coking unit at the **Perm Refinery** was brought back into operation following reconstruction and replacement of the coke chambers. Technical furnaces at the Refinery are also being replaced in order to raise operating efficiency and reduce atmospheric emissions.

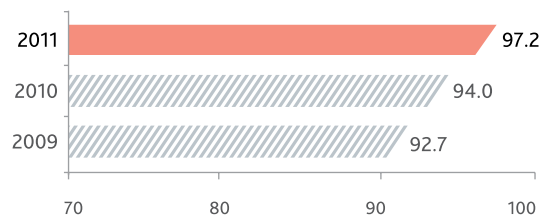
Work on construction of a deep refining complex at the Perm refinery was in progress in 2011, including a delayed coking unit with 2.1 million tonnes annual capacity, a diesel hydrotreatment unit, a hydrogen unit and a sour water stripping unit. Project implementation will terminate fuel oil production and increase light product yield while complying with current and planned requirements for industrial safety and protection of the environment. Launch of the complex is scheduled in 2015.

Work continued at the **Ukhta Refinery** in 2011 on technical re-equipping of the vacuum block at the atmospheric-vacuum distillation units and modernization of the reaction block of the GDS-850 hydrodewaxing unit. The purpose of re-equipment of the vacuum block is to achieve deeper refining of crude oil by processing all fuel oil outputs. The extra vacuum annual capacities will also make it possible to refine more oil from the Yaregskoye field as production levels there increase.

**Oil refining by the Company, million tonnes**



**Share of high-octane gasoline in total output of gasoline, %<sup>1</sup>**



<sup>1</sup> Excluding mini-refineries and the ISAB and Zeeland complexes.

Modernization of the reaction block of the hydro-dewaxer will enable production of Euro-5 diesel fuel.

**FOREIGN REFINERIES**

Refinery throughputs in 2011 at LUKOIL Group's international refineries, including the Group's share of refining at the ISAB and Zeeland complexes, were 19.6 million tonnes, which is 6.3% less than in 2010. The decrease was due to stoppage of the Odessa Refinery at the end of 2010.

Light product yield (not including ISAB and Zeeland) was 67.8% (66.0% in 2010). Irrecoverable losses at foreign refineries amounted to 0.7% in 2011.

Capital expenditures for modernization of the Group's foreign refineries were \$197 million in 2011 (\$160 million in 2010).

The **Odessa Refinery** (Ukraine) was closed down in the fourth quarter of 2010 due to the unfavourable market environment in Ukraine and switching of the Odessa-Brody pipeline from reverse mode, which made pipeline oil deliveries impossible. Sea deliveries would increase costs significantly. There was no improvement of the economic situation, which could justify resumption of refining operations in 2011. Possible reopening of the Refinery in 2012 is now under consideration.

At the **Burgas Refinery** (Bulgaria) a project for optimization of boiler fuel loading arrangements at the Rosenets oil terminal was completed in 2011, and work on reservoir facilities was also completed. Management systems for primary refining capacities and for catalytic cracking were upgraded.

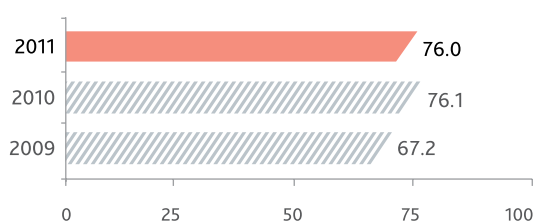
Design work as well as equipment procurement on a processing complex for heavy residues is continuing and is due for completion in 2015. The goals of the project are to increase oil conversion at the Refinery, to end production of high-sulphur heating oils, and to raise output of diesel fuels that comply with Euro-5 standards. The central part of the new complex will be a tar hydrocracker with 2.5 million tonnes capacity.

At the **Ploiesti Refinery** (Romania) most work was completed in 2011 on a project for launch of propylene production with sulphur content below 5 ppm, which will fetch higher prices on the market.

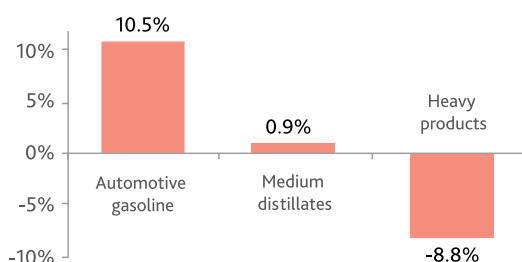
The Company's interest in the **ISAB Refining Complex** (Sicily, Italy) was increased from 49% to 60% in 2011. Value of the transaction was \$342 million. The Group share in refining at ISAB was 6.95 million tonnes.

The TRN Refinery in the Netherlands changed its name in 2011 to the **Zeeland Refinery**. Total 4.51 million tonnes of oil (the Group share) was refined there in 2011.

Share of diesel fuel with sulphur content below 50 ppm in total diesel production, % <sup>1</sup>



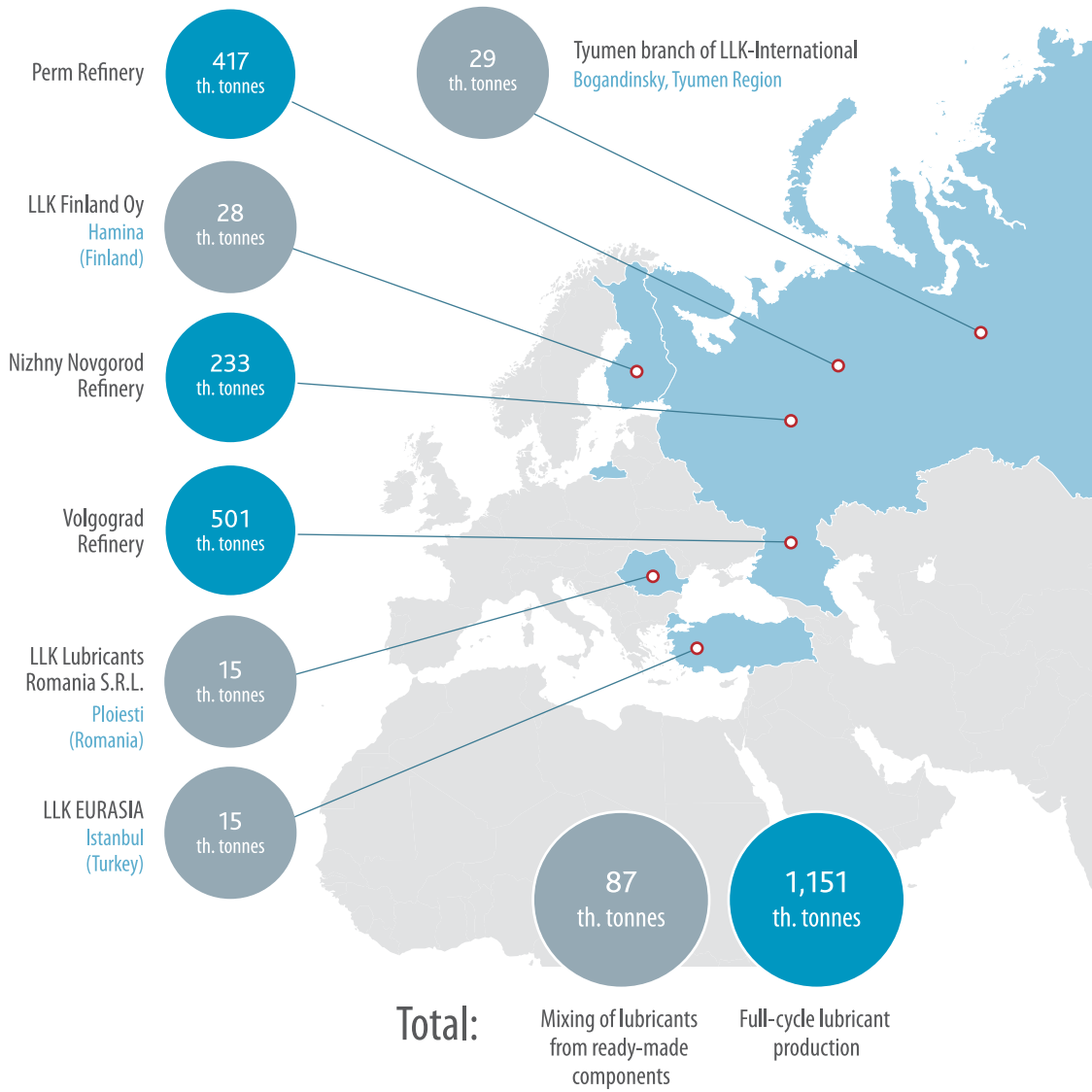
Change in output levels of petroleum products at Company's refineries in 2011 compared with 2010, % <sup>1</sup>



<sup>1</sup> Excluding mini-refineries and the ISAB and Zeeland complexes.

# Production of Lubricants

## LUBRICANT PRODUCTION AT LUKOIL GROUP REFINERIES IN 2011





Production and sale of lubricants is an important part of LUKOIL's business. The Group is constantly improving the quality of products and expanding their range, as well as raising efficiency of the sales system and diversifying the geography of this business sector.

**LUKOIL is the leader on the Russian lubricants market, accounting for about 44% of domestic production.** Lubricants are produced at Group refineries in Perm, Volgograd and Nizhny Novgorod. The Company also mixes lubricants from ready-made components (both produced by the Company and bought from third parties) at facilities in Russia, Finland, Romania and Turkey.

Lubricant production including mixing from ready-made components totalled 1.238 million tonnes in 2011. Branded lubricant production was 316,000 tonnes in 2011, representing an increase of 13% from 2010.

**THE NUMBER OF DIFFERENT OILS & LUBRICANTS AND OTHER VEHICLE CHEMICALS MADE AT LUKOIL'S RUSSIAN REFINERIES INCREASED FROM 230 TO 261 IN 2011 COMPARED WITH 2010. OUTPUTS INCLUDE MOTOR AND TRANSMISSION OILS FOR ALL TYPES OF TRANSPORT, LUBRICANTS FOR INDUSTRIAL EQUIPMENT, AND BASE OILS (USED AS INPUTS FOR PRODUCTION OF READY-TO-USE OILS, LUBRICANTS AND ADDITIVES).**

The Group continued its efforts in 2011 to improve efficiency in sales of lubricants, including further development of an import substitution program. The program includes regular supplies of lubricants to the Russian coal mining company, OJSC Kuzbassrazrezugol, and LLK-International has reached a long-term agreement for 2012, by which it will remain the sole supplier to this customer. A pilot project has been launched at Taldinsky Coal Mine for use of a mobile oil-changing complex. Availability of such mobile complexes expands LUKOIL's opportunities for signing long-term contracts with leading mining companies in Russia. Lubricant deliveries to enterprises that are part of the ferrous metallurgy holding, OJSC Metalloinvest, continued in 2011 and a five-year strategic partnership and cooperation agreement has been signed with another Russian steelmaker, CherMK OJSC Severstal. A tendering competition carried out in December 2011 by CJSC Severstal Resource selected the LUKOIL company, LLK-International, as sole supplier to a number of Severstal Resource enterprises, and the non-ferrous metals giant, GMK Norilsk Nickel, held a competition, as a result of which LUKOIL won the right to supply 450 tonnes of lubricants, which is twice more than the previous supply order placed by Norilsk.

LLK-NAFTAN, the joint venture of LUKOIL and the Naftan refinery (Belarus), met 46% of LUKOIL's requirements for additives used in lubricant production in 2011. The JV has increased output by more than seven times, from 3,000 to 23,000 tonnes, since its creation in 2006.

LUKOIL carries out sales of lubricants in more than 40 countries worldwide and its sales geography is constantly expanding. In 2011 the Company began **lubricant sales** in Afghanistan, Mongolia and China.

In a major breakthrough for LUKOIL's lubricant business the Company obtained its first-ever contracts in 2011 for lubricant supplies to newly-built ships, winning a tender for first-filling of 71 vessels. MAN limitations on maximum size of engines suitable for LUKOIL lubricants were lifted. Approvals were obtained from Japanese marine engine manufactu-

ers, Daihatsu and Yanmar, and also from the biggest South Korean shipbuilder, Hyundai Heavy Industries. LUKOIL began supplying lubricants to the global shipping companies, Sovcomflot, Maersk, Hapag Lloyd and ZIM. The Company's ship lubricants were available in 550 ports in more than 62 countries worldwide by the end of 2011 and the share of LLK Marine on the global market reached 2%.

The Company prioritizes customer relations in its lubricant business. LUKOIL was among the first companies in the industry to offer comprehensive service with full product support, from placement of client orders to delivery of the product, as well as analysis of used lubricants and recommendations for their further application.

LUKOIL continued scheduled work on development of new high-efficiency lubricants during 2011. A total

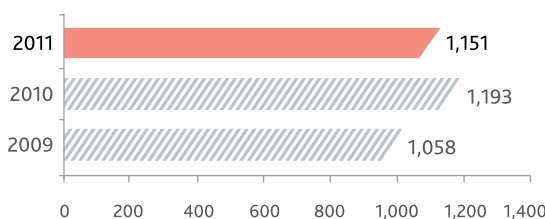
of 38 new products were developed during the year and 48 official approvals were obtained from manufacturers of machines and equipment. As of today LUKOIL lubricants have more than 350 valid official approvals from original equipment manufacturers (OEMs). LUKOIL LUX 5W-40 synthetic is the first oil from a Russian producer to win a license from the American Petroleum Institute (API) in the highest certification category ('SN').

Launch of a new range of lubricants, LUKOIL GENESIS, on the Russian market is planned in 2012. The lubricants will meet the latest criteria of international vehicle manufacturers, including those in respect of fuel economy and environmental characteristics. New, up-to-date lubricants for heavy diesel engines, AVANGARD Professional 10W-30, will also be presented, as well as a series of synthetic products for automatic transmissions.

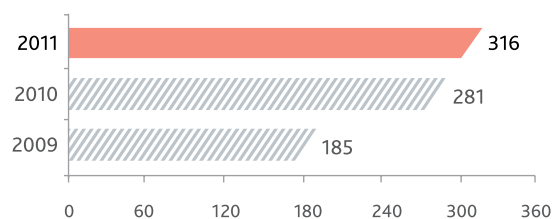
LUKOIL motor oils meet international requirements of the Society of Automotive Engineers (SAE), the American Petroleum Institute (API), the European Automobile Manufacturers Association (ACEA) and the Russian Association of Automobile Engineers (AAE). Our oils are produced using the latest technologies and contain high-quality additives supplied by Russian and foreign producers.

High performance qualities of LUKOIL lubricants have been acknowledged by major automotive manufacturers in Russia and abroad. Company motor oils have passed tests at western certification centers on engines made by DaimlerChrysler, BMW, Volkswagen, MAN, Porsche, Volvo, Renault trucks and Cummins, and have been approved for use in these engines. A total of 38 new lubricant products were brought into production in 2011 and 48 manufacturer approvals were obtained.

Lubricant production at Company refineries, *thousand tonnes*

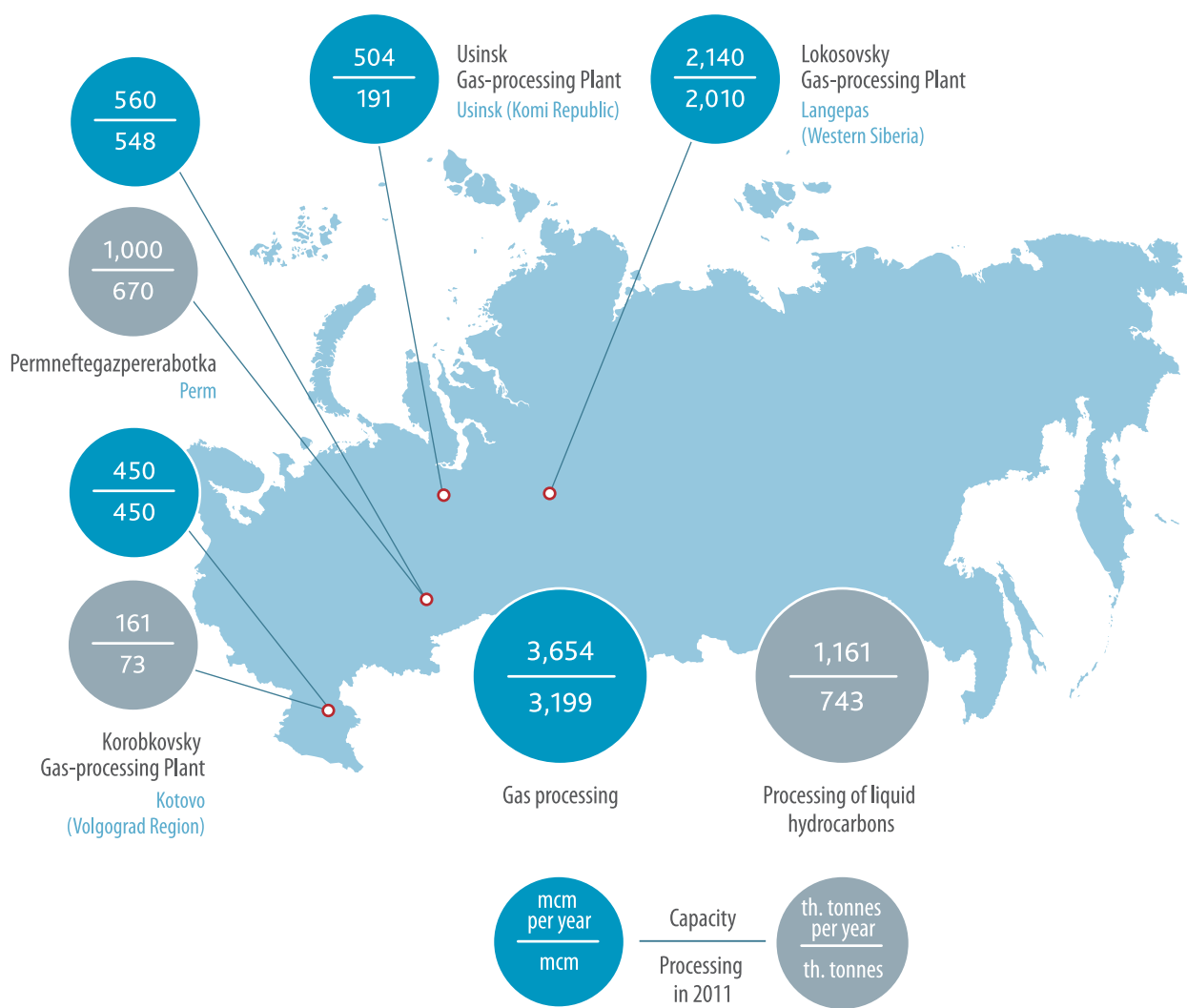


Sales of branded lubricants, *thousand tonnes*



# Gas Processing

## GAS-PROCESSING PLANTS OF LUKOIL GROUP



GAS-PROCESSING PLANTS OF LUKOIL GROUP PROCESS ASSOCIATED GAS FROM FIELDS IN RUSSIA INTO MARKETABLE GAS (FED INTO THE GAZPROM GAS PIPELINE SYSTEM) AND LIQUID HYDROCARBONS.

IN 2011 THE COMPANY'S GAS-PROCESSING PLANTS PROCESSED 3,199 MILLION CUBIC METERS OF GAS FEEDSTOCK (+1.0% TO 2010) AND 743,000 TONNES OF LIQUID HYDROCARBONS (-2.2% TO 2010). THE INCREASE IN GAS PROCESSING WAS DUE TO HIGHER DEMAND FOR PRODUCTS.

Company plants produced 2,523 million cubic meters of stripped gas, 1.518 million tonnes of liquefied gas including natural gas liquids and 194,000 tonnes of liquid hydrocarbons (stable gas naphtha, isopentane and hexane-heptane fractions, and natural gas liquids).

Expansion of capacities to 1,460 thousand tonnes for gas and to 1,700 thousand tonnes for natural gas liquids is planned for **LUKOIL-Permneftegazpererabotka**. The new production line will enable LUKOIL to meet its targets for utilization of associated oil gas in Perm Territory and also to raise the quality of outputs by separate processing of wet gas from LUKOIL-Permnefteorgsintez and of associated oil gas.





# Petrochemicals

## LUKOIL GROUP PETROCHEMICAL PLANTS

### Petrochemical plants

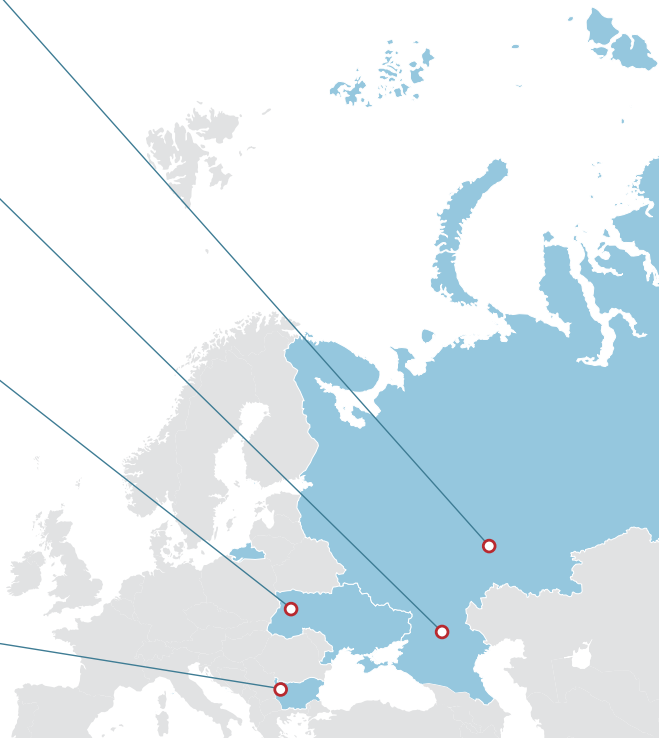
**Saratovorgintez** **Saratov (Russia)**  
Acrylonitrile and other organic synthesis products

**Stavrolen** **Budennovsk (Stavropol Region, Russia)**  
Polyethylene and other products

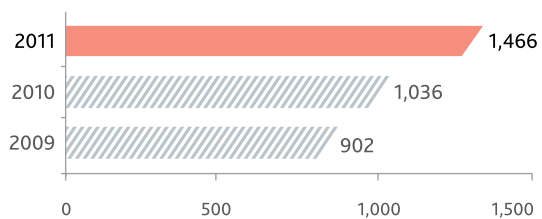
**Karpatneftekhim** **Kalush (Ukraine)**  
Polyethylene, polyvinyl chloride and other products

### Refineries with petrochemical units

**LUKOIL Neftokhim Burgas AD** **Burgas (Bulgaria)**  
Polymers



### Petrochemical production, *thousand tonnes*



LUKOIL's petrochemical business is one of the biggest in Russia, CIS and Eastern Europe. Company plants in Russia, Ukraine and Bulgaria produce pyrolysis and organic synthesis products, fuel fractions and polymer materials. LUKOIL meets a major share of Russian domestic demand for various chemicals and is a major exporter of chemicals to more than 30 countries worldwide.

**IN ACCORDANCE WITH ITS DEVELOPMENT STRATEGY IN THE PETROCHEMICALS SECTOR, LUKOIL IS STEADILY INCREASING PRODUCTION OF CHEMICALS WITH HIGH VALUE ADDED (POLYMERS, MONOMERS AND ORGANIC SYNTHESIS PRODUCTS) AND REDUCING PRODUCTION OF CHEMICALS WITH LOW VALUE ADDED (SECONDARY PYROLYSIS PRODUCTS AND FUEL FRACTIONS).**

LUKOIL petrochemical plants including Neftokhim Burgas produced 1,466 million tonnes of petrochemicals in 2011, which is 41.5% more than in 2010. The increase was due to launch of production at Karpatneftekhim in September 2010.

**The price environment on the petrochemical market was unfavourable in 2011.** Sales prices in Russia for polyethylene rose by 3.8%, but prices for polypropylene fell by 9.5%, and prices for benzol fell by 5.8%. Prices for the same outputs also declined in Europe, by 3.1% for polyethylene, 17.2% for polypropylene and 6.7% for benzol.

LUKOIL implemented various measures in 2011 for modernization of existing production and installation of new facilities as part of its strategy for development of the petrochemical sector. Capital expenditures in the sector were \$89 million in 2011, which is 17% more than in 2010.

A unit for production of polyvinyl chloride (PVC) suspension was built and brought into operation during 2011 at **Karpatneftekhim**. Equipment assembly began as part of the construction of PVC production unit, which should be commissioned in 2012.

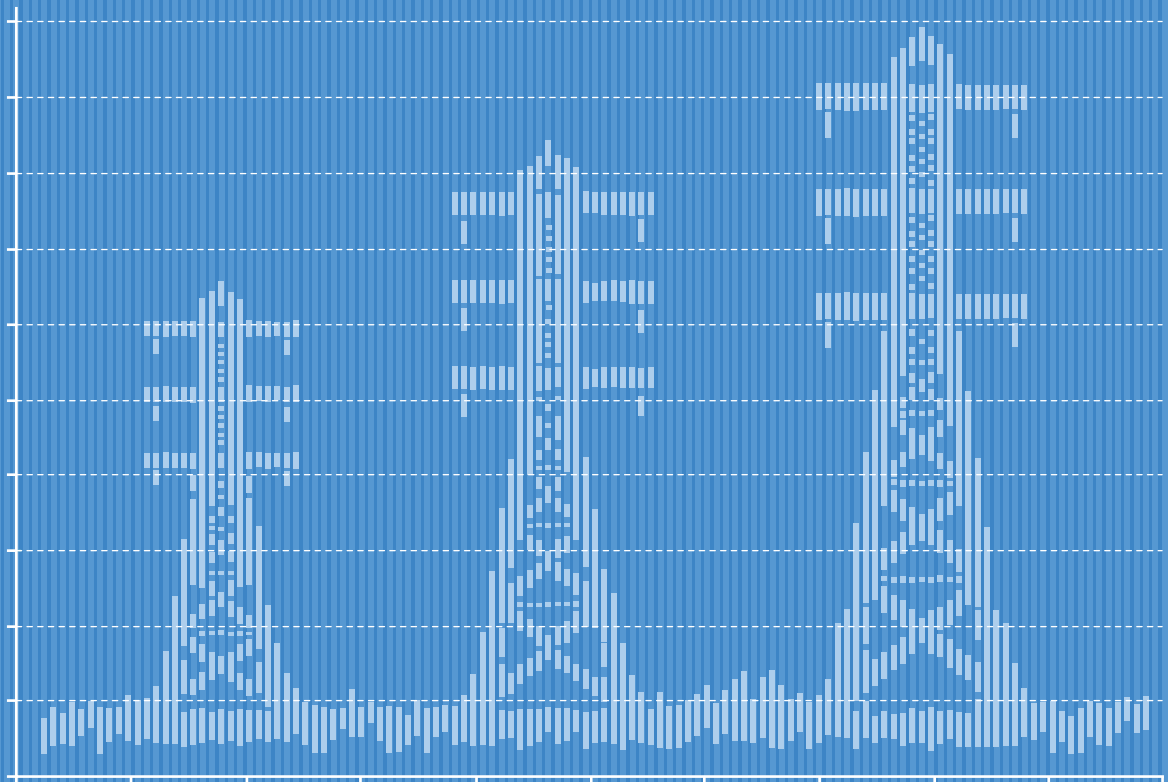
Work was completed in the reporting year at **Saratovorgsintez** for expansion of sodium cyanide production to a level of 18,000 tonnes per year.

A particularly large project scheduled for coming years is the creation of an industrial complex at **Stavrolen** for processing of Northern Caspian gas. Inputs will come from fields under LUKOIL development in the Caspian region. The purpose of the project is to achieve more value-added by deeper refining of ethane and natural gas liquids. The complex will also process ethylene into polyethylene, polypropylene and other chemical products. A first production line is scheduled to open in 2015 with capacity of 2 billion cubic meters of gas and modernization of existing ethylene and polyethylene units will be completed at the same time.

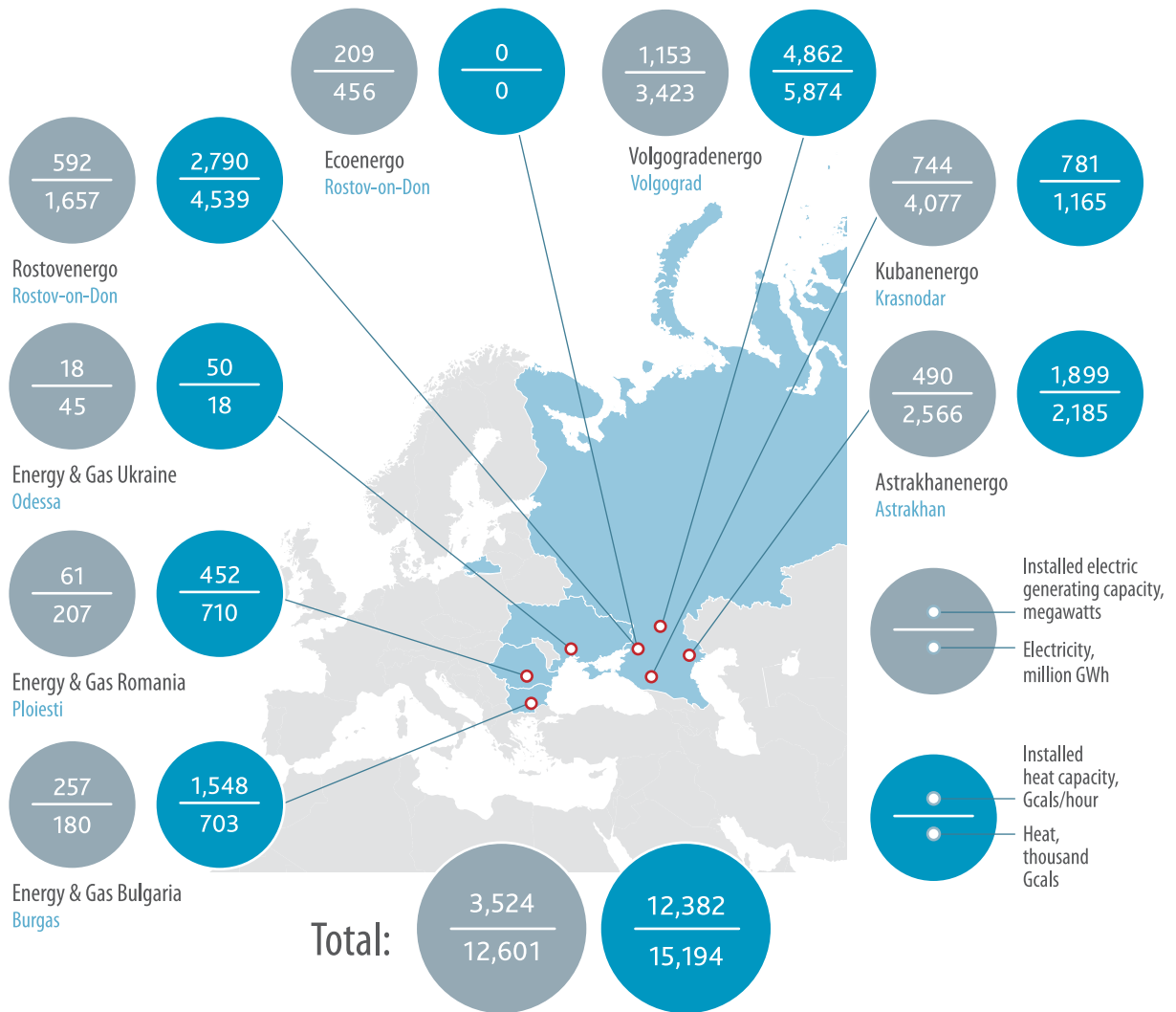
Pre-project studies and preparatory work for construction of the complex were carried out in 2011. They included synchronization of schedules and stages of construction with the time-frame for development of fields in the Northern Caspian, preparation of project documentation for the gas processing unit with initial processing capacity of 2 billion cubic meters, and positive outcomes of official studies by Government. The Russian Government also approved the passport for a regional investment project, which will enable release of budget financing for construction of external infrastructure facilities, including rail links and high-tension power transmission lines.

# 3

## POWER GENERATION



LUKOIL POWER GENERATING COMPANIES



LUKOIL's new business sector, Power Generation, was created in 2008 as part of the Group's Strategic Development Program, and the sector has a special role to play in the Group's updated Strategy for 2012–2021. Power Generation will be an important factor for growth of cash flow and shareholder value in the long term.

The business comprises all aspects of power generation, including delivery and marketing of electrical energy and of heat produced at power plants. The nucleus of the segment is the Russian power generating company, UGK TKG-8, which was acquired by LUKOIL in 2008, but it also includes companies producing electricity and heat at Company refineries in Bulgaria, Romania, and Ukraine.

**THIS BUSINESS SECTOR PROVIDES ENERGY BOTH FOR THE COMPANY'S OWN NEEDS (IN THE EXPLORATION & PRODUCTION AND REFINING & MARKETING SEGMENTS) AND FOR EXTERNAL POWER AND HEAT CUSTOMERS IN THE SOUTHERN FEDERAL DISTRICT OF RUSSIA.**

## STRUCTURAL TRANSFORMATIONS

From January 1, 2011 hydroelectric stations owned by LUKOIL-Rostovenergo and LUKOIL-Kubanenergo were transferred to the new company, LUKOIL-Ecoenergo.

In August 2011 Dagestanenergo was sold by LUKOIL Group as part of final procedures for the disposal of power assets in the Republic of Dagestan.

## ELECTRICITY AND HEAT GENERATION

Companies in LUKOIL's Power Generation segment generated about 12.6 billion kWh of power in 2011. Total supplies of heat were 15.2 million Gcal, of which 13.8 million Gcal in Russia. Levels of production were dictated by conditions on the market for electricity and heat energy.

Work continued in 2011 under the Capacity Provision Agreement, to which LUKOIL subscribed when it acquired assets during reorganization of RAO

### Structure of LUKOIL's Power Generation business

Generation	Transport	Marketing	Service
LUKOIL-ASTRAKHANENERGO	LUKOIL-ELECTRIC NETWORKS	TD-ENERGOSERVICE	LUKOIL-ENERGO-ENGINEERING
LUKOIL-VOLGOGRADENERGO	LUKOIL-TTK	ASTRAKHAN ENERGY SUPPLY COMPANY	LUKOIL-TSUR
LUKOIL-ROSTOVENERGO			
LUKOIL-KUBANENERGO			
LUKOIL-ECOENERGO			
LUKOIL-STAVROPOLENERGO			
International			
LUKOIL ENERGY & GAS BULGARIA			
LUKOIL ENERGY & GAS ROMANIA			
LUKOIL ENERGY & GAS UKRAINE			



UES (the former Russian power sector monopoly). Combined-cycle facilities in Astrakhan Region (110-megawatt capacity) were brought into operation, and launch of a 410-megawatt combined-cycle generator is scheduled for 2012 in Krasnodar. These two facilities, with combined capacity in excess of 500 megawatts are only the first stage of LUKOIL's ongoing work for modernization of Russian energy facilities and capacity increase in energy-deficient regions. Other projects in the Southern Federal District in fulfilment of the Capacity Provision Agreement are now being developed, and LUKOIL is committed to building 900 megawatts of generating capacity in total.

Liberalization of the wholesale market for electrical energy and capacity entered its concluding stage in 2010 and these markets were fully liberalized in 2011. However, government regulation continues to have significant impact on the power generating segment. Amounts of electrical and heat energy, which the Government requires to be sold at regulated tariffs remains substantial (up to 35% of out-

puts by some generators). In 2011 electricity and capacity was sold at regulated tariffs to households and other consumers with equivalent status.

#### SMALL-SCALE GENERATING

**LUKOIL is rapidly developing its own electricity generating facilities at oil and gas fields, enabling the Group to substantially reduce electricity purchases and increase the rate of associated gas use by using it to generate electricity at gas-fired facilities.** The Company has total small-generating capacity of 549 MW. Electricity generation at company facilities in this segment were 2,201 GWh in 2011, representing 17.3% of total consumption of electricity in production operations.

Electricity supply arrangements have been made more secure by use of the latest technologies in investment projects for construction and reconstruction of the Company's own generating facilities. Use of new technologies also enables the Company to limit spending on its electricity

needs, through improvement of energy efficiency and use of the Company's own refined products as generating fuel.

**ENERGY-SAVING TECHNOLOGIES**

LUKOIL works constantly to improve reliability of its electricity supply arrangements and to reduce spending on energy. These efforts have been coordinated through corporate programs for energy saving and improvement of the reliability of power supplies.

An energy-saving Program for LUKOIL organizations was approved at the start of the reporting year, prepared on the basis of proposals by enterprises themselves with the objective of limiting and reducing energy consumption in hydrocarbon production and refining, petroleum product marketing, petrochemicals, power generation and transportation. Energy savings of \$35 million were achieved in 2011 thanks to the Program.

In 2011 LUKOIL developed an energy efficiency policy, which coordinates actions in this sphere through-

out the Group. The policy defines progressive solutions and indicators for equipment quality, application of which will be compulsory in planned future projects. All investment projects and programs were subjected to expert analysis to ensure their compliance with criteria of energy efficiency and use of the latest energy saving solutions.

Rational use of electricity substantially reduces Group spending on energy resources. An automated information and measurement system for industrial metering of electricity use has been installed and is operational at all Company subsidiaries. The system enables reduction of spending on electrical energy by most advantageous use of tariffs that are differentiated according to the time of day, by greater accuracy of metering, and by enabling purchase of electrical energy and capacity on the wholesale market.

During 2011 LUKOIL addressed issues connected with installation of an energy management system and certification to the ISO 50001 international standard 'Energy Management Systems – Requirements and Guidance'. Risks, viability and cost of the





system were assessed, a provisional schedule and road map for implementation were prepared, and pilot projects were selected.

### RENEWABLE ENERGY

LUKOIL specialists appreciate the huge potential of resource and energy savings, which is offered by alternative sources of energy. Priority types of alternative renewable energy include hydro, wind, solar and geothermal energy. LUKOIL is developing alternative energy in partnership with international companies, which are already engaged in this sphere. In 2011 LUKOIL rapidly developed cooperation in the field of renewables with the Italian company, ERG Renew, which has extensive experience in construction and operation of renewable energy facilities. A working group of LUKOIL and ERG Renew is designing a number of wind-energy projects in Bulgaria, Romania, Ukraine and Russia. First priority has been given to renewable-energy

power stations in countries where the Company has strong operating presence and where there is administrative and economic support for renewable energy at government level. This particularly concerns projects for wind power stations in Bulgaria and Romania.

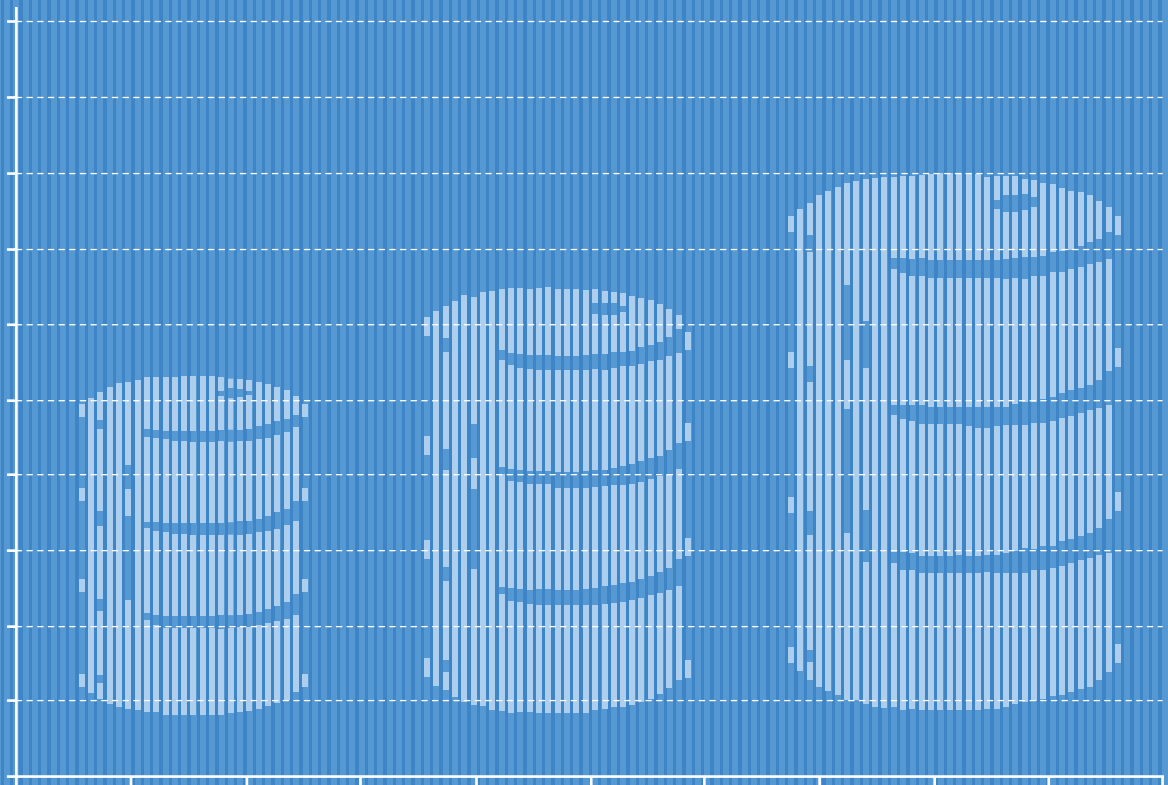
In Uzbekistan LUKOIL is working on a project for construction of a solar power station with 100 megawatt capacity in association with the Uzbek Government and the Asian Development Bank.

At the end of 2011 a 1.25 megawatt photovoltaic (solar) generating facility was brought into use at a fuel-fired power station belonging to LUKOIL in Bulgaria. Estimated annual production of electricity is about 1,500 megawatt-hours. Operation of the solar power facility will substantially reduce environmental impacts.



# 4

## SALES AND MARKETING



## STRATEGY

- Logistics optimization: reduction of transportation expenses
- Tight management of trade flows
- Increase of trading operations efficiency
- Increase of retail sales of petroleum products and related goods and services
- Retail network optimization



## Crude oil sales

**Total volume of crude oil sales by the Company in 2011, including deliveries for refining at the Company's own refineries and at third-party refineries, was 110 million tonnes.** Deliveries of oil to the domestic market were more efficient than most non-CIS delivery export routes, therefore substantial volumes of oil were reallocated from less efficient export routes to Company refineries or to the domestic market. Refining at facilities inside Russia remains the most efficient use of crude oil produced by LUKOIL. **Crude oil deliveries to Group refineries in Russia** in 2011 were 45.3 million tonnes in 2011, which is almost the same as in 2010.

Crude oil volumes of 259,000 tonnes were also purchased from third parties with delivery to the Nizhny Novgorod and Ukhta Refineries, enabling reallocation of the Group's own oil to the most profitable export routes.

The Company resumed the practice of crude oil substitution arrangements in deliveries for refining at third-party refineries. These third-party refineries were: the Ufa group of refineries, the Krasnodar, Khabarovsk, Ilsky, Mary and Antipinsky refineries, the Slavyansky Bitumen Plant and the Afipsky Refinery. Total of 1.43 million tonnes of the Company's oil were supplied via these arrangements, and an equivalent

quantity of oil belonging to counter parties was delivered to the Nizhny Novgorod and Ukhta refineries. Substitution arrangements give additional economic benefits through optimization of transport costs.

Deliveries of LUKOIL feedstock to the **Group's foreign refineries and to the ISAB and Zeeland complexes** were 19.6 million tonnes in 2011, which is 6.3% less than in 2010, mainly due to suspension of operations at the Odessa Refinery at the end of 2010. Deliveries of oil for refining at third-party refineries outside Russia totalled 0.27 million tonnes, which is many times more than in 2010 thanks to resumption of deliveries to refineries in Belarus and growth of deliveries to refineries in Kazakhstan.

Crude oil sales on the **domestic market** totalled 4.5 million tonnes in 2011, exceeding the figure in 2010 by 22.8%. Domestic crude sales contracts are arranged to ensure guaranteed take-up of crude oil on the domestic market using formulas that offer a premium to the export alternative.

**Crude oil exports** from Russia by LUKOIL subsidiaries (including oil acquired from other producers) were 34.7 million tonnes in 2011 (696,800 barrels per day), which is 14.5% less than in 2010. Lower exports were the result of lower output of crude oil.

Most of the Company's exports of crude oil are delivered via the Transneft pipeline system (deliveries via the system accounted for 84.7% of exports), but Transneft deliveries declined by 6.9% in 2011 to 29.4 million tonnes. The share of export deliveries by-passing the Transneft system decreased in 2011

from 22.2% to 15.2%, due to reduction of output at the Yuzhno-Khylchuyuskoye field. The latter deliveries were valued on the basis of actual quality of the crude oil, with a premium to the Urals price.

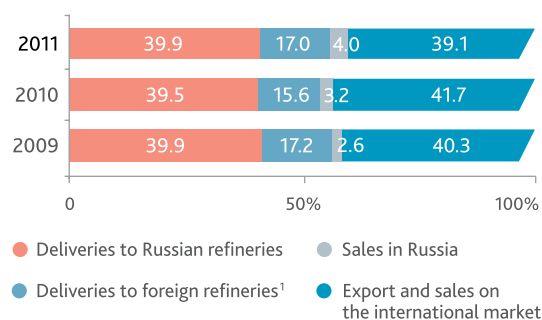
**THE COMPANY EXPORTED 5.1 MILLION TONNES OF CRUDE OIL VIA ITS OWN TRANSPORT TERMINALS IN 2011. EXPORTS THROUGH THE VARANDEY TERMINAL ACCOUNTED FOR 4 MILLION TONNES, AND EXPORTS THROUGH THE PORT OF SVETLY WERE 1.1 MILLION TONNES.**

In 2011 LUKOIL set up a joint venture for development of the R. Trebs and A. Titov oil fields, signing an agreement for acquisition by LUKOIL of a 25.1% stake in Bashneft-Polyus which owns the license for mineral resource use at the fields. A joint-venture agreement was also signed, under which oil from the Trebs and Titov fields will be transported via the Varandey Terminal.

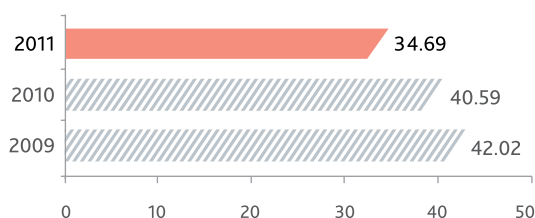
Work was carried out in 2011 to optimize export routes. Deliveries of oil via the port of Novorossiysk were substantially reduced due to low efficiency (until November 2011) and excess volumes were allocated to the most efficient export routes (Belarus and Kazakhstan) and to third-party refineries in Russia.

Sales of crude oil on the **international market** (including exports) were 43.8 million tonnes in 2011, of which 6.2 million tonnes were sold in the CIS countries and 37.6 million tonnes on other markets. Total sales of oil on Russian and international markets in 2011 were 48.3 million tonnes, which is 6.1% less than in 2010.

**Structure of crude oil deliveries, %**



**Crude oil exports from Russia, million tonnes**



<sup>1</sup> Including oil products delivered to ISAB and Zeeland.

## Gas Sales

THE GAS SEGMENT IS A NEW AND RAPIDLY DEVELOPING BUSINESS SEGMENT FOR LUKOIL GROUP. EXPANSION IN THE GAS SEGMENT IS ONE OF THE COMPANY'S STRATEGIC GOALS, SINCE COMMERCIALIZATION OF GAS RESERVES WILL SIGNIFICANTLY BOOST COMPANY VALUE

**Sales of natural, associated and stripped dry gas by the Group's Russian organizations totalled 13.846 billion cubic meters in 2011, which is 2% less than in 2010.** In particular, 9.780 billion cubic meters of gas were sold to Gazprom (including nearly 8.3 billion cubic meters of natural gas from the Company's Nakhodkinskoye field) and 4.066 billion cubic meters of gas were sold to other consumers (including deliveries to the Company's own gas-processing plants).

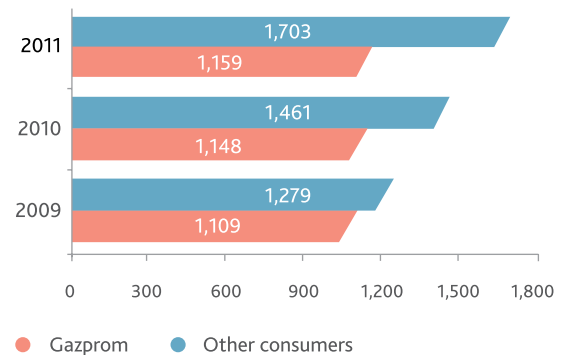
LUKOIL reached agreement with Gazprom in the reporting year on deliveries of 8.35–12.11 billion cubic meters of gas from fields in the Bolshekhetskaya Depression during 2012–2016 at a price equal to the minimum stipulated by the Federal Tariff Service for industrial users in the Yamal-Nenets Autonomous District minus 15%. The agreement also states that Gazprom will make every effort to accept all of LUKOIL's gas output from fields in the Northern Caspian into its gas transport system after LUKOIL begins production in that region and will deliver equivalent amounts to LUKOIL enterprises.

Thanks to intensive work by Company specialists, amendments have been made to the principles by which gas transportation tariffs via the Gazprom pipeline system are calculated for external producers. The amendments enable efficient transportation of gas over large distances.

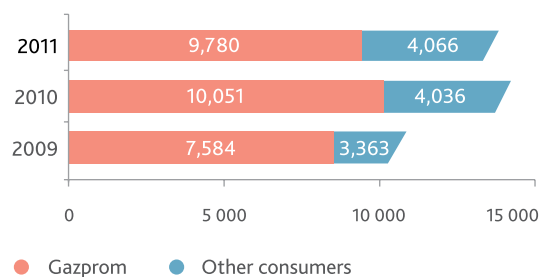
Average-weighted price of gas sales in the reporting year rose by 5% in comparison with 2010 to 1,290 rubles per thousand cubic meters (1,159 rubles in

sales to Gazprom and 1,703 rubles in sales to end-users). The increase was due to growth in the share of more efficient sales to end-users and of prices for end-users.

LUKOIL selling price for gas, rubles per thousand cubic meters



Structure of gas sales by LUKOIL, rubles per thousand cubic meters



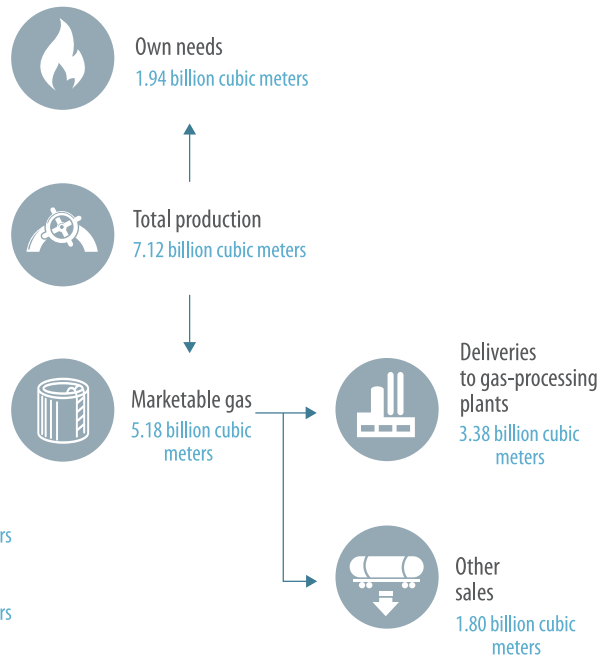
# Gas Production and Supply Structure

## RUSSIA

### NATURAL GAS

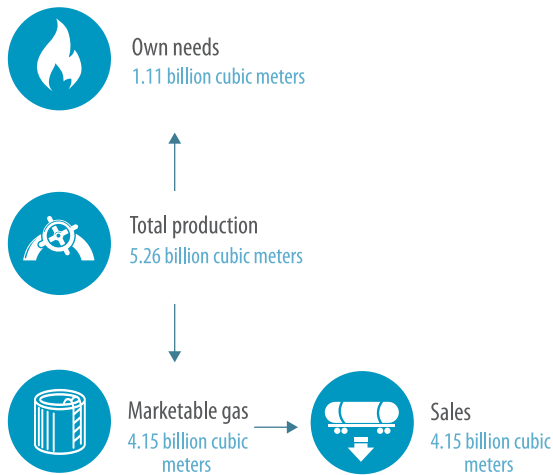


### ASSOCIATED GAS

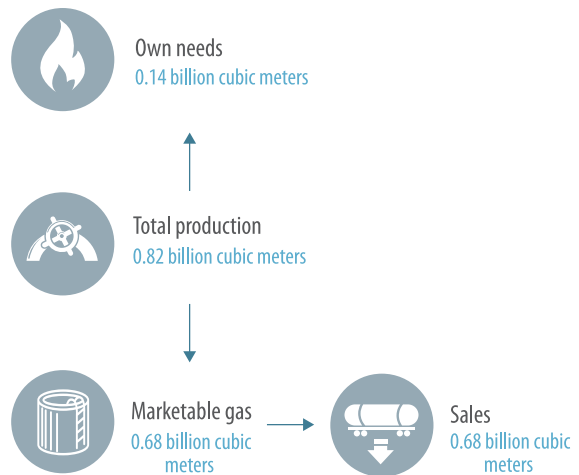


## INTERNATIONAL

### NATURAL GAS

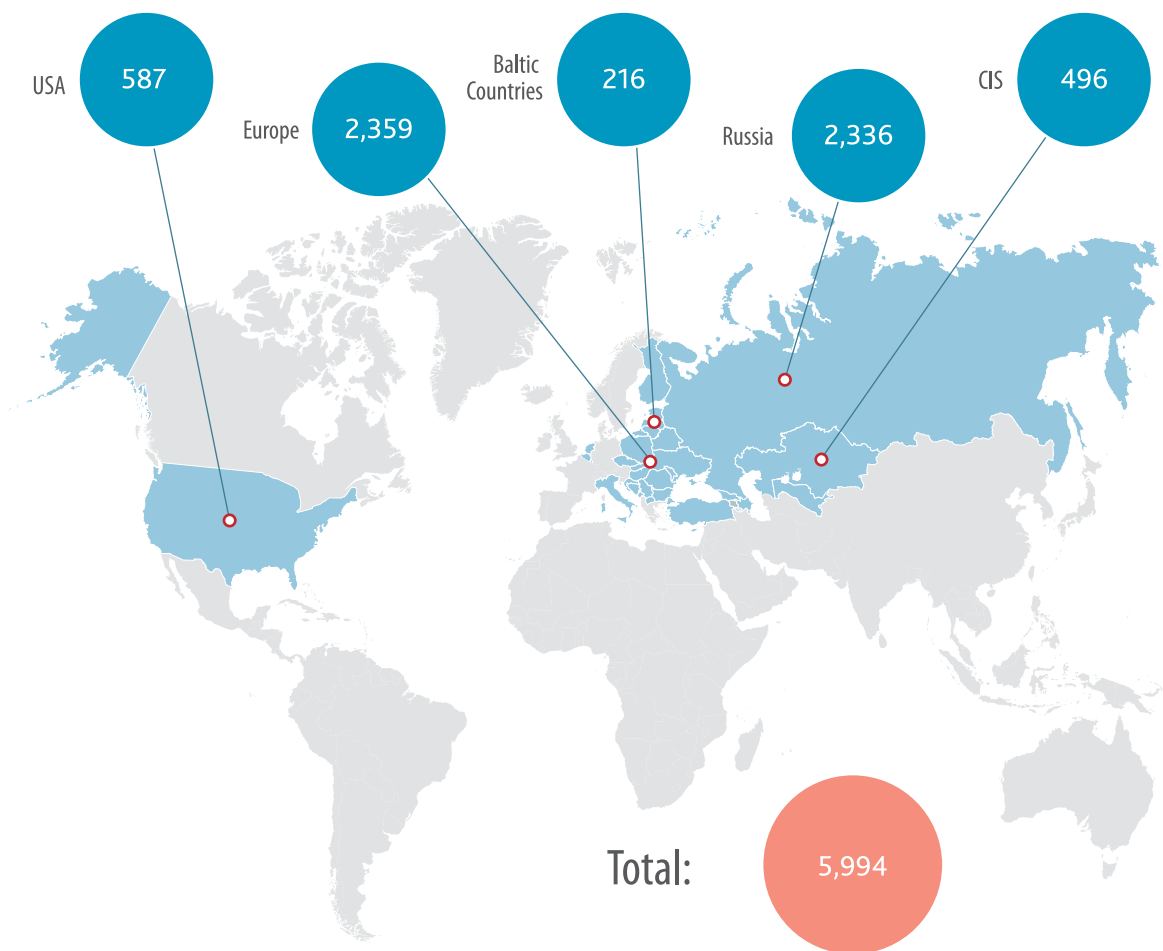


### ASSOCIATED GAS

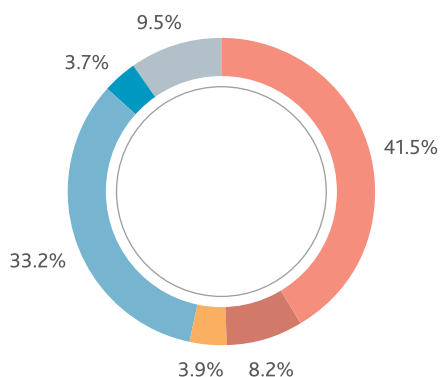


# Petroleum Product Marketing

LUKOIL RETAIL NETWORK (NUMBER OF FILLING STATIONS) AS OF 31.12.2011



**Structure of petroleum product sales in 2011**  
*(own production, wholesale and retail)*



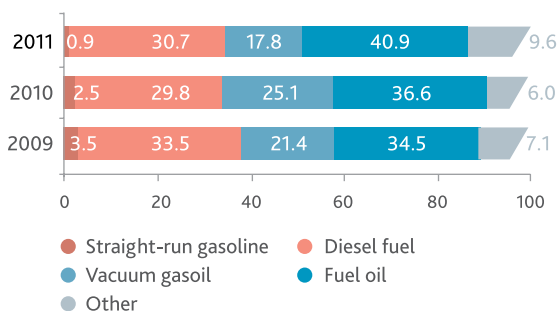
- Russia
- Europe
- CIS
- Turkey
- Baltics
- USA

**PETROLEUM PRODUCT AND PETROCHEMICAL WHOLESALE**

LUKOIL sold 11.0 million tonnes of petroleum products to wholesale customers on the **domestic market** in 2011, representing an increase of 0.4% compared with 2010.

**Export of petroleum products** declined by 6.9% in 2011 to 24.0 million tonnes as deliveries of medium distillates to the domestic market were increased. The structure of exports remained unchanged in the

**Structure of petroleum product exports, %**



reporting year: company exports were dominated by diesel fuel, fuel oil and gasoil, which together accounted for 89% of total export volumes. The Company's petroleum product export structure mainly corresponds to the structure of product exports from Russia as a whole.

Railway remained the chief means of transport for Group exports of petroleum products (about 79% of the total). Products were carried by railway to the Vysotsk terminal, via which 9.9 million tonnes of products were dispatched in 2011 (including 0.5 million tonnes of vacuum gasoil, 2.0 million tonnes of diesel fuel and 6.4 million tonnes of fuel oil).

Petroleum products were also exported by sea and by pipeline (12% and 9% of export volumes, respectively).

Work continued in 2011 to raise the efficiency of petroleum product sales by improvement of logistics arrangements. Deliveries of low-density polyethylene and polypropylene were redirected from export routes to the domestic market, and from less profitable to more profitable export routes (from China to Ukraine, Azerbaijan and Kyrgyzstan). Mutual deliveries of petrochemicals were made in 2011 under agreements between LUKOIL and SIBUR Holding, which gave additional economic benefits due to optimization of delivery routes.

LUKOIL is rapidly developing its **international petroleum product trading business**, increasing both scale and international diversification of this business. The Group's objective is to achieve maximum efficiency in resource placement, including direct sales to end-users by-passing third-party traders, deliveries of third-party's resources and efficient provision of the Company's own networks.

LUKOIL has trading offices in nine countries worldwide and makes deliveries of crude oil and petroleum products to markets in Europe, the USA and the Asia-Pacific region, as well as increasing its sales volumes in new regions (Africa, Latin America and the Middle East). The Company had trading business in 90 countries worldwide during the reporting year.

## PETROLEUM PRODUCT RETAIL

LUKOIL's retail network operated in 26 countries at the start of 2012, including Russia, CIS and European countries (Azerbaijan, Belarus, Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Estonia, Finland, Georgia, Hungary, Italy, Latvia, Lithuania, Luxembourg, Macedonia, Moldova, Montenegro, Poland, Romania, Serbia, Slovakia, Turkey and Ukraine) as well as the USA. The network included 183 storage facilities with total reservoir capacity of 2.7 million cubic meters and 5,994 filling stations (including franchises).

### RETAIL SALES OF PETROLEUM PRODUCTS THROUGH OWNED AND LEASED FILLING STATIONS INCREASED BY 6% IN THE REPORTING YEAR COMPARED WITH 2010 TO A LEVEL OF 15.25 MILLION TONNES. IN 2011 AVERAGE DAILY SALES PER FILLING STATION (OWNED AND LEASED) ROSE FROM 8.1 (IN 2010) TO 8.8 TONNES.

Increase of retail sales mainly reflected a trend on the Russian market, where sales volumes were 15.4% higher than in 2010. There was a scheduled reduction in sales of Class-2 fuel in Russia during 2011 due to the Government's Technical Regulations, but half of the country's producers lacked technical capacity to produce higher-class fuels. So there was a major shortage of high-quality fuel on the domestic market in 2011. Demand for LUKOIL fuels at Russian filling stations was higher than earlier predictions based on natural growth of annual consumption and seasonal demand increases. However, sales on the international market declined in 2011, mainly due to restructuring of the Company's retail network in the USA.

The Company continued optimization of its retail network in 2011 in order to reduce costs and increase efficiency. In Europe and CIS countries 78 filling stations were optimized (21 were leased, 6 were closed down, and 51 were put under dealer management). In Russia the changes affected 102 filling stations (27 were leased, 9 were closed down, 18 were sold, and 48 were put under dealer management) and 9 storage facilities (1 was leased, 4 were sold, 2 were temporarily closed, and 2 were

closed permanently). At the same time, construction and acquisition of highly-efficient stations continued, and upgrading was carried out at existing stations. In Europe and the CIS 10 filling stations were built, 8 were acquired and 80 were upgraded (including installation of gas modules and rebranding actions). In Russia 34 filling stations were built and brought into operation, 35 were upgraded and 35 were acquired.

Investments for development of the retail business totalled \$339 million in 2011.

The Company continued to implement its program for development of a marketing and sales network for liquefied and compressed gas in 2011. Total Group sales of these products were 891,000 tonnes (of which 489,000 tonnes via the retail network), which is 6.5% more than in 2010.

The Company continued to develop its system for non-cash payment by customers at its filling stations in 2011, using the LICARD fuel card system. A total of 2,796 filling stations in Russia (including franchises) were capable of accepting the cards for payment at the start of 2012. There were 771 stations using the cards outside Russia. Total volume of fuel sales using LICARD was 4.3 million tonnes in 2011 with total value of \$4.9 billion, including about 3.9 million tonnes sold in Russia.





LUKOIL has been implementing a customer incentive scheme since the middle of 2010, and 2.5 million customers in Russia had been brought into the scheme as of January 1, 2012. Total fuel sales using incentive cards were about 2 million tonnes in 2011.

**RUSSIA**

As of January 1, 2012 LUKOIL's retail network in Russia consisted of 2,336 filling stations (including franchises) and 109 storage facilities with reservoir capacity of 1.12 million cubic meters. The filling stations and storage facilities are operated by 7 petroleum product supply organizations, which do business in 62 of Russia's administrative regions.

VOLUME OF RETAIL SALES OF PETROLEUM PRODUCTS ON THE DOMESTIC MARKET IN 2011 WAS 8.3 MILLION TONNES, WHICH IS 18.3% MORE THAN IN 2010. AVERAGE DAILY SALES PER FILLING STATION IN RUSSIA ROSE FROM 10.2 TO 11.7 TONNES, WHICH IS 14.7% MORE THAN IN 2010.

Investments in development of the Group's Russian retail business were \$216 million in 2011.

The Company carried out various actions in 2011 to lower expenses and raise efficiency of its Russian marketing network. These included the sale of 19 filling stations and 1 storage facility, lease-out of 33 filling stations, closure of 7 stations and transfer of 81 to dealer management, while 2 storage facilities suspended operations, 2 were closed and 2 were leased out. The Group built 34 new filling stations, upgraded 35 existing stations and acquired 35 stations.

The Company continued to develop production and sales of its new-generation EKTO fuel brands in 2011 in order to maximize profitability. Total sales of EKTO fuels (gasoline and diesel) in 2011 through the Company's retail network in Russia were 2.8 million tonnes, which is 5% more than in 2010. The share of EKTO products in overall retail sales of motor fuel in 2011 was about 34%.

Since the first quarter of 2011 production of high-octane gasoline (92/95) at Company's refineries



has been in compliance with the Class-4 (Euro-4) requirements of the Russian Technical Regulations.

Development of retail sales of non-fuel products and services is an important part of the Group's Refining & Marketing Strategy and work in this direction was continued in 2011. Revenue from sales of non-fuel products and services through the Group's retail network amounted to \$193 million in 2011, which is 32.2% more than in 2010 (45% of this revenue was from sales of food products, 23% represented packaged goods, and 32% was from sales of accessories and services). The revenue increase reflects improvement in service quality at filling stations and optimization of the range of goods and services. Development of non-fuel business is an important factor for positioning of LUKOIL Group as a customer-oriented company with international standards of service.

## INTERNATIONAL

LUKOIL's retail network in the CIS (outside Russia), Europe, and the USA consists of 3,658 filling stations (including franchises) and 74 storage facilities with reservoir capacity of 1.6 million cubic meters.

Investments in development of international retail network were \$123 million in 2011.

Retail sales of petroleum products on international markets in the reporting year were 6.9 million tonnes, which is 5.0% less than in 2010. The decline was mainly due to restructuring of the retail network in the USA. Average daily sales per filling station in Europe were 6.8 tonnes compared with 6.5 tonnes in 2010. Withdrawal of inefficient stations gave an increase in sales volume per filling station comparing with 2010, despite reduction of demand in some countries.

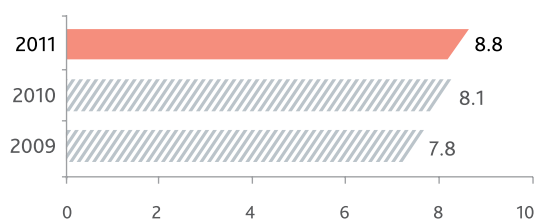
The Group brought 18 filling stations into operation in Europe and the CIS during 2011, of which 10 were newly built and 8 were acquired, and 80 stations were upgraded.

Work continued to promote the Group's EKTO fuel brand on foreign markets in 2011 (in Lithuania, Latvia, Estonia, Ukraine, Romania, Turkey, Moldova, Bulgaria, Macedonia and Croatia). The geography of EKTO sales is expanding year by year, and will be extended to Azerbaijan and Montenegro in 2012. Total sales of EKTO fuel (diesel and gasoline) outside Russia in 2011 were 723,000 tonnes, via more than 1,200 filling stations.

A loyalty program was implemented in 2011 for customers using the LUKOIL-brand filling station network in Turkey. A total of 432 stations have joined the program and more than 400,000 loyalty cards have been issued. A loyalty program was also launched in Romania, where 30 filling stations in Bucharest have joined the pilot program.

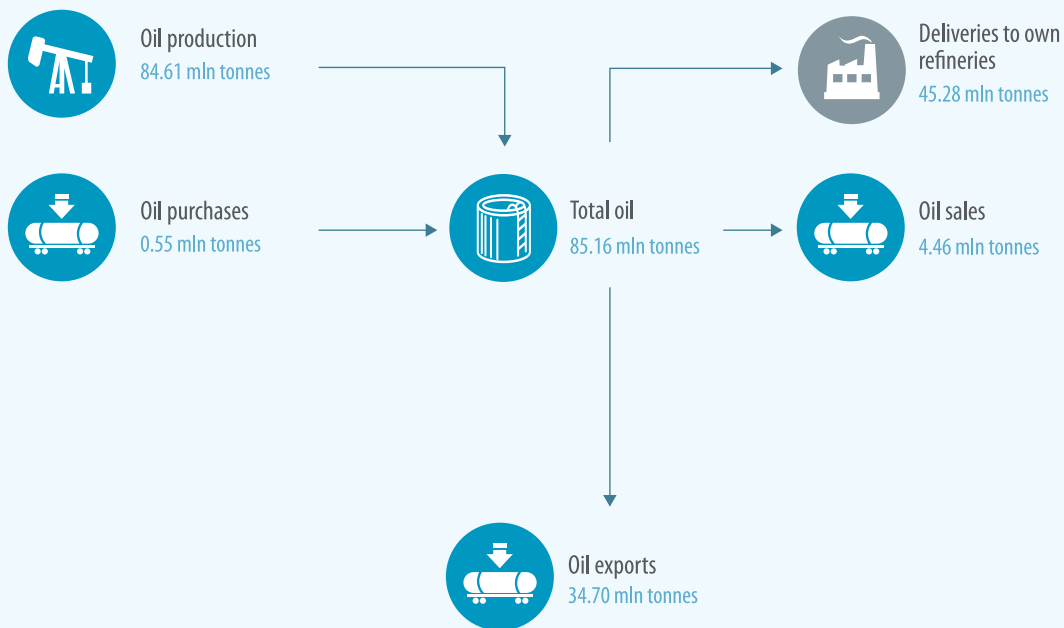
Abroad, as well as in Russia, LUKOIL is working hard to increase profitability of its filling stations, particularly through development of retail sales of non-fuel products and services. Revenue from sales of non-fuel products and services at filling stations in Europe and the CIS was \$507 million in 2011, which is 10% more than in 2010. The Company plans to further increase non-fuel revenues from filling stations abroad through marketing, optimization of the product range, improvement of fast-food services at filling stations, new service additions, work with suppliers, use of best trading practices, and better standards of customer service.

Average daily sales of petroleum products per filling station, tonnes per day

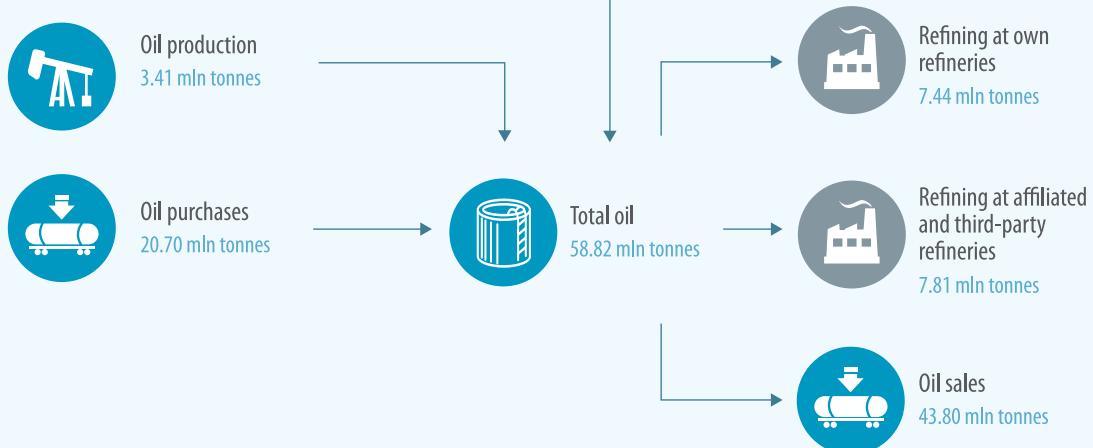


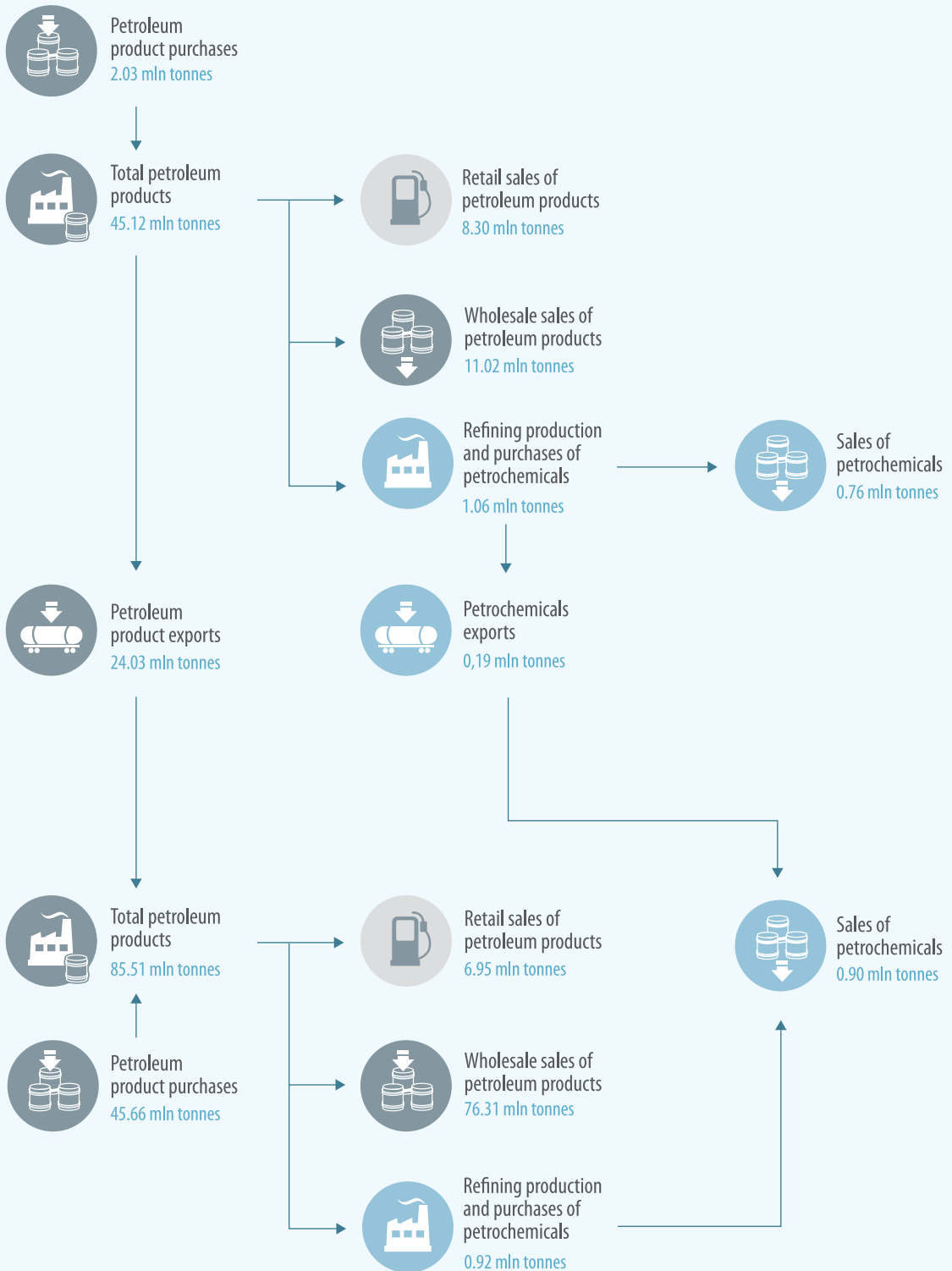
# Trade Balance of LUKOIL Subsidiaries (2011)

## RUSSIA



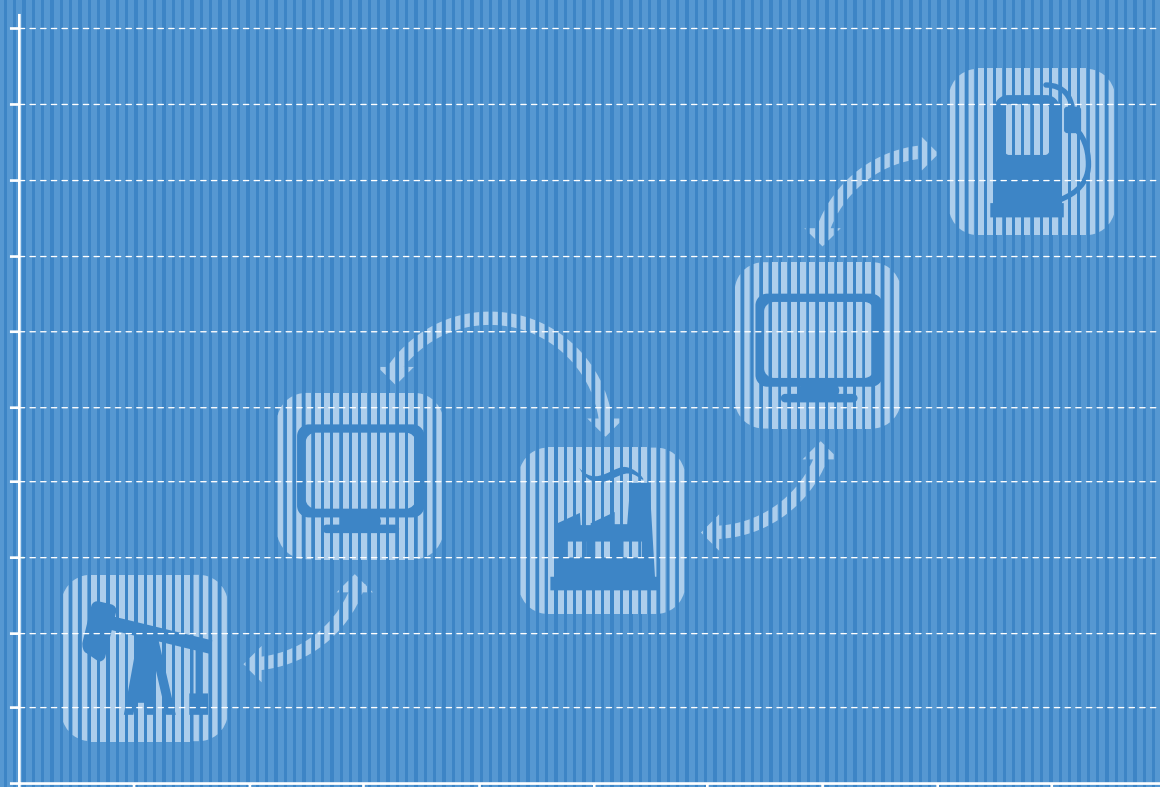
## INTERNATIONAL





# 5

## TECHNOLOGY AND INNOVATION





**INNOVATION AND THE APPLICATION OF NEW TECHNOLOGIES ARE AMONG THE MAIN COMPETITIVE STRENGTHS OF LUKOIL. THE COMPANY'S SPECIALISTS BOTH DESIGN NEW TECHNOLOGIES AND WORK TO MODERNIZE EXISTING TECHNOLOGIES.**

Total Research and Development financing increased in 2011 and accounted for more than \$140 million (comparing with more than \$120 million in 2010). Organizational transformation of LUKOIL's scientific project capacities was completed in 2011. Four regional institutes were taken into LUKOIL-Engineering, which established five branches in different geographical regions where it has activities. The institutes, which are the core of LUKOIL's scientific project capacity, carried out R&D work, project studies and other work with total value of \$310 million in 2011.

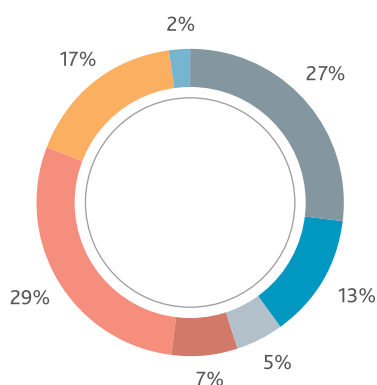
A LUKOIL working group was set up in 2011 to consider issues associated with participation in the Russian Government's Skolkovo innovation project. Work was carried out during the year on selection of scientific and technology projects, which have been recommended for implementation as part of joint work with the Skolkovo Innovation Center. Joint scientific research work between OJSCRITEK (LUKOIL subsidiary) and the Skolkovo Center is scheduled in 2012–2014.

The Group continued to work closely in 2011 with the Russian Corporation of Nanotechnologies (RUSNANO) on commercialization of nanotechnologies and their application in the oil and gas industry. OJSCRITEK carried out joint work with RUSNANO during the accounting year on innovative developments for extraction of difficult reserves in Bazhenov formations.

## Exploration & Production Technologies

LUKOIL fully recognizes the vital role of technology in supporting competitiveness of the Exploration & Production segment. Most R&D work in the segment in 2011 was focused on development of geological and geophysical study techniques, improvement of reserve assessment methods (work continued on a methodology to assess hydrocarbon reserves in reservoirs with complex structure), as well as design and improvement of methods for increasing oil recovery and optimizing technological solutions used for development of new areas and deposits. The Company is particularly keen to develop technologies that ensure environmental safety during field development, most notably in development of offshore fields.

Structure of EOR techniques used by LUKOIL Group in 2011



- Hydrofracturing
- Other physical techniques
- Hydrodynamic techniques
- Intensification of oil production
- Drilling of sidetracks
- Chemical techniques
- Heat techniques

A PROGRAM OF INDUSTRIAL TESTING ENABLED A TECHNOLOGY BREAKTHROUGH IN 2011, WHICH RAISES THE FORECAST FOR VIABLE DEVELOPMENT OF NEW RESERVES IN 2012–2021 BY 3.6 BILLION BARRELS OF OIL THANKS TO INCREASE OF OIL RECOVERY RATES AT FIELDS IN RUSSIA.

### NEW DRILLING TECHNOLOGIES

LUKOIL made particularly rapid advances during 2011 in drilling of horizontal wells that use multizonal hydrofracturing of strata. A total of 96 wells with multizonal hydrofracturing were brought into operation in 2011 and gave 637,000 tonnes of oil. Average daily oil flow from the wells was 56.3 tonnes. Application of this technique at the Urevskoye and Tevlinsko-Russkinskoye fields led to significant adjustment of field development plans, increasing the target recovery factor and thereby raising rates of return in these investment projects.

In another technology advance an expanded logging-while-drilling (LWD) complex was used for construction of horizontal wells on an industrial scale, enabling real-time drilling of horizontal boreholes in productive strata, thereby ensuring maximum contact with the reservoir.

Drilling of horizontal wells in the depression at wells in Western Siberia gave an increase of oil flow rates by 2–4 times compared with previously drilled wells using clay-polymer solutions, while reducing unit costs by 30%.

Successful work in drilling and invariant well completion led to significant adjustment of production drilling programs for the medium term, when the Company plans to make greater use of complex completion. This work has also had favourable impact on the economics of investment projects.

## ENHANCED OIL RECOVERY TECHNIQUES

One key outcome of the Company's technology drive is ever greater application of methods for intensification of oil production and of enhanced oil recovery (EOR) techniques. These methods offer significant increase of recoverable reserves and oil production, enabling commercial development of high-viscosity oil, oil in low permeability reservoirs, and hard-to-recover reserves at late stages of field development. **In recent years the share of oil produced at LUKOIL fields using various technologies that act on oil strata has been over 20% of total oil production. The Company applies physical, chemical, hydrodynamic and heat methods to stimulate extraction.**

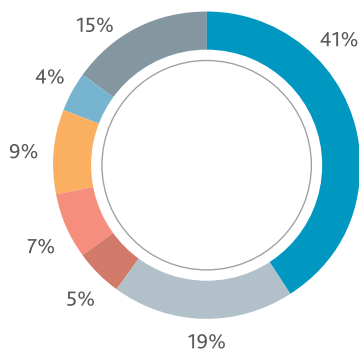
The Group carried out 4,894 EOR operations in 2011, which is roughly equal to the number in 2010. Additional production obtained as a result of EOR techniques was 22.3 million tonnes, or 26% of total

oil production by the Company in Russia. Most of the additional production volume (almost 14.5 million tonnes) was obtained using physical methods, primarily hydrofracturing.

The Group carried out 681 hydrofracturing operations at fields in 2011, achieving average additional oil flows of 10.8 tonnes per day. The effectiveness of hydrofracturing operations in 2011 was comparable with results in 2010. Maintenance of levels of additional output from hydrofracturing was achieved through improvement of project planning, selection of wells using permanently acting hydrodynamic models, and tighter quality control over the materials and reagents, which were used by service companies.

Use of other EOR methods (hydrodynamic, heat, chemical methods and oil production intensification) gave 8 million tonnes of production. The Company continued to make extensive use of the latest chemical technologies in 2011 (there were 1,417 operations using chemical technologies in 2011 compared with 1,351 in 2010).

Shares of additional production obtained by use of various EOR techniques in 2011



- Hydrofracturing
- Drilling of sidetracks
- Other physical techniques
- Chemical techniques
- Hydrodynamic techniques
- Heat techniques
- Intensification of oil production

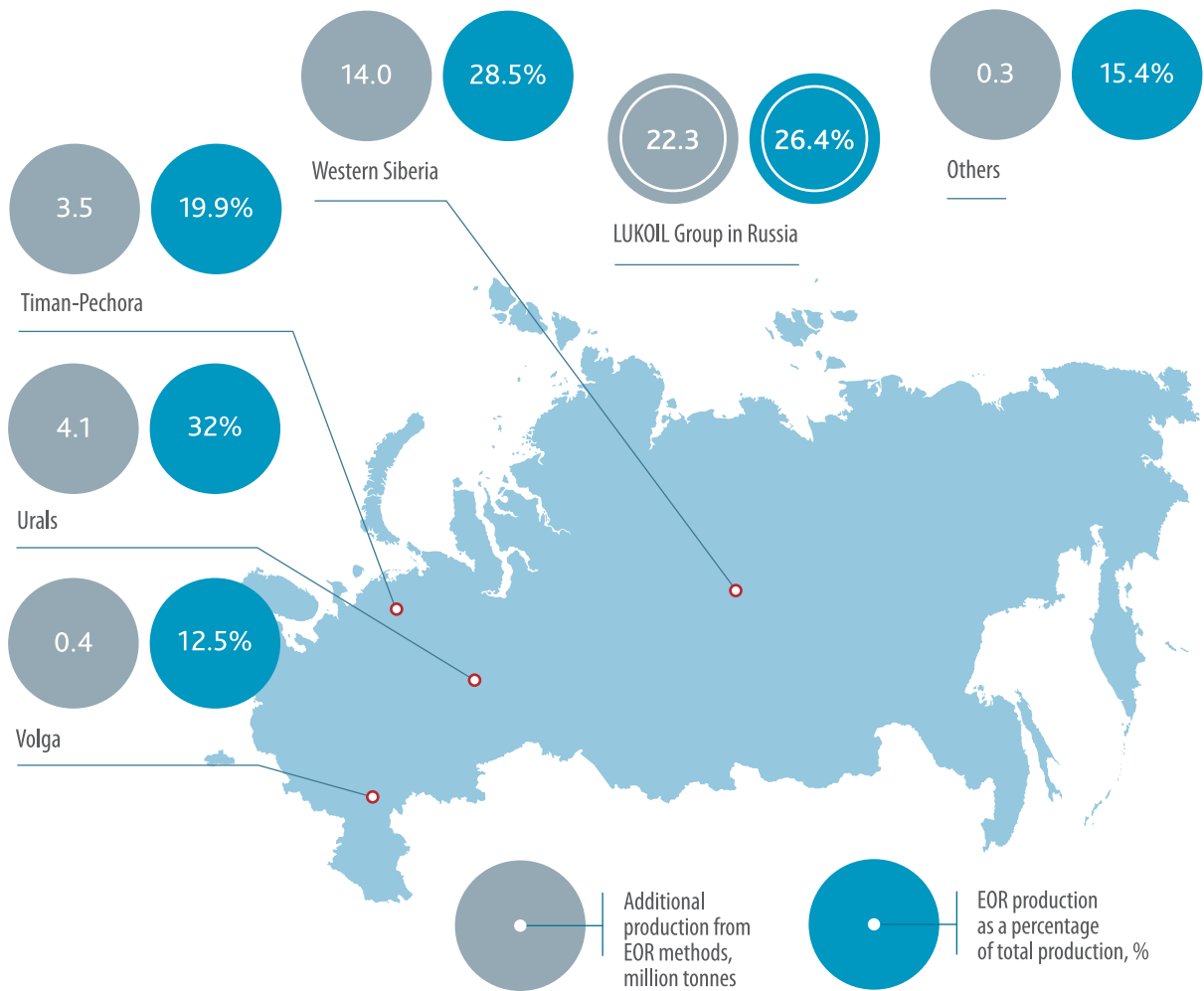
Drilling of sidetracks at existing wells has also proved a highly-efficient form of EOR. The Company continued drilling of sidetracks in 2011 (241 sidetracks drilled in comparison with 224 in 2010), giving an average daily flow increase of 20.4 tonnes. Consistently high efficiency was achieved through science-based mini-projects with use of hydrodynamic modelling, as well as greater accuracy in forecasting of the geological structure of reserves at locations where sidetracks were drilled. Sidetracks are mainly used to extract residual oil reserves at wells, which have been taken out of operation.

## PRODUCTION OF HIGH-VISCOSITY OIL

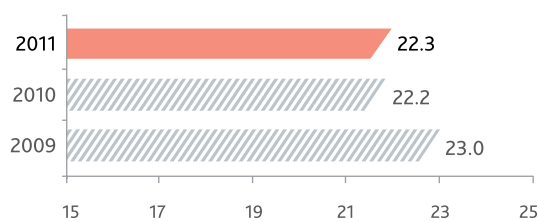
LUKOIL is rapidly developing and applying new technologies for production of high-viscosity oils. Experience of work with high-viscosity oil extraction in Russia is concentrated in the Komi Republic, where LUKOIL is developing the Yaregskoye and Usinskoye fields. Thermal methods are used at both fields to increase oil recovery and annual production is over 3 million tonnes.



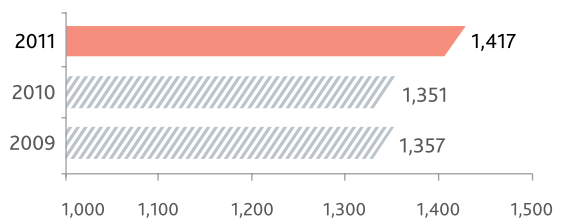
EFFECT FROM EOR (2011)



Additional production from EOR in Russia, million tonnes



Use of chemical methods, wells



The **Permocarbon deposit at the Usinskoye field** is being developed using steam-heating and cyclic-steam stimulation across extended areas. There has been successful work in recent years to improve efficiency of thermal applications at vertical wells (development of combined cyclic-steam stimulation (CSS) is being continued and trials have begun to increase oil flow through simultaneous injection of heat carriers and composites for oil displacement). New thermal technologies are being introduced: steam-heat stimulation of rock formations in horizontal well systems; technology for perpendicular thermo-gravitational deposit draining; CCS technologies for horizontal wells, vertical wells with radial channels, and for an entire productive interval; and technologies for oil recovery by steam. Additional oil production at the deposit obtained by use of thermal methods has been in excess of 6.1 million tonnes since the start of their application.

The Company applied thermal action on strata via a horizontal-well system for the first time in 2011 (in test mode). Experimental work with perpendicular thermo-gravitational strata draining is planned for 2012.

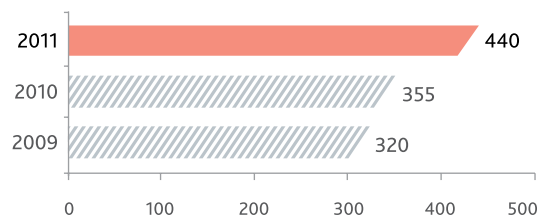
The **Yaregskoye field** is being developed using a thermal mine-shaft technology (production at the field mainly uses a mining technique). Work began in test mode during 2011 to improve heat treatment applications by use of a new drilling rig which enables underground boreholes to be drilled to a length of 800 m (more than double the length of traditional underground boreholes). Use of the new drilling rig, together with use of boring combines, will substantially reduce spending on preparation for development of slanted blocks and will raise productivity.

Five pairs of production and injection wells were drilled at the Lyaelskaya area of the Yaregskoye field in 2011 with horizontal completions and borehole length up to 1,100 m. The purpose of this test work is to obtain know-how in use of horizontal boreholes for injection and production purposes. The technology is similar to Steam Assisted Gravity Drainage (SAGD), which is being applied to oil sands in Canada, and the tests have confirmed its efficiency.

## GEOLOGICAL AND HYDRODYNAMIC MODELS

Oil and gas production subsidiaries of LUKOIL produced hydrocarbons at 358 fields in the Russian Federation during 2011. Geological and hydrodynamic modelling is used for monitoring of development processes, choice of technologies, and for measuring efficiency during production of reserves. Use of geological and hydrodynamic models enables optimal technological solutions to be put into effect during field development, and helps to select the most appropriate solutions for the specific geological structure and composition of available reserves. Modelling leads to improvement of oil recovery rates and reduces expenditures on field development. Models are widely used by the Company when drilling over fields and applying EOR methods, and are designed to cover all fields in Western Siberia, Timan-Pechora and Kaliningrad Region. Although reserves in traditional production regions have been in development for long periods of time, use of modelling has enabled the Company to keep output levels steady and in some cases to increase output. This result reflects improved quality of the models and ever greater use of such models during production drilling, as well as continued work to improve the techniques of well completion, and of primary and secondary drilling into productive strata.

### Number of geological-hydrodynamic field models



## Refining Technologies



LUKOIL places much emphasis on development, modernization and construction of high-tech equipment that reduces costs in refining operations and enables production of new, high-quality product types. Constant improvement of quality serves the interests of customers and protects the environment, and sales of products with a large share of value-added generate additional profit for the Group.

LUKOIL is currently working on construction of new equipment and modernization of all its refineries. Re-equipment of the vacuum block on atmospheric distillation unit at the Ukhta Refinery was continued in 2011, as was modernization of the reactor block on the GDS-850 hydrodewaxer. A hydrogen fluoride alkylation unit was brought into operation in the first quarter of 2011 at the Nizhny Novgorod Refinery and scheduled production levels were achieved by the complex for catalytic cracking of vacuum gasoil, construction of which was completed at the end of 2010. At the Volgograd Refinery

a new delayed coking unit with one million tonnes annual capacity was brought into operation in December 2011.

The strategic development program for LUKOIL refineries 2012–2021 includes construction of a number of facilities and units, which will result in substantial increase of light product yield and volumes of high-quality gasoline and diesel outputs. There will also be a significant reduction of negative environmental impacts.

Studies are also being carried out to find ways of improving energy efficiency and levels of safety in operations at oil refineries, gas-processing plants and petrochemical facilities.

LUKOIL is devoting much attention to the development of the latest technologies for production of lubricants and additives, and a science and technology unit focused on this issue has been set up within the Company. Its main functions are development

and marketing of high-quality products, which are required for proper operation of the latest machinery, as well as development of new technologies and blends. This work is being carried out by Company specialists in collaboration with scientific centres in Russia.

Much was done in the reporting year to optimize production processes and improve the quality of

lubricant outputs. Achievements included reduction of energy consumption and improvement of the quality of base oils. The Company developed 38 new lubricant types during the year. A new lubricant product line under the name LUKOIL GENESIS will be marketed in Russia during 2012, and will meet the highest standards of international vehicle producers including those for fuel economy and environmental aspects.

## Information Technologies

We apply the latest information technologies to optimize our business processes in a variety of spheres. LUKOIL continues to develop and install automated systems for management of production and technology processes, as well as IT systems to help manage Group companies. The Company is also working to improve quality of its telecommunication systems, information security, IT hardware and office equipment.

IT technologies can be of great value for enhancing the efficiency of both industrial operations and business management. LUKOIL has expanded functionality of all software programs and applied them at an ever increasing number of Group orga-

nizations. Consecutive creation and development of the Integrated Management System<sup>1</sup> with SAP architecture had enabled installation of 24 modules at nearly 112 Group organizations by the end of 2011.

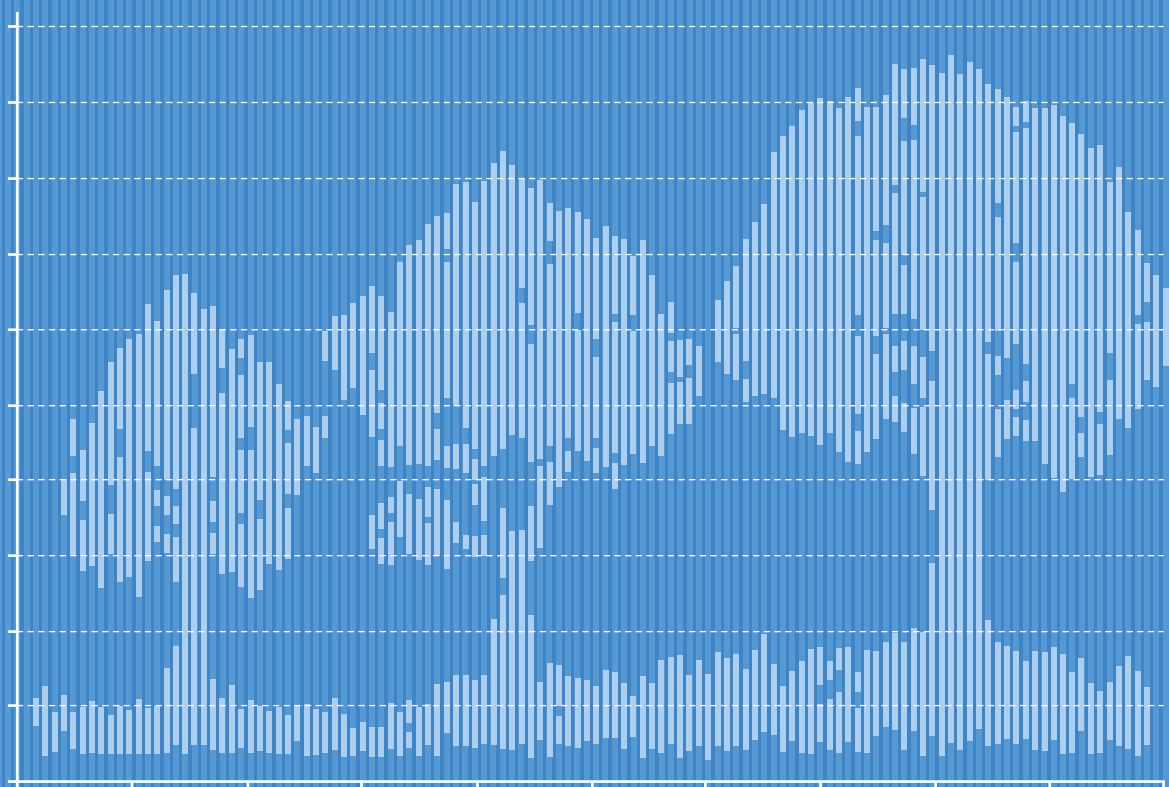
There was further progress in adoption of the Global Integrated Management System, which will enable a single standard and proper organization of information flows between LUKOIL organizations: local rules for asset portfolios and/or projects and business processes were designed, using base documents of the new corporate management system. A process management model for the Group was designed, enabling harmonious interaction between business processes.



<sup>1</sup> Page 83, LUKOIL Annual Report 2010

# 6

## SOCIAL RESPONSIBILITY



## Environment Protection



A functional development program for environmental protection was prepared in 2011 as part of LUKOIL Group Strategy 2012–2021. The following strategic guidelines for achievement of environmental security were defined:

- 95% utilization of associated oil gas;
- ending discharge of effluent into natural water spaces;
- reducing greenhouse gas emissions and obtaining additional income through implementation of the mechanisms of Article 6 of the Kyoto Protocol;
- fully overcoming the aftermath of previous environmental damage;
- obtaining a ratio of waste accumulation to use/recycling of waste no higher than 1;
- payments for negative environmental impact should not exceed the standard rate of such payments by more than 15%;
- reduction of pipeline failures and purification of land that has been damaged as a result of such failures.

LUKOIL is guided in its work by the highest standards of care for the environment and industrial safety. Acknowledgement of responsibility to society for rational use of natural resources and preservation of the environment in a favourable state are among key considerations for LUKOIL in implementation of its industrial projects.

Scheduled work was carried out in 2011 at LUKOIL and Group organizations to ensure industrial and environmental safety and for the prevention and resolution of emergency situations.

In July 2011 the Company's senior management approved amendments for 2011–2013 to the previously approved Environmental Safety Program of LUKOIL organizations for 2009–2013. The amendments took account of an updated review of environmental issues, proposals by Group organizations, and the creation within the Group of a Power Generation business sector. Financing assigned for implementation of the Program measures in 2011–2013 is about \$2 billion.

More than \$700 million were spent on environmental measures in the reporting year. A significant share of this money was used to comply with the Government requirement that utilization of associated gas must reach a level of 95% in 2012.

Environmental measures by the Company in 2011 enabled a reduction of most environmental impact indicators (including relative indicators), with the exception of atmospheric emissions. Growth of emissions was due to increased operation of small-scale generating facilities at Company production sites and resulting growth in fuel consumption, as well as increased flaring of associated gas by a number of Company organizations. We are now intensifying our efforts to raise levels of associated gas utilization in order to comply with Russian Government requirements for 95% of such gas to be utilized and thereby to avoid liability to above-standard environmental payments from 2012 onwards. All Group enterprises should be compliant with the required utilization rate by 2015.

Discharge of waste water was more than halved in 2011 thanks to actions to improve efficiency of purification equipment. Reduction of water use by 6% was mainly achieved as a result of technical and organizational measures for rational use of water by companies in the Power Generation sector, which is the largest user of water in the Group.

The environmental and economic measures introduced by the Kyoto Protocol are an important incentive for investments to reduce greenhouse gas emissions. By the start of 2012 LUKOIL's portfolio of projects for reduction of greenhouse gas emissions included 14 projects for implementation in Russia, total impact of which in 2008–2012 should be equal to about 33 million tonnes of CO<sub>2</sub>-equivalent. At present four projects are closest to completion: these projects have completed all the necessary design stages, secured support from Sberbank of Russia, and been approved by decrees of the Russian Ministry for Economic Development as projects for joint implementation in accordance with Article 6 of the Kyoto Protocol. A sale of emissions quotas has already been transacted for projects developed by OJSC RITEK.

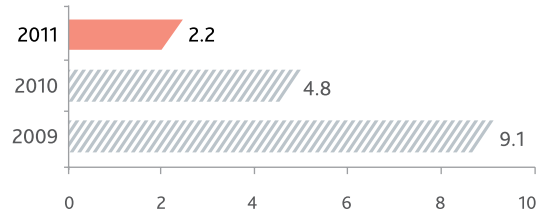
LUKOIL organizations pursued the goals of environmental security in 2011 through actions for rational use of water resources and prevention of water pollution, reduction of atmospheric emissions, recycling of accrued waste that contains crude oil, and non-polluting, sustainable use of land. Specific steps carried out in the reporting year were as follows:

- diagnostics and major repairs of pipelines;
- modernization and construction of facilities, which increase the rate of utilization of associated gas;
- acquisition of equipment for resolving crude oil and petroleum product leakages;
- recultivation of disturbed land and land polluted by crude oil;
- various works for monitoring of environmental components;

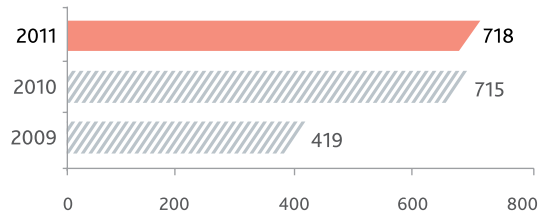
- construction of new and reconstruction of existing networks for water supply and water discharge;
- installation of chlorination units for decontamination of industrial and river water;
- replacement of equipment and optimization of technologies for reducing pollutant emissions;
- construction of a complex for processing of waste that contains crude oil.

A supervisory audit of LUKOIL's health, safety and environment (HSE) management system was carried out in 2011. Auditors of the international certification company, Bureau Veritas, visited 21 Group organizations. Two substantial compliance failures were detected at CJSC LUKOIL-AIK (rectified in the course of the audit) as well as 17 minor failures requiring corrective and preventative measures.

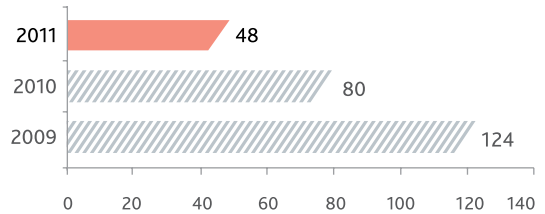
**Waste water discharge, million cubic meters**



**Environmental spending, \$ million**



**Number of accidents with environmental impact**





## Health and Safety

LUKOIL continued to ensure health and safety of its employees in the reporting period in accordance with the Company's Health, Safety & Environment Policy for the 21<sup>st</sup> Century and with due respect for Russian law and the laws of countries where LUKOIL has operations.

A Program for health and safety, improvement of working conditions, and prevention and resolution of emergency situations at organizations in LUKOIL Group for 2011–2015 was designed and approved in the reporting year. The Program involves 67 Company organizations and spending on measures as part of the Program in 2011 was nearly \$300 million.

Accident and injury rates improved in 2011 compared with 2010. There were 19 accidents at LUKOIL organizations during the year compared with 43 in 2010. The number of people who suffered injuries as a result of accidents declined from 49 to 25, and there were no fatalities (compared with 2 fatalities in 2010).

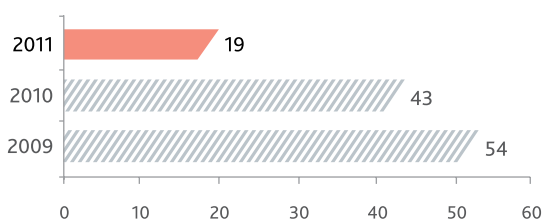
However, one serious accident did occur in 2011, involving an explosion and subsequent fire at the pyrolysis gas separation and benzol production section of Stavrolen. As a result, nine employees and contractors received injuries of varying severity.

Fire services attached to the Russian Ministry for Emergency Situations attended the incident and were assisted by other accident and rescue services.

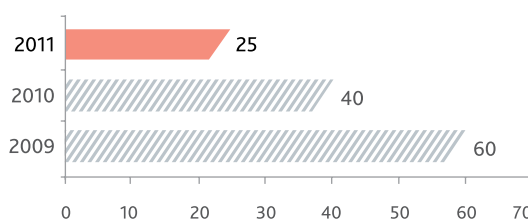
Scheduled preventative measures ensured that there were no incidents during 2011, which could be classed as emergencies. Safety drills and training sessions are held regularly at sea and river terminals, and at production, refining and storage sites, to ensure that the Company's special teams and equipment remain in a high state of readiness to deal with any oil or petroleum product leakages. A total of 90 drills and training sessions were held in 2011 for dealing with emergency oil and product leakages.

An international emergency training event, 'Caspian 2011', was held during September 2011 in the Caspian Sea with participation by rescue services from Kazakhstan and Azerbaijan (observers from Turkmenistan also took part for the first time). Aircraft, special sea craft and coastal detachments were active in the manoeuvres. Levels of preparedness of the participants, coordination between the various rescue services (including those from other countries), and work by the rescue coordination center and by the emergency service section of LUKOIL-Nizhnevolzhskneft were highly commended by the Russian Ministry for Emergency Situations.

Number of accidents



Number of people injured in accidents



## Personnel and Social Programs

The Company's success is completely dependent on the people who work for it. LUKOIL therefore does everything within its power to create and maintain a team of professionals who are capable of achieving all the ambitious tasks, which the Company sets itself. LUKOIL's social policy is designed to help its employees to work efficiently and realize their potential in the confidence that they enjoy comprehensive social protection. We take issues of staff motivation very seriously and try to ensure that each employee takes a personal interest in achievement of the best possible results by the Company.

LUKOIL aspires to a system of human resource management that matches the best global standards. During the reporting year Company experts carried out an analysis of how best-practice systems for management of resources, assets and business processes have been constructed at the world's leading energy companies. Unified models have been designed for management of core business at the Group companies, eliminating inefficient links and duplication of management functions. Optimization of organizational structures at LUKOIL companies is being implemented in accordance with the new models and constructs, and this work is scheduled for completion by the end of 2012.

The Company makes full use of social partnerships in the labour sphere, expanding cooperation with trade unions, government bodies and local communities. Since 2008 LUKOIL has been the official representative of the Russian Union of Industrialists

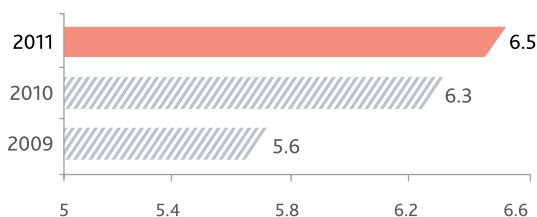
and Entrepreneurs in the Tripartite Commission for Regulation of Social and Labour Relations, which is the most senior social partnership organization acting under the Labour Code of the Russian Federation. In 2011 the Company took part in 10 sessions of the Commission, at which 79 issues were considered.

Approaches used for improving operational and financial efficiency within LUKOIL Group include reorganization of structural sub-divisions and transfer of non-core sub-divisions from the Group to external providers. As a result the overall number of employees at LUKOIL organizations decreased by 7.5% in 2011 in comparison with 2010, maintaining the trend towards higher productivity and per-unit efficiency indicators at the Company: revenue per employee grew by 37.6% in the reporting year, and net profit rose by 24.3%.

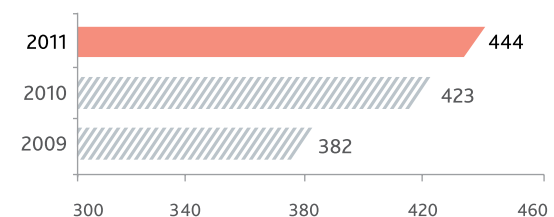
Much attention was paid in the reporting year to development of the system of staff appraisal. Appraisals of the work of more than 1,800 staff at the Company's central office were carried out and the results were used to prepare personal development plans and in calculation of annual bonuses for 2010. A pilot project was also carried out to assess candidates for LUKOIL's executive reserve (to fill senior executive posts at the Company) in accordance with an approved model of corporate competences.

LUKOIL fully understands the importance of a well-designed system of salaries and remuneration for supporting motivation among its employees

Hydrocarbon production per employee, thousand boe



Refinery throughput at own refineries per employee, tonnes



and ensuring their commitment to growth of the Company's shareholder value. Wage levels in the industry are constantly monitored, which enables timely decisions on adjustment of wages in order to make them competitive and to encourage highly qualified specialists to seek employment at the Company. As a result Company payroll has expanded by 5% in the last five year despite a substantial reduction in employee numbers (by more than 20%).

In addition to material incentives, LUKOIL provides encouragement to personnel through marks of merit for outstanding achievements at work. Special events were held at all Group companies in 2011 at which workers and groups of workers received national awards, sectoral marks of distinction and LUKOIL awards. There were 38 winners of national awards among LUKOIL employees in 2011, while sectoral distinctions were earned by 754 workers and the Company's own awards were conferred on 2,017 employees and 20 groups of employees. 30 LUKOIL employees were awarded prizes by the Russian Union of Oil and Gas Workers in 2011.

An efficient system of social guarantees helps to attract highly-qualified specialists to the Company, reduce employee turnover rates and strengthen corporate spirit, and is therefore of fundamental importance for LUKOIL operations. The Company offers a broad range of programs and opportunities to its employees as part of the LUKOIL social package. These include:

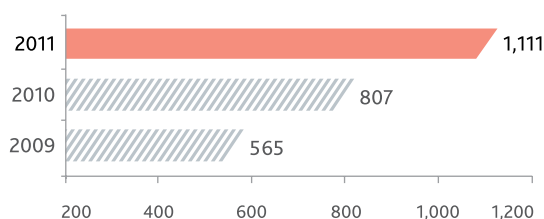
- leisure and recreation provisions for employees and their families, organization of sport and fitness events
- health care and medical treatment for Company employees, including voluntary health insurance

- help to employees in acquiring housing
- social support to women and families with children
- social support to young specialists.
- non-state pension provision for employees, which has operated since 2004 on the principle of shared funding of non-state pensions by employee and employer. By the end of 2011 more than 38,000 employees of LUKOIL organizations in Russia had entered the shared funding system, and the sum of their contributions during the year was over \$12.5 million. The Company's total contributions under non-state pension provision programs in Russia and abroad for the reporting period were \$37 million.

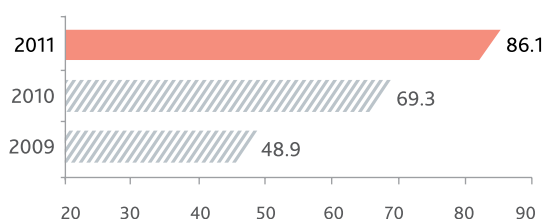
Total spending by LUKOIL companies in 2011 for implementation of social programs for employees, their families and pensioners was \$286 million, and spending on infrastructure for provision of social services totalled \$83 million.

LUKOIL gives priority to work with young specialists as part of the Group's comprehensive target program for cooperation with young people and young specialists in the period from 2008 to 2017. Committees of young specialists operate at the Company enterprises, and their functions include support to young specialists in adjustment to new working conditions, obtaining and improving skills, and commitment to corporate values and corporate culture. The Company held a sixth competition in 2011 to find the Best Young Specialist of the Year, as a result of which the title was awarded to 68 of the Company's young specialists. LUKOIL personnel also took an active part in the TEK-2010 annual competition to find the best R&D project by a young

*Sales per employee, \$ thousand*



*Net income per employee, \$ thousand*



engineer to address technical challenges in the fuel & energy industry: 27 employees of LUKOIL companies were prize winners in the competition.

Further trainings were organized and held as part of the Young Specialist's School in 2011. Such trainings are an integral part of the system for enhancing the knowledge and skills of new recruits to the Company, reducing the amount of time needed for their adaptation to the corporate environment and raising their professional efficiency.

The tradition of work experience opportunities at the Company for students of leading Russian higher education was continued (66 students benefited from a period of work experience at the Company in 2011). Work also continued on joint schemes with specialized oil & gas institutes around the country, including the 'Step into the Future' program for the selection of best students.

The second Forum for young workers of LUKOIL Group companies was held in Western Siberia during the reporting year and was dedicated to the 20<sup>th</sup> anniversary of the Group. A tele-bridge enabled young specialists from Timan-Pechora, Moscow, Perm, Nizhny Novgorod, Western Siberia, as well as regions of Southern and Eastern Europe to participate in the Forum.

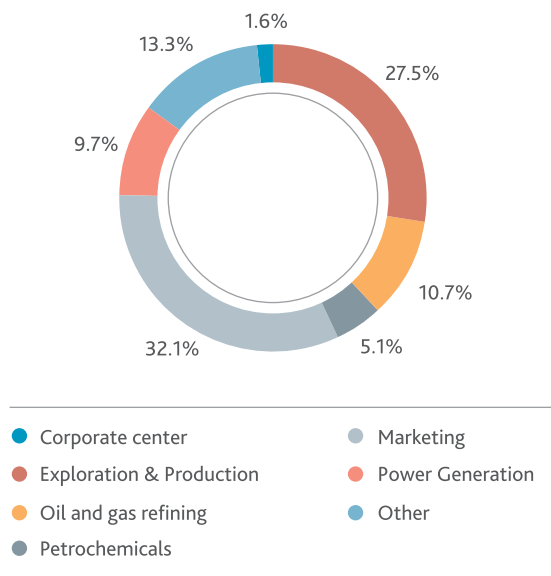
Our work with personnel is focused on skill levels. The Group has a system of continuous training, which is designed to ensure that LUKOIL personnel acquire the knowledge and skills, which they require in their jobs. LUKOIL uses the whole spectrum of modern training aids: workshops, seminars away from the work place, special training programs, work placements abroad, trainings, courses for improvement of qualifications, professional training days, distance learning, MBA programs, etc.

The Corporate Study Centre which was opened in 2011 in the city of Astrakhan trains workers for operations on offshore oil and gas platforms and at river and sea terminals, as well as teaching employees how to deal with emergency situations and ensuring that they are familiar with industrial and fire safety drills. An agreement has also been signed with the Makarov State Maritime Academy for training,

retraining and raising the qualifications of workers in offshore projects.

Another group of 15 LUKOIL employees undertook an internship at ConocoPhillips in 2011.

Employees by business segments in 2011, %



## Sponsorship and Charity



Social and charity programs are an integral part of the Company's corporate strategy and help to ensure constructive partnership with the state, business and society. Corporate programs have a targeted character and are based on professional experience and human potential in regions where the Company operates. At the same time, the Company has come to understand the danger of creating social dependence through charity actions. Therefore, together with its traditional charity actions, LUKOIL makes increasing use of strategic support programs and social investments, which combine solutions to social problems with the strategic interests of the Company. This approach is based on joint work between business and the non-profit and government sectors to address urgent social and economic problems in local communities.

Total spending by the Company on charity and social programs was about \$99 million in 2011.

Company policy in this field has two principal components:

- social investments
- sponsorship and traditional charity programs

### SOCIAL INVESTMENT PROGRAMS

#### SUPPORT FOR CHILDREN'S HOMES AND SCHOOLS

Helping children is a Company priority, and underlies all of the social programs, which we have built and which we pursue: charitable programs, sponsorship, sports development programs for children and young people, and cultural programs. Social investments in human capital are particularly valuable in today's environment and LUKOIL strives

to achieve a balanced approach, providing support both to children, who by virtue of their family circumstances or health find themselves in a worse situation than their peers, and to children with favourable family backgrounds by helping them to develop their natural abilities and talents.

The Company, its subsidiaries and the LUKOIL Charity Fund provide help to children in 70 Russian children's homes and boarding schools, ensuring that they remain in good health and obtain an education, which will enable them to acquire a profession and find their place in life.

Every year the LUKOIL Charity Fund organizes summer vacations by the Black Sea for children from sponsored children's homes in Kirov, Kstovo, Ishim, Nizhny Novgorod, Leningrad Region, Perm Territory, Astrakhan and Volgograd Regions, as well as organizing educational trips around Russia.

The Charity Fund has also been providing special LUKOIL grants since 2006 to students who continue their studies in higher education or technical institutes after leaving children's homes. Such grants were paid to 45 young people in 2011.

Since 2008 the LUKOIL Charity Fund and the subsidiaries of the Company in Astrakhan Region have been working on a project, by which children from care homes and disadvantaged families are trained for work in managerial and technical capacities at LUKOIL. The project is motivated by a severe deficit of technical specialists, needed for a new large-scale project, which LUKOIL is implementing in the region. The young people from children's homes and disadvantaged families have been given the opportunity to train at technical and higher-education colleges for a career with LUKOIL: 20 such students have already been placed at Astrakhan Polytechnic College and the Volga-Caspian Fishery and Industry Complex. The LUKOIL Charity Fund is covering costs of their tuition and living expenses, and they will be given employment at Group organizations in the region after completion of their studies.

In Nizhny Novgorod Region the Company provides assistance to the Kstovo Oil Industry College, where

students include children who were formerly at LUKOIL care homes. The students regularly visit LUKOIL's Nizhny Novgorod Refinery to learn about its operations and to acquire practical knowledge and skills.

In 2011 the LUKOIL Charity Fund and the Nizhny Novgorod Museum of Art joined forces to implement a successful art and education project under the title, 'New talents discovered', which was designed to help gifted young people of between 13 and 16 years of age at children's homes to make the best of their talents. The teenagers mastered basic skills in drawing, painting and composition, and were taught the fundamentals of fine art and the history of art. The climax of the project for its participants was a culminating exhibition of children's drawing held at the Nizhny Novgorod Museum of Art in October 2011 and attended by the President of LUKOIL, Vagit Alekperov, and the Governor of Nizhny Novgorod Region, Valery Shantsev. The best and most impressive of the children's drawings were used to create the new corporate calendar of LUKOIL-Volganefteprodukt.

The Group gives special attention to children with special medical needs. One project, which LUKOIL has maintained over a number of years, is called 'An illustrated book for every little blind child' and is part of a larger program, 'Illustrated Books for Blind Children'. In 2011 publications were supplied to specialized children's institutions in Kazan as part of this project.

## EDUCATION PROGRAMS

Concern for the young generation and training of qualified, young specialists for the Russian oil industry are important aspects of LUKOIL's activity. The Company provides support to a number of higher education institutes, which prepare specialists for a career in oil and gas, including the Gubkin Russian State Oil and Gas University, Perm National Research Polytechnic University, Ukhta State Technical University, Tyumen State Oil and Gas University, Ufa State Oil and Technical University, Volgograd State University, Volgograd State Technical University, Astrakhan State Technical

University, the Mendeleev Chemical Technologies Institute, and the Plekhanov Mining Institute in Saint Petersburg.

As well as providing assistance to institutes with oil and gas specializations, the Company also supports the Higher School of Economics (National Research University), the Financial University (attached to the Russian Federal Government), the Volzhsky branch of the Moscow Energy Institute, Rostov State Railway University, Moscow State Social Humanitarian Institute, as well as secondary education institutions, including the Kstovo State Technical College, Budennovsk Regional Polytechnic College, Stavropol College of Geological Exploration, and Moscow School Gymnasium №45.

Several oil and gas institutes in the CIS countries also benefit from Company support, including the State Oil Academy of Azerbaijan.

#### **Grant programs**

Since 2000 the Company has paid grants to particularly talented students at oil industry and technical institutes in Russia. In 2011 monthly corporate grants of 2,500 and 3,000 rubles were paid to about 200 students in various Russian cities. Total grant payments in the period from 2007 to 2011 were nearly \$700 thousand, of which more than \$170,000 were paid in 2011.

#### **Teaching staff: the key to survival of scientific potential**

About 90 talented young teachers at leading Russian oil and gas institutes receive grants as part of LUKOIL's program for support to young teachers. Total grant payments in the period from 2007 to 2011 were in excess of \$1.2 million, including \$250,000 in 2011.

#### **Provision of teaching resources**

Assistance to higher education institutes for improvement of their equipment and resource base is of crucial importance, ensuring that high standards of education are achieved. The Company helps oil

and gas institutes in Russia to acquire scientific equipment for their laboratories. Substantial sums were allocated in 2008–2011 for new equipment and repairs to buildings at Tyumen State Oil and Gas University, Ukhta State Technical University, Ufa State Oil and Technical University, Perm State Technical University and the Gubkin State Oil and Gas University.

#### **SUPPORT FOR MEDICAL INSTITUTIONS**

LUKOIL provides assistance to a number of major specialized medical research centers: the Center for Haematology Research (part of the Russian Academy of Medical Science), the Russian Cardiovascular Scientific and Production Complex, and the A. V. Vishnevsky Institute of Surgery.

The Company also supports development of the system of medical services in regions where it has operations. In 2008–2011 the Company helped to purchase expensive equipment for the Limanskaya Central District Hospital in Astrakhan Region, the Astrakhan Children's Clinical Hospital №1, Bolshemurashkinskaya Central District Hospital in Nizhny Novgorod Region, Natal Clinic №4 in Moscow and the Kstovo Central District Hospital.

#### **SOCIAL PROJECT COMPETITIONS**

Social project competitions, which are held annually by LUKOIL subsidiaries in association with the LUKOIL Charity Fund, offer a particularly efficient way of implementing programs of social importance. Holding of the competitions in regions of Company presence has become an integral part of LUKOIL's system of corporate responsibility. Success of the social project competitions has proved that distribution of charity funds on a competitive basis is one of the most effective means of social investment. The system is founded on competitiveness, transparency and openness, and the intention is to support the projects and initiatives of local communities to solve the most pressing problems which their regions face, while at the same time maximizing the impact of charity assistance provided

by LUKOIL. In this respect the main task of social project competitions is to encourage more people to be socially active and to learn the necessary skills to solve their own problems and the problems of their community.



Social project competitions have been held in regions of LUKOIL presence since 2002, when the first competition was organized in Perm Territory. Geography of the events has greatly expanded in recent years: they are now held in 10 of Russia's administrative regions.

A total of \$2.5 million were set aside by the Company for social project competitions in 2011, which is almost double the amount spent five years ago.

The social project competitions have several nominations, which are the same in every region where they are held: 'ecology', 'charity', 'culture and art', 'physical exercise, sport and tourism' and 'Where I live'. But other nominations may be added to suit the specific needs of a particular territory,

or to serve Government priorities in the social sphere. For example, a 'family-values' nomination was added in 2008, which had been officially declared 'Year of the Family' by the Russian Government and, similarly, a special nomination was created in 2009, which was the 'Year of Youth' in Russia. Celebration of the 65<sup>th</sup> anniversary of victory in World War II justified a nomination to support projects on the theme of that commemoration and in 2011 a special nomination dedicated to LUKOIL's 20<sup>th</sup> anniversary was added.

LUKOIL's social project competitions have proved their worth in recent years as a unique vehicle for nurturing social initiative. Independent experts agree that the competition mechanism enables funds to be allocated more efficiently. Most importantly, the system has a strong motivational element, encouraging 'grassroots' initiative by the people and organizations, who receive funding. The mechanism enables project participants to develop their potential, set themselves goals and organize their progress towards achievement of those goals, helped by the informational and financial resources provided by LUKOIL.

## SPONSORSHIP AND CHARITY PROGRAMS

### PRESERVING CULTURAL AND HISTORICAL HERITAGE

#### Support for museums and the arts

Supporting culture is a traditional sphere of sponsorship and charity for Russian companies. Partnership with cultural institutions involves sponsorship (financing of productions, concerts, exhibitions, etc.), but also has a pure charity element. The Company's priority is to support classical art in all its varieties.

LUKOIL provides support to a number of leading museums in Russia, including the Tretyakov Gallery, the Museums of the Moscow Kremlin, the Pushkin Museum of Fine Arts, the Russian Museum, and the V. M. and A. M. Vasnetsov Art Museum in the town of Vyatka.



In 2011 LUKOIL was among partners of the Tretyakov Gallery exhibition, 'What is Truth? The 180<sup>th</sup> Anniversary of the Birth of Nikolai Ge'.

A touring exhibition, 'The Kremlin from the Moscow Principality to the last Coronation' was organized in 2011 in Kazan as part of the joint culture and education project with the Museums of the Moscow Kremlin, which began in 2004. Continuing the tradition of previous years, lecture-and-visit activities as well as a children's drawing competition were provided by staff of the Museums for young people at children's homes in Tatarstan. Similar touring exhibitions have already been held in Perm, Nizhny Novgorod and Volgograd in the years since the project began.

The Company also supported the exhibition 'Poiret, King of Fashion', which was held at the Museums of the Moscow Kremlin in 2011.

Funding was provided to the Pushkin Museum of Fine Arts for creation of a multimedia site devoted to the Museum's collection of antiquities and for publication of the album, 'Masterpieces of the Antiquities Collection at the Pushkin Museum of Fine Arts'.

The Russian Museum received assistance for organization of an exhibition devoted to the 150<sup>th</sup> anniversary of Konstantin Korovin.



The V. M. and A. M. Vasnetsov Regional Museum of Fine Arts received support from LUKOIL for acquisition and installation of computer and multimedia equipment, as well as multimedia software to create a museum internet class for children and teenagers.

LUKOIL has a long-running association with the Tchaikovsky Symphony Orchestra, conducted by Vladimir Fedoseyev. Concerts were organized in Brussels, Geneva, Zagreb, Nizhny Novgorod and Kstovo in 2011 as part of celebrations of LUKOIL's 20<sup>th</sup> anniversary.

The Company has provided support over many years to the Perm State Theatre of Opera and Ballet, the Kaliningrad Regional Philharmonia (and its program, 'Bring the family to the concert hall'), as well as the Urals Academic Philharmonic Orchestra.

LUKOIL is the official partner of the Spasskaya Bashnya festival of military bands, which is held annually on Red Square in Moscow.

Other events supported by the Company in 2011 included the 'Great Caucasus' festival of art from the Caucasus (held in Perm Territory), the 2<sup>nd</sup> 'Golden Harp' international musical charity project, the 'Crescendo' music festival, and the 2<sup>nd</sup> M. Magomaev Vocalists Competition, as well as activities by the Russian Synod Choir. In Astrakhan the Company gave its support to a concert by the pianist Denis Matsuev, who was given an enthusiastic welcome by the local audience.

**Support for religious confessions**

Participation of the Company and its subsidiaries in the revival of Russia's religious traditions and spiritual culture is an integral part of LUKOIL's charity activity. LUKOIL is particularly keen to support those religious institutions, which are most active in the service of society.

The Company supports the program for reconstruction and restoration of the Optyna Pustyn monastery, and has provided funds to help equip auditoria at the Cyril and Methodius Graduate

and Doctoral Centre, as well as for the Church of the Resurrection at Kadashy.

Company subsidiaries also play an active part in the revival and development of centres of church and spiritual life in Russia and abroad.

#### **Program for revival of traditional arts and crafts**

LUKOIL-Perm has carried out a number of programs in recent years to support traditional crafts in the region around Perm in the northern Urals (the Kama river region).

Perm Territory is now almost unique in Russia for the amount and the variety of traditional handicrafts, which are practised there and which have their roots in past centuries.

The best examples of this work are displayed annually at an interregional exhibition-fair of traditional crafts and applied-decorative art under the general sponsorship of LUKOIL-PERM.

The Govorlivskoye Gulbishe festival, which was held in 2011 using a social competition grant from LUKOIL-PERM gave a new impulse to the development of traditional handicrafts and revival of ethnic culture. The grant money was used to set up an experimental craft centre where young people are taught the skills of processing sylvinite, a natural material that is found in Perm Region. Funds provided to the winner of another social projects competition have been used to create a unique museum, the Tatar Hut, which has become a major attraction for visitors and tourists. Master classes are held at the museum, where people can learn how to make traditional items, and a unique collection of ancient embroidered cloths has been put on display.

Organizational and financial assistance is also provided to a regional honey festival, the 'Selenite Casket' children's festival of traditional handicrafts, as well as to the 'Yelovskaya Rybka' fishing and sport festival and the 'Khlebny Spas' harvest festival.

## TARGETED ASSISTANCE

### **Help for war veterans, the disabled, and disadvantaged groups**

Oil workers and other veterans of the Great Patriotic War (World War II), as well as veterans of the labour front, have a special place in LUKOIL's social programs. Every year they receive special payments and gifts from the Company to coincide with Victory Day. The Company also provides assistance to families of members of the armed forces, who have perished in more recent armed conflicts.

LUKOIL provides financial assistance to people with disabilities, including support to help them to earn a living independently and thus to feel a part of society.

### **WORKING WITH PEOPLES OF THE RUSSIAN FAR NORTH**

Operations by LUKOIL in Siberia and the Far North of Russia can have significant impact on the living conditions of small indigenous peoples, creating various social and economic problems. Areas that are being developed for extraction of oil and gas are also areas where these peoples carry out economic activities (reindeer herding, fishing and hunting), that are essential to their survival. Resulting changes in the traditional way of life of these peoples can give rise to social and economic problems. LUKOIL's objective is to resolve these issues by moving gradually away from charity provision to the indigenous inhabitants of these regions and towards an economic partnership with them.

The Company develops and implements special programs for work with the owners of kinship lands. In Khanty-Mansiysk Autonomous District (Yugra) LUKOIL-Western Siberia makes agreements for social and economic development of districts and locations inhabited by small indigenous people in order to preserve and develop the traditional way of life of the Khanti, Mansi, Nenets and Selkup peoples. Issues in the relationship between the Company and indigenous peoples are resolved at meetings between LUKOIL managers and representatives of the

Assembly of small indigenous peoples of the North, heads of administrative districts, and the local inhabitants themselves. LUKOIL works actively with the social organizations 'Save Yugra' and 'Yamal for our Children'. In Yugra LUKOIL has industrial activities at 34 traditional resource areas, on which 164 families depend for their livelihood. The Company provides material assistance to each family in the form of petrol, construction materials, boats and boat engines, as well as snowmobiles. Financing is made available for construction and repairs to villages, and apartments are provided for local people in nearby towns.

Members of the young generation of indigenous peoples also benefit from the Company's attention. LUKOIL has begun work on the Kar Tokhi children's camp for local ethnic groups, where children can learn the basics of hunting, reindeer herding and fishing, train in traditional handicrafts and learn how to handle a snowmobile.

LUKOIL's Western Siberian subsidiaries view preservation of the lifestyle, language and culture of indigenous peoples as an important goal. They therefore work with local administrations, helping to finance the construction of educational facilities, maintenance of places of worship, and holding of national festivals.

The Company is also carrying out social and charity projects in the Nenets Autonomous District in order to improve the living standards of the indigenous Nenets and Komi peoples. An agreement between the Administration of Nenets Autonomous District and LUKOIL ensures that local people are in regular receipt of social assistance. In 2011 such assistance included support to seven groups of families and also to the Yasavey Association of the Nenets People.

Since 2008 LUKOIL-Komi together with the Administration of Nenets Autonomous District and the Yasavey non-government organization have been implementing the 'Red Tent' project, which provides health checks for the indigenous population and subsequent courses of treatment, when necessary, at the hospital in Naryan-Mar. There is particular need

for dental services, so the medical team includes a mobile stomatology unit. Red Tent also provides training in first aid and use of mini-drugstores.

## SPORT PROJECTS

Support for Russian sport has been a key aspect of LUKOIL's social policy over many years. The Company's key priorities at the present time in the sphere of sport and fitness are:

- encouraging health and fitness among Company employees and their families, developing mass sport
- supporting professional sports teams in Russia, national sporting federations and the Russian Olympic movement
- helping to develop children's sport in Russia

The health and fitness of Company employees is of much concern to LUKOIL, which therefore organizes competitions in various summer and winter sports in all regions of Russia where it has operations.

The international 'Spartakiada' sports competitions organized by LUKOIL are of particularly importance for developing and achieving broad involvement in physical culture and sport.

The 5<sup>th</sup> Spartakiada, dedicated to the 20<sup>th</sup> anniversary of the Company's creation, was held in summer 2011 in Perm, and included competitions in mini-football, volleyball, streetball, weight-lifting, arm-wrestling, track and field athletics, swimming, chess, tug-of-war, and table tennis. The home team from Perm won the competition for the 5<sup>th</sup> consecutive year.

LUKOIL provides support to a number of leading Russian sports teams to encourage the development of professional sport in Russia. Professional teams that benefit from Company sponsorship include Moscow Spartak football club, Caspian Dawn handball club in Astrakhan, Volgograd Spartak



water polo club, Moscow Dinamo hockey club, and Torpedo hockey club in Nizhny Novgorod. The Company is the official partner of the VTB League, which brings together the strongest basketball teams of Eastern Europe.

For many years the Company has been the general sponsor of the national ski-racing team and partner of the Russian Ski-Racing Federation. LUKOIL assists both in training of the national team and development of amateur ski sport in Russia.

As part of its support to the Russian Olympic Movement the Company is cooperating with the Russian Olympic Support Foundation, which provides targeted support to sportsmen in Russian national teams practising Olympic sports.

In addition to its support for sports teams, LUKOIL also views sport as a way of testing the Company's own products to the limits. The successes and victories of LUKOIL Racing Team, which is the strongest car racing team in Russia, continue to prove the efficiency

of the Company's fuels and lubricants at both circuit and rally competitions in prestigious Russian and international racing series. The Company's involvement in racing goes beyond support to its own team: in 2011 LUKOIL became the official fuel supplier for the Silk Road rally, which is now the part of the world-famous Dakar rally series.

LUKOIL also plays a major role in development of sport among children and young people. The Company has provided support since 2001 for one of the biggest children's sport organizations in Russia, the Children's Football League. About 3,000 teams and more than 5,000 young football players from all parts of Russia take part in League competitions each year. Since 2002 the Children's Football League has held an annual tournament under the title of the 'LUKOIL International Children's League of Champions'. Tournament matches in 2011 were dedicated to the 20<sup>th</sup> anniversary of LUKOIL: qualifying rounds were held in seven cities in Russia and three foreign cities, with a final in Moscow and a super-final in the Turkish city of Alania.



In 2011, as part of its 20<sup>th</sup> anniversary celebrations, the Company organized competitions in football, skiing, artistic gymnastics, paintball, bowling, volleyball and handball for children, students and Company employees in Kaliningrad, Astrakhan, Volgograd, Rostov, Moscow, Tyumen, and Krasnodar regions. The competitions were also dedicated to people who have made major contributions to past development of the Russian oil industry: N. K. Baibakov, S. A. Povkh, V. Yu. Filanovsky-Zenikov, V. G. Schmidt, Yu.S. Korchagin and V. P. Sukharev. With the slogan ‘Win with us!’, these competitions were a logical continuation of sports actions by the Company in previous years: ‘Live with sport!’, ‘Believe in yourself!’ and the LUKOIL President’s Cup.

#### LUKOIL MUSEUMS

LUKOIL’s network of corporate museums was created in 2005 and now consists of more than 20 museums at Group organizations in various regions of Russia, as well as in Ukraine, Bulgaria and Romania.

More than 20 touring exhibitions were held in 2011 including ‘LUKOIL’s Offshore Projects’, ‘140 years since the birth of I. M. Gubkin’, ‘Petroleum Products Business’, ‘Power Generation’, ‘Social Project Competitions’ and ‘LUKOIL for Children’. The exhibitions were displayed at the Company’s central office and at other venues, including the Russian Ministry of Energy, the Russian Ministry of Natural Resources and Ecology, the State Maritime Academy, and the Crocus Expo international exhibition center.

An exhibition dedicated to the Company’s 20<sup>th</sup> anniversary was displayed at the Kremlin Palace, the Pillar Hall at the House of the Unions, and also in Switzerland, Belgium, Holland and Qatar.

The LUKOIL Museum also played an important role in the organization of an exhibition in 2011 to mark the 100<sup>th</sup> anniversary of the birth of the N. K. Baibakov, held at the Central Museum of the Modern History of Russia, as well as contributing to themed sections at the exhibitions ‘The Space Age’ and ‘P. A. Stolypin. A Life for his Country’.

The Company Museum also provided assistance in the making of a film about I.M. Gubkin and re-issue of D. Ergin book, The Prize.

The LUKOIL Museum holds regular sessions with students of the Gubkin Oil and Gas State University to study the history of the Russian oil industry.

### BLOOD DONATION ACTIONS

LUKOIL holds voluntary blood donation actions for employees at the Company's central office and also at subsidiaries in Perm Territory and Astrakhan Region.

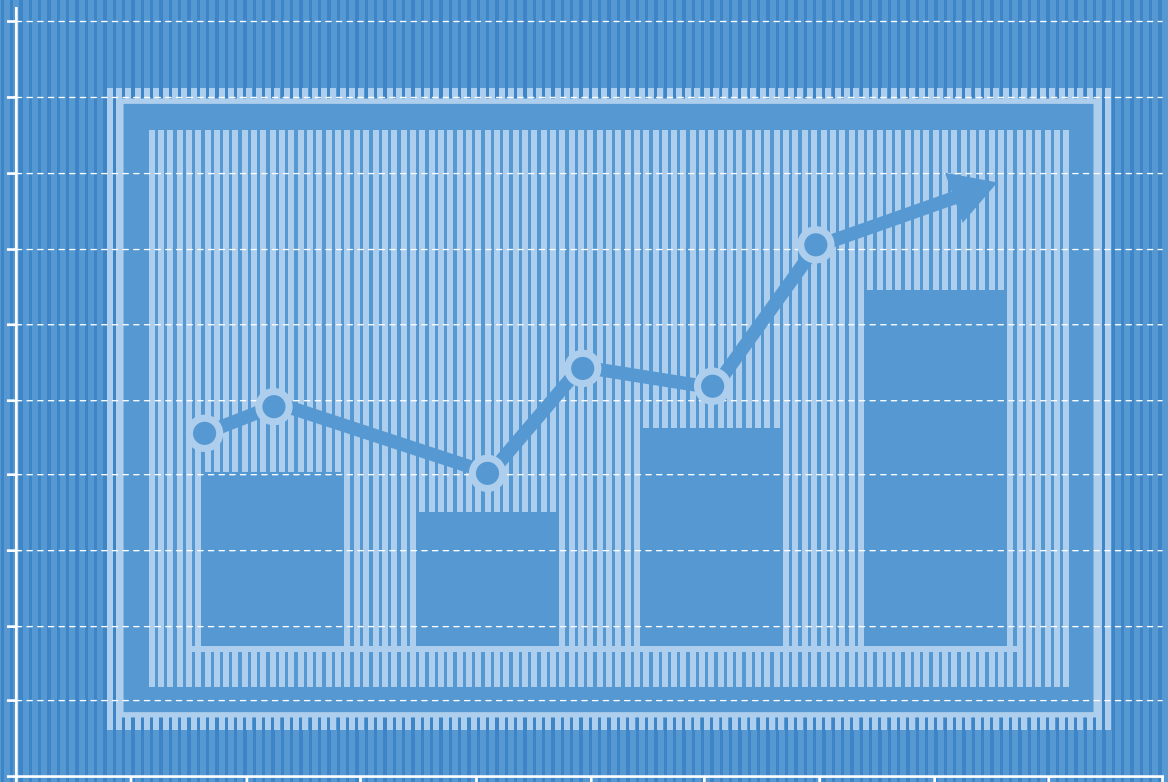
Such actions were first held in 2010 when 380 employees at the central office and a number of subsidiaries took part, collecting about 170 liters of blood.

In 2011 a blood donation event at the central office, held to coincide with Blood Donor's Day, collected about 160 liters of blood.

The Company views blood donation as a valuable form of corporate voluntary action, which both helps society and helps to strengthen corporate culture by bringing members of staff together and forging links between them. Such events are also a way of developing a sense of corporate responsibility, which is something that the Company views as highly important.

# 7

## CORPORATE GOVERNANCE AND SECURITIES



## Corporate Governance



LUKOIL'S SYSTEM OF CORPORATE GOVERNANCE IS AN EFFECTIVE TOOL FOR PROTECTING THE RIGHTS AND INTERESTS OF COMPANY SHAREHOLDERS. EFFICIENT CORPORATE GOVERNANCE LOWERS THE WEIGHTED AVERAGE COST OF CAPITAL AND REDUCES INVESTMENT RISKS, MAKING INVESTMENTS IN LUKOIL MORE ATTRACTIVE AND, AS A CONSEQUENCE, RAISING SHAREHOLDER

VALUE OF THE COMPANY. LUKOIL'S CORPORATE GOVERNANCE SYSTEM ATTACHES SPECIAL IMPORTANCE TO PROTECTING THE RIGHTS OF MINORITY SHAREHOLDERS.

High quality of the Company's corporate governance system has been recognized by the investment community over many years.



## Board of Directors and Management Committee



### BOARD OF DIRECTORS OF LUKOIL

The Board of Directors plays a crucial role in LUKOIL's system of corporate governance, exercising overall control of Company activities in the interests of investors and shareholders. In accordance with Russian legislation and the LUKOIL Charter, the Board of Directors defines priorities for Company development and ensures efficient functioning of the Company's executive bodies.

The Board of Directors of LUKOIL has 11 members who are elected by a cumulative vote of the General Meeting of Shareholders. Shareholders who own no less than 2% of voting shares in the Company have the right to propose candidates to the Board. Such proposals must be submitted to the Company not later than 30 days after the end of the financial year. The Board of Directors takes a decision on the final list of candidates during the last five days after the end of that period, usually by a vote in absentia. Members of the Board of Directors are elected until the next

General Meeting of Shareholders and there is no limit on the number of times they can be re-elected.

In accordance with the Code of Corporate Conduct, which was recommended for adoption by companies by the Decree of the Federal Commission for the Securities Market on April 4, 2002, the Board of Directors of LUKOIL includes independent directors, whose presence enables the Board to formulate an objective opinion on matters discussed and therefore to strengthen confidence in the Company on the part of investors and shareholders. At the present time 7 of the 11 members of the Board of Directors are independent.

The Board of Directors held 8 meetings in person during 2011 and carried out 16 votes in absentia. The Board of Directors dealt with the following matters within its competence during 2011:

- definition of Company business priorities, strategic, medium-term and annual planning, and review of business results

- in-depth study and design of specific measures for development of Group business segments;
- improvement of corporate governance
- formation of the Management Committee, guidelines for selection of the external auditor
- preparations for holding the General Meeting of Shareholders
- approval of transactions with interest

#### PARTICIPATION BY MEMBERS OF THE BOARD OF DIRECTORS AT IN-PERSON MEETINGS OF THE BOARD OF DIRECTORS IN 2011\*

##### Meetings

Vagit Alekperov	8/8
Igor Belikov (until June 23, 2011)	3/3
Viktor Blazheev	8/8
Valery Grayfer	7/8
Herman Gref	7/8
Igor Ivanov	8/8
Ravil Maganov	8/8
Richard Matzke (from June 23, 2011)	5/5
Sergei Mikhailov	8/8
Mark Mobius	8/8
Guglielmo Moscato (from June 23, 2011)	5/5
Alexander Shokhin	8/8
Donald Wallette Jr (until June 23, 2011)	3/3

\* In accordance with the resolution of the Board of Directors, for purposes of defining a quorum in conduct of a BoD meeting and voting results, the written opinion of an absent Board member concerning the agenda items, which is received by the Board Secretary before the start of the meeting, is

taken into account. So a Board member who submits his written opinion before the start of the meeting is considered to have taken part in the meeting.



## Members of the Board of Directors of LUKOIL



**Valery Grayfer**

Chairman of the LUKOIL Board of Directors  
Chairman of the RITEK Board of Directors

Born 1929

Graduated in 1952 from the Gubkin Moscow Oil Institute. Doctoral Candidate in Technical Sciences. Awarded six orders, four medals, and a Diploma of the Supreme Soviet of the Tatar ASSR. Awarded a Diploma of the President of the Russian Federation in 2009. Deputy to the USSR Oil Industry Minister, Head of the Tyumen Main Office for the Oil and Gas Industry (from 1985). CEO of RITEK (1992–January 1, 2010); Chairman of the Board of Directors of RITEK (from 2010). Chairman of the Board of Directors of LUKOIL (from 2000). Professor of the Gubkin Russian State Oil and Gas University, Lenin Prize Winner and Russian Government Prize Winner.

Elected to the LUKOIL Board of Directors since 1996.



**Vagit Alekperov**

President of LUKOIL  
Member of the LUKOIL Board of Directors  
Chairman of the LUKOIL Management Committee

Born 1950

Graduated in 1974 from the Azizbekov Institute of Oil and Chemistry in Azerbaijan. Doctor of Economics, current Member of the Russian Academy of Natural Sciences. Awarded four orders, eight medals, a Diploma and Letter of Acknowledgement from the President of the Russian Federation. Winner of two Russian Government Prizes. Worked in the oil industry in Azerbaijan and Western Siberia (from 1968). CEO of Kogalymneftegaz (oil production company), a division of Glavtyumenneftegaz within the Ministry of the Oil and Gas Industry of the USSR (1987-1990). Deputy, then First Deputy to the USSR Oil and Gas Industry Minister (1990-1991). President of Langepasuraykogalymneft (oil production group) (1992-1993). Chairman of the Board of Directors of LUKOIL (1993–2000). President of LUKOIL (from 1993).

Elected to the LUKOIL Board of Directors since 1993.



### Igor Belikov

Independent Member of the Board of Directors of LUKOIL <sup>1</sup> (until 23.06.2011)  
Director of the Russian Institute of Directors (since 2002)  
Member of the HR and Remuneration Committee of the LUKOIL Board of Directors (until 23.06.2011)

Born 1956

Graduated in 1980 from Voronezh State University, post-graduate studies at the Africa Institute of the Academy of Sciences of the USSR, Doctoral Candidate in Historical Science, completed a period of study at London University, Diploma in Banking and Insurance awarded by the Further Qualification Institute of the Financial Academy (attached to the Government of the Russian Federation), Audit Certificate and Corporate Governance Certificate from Schulich School of Business (York University, Toronto, Canada, 2002), Corporate Governance Consulting Certificate (Global Corporate Governance Forum, Washington, USA, 2008). Director of the Russian Institute of Directors (from 2002). Co-author of the Russian Code of Corporate Conduct (2002) and of the first National Report on Corporate Governance (2004). Member of the Expert Council of the Federal Commission for the Securities Market (FCSM) (2002–2004). Executive Secretary of the National Council for Corporate Governance (2003–2004). Member of the Expert Council for Corporate Governance at the Federal Service for Financial Markets, Deputy Chairman of the College of the Association of Corporate Directors, member of the International Corporate Governance Network (ICGN) (from 2004). Expert on the Intergovernmental Group of Experts on International Accounting Standards of the UN Conference on Trade and Development (UNCTAD, Geneva) (2003–2006).

Elected to the Board of Directors of LUKOIL from 2008 to 2009 and from 2010 to June 2011.



### Viktor Blazheev

Independent Member of the LUKOIL Board of Directors <sup>1</sup>  
Rector of the Kutafin Moscow State Academy of Law  
Member of the LUKOIL BoD Audit Committee

Born 1961

Graduated from the All-Union Correspondence-Study Law Institute (ACLI) in 1987; completed a post-graduate program at ACLI/Moscow Law Institute (Civil Litigation Faculty) in 1990. Since 1994 he has combined work as a lecturer with various administrative posts at the Moscow State Academy of Law. Dean of the Full-time Department of the Moscow State Academy of Law (1999–2001). Vice-Rector of Moscow State Academy of Law in charge of academic agenda (2001–2002). First Vice-Rector of Moscow State Academy of Law in charge of academic agenda (2002–2007). Rector of Kutafin Moscow State Academy of Law (from 2007).

Elected to the LUKOIL Board of Directors since 2009.

<sup>1</sup> In accordance with the provisions of the Code of Corporate Conduct, which was recommended for application by the Decree of the Russian Federal Commission for the Securities Market, dated April 4, 2002. The same applies to all other independent BoD members listed in this section



**Herman Gref**

Independent Member of the LUKOIL Board of Directors <sup>1</sup>  
 President, Chairman of the Executive Board of SBERBANK  
 (Savings Bank of the Russian Federation)  
 Chairman of the LUKOIL BoD Audit Committee

Born 1964

Graduated from Omsk State University in 1990, completed a post-graduate program at St. Petersburg State University in 1993. First Deputy Minister of Property Relations of the Russian Federation (1998–2000). Minister of Economic Development and Trade of the Russian Federation (2000–2007). President, Chairman of the Executive Board of SBERBANK (Savings Bank of the Russian Federation) (from 2007). Doctoral Candidate in Economic Science.

Elected to the LUKOIL Board of Directors since 2009.



**Igor Ivanov**

Independent Member of the LUKOIL Board of Directors <sup>1</sup>  
 President of the Russian Council for International Relations  
 Chairman of the LUKOIL BoD Strategy and Investment Committee

Born 1945

Graduated from the Maurice Thorez Moscow State Institute of Foreign Languages in 1969. Corresponding Member of the Russian Academy of Sciences. Doctor of Historical Science, Professor. Awarded Russian and foreign orders and medals. First Deputy Minister of Foreign Affairs of the Russian Federation (1993–1998). Minister of Foreign Affairs of the Russian Federation (1998–2004). Secretary of the Security Council of the Russian Federation (2004–2007). Professor of the Moscow State Institute of International Affairs (University), attached to the Russian Ministry of Foreign Affairs.

Elected to the LUKOIL Board of Directors since 2009.

<sup>1</sup> In accordance with the provisions of the Code of Corporate Conduct, which was recommended for application by the Decree of the Russian Federal Commission for the Securities Market, dated April 4, 2002. The same applies to all other independent BoD members listed in this section



### Ravil Maganov

Member of the LUKOIL Board of Directors  
Member of the LUKOIL Management Committee  
First Executive Vice-President of LUKOIL (Exploration & Production)  
Member of the LUKOIL BoD Strategy and Investment Committee

Born 1954

Graduated in 1977 from Moscow Gubkin Petrochemical & Gas Institute. Honored Employee of the Oil and Gas Industry of the Russian Federation. Awarded three orders and three medals. Winner of three Russian Government Prizes in science and technology. Chief Engineer, Deputy CEO, CEO of Langepasneftegaz (oil production company) (1988-1993). Vice-President of LUKOIL (1993-1994). First Vice-President of LUKOIL (1994-2006). First Executive Vice-President of LUKOIL (from 2006).

Elected to the LUKOIL Board of Directors since 1993.



### Richard Matzke

Independent Member of the LUKOIL Board of Directors <sup>1</sup>  
Member of the LUKOIL BoD Strategy and Investment Committee

Born 1937

Graduated from Iowa State University (1959), Pennsylvania State University (1961), and St. Mary's College in California (1977). Masters in Geology, MBA. President of Chevron Overseas Petroleum and Member of the Board of Directors of Chevron Corporation (1989-1999). Vice-Chairman of Chevron and Chevron-Texaco Corporation (2000-2002). Awarded a non-Government (sectoral) medal 'For Development of the Russian Oil and Gas Industry' in 2006; winner of the national prize 'Director of the Year, 2006' (Russia) in the 'Independent Directors' nomination, organized by the Association of Independent Directors and PricewaterhouseCoopers. Member of the Board of Directors of Eurasia Drilling Company (from 2010)

Elected to the LUKOIL Board of Directors in 2002-2010 and from June 2011.

<sup>1</sup> In accordance with the provisions of the Code of Corporate Conduct, which was recommended for application by the Decree of the Russian Federal Commission for the Securities Market, dated April 4, 2002. The same applies to all other independent BoD members listed in this section



**Sergei Mikhailov**

Member of the LUKOIL Board of Directors  
 CEO of CJSC Consulting Group  
 Member of the LUKOIL BoD Audit Committee  
 Member of the LUKOIL BoD HR and Remuneration Committee

Born 1957

Graduated in 1979 from Dzerzhinsky Military Academy, in 1981 from Moscow Aviation Institute (Further Qualification Faculty), and in 1998 from the Plekhanov Russian Economics Academy. Doctoral Candidate in Technical Sciences, Doctor of Economics, Professor. Awarded four medals. Service in the armed forces (1974-1992). Head of Section, Deputy Chairman of the Russian Federal Property Fund (1992-1996). Head of the Restructuring and Investment Department of the Ministry of Industry (1996-1997). CEO of Management-Center (management company) (1997–2003). CEO of Management-Consulting (from 2001). Chairman of the Board of Directors of Capital Unit Investment Funds (Management Company), Member of the Board of Russian Mediagroup, Spartak-Moscow Football Club, and Petrocommerce Commercial Bank (from 2004). Member of the Board of Directors of IFD Capital (from 2005). Chairman of the Board of Directors of Capital Investment Group (2008–2009). Member of the Board of Directors of Capital Management Company, Chairman of the Board of Directors of Capital Asset Management (from 2008). Chairman of the Board of Directors of Capital Group Asset Management (from 2010). Deputy CEO of Capital Management Company (from 2011).

Elected to the LUKOIL Board of Directors since 2003.



**Mark Mobius**

Independent Member of the Board of Directors of LUKOIL <sup>1</sup>  
 Executive President of Templeton Emerging Markets Group  
 Member of the Strategy and Investment Committee of the Board of Directors

Born 1936

Graduated from the Massachusetts Institute of Technology (USA) in 1964. Doctor of Economic and Political Science. BA and Masters Degree from Boston University (USA). Executive President of Templeton Asset Management Ltd (until August 2010). Executive President of Templeton Emerging Markets Group (since August 2010). Works at Franklin Templeton Investments since 1987.

Elected to the Board of Directors of LUKOIL in 2002–2004 and since June 2010 .

<sup>1</sup> In accordance with the provisions of the Code of Corporate Conduct, which was recommended for application by the Decree of the Russian Federal Commission for the Securities Market, dated April 4, 2002. The same applies to all other independent BoD members listed in this section



### Guglielmo Antonio Claudio Moscato

Independent Member of the Board of Directors of LUKOIL  
Chairman of the Board and CEO of GasMediterraneo & Petrolio  
Member of the LUKOIL BoD Strategy and Investment Committee  
Member of the LUKOIL BoD HR and Remuneration Committee

Born 1936

Graduated in 1961 from Milan Polytechnical University. Previously held positions as BoD Chairman of ENI SpA, BoD Chairman and CEO of AGIP SpA (also BoD Chairman of the Enrico Mattei Foundation (Eni) and Chairman of the Eni Corporate University). Currently holds the position of BoD Chairman and CEO of GasMediterraneo & Petrolio.

Elected to the Board of Directors of LUKOIL since 2011.



### Alexander Shokhin

Independent Member of the LUKOIL Board of Directors <sup>1</sup>  
President of the Russian Union of Industrialists and Entrepreneurs  
President of the National Research University – Higher School of Economics.  
Head of the Faculty for Theory and Practice of Interaction between Business and Government.  
Chairman of the LUKOIL BoD HR and Remuneration Committee

Born 1951

Graduated from the Economics Faculty of Lomonosov Moscow State University in 1974, Doctor of Economics, Professor. Awarded an order for 'Services to Russia' (3<sup>rd</sup> and 4<sup>th</sup> grade) and a medal of the Russian Security Council for 'Services to National Security'. Began working career in 1969. Deputy Chairman of the Government of the Russian Federation, Minister of the Economy, Minister for Labour and Employment (1991–1994). Deputy in three elected State Dumas of the Russian Federation (1994–2002). First Deputy Chairman of the State Duma of the Russian Federation (1996–1997). Chairman of Duma Fraction 'Our Home is Russia' (1997–1998). Deputy Chairman of the Russian Government in 1998. Chairman of the Supervisory Council of Renaissance Capital Investment Group (2002–2006). Member of the Public Chamber of the Russian Federation (2005–2009). President of the Russian Union of Industrialists and Entrepreneurs (from 2005).

Member of the Russian Presidential Commission for Formation and Preparation of the Executive Managers' Reserve, of the Competitiveness and Enterprise Council of the Prime Minister of Russia, and of Government Commissions for Administrative Reform, for Drafting of Legislation, for High-Technology and Innovation, for Transport and Communications, and for Development of Small and Medium-sized Business.

Elected to the LUKOIL Board of Directors since 2005.

<sup>1</sup> In accordance with the provisions of the Code of Corporate Conduct, which was recommended for application by the Decree of the Russian Federal Commission for the Securities Market, dated April 4, 2002. The same applies to all other independent BoD members listed in this section





### Donald Walette Jr

Independent Member of the LUKOIL Board of Directors (until 23.06.2011) <sup>1</sup>  
President of the Asia-Pacific Regional Division of ConocoPhillips  
Member of the LUKOIL BoD Strategy and Investment Committee  
(until 23.06.2011)

Born 1958

Graduated from the University of Southern California with a Degree in Chemical Engineering in 1981. ConocoPhillips Manager for Production Support and Optimization (2002–2005). Vice-President for the Shtokman Project in the Russia/Caspian Region Division of ConocoPhillips (2005–2006). Russia/Caspian Region President of ConocoPhillips (December 2006 to August 2010). President of the Asia-Pacific Regional Division of ConocoPhillips (from September 2010).

Elected to the LUKOIL Board of Directors from 2007 to June 2011.

<sup>1</sup> In accordance with the provisions of the Code of Corporate Conduct, which was recommended for application by the Decree of the Russian Federal Commission for the Securities Market, dated April 4, 2002. The same applies to all other independent BoD members listed in this section

## Committees of the Board of Directors

COMMITTEES OF THE BOARD OF DIRECTORS HAVE BEEN CREATED TO ENSURE EFFICIENT FUNCTIONING OF THE BOARD OF DIRECTORS, AS FOLLOWS: FOR STRATEGY AND INVESTMENTS; FOR AUDIT; AND FOR HR AND REMUNERATION. THE COMMITTEES CARRY OUT PRELIMINARY EXAMINATION OF MATTERS OF IMPORTANCE AND PREPARE RECOMMENDATIONS TO THE BOARD OF DIRECTORS.

### STRATEGY AND INVESTMENT COMMITTEE

The Committee for Strategy and Investments prepares recommendations to the Board of Directors concerning strategy objectives for long-term Company development. The principal function of the Committee is to prepare recommendations on the following issues:

- analysis of strategic development concepts, programs and plans of the Company
- the amount of dividends to be paid on shares and the procedure for dividend payment
- distribution of Company profit and loss for the financial year

Members of the Strategy and Investments Committee are elected from among BoD members and are at least three in number. At least one member of the Committee must be independent, assuming that at least one independent member has been elected to the Board. Committee members are elected at a meeting of the newly elected Board of Directors for the period until election of the next Board of Directors by the General Meeting of Shareholders.

The Committee consists of Igor Ivanov (Chairman), Ravil Maganov, Mark Mobius, Richard Matzke and Guglielmo Moscato.

### AUDIT COMMITTEE

The Audit Committee analyzes the results of audit of the financial accounts of LUKOIL, carried out by external auditors, and prepares recommendations to the BoD for decisions on the following issues:

- selection of the candidate for external auditor of the Company
- assessment of the auditor's opinion
- assessment of the level of objectivity and independence of the Company auditor

Members of the Audit Committee are elected from among non-executive members of the Board of Directors of the Company and are at least three in number. At least one member of the Committee must be independent, assuming that at least one independent member has been elected to the Board. Committee members are elected at a meeting of the newly elected Board of Directors for the period until election of the next Board of Directors by the General Meeting of Shareholders.

The Committee consists of Herman Gref (Chairman), Sergei Mikhailov and Viktor Blazhev.

Members of the HR and Remuneration Committee are elected from among non-executive members of the Board of Directors of the Company and are at least three in number. At least one member of the Committee must be independent, assuming that at least one independent member has been elected to the Board. Committee members are elected at a meeting of the newly elected Board of Directors for the period until election of the next Board of Directors by the General Meeting of Shareholders.

The Committee consists of Alexander Shokhin (Chairman), Guglielmo Moscato and Sergei Mikhailov.

## HR AND REMUNERATION COMMITTEE

The HR and Remuneration Committee has responsibility for the following issues:

- defining criteria for choice of candidates to the Board of Directors, Management Committee and the post of Company President
- preliminary assessment of candidates to the Management Committee and post of Company President
- preparing recommendations to the Board of Directors for decisions on HR issues and issues of remuneration to members of Company management bodies and of the Audit Commission

## Management Committee of LUKOIL



Vagit Alekperov

President of LUKOIL  
Member of the LUKOIL Board of Directors  
Chairman of the LUKOIL Management Committee

Born 1950

Graduated in 1974 from the Azizbekov Institute of Oil and Chemistry in Azerbaijan. Doctor of Economics, current Member of the Russian Academy of Natural Sciences. Awarded four orders, eight medals, a Diploma and Letter of Acknowledgement from the President of the Russian Federation. Winner of two Russian Government Prizes. Worked in the oil industry in Azerbaijan and Western Siberia (from 1968). CEO of Kogalymneftegaz (oil production company), a division of Glavtyumenneftegaz within the Ministry of the Oil and Gas Industry of the USSR (1987–1990). Deputy, then First Deputy to the USSR Oil and Gas Industry Minister (1990–1991). President of Langepasuraykogalymneft (oil production group) (1992–1993). Chairman of the Board of Directors of LUKOIL (1993–2000). President of LUKOIL (from 1993).



Anatoly Barkov

Member of the LUKOIL Management Committee  
Vice-President, Head of the Main Division of General Affairs, Corporate Security and Communications of LUKOIL

Born 1948

Graduated in 1992 from Ufa Oil Institute. Doctoral Candidate in Economic Science. Honored Employee of the Oil and Gas Industry of the Russian Federation. Awarded an order and 10 medals. Head of Operations, Head of Oil and Gas Production, Senior Engineer at Kogalymneftegaz (1987–1992). Executive Director, then Director of the Department of Foreign Projects at Langepasuraykogalymneft (1992–1993). Vice-President, Head of the Main Division of General Affairs, Corporate Security and Communications of LUKOIL (1993 – January 2012). Vice-President for General Affairs, Corporate Security and Communications of LUKOIL (from February 2012).



### Gennady Fedotov

Member of the LUKOIL Management Committee  
Vice-President for Economics and Planning of LUKOIL

Born 1970

Graduated from the Moscow Physics and Technology Institute in 1993. Awarded a medal of the order 'For Services to Russia' (2<sup>nd</sup> grade). Worked at the companies Halliburton and Shell (1994–2002). Head of Section, Deputy Head, Head of the Main Division for Corporate Budget and Economic Planning of LUKOIL (2002–2007). Vice-President, Head of the Main Division for Economics and Planning of LUKOIL (2007 – January 2012). Vice-President for Economics and Planning of LUKOIL (from February 2012).



### Leonid Fedun

Member of the LUKOIL Management Committee  
Vice-President for Strategic Development of LUKOIL

Born 1956

Graduated in 1977 from Rostov Nedelin Higher Military School. Doctoral Candidate in Philosophy. Awarded an order and seven medals. CEO of LUKoil Consulting (1993-1994). Vice-President and Head of the Main Division of Strategic Development and Investment Analysis of LUKOIL (1994 – January 2012). Vice-President for Strategic Development of LUKOIL (from February 2012).



### Evgeny Khavkin

Member of the LUKOIL Management Committee  
Vice-President, Head of the BoD Office of LUKOIL

Born 1964

Graduated in 2003 from Moscow Institute of Economy, Management and Law. Awarded two medals. Worked in oil companies in Western Siberia (from 1988). Deputy Head, then First Deputy Head of the BoD Office of LUKOIL (1997–2003). BoD Secretary, Head of the BoD Office of LUKOIL (2003 – January 2012). Vice-President, Head of the BoD Office of LUKOIL (from February 2012).



### Lyubov Khoba

Member of the LUKOIL Management Committee  
Vice-President, Chief Accountant of LUKOIL

Born 1957

Graduated in 1992 from Sverdlovsk Institute of National Economy. Doctoral Candidate in Economic Science. Honored Economist of the Russian Federation. Awarded two medals and an order. Chief Accountant at Kogalymneftegaz (1991-1993). Chief Accountant at LUKOIL (1993–2000). Vice-President of LUKOIL, Head of Financial Accounting (2000–2003). Chief Accountant and Vice-President of LUKOIL (2003–2004). Chief Accountant of LUKOIL (2004 – January 2012). Vice-President, Chief Accountant of LUKOIL (from February 2012).



### Sergei Kukura

Member of the LUKOIL Management Committee  
First Vice-President of LUKOIL (Economics and Finance)

Born 1953

Graduated in 1979 from the Ivano-Frankovsk Institute of Oil and Gas. Doctor of Economics. Honored Economist of the Russian Federation. Awarded an order and five medals, and Letter of Acknowledgement from the President of the Russian Federation. Winner of a Russian Government Prize for Science and Technology. Vice-President of Langepasuraykogalymneft (1992–1993). First Vice-President of LUKOIL (from 1993).



### Ravil Maganov

Member of the LUKOIL Board of Directors  
Member of the LUKOIL Management Committee  
First Executive Vice-President of LUKOIL (Exploration & Production)  
Member of the LUKOIL BoD Strategy and Investment Committee

Born 1954

Graduated in 1977 from Moscow Gubkin Petrochemical & Gas Institute. Honored Employee of the Oil and Gas Industry of the Russian Federation. Awarded three orders and three medals. Winner of three Russian Government Prizes in science and technology. Chief Engineer, Deputy CEO, CEO of Langepasneftegaz (oil production company) (1988–1993). Vice-President of LUKOIL (1993–1994). First Vice-President of LUKOIL (1994–2006). First Executive Vice-President of LUKOIL (from 2006).



### Sergei Malyukov

Member of the LUKOIL Management Committee  
Vice-president for Internal Control and Audit of LUKOIL

Born 1954

Graduated in 1977 from Dzerzhinsky Military Academy and in 1997 from the Higher School of Economics. Doctoral Candidate in Philosophy. Awarded five medals. Service in the armed forces (1972–1995). Head of Section, Head of Division, Head of Department of the Main Division for Strategic Development and Investment Analysis of LUKOIL (1995–2010). Head of the Main Division for Control, Internal Audit and Risk Management (2010 – January 2012). Vice-President for Internal Control and Audit of LUKOIL (from February 2012).



### Ivan Masliaev

Member of the LUKOIL Management Committee  
Vice-President, General Counsel of LUKOIL

Born 1958

Graduated in 1980 from Lomonosov Moscow State University. Doctoral Candidate in Law. Honored Lawyer of the Russian Federation. Awarded three medals. Head of the Legal Department of Langepasuraykogalym-neft (1992–1993). Head of the Legal Department at LUKOIL (1994–1999). Head of the Main Division for Legal Support at LUKOIL (2000 – January 2012). Vice-President, General Counsel of LUKOIL (from February 2012).





### Alexander Matytsyn

Member of the LUKOIL Management Committee  
Vice-President for Finance of LUKOIL

Born 1961

Graduated in 1984 from Lomonosov Moscow State University. Doctoral Candidate in Economics. Honored Economist of the Russian Federation. MBA from Bristol University (1997). Awarded a medal, 'For services to Russia' (2<sup>nd</sup> grade). Director and CEO of international auditing firm KPMG (1994–1997). Vice-President, Head of the Main Division of Treasury and Corporate Finance of LUKOIL (1997 – January 2012). Vice-President for Finance of LUKOIL (from February 2012).



### Anatoly Moskalenko

Member of the LUKOIL Management Committee  
Vice-President for Human Resource Management and Corporate Structure  
Development of LUKOIL

Born 1959

Graduated in 1980 from Moscow Higher School of the Armed Forces, from the Military-Diplomatic Academy in 1987, and from the Russian Presidential Civil Service Academy in 2005. Doctoral Candidate in Economics. Awarded five orders and 20 medals. Served in the Armed Forces (1976–2001). Head of the Human Resources Department of LUKOIL (2001–2003). Head of the Main Division of Human Resources at LUKOIL (2003 – January 2012). Vice-President for Human Resource Management and Corporate Structure Development of LUKOIL (from February 2012).



### Vladimir Mulyak

Member of the LUKOIL Management Committee  
Vice-President for Technologies and Development of Oil and Gas Fields  
of LUKOIL

Born 1955

Graduated from Moscow Gubkin Petrochemical & Gas Institute in 1977. Doctoral Candidate in Geological and Mineral Sciences. Awarded a medal of the order 'For services to Russia' (2<sup>nd</sup> grade). Winner of a Russian Government Prize for Science and Technology. Chief Engineer, Head of Lasyeganneft oil and gas production unit of LUKoil-Langepasneftegaz (1990–1996). First Deputy CEO for Production, CEO of Belorusneft (1996–2001). First Vice-President for Production of KomiTEK in 2001. Chief Engineer, First Deputy CEO, CEO of LUKOIL-Komi (2002–2007). Vice-President, Head of the Main Division of Oil and Gas Production of LUKOIL (2007 – January 2012). Vice-President for Technologies and Development of Oil and Gas Fields of LUKOIL (from February 2012).



### Vladimir Nekrasov

Member of the LUKOIL Management Committee  
First Vice-President of LUKOIL (Refining & Marketing)

Born 1957

Graduated in 1978 from Tyumen Industrial Institute. Doctoral Candidate in Technical Science, Member of the Academy of Mining Sciences. Awarded two orders and three medals. Winner of a Russian Government Prize. Chief Engineer, CEO of Kogalymneftegaz (part of LUKOIL-Western Siberia) (1992–1999). Vice-President of LUKOIL and CEO of LUKOIL-Western Siberia (1999–2005). First Vice-President of LUKOIL since 2005.



**Valery Subbotin**

Member of the LUKOIL Management Committee  
 Vice-President for Supplies and Sales of LUKOIL

Born 1974

Graduated from Tyumen State University in 1996. Awarded a medal of the order 'For Services to Russia' (2<sup>nd</sup> grade). Worked at LUKOIL-Prague, LUKOIL-Bulgaria, and the Moscow Representative Office of the company LITASCO (1998–2003). First Deputy Head of the Office of the Board of Directors of LUKOIL (2003–2005). Vice-President, Head of the Main Division of Supplies and Sales of LUKOIL (2007 – January 2012). Vice-President for Supplies and Sales of LUKOIL (from February 2012).



**Vadim Vorobyov**

Member of the Management Board of LUKOIL  
 Vice-President for Coordination of Petroleum Products Sales of LUKOIL

Born 1961

Graduated in 1983 from the Lobachevsky Gorky State University, in 1998 from the Lobachevsky Nizhny Novgorod State University in 1998. Doctoral Candidate in Economics. Awarded a medal of the order, 'For services to Russia' (2<sup>nd</sup> grade). Komsomol and Communist Party work (1981–1992). Management positions in insurance and bank structures in Nizhny Novgorod (1992–1998). Vice-President, President of NORSI-OIL (1998–2002). CEO of LUKOIL-Volganefteprodukt (2002–2005). Vice-President of LUKOIL and Head of the Main Department for Coordination of Petroleum Product Sales in Russia (2005–2009). Vice-President of LUKOIL and Head of the Main Department for Coordination of Petroleum Product Sales (2009–2012). Vice-President for Coordination of Petroleum Product Sales of LUKOIL (from 2012).

**SHARES OF BOD AND MANAGEMENT COMMITTEE MEMBERS IN CHARTER CAPITAL,  
AS OF DECEMBER 31, 2011 <sup>1</sup>**

<b>BoD and Management Committee members</b>	<b>Share, %</b>
Vagit Alekperov	20.60 <sup>2</sup>
Anatoly Barkov	0.07
Igor Belikov	–
Viktor Blazheev	–
Gennady Fedotov	0.02
Leonid Fedun	9.27 <sup>2</sup>
Valery Grayfer	0.007
Herman Gref	–
Igor Ivanov	–
Evgeny Khavkin	0.01
Lyubov Khoba	0.34
Sergei Kukura	0.39
Ravil Maganov	0.37
Sergei Malyukov	0.001
Ivan Masliaev	0.02
Richard H. Matzke	–
Sergei Mikhailov	0.06
Mark Mobius	–
Guglielmo Moscato	–
Anatoly Moskalenko	0.01
Vladimir Mulyak	0.01
Vladimir Nekrasov	0.04
Alexander Shokhin	–
Valery Subbotin	0.005
Vadim Vorobyov	0.006

<sup>1</sup> Unless otherwise indicated, share stakes of BoD and Management Committee members are shown in accordance with requirements of Russian law for disclosure of such information, and include shares held directly by Board/Management Committee members as well as shares held by nominee investors in their names.

<sup>2</sup> Including beneficiary ownership.

## REMUNERATION TO MEMBERS OF THE BOARD OF DIRECTORS AND MANAGEMENT BOARD

In compliance with the decision of the LUKOIL Annual General Meeting of Shareholders, each member of the Board of Directors was paid a remuneration of 4.47 million rubles in 2011 for carrying out their duties. There were additional payments for the roles of Board Chairman (1.04 million rubles), Chairman of a BoD Committee (520,000 rubles), as well as some other types of payment associated with duties of Board members and members of BoD Committees. Members of the Board of Directors also received compensation for costs associated with fulfilment of their duties as Board members, the nature of which was defined by the LUKOIL Annual General Meeting of Shareholders on 24 June 2004, in the amount of factually incurred costs, which are confirmed by documents. Mark Mobius, a BoD member, filed for rejection of the remuneration that was offered to him by the decision of the LUKOIL Annual General Meeting. The rejection was taken into account when payments were made to the BoD members.

In the reporting year members of the Management Committee were paid remuneration equal to their monthly salary in their principle job. This payment was made in accordance with the main terms of contracts, drawn up with members of the Management Committee, subject to achievement of key corporate targets in the reporting period. Members of the Management Committee also received an annual base salary, annual bonus payments based on results of their work during the year, additional compensations of a social nature, and annual long-term premium payments in the framework of the long-term incentive program for employees of LUKOIL and its subsidiaries. Size of long-term premium payments was calculated by multiplying the number of shares conditionally owned by a Company official by the dividend per share, which was approved by the Annual General Meeting of Shareholders.

## REMUNERATION IN 2011 TO MEMBERS OF THE BOD AND MANAGEMENT COMMITTEE OF LUKOIL

	Paid in 2011, thousand rubles				Total
	Salary	Bonuses	Remuneration	Other payments	
Board of Directors	–	–	50,316	4,074	54,390
Management Committee	485,740	475,088	32,916	22,697	1,016,441

## Changes in Group Structure

The Program for restructuring of LUKOIL has been in progress since 2002. Its main purpose is to increase shareholder value by raising the level of transparency and efficiency of management processes, consolidating core subsidiaries and withdrawing non-core and inefficient assets from the Group.

The Company continued work in 2011 to dispose of non-core, unused and inefficient assets. A total of 950 assets were disposed of for a total gain of almost \$290 million. The biggest transactions were sale of 100% of the Company's interests in Global-Flot LLC, LANKOR LLC, and of equity investments in Kiinteistoosakeyhtio Oy Bulevardi 26. Part of the proceeds from these sales was used for financing of the Company's core activities. More than 4,000 non-core, unused and inefficient property assets are to be withdrawn from the Group during 2012–2013.

Acquisition by LUKOIL of a 25.1% equity holding in Bashneft-Polyus LLC and an agreement between

LUKOIL-Komi and Bashneft-Polyus LLC for sale and purchase of 20 wells at the Trebs and Titov fields were both completed in 2011 as part of agreements made between LUKOIL and Bashneft Oil Company for involvement of LUKOIL in development of the Trebs and Titov fields.

LUKOIL acquired 11% in a joint venture for management of the ISAB oil refining complex in Italy, from the company ERG. The transaction increases LUKOIL's stake in the JV from 49% to 60%. Thus ERG partially exercised its sell option in accordance with the agreement on JV creation in 2008.

The number of companies within LUKOIL Group and of companies, in which LUKOIL companies have an interest, decreased by 25 units to 337 (subsidiary and associate companies, as defined by US GAAP criteria). 16 companies were added to the Group in the reporting period, and 41 were disposed of.

## Financial Management

THE COMPANY USES A GLOBAL APPROACH TO FINANCIAL MANAGEMENT, REFLECTING THE SCALE AND GEOGRAPHICAL DIVERSITY OF ITS BUSINESS. THE SYSTEM FOR CENTRALIZED MANAGEMENT OF TREASURY OPERATIONS, WHICH WAS CREATED BY THE COMPANY IN 2006, ENSURES EFFICIENT DISTRIBUTION OF CAPITAL AMONG GROUP ORGANIZATIONS.

Work continued in 2011 for improvement of the cash management system inside LUKOIL Group. A project was successfully implemented for automat-

ed cash debiting/crediting in intra-corporate financing inside Russia, and all major companies within LUKOIL Group (over 50 in total) were included in the project. Changeover to a fully automated system has increased the efficiency of liquidity management by reducing withdrawal of sums from cash turnover, and lessened the financial burden on Group companies.

Intra-Group settlements were optimized by design and implementation of a single agreement for offsetting of loan debt with respect to all Group

companies in Russia, enabling an automated system of cash transfer between the parent company, as the pool leader, and the Group's Russian companies. A system for novation of intra-Group settlement obligations with respect to commission and loan agreements has also been designed and is ready to be implemented, enabling substantial reduction in the amounts withdrawn from Group cash turnover through changes to the operating systems of main servicing banks.

The Company continued work in 2011 for optimization of its credit portfolio, reducing debt financing costs and extending the term of current debt instruments on the best market terms.

LUKOIL increased the volume of its committed credit lines from \$900 million to \$1.3 billion in 2011 in order to maintain investment rating of the Company's liquidity ratio at the requisite level. Work was also carried out to extend the terms of current agreements.

The Company installed a system of financial risk monitoring as part of its project to build a system that prevents cash flow interruptions; adequacy and availability of relevant information was tested and a mathematical business model for LUKOIL Group was designed as well as an interactive Group report taking account of risk factors.

## Internal Control and Audit

The system of internal control and internal audit is an integral part of the Company's corporate governance structure, ensuring that the Company operates efficiently and that the interests of its shareholders and investors are protected. The Group has an Internal Audit Service, which ensures that management receives objective and accurate information on the business of organizations in LUKOIL Group.

**A total of 20 control and internal audit checks were carried out at LUKOIL Group organizations in all business segments during 2011.** The main purposes of the checks were:

- monitoring of business efficiency, including investment efficiency, of LUKOIL Group organizations
- checking that business of Group organizations is in accordance with LUKOIL's strategic goals
- and monitoring compliance with Company management decisions, including decisions taken as a result of previous checks
- identifying significant risks related to business of Group organizations and designing recommendations on ways to minimize risks
- assessing measures by management of subsidiaries and structural subdivisions of the Company to ensure stable and efficient functioning of various components of the internal control system
- assessing whether organization and conduct of book-keeping and financial accounting help to make operating and financial control more efficient, contribute to further growth of shareholder value and protect shareholder interests

- ensuring that LUKOIL Group assets are properly kept and efficiently used

The results of audit and control checks were submitted to the Company President, and were brought to the notice of heads of the audited subsidiaries and of the Audit Committee of the Board of Directors of LUKOIL, in accordance with the established procedure.

Audit recommendations and management decisions were designed based on outcome of the checks in order to raise efficiency of Company business and minimize any risks, which had been identified. Based on these recommendations, subsidiaries and Group sub-divisions, which supervise the activity of subsidiaries, have designed measures to eliminate failures and violations that were identified by the internal audit process.

In order to ensure efficiency of its internal audit process, LUKOIL constantly monitors execution of decisions taken by the Company's governing bodies as a result of audits and execution of approved measures

that have been designed on the basis of internal audit recommendations. Monitoring showed that 94.8% of such instructions were executed to schedule in 2011 (the level in 2010 was 90.6%).

The Group works constantly to organize and coordinate audit activity at LUKOIL companies. During 2011 checks of financial and business activity in 2010 were carried out at 69 Group companies and checks of activity during nine months of 2011 were carried out at 63 Group companies.

The Company continued its work in 2011 to improve its risk management system. A new document, the LUKOIL risk management policy, was prepared in the reporting year, setting out a conceptual basis for risk management by the Group. A risk committee was also created, answering directly to the President of LUKOIL, and a provisional method for identification, description, and assessment of risks at LUKOIL organizations was compiled. The method was tested and approved at a number of Group organizations during the accounting year.



## Information Disclosure

Since receiving a full secondary listing on the London Stock Exchange in 2002 the Company has set up and successfully operates a system of corporate information disclosure for the investment community. LUKOIL's level of informational openness and quality of information disclosure fully comply with internationally accepted standards and with standards of the UK Financial Services Authority.

**LUKOIL won prizes in several annual report competitions in 2011, as in previous years. Such prizes are a testimony to the Company's efforts to enhance the scale and efficiency of information disclosure about Company business to investors, shareholders and the general public.**

The Company's policy of informational openness includes:

- quarterly publication of financial statements, prepared in accordance with US GAAP
- conference calls and webcasts for the investment community to accompany publication of financial results and announcement of other important corporate events
- annual publication of international audit of Company hydrocarbon reserves
- annual publication of an Analyst Databook and Fact Book containing detailed industrial and financial statistics
- publication every two years of a Company Sustainability Report on the Company's activities in the Russian Federation
- regular meetings with investors and shareholders
- trips for representatives of the investment community to Company operating regions

**In accordance with the Disclosure and Transparency Rules of the UK Financial Services Authority (FSA), as a foreign company with a standard listing in the United Kingdom, LUKOIL started from 2011 to prepare a Corporate Governance Report for the previous year.**

The Company continued to prioritize outside meetings with shareholders for purposes of imparting information. Such meetings were held in 2011 in Ufa and Saint Petersburg. Matters discussed at the meetings included: rights and duties of shareholders, dividend policy of LUKOIL and procedure for dividend payment, ownership rights to shares that are inherited, details of how inherited dividends can be received, changes of shareholders details in the register of owners of securities, and obtaining information from the shareholder register.

Meetings with shareholders were carried out as part of the Program for improvement of shareholder rights mechanisms in the period 2010–2014, which was approved by the Board of Directors of LUKOIL on May 18, 2010. This Program calls for regular meetings with Company shareholders living in various regions of the Russian Federation and wider use of information technologies, and electronic means of communication with shareholders in order to ensure that they are better informed of their rights and the means of exercising those rights.

## Company Securities

The LUKOIL share price saw major fluctuations in 2011, reflecting the situation on the Russian and international stock markets. Maximum price per share in the reporting year was 2,090 rubles and the minimum price level was 1,500 rubles. However, LUKOIL shares remained among the most liquid securities on the Russian stock market in 2011 and were included in calculation of all main share indexes. As in previous years, trading in Company shares in Russia was concentrated on the Moscow Interbank Currency Exchange (MICEX) and the RTS Stock Exchange.

Rapid growth of the LUKOIL share price in the first half of the year was due mainly to growth of prices for hydrocarbons, caused by supply limitations associated with political instability in the Middle East and North Africa. Prices began to decline in the second quarter of the year, due to intensification of the debt crisis in peripheral countries of the

European Union, which exerted pressure on markets worldwide. High levels of volatility continued until November 2011, due to uncertainty about further actions by governments in developed countries to tackle the problems of mounting debt. Market concern over the state of the US, European and Japanese economies had negative impact on all of the world's leading share indexes. By October markets were at their lowest levels since the beginning of 2011, after which the situation stabilized towards the end of the year.

The LUKOIL share price on the MICEX exchange fell by 2.4% in the course of 2011 and stood at 1,701 rubles (\$53.1) per share at the end of December. However, that performance should be compared with a 16.9% fall by the MICEX Index. So prices for LUKOIL shares were much stronger than the overall Russian stock market. LUKOIL's capitalization as of 31 December, 2011 was \$44.9 billion.

### LUKOIL SHARE PRICE ON THE MICEX EXCHANGE IN 2011



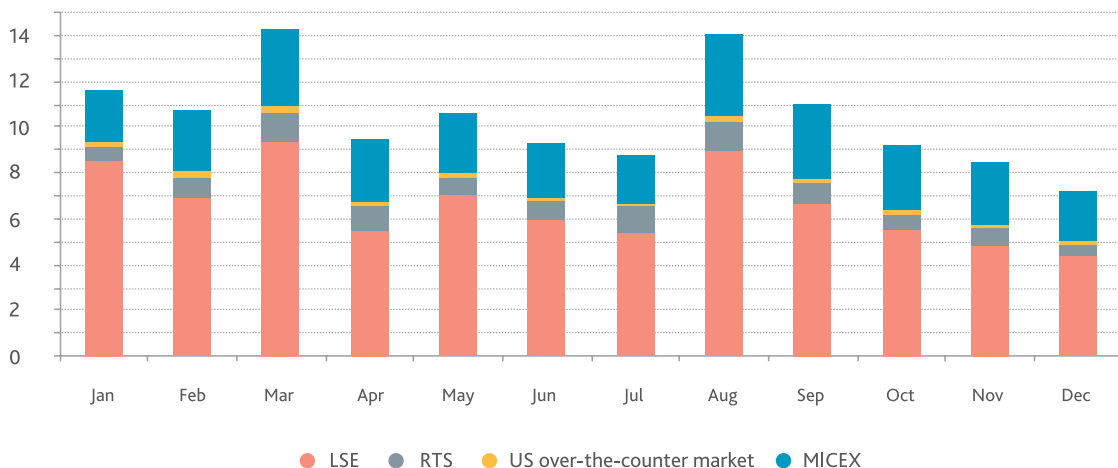
The volume of trading in LUKOIL shares and depository receipts increased in 2011 compared with 2010. According to the exchanges total traded volume of LUKOIL shares at MICEX and RTS increased by 22.7% to 746 million shares, or by 25.3% to \$43.5 billion. The Company's depository receipts were traded on the US over-the-counter market, and on exchanges in London, Frankfurt, Munich and Stuttgart. The total number of receipts (ADRs) issued on the Company's common shares at the end of 2011 was 548.33 million (64.47% of Company share capital). The volume of trading in the Company's ADRs on the London Stock Exchange (the main institution where they are traded) increased by 58.7% in the reporting year to a level of \$79.6 billion. LUKOIL ADRs had the second largest traded volume among international companies on London Stock Exchange IOB system (15.1% of total volumes traded in the system).

LUKOIL shares are still used as the base instrument for derivative securities on forward markets. Future and option contracts for delivery of LUKOIL shares are one of the main instruments in the futures section of the RTS market.

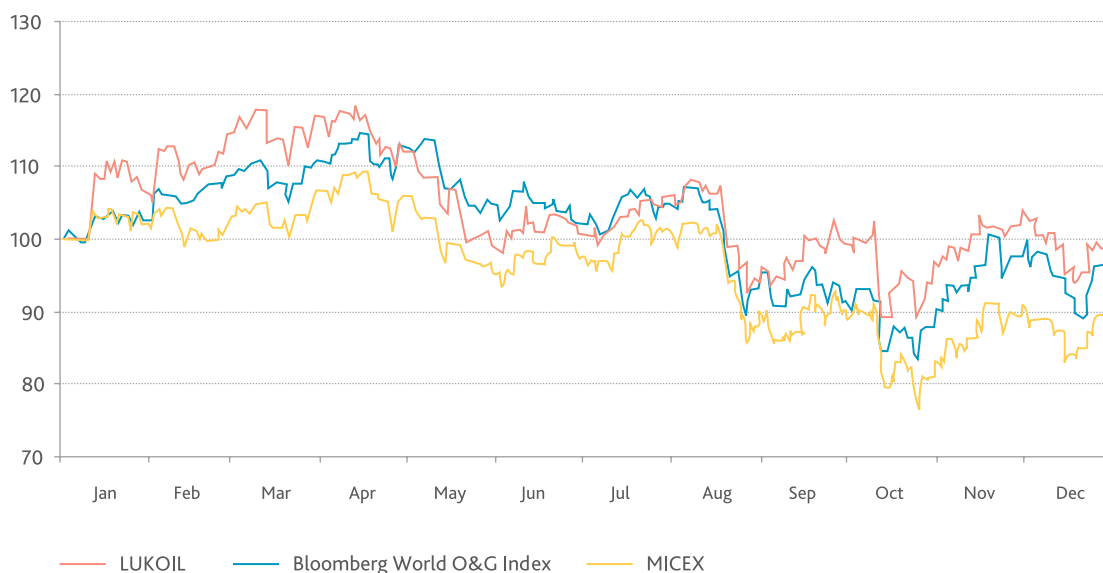
In contrast with 2010, LUKOIL Group did not carry out issues and placements of bonds in 2011, and the Group was therefore able to significantly reduce its debt burden in the course of the year.

LUKOIL did its utmost in the reporting year to maintain shareholder value. Record levels of net income and free cash flow were achieved, despite lower operating results, ensuring that the Company remained attractive to investors in the context of instability of the world financial system.

**MONTHLY VOLUME OF TRADING IN SHARES (ADR) OF LUKOIL IN 2011, \$ million**



### LUKOIL SHARE PRICE COMPARED WITH BLOOMBERG OILS INDEX AND MICEX INDEX IN 2011, %



### CHANGES IN OWNERSHIP STRUCTURE OF LUKOIL SHARE CAPITAL IN 2011

#### Main LUKOIL shareholders (> 1% of ordinary shares)<sup>1</sup>

	Number of shares on January 1, 2011	% of total shares on January 1, 2011	Number of shares on January 1, 2012	% of total shares on January 1, 2012
ING Bank (Eurasia) ZAO	645,159,254	75.85	645,877,294	75.94
Depository-Clearing Company	69,483,048	8.17	72,002,391	8.47
National Depository Center	52,526,643	6.18	46,976,333	5.52
SDK Garant	33,411,404	3.93	33,427,724	3.93
DK URALSIB	12,065,926	1.42	12,049,529	1.42
J.P. Morgan Bank International LLC	7,778,301	0.91	10,983,473	1.29

<sup>1</sup> Nominee.

## Dividends

LUKOIL bases its dividend policy on a balance of interests between the Company and its shareholders, aiming to increase the Company's investment attractiveness and shareholder value, and to respect and strictly observe the rights of shareholders, as set out in acting legislation of the Russian Federation, the Company Charter and internal documents.

**DIVIDENDS ACCRUED IN 2011 ON RESULTS FOR 2010 WERE \$1,646 MILLION OR 18.3% OF CONSOLIDATED NET INCOME OF LUKOIL GROUP FOR 2010 UNDER US GAAP.**

Dividend payments for 2011 will be increased in comparison with payments for 2010. On 27 April 2012 the Board of Directors recommended the Annual General Meeting of Shareholders to approve dividends for 2011 at a level of 75 rubles per share (\$2.33 at the exchange rate on 31 December 2011). So the share of dividends in consolidated net income of LUKOIL will be 19.1% and dividend yield will be 4.2%. Basic earnings per share in 2011 were \$13.30 in comparison with \$10.95 in 2010.

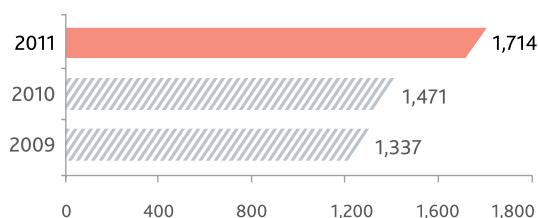
### DIVIDENDS PER COMMON SHARE (RUBLES) AND DIVIDEND YIELD, %

	Dividend, rubles	Dividend yield, % <sup>2</sup>
2007	42	2.02
2008	50	2.86
2009	52	3.48
2010	59	3.52
2011 <sup>1</sup>	75	4.17

<sup>1</sup> Dividends recommended by the LUKOIL Board of Directors for approval at the Annual General Meeting of Shareholders.

<sup>2</sup> Dividend yield is calculated based on the average market price for LUKOIL ordinary shares on the MICEX exchange and the dollar exchange rate at the end of the year, for which the dividends are paid.

### Dividends paid on ordinary shares of the Company, \$ million



# OAO LUKOIL CONSOLIDATED FINANCIAL STATEMENTS

As of December 31, 2011 and 2010  
and for each of the years in the three-year  
period ended December 31, 2011

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prepared in accordance  
with US GAAP



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## Independent Auditors' Report

The Board of Directors  
OAO LUKOIL:

We have audited the accompanying consolidated balance sheets of OAO LUKOIL and subsidiaries as of December 31, 2011 and 2010, and the related consolidated statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three year period ended December 31, 2011. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of OAO LUKOIL and subsidiaries as of December 31, 2011 and 2010, and the results of their operations and their cash flows for each of the years in the three year period ended December 31, 2011, in conformity with U.S. generally accepted accounting principles.

U.S. generally accepted accounting principles require that the Supplementary Information on Oil and Gas Exploration and Production Activities on pages 180 through 188 be presented to supplement the basic consolidated financial statements. Such information, although not a part of the basic consolidated financial statements, is required by the Financial Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic consolidated financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic consolidated financial statements, and other knowledge we obtained during our audit of the basic consolidated financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

ZAO KPMG

ZAO KPMG  
Moscow, Russian Federation  
February 24, 2012

ZAO KPMG, a company incorporated under the Laws of the Russian Federation, a subsidiary of KPMG Europe LLP, and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity.

OAO LUKOIL Consolidated Balance Sheets As of December 31, 2011 and 2010  
(Millions of US dollars, unless otherwise noted)

	Note	2011	2010
<b>Assets</b>			
<b>Current assets</b>			
Cash and cash equivalents	3	2,753	2,368
Short-term investments		157	168
Accounts receivable, net	5	8,921	8,219
Inventories	6	7,533	6,231
Prepaid taxes and other expenses		3,219	2,934
Other current assets		946	697
<b>Total current assets</b>		<b>23,529</b>	<b>20,617</b>
Investments	7	5,952	5,637
Property, plant and equipment	8, 9	56,803	54,629
Deferred income tax assets	13	591	676
Goodwill and other intangible assets	10	1,344	1,446
Other non-current assets		2,973	1,012
<b>Total assets</b>		<b>91,192</b>	<b>84,017</b>
<b>Liabilities and Equity</b>			
<b>Current liabilities</b>			
Accounts payable		5,995	5,607
Short-term borrowings and current portion of long-term debt	11	1,792	2,125
Taxes payable		2,271	2,099
Other current liabilities		1,050	944
<b>Total current liabilities</b>		<b>11,108</b>	<b>10,775</b>
Long-term debt	12, 16	7,300	9,069
Deferred income tax liabilities	13	2,790	2,417
Asset retirement obligations	8	2,120	1,788
Other long-term liabilities		408	360
<b>Total liabilities</b>		<b>23,726</b>	<b>24,409</b>
<b>Equity</b>			
<b>OAO LUKOIL stockholders' equity</b>			
Common stock	15	15	15
Treasury stock, at cost		(4,081)	(3,683)
Equity-linked notes		(980)	(980)
Additional paid-in capital		4,798	4,700
Retained earnings		67,940	59,212
Accumulated other comprehensive loss		(54)	(67)
<b>Total OAO LUKOIL stockholders' equity</b>		<b>67,638</b>	<b>59,197</b>
Non-controlling interests		(172)	411
<b>Total equity</b>		<b>67,466</b>	<b>59,608</b>
<b>Total liabilities and equity</b>		<b>91,192</b>	<b>84,017</b>

President of OAO LUKOIL

Alekperov V.Y.

Vice-president –  
Chief accountant of OAO LUKOIL

Khoba L.N.

The accompanying notes are an integral part of these consolidated financial statements.



OAO LUKOIL Consolidated Statements of Income For the years ended December 31, 2011, 2010 and 2009  
(Millions of US dollars, unless otherwise noted)

	Note	2011	2010	2009
<b>Revenues</b>				
Sales (including excise and export tariffs)	21	133,650	104,956	81,083
<b>Costs and other deductions</b>				
Operating expenses		(9,055)	(8,298)	(7,340)
Cost of purchased crude oil, gas and products		(59,694)	(43,250)	(31,761)
Transportation expenses		(6,121)	(5,608)	(4,830)
Selling, general and administrative expenses		(3,822)	(3,558)	(3,306)
Depreciation, depletion and amortization		(4,473)	(4,154)	(3,937)
Taxes other than income taxes	13	(12,918)	(8,978)	(6,474)
Excise and export tariffs		(22,217)	(18,878)	(13,058)
Exploration expenses		(532)	(336)	(218)
Loss on disposals and impairments of assets		(1,663)	(363)	(381)
<b>Income from operating activities</b>		<b>13,155</b>	<b>11,533</b>	<b>9,778</b>
Interest expense		(694)	(712)	(667)
Interest and dividend income		211	174	134
Equity share in income of affiliates	7	690	472	351
Currency translation loss		(301)	(122)	(520)
Other non-operating income (expense)		58	125	(13)
<b>Income before income taxes</b>		<b>13,119</b>	<b>11,470</b>	<b>9,063</b>
Current income taxes		(2,678)	(2,104)	(1,922)
Deferred income taxes		(615)	(247)	(72)
<b>Total income tax expense</b>	13	<b>(3,293)</b>	<b>(2,351)</b>	<b>(1,994)</b>
<b>Net income</b>		<b>9,826</b>	<b>9,119</b>	<b>7,069</b>
Net loss (net income) attributable to non-controlling interests		531	(113)	(58)
<b>Net income attributable to OAO LUKOIL</b>		<b>10,357</b>	<b>9,006</b>	<b>7,011</b>
Earnings per share of common stock attributable to OAO LUKOIL (US dollars):				
Basic	15	13.30	10.95	8.28
Diluted	15	13.04	10.94	8.28

The accompanying notes are an integral part of these consolidated financial statements.

OAO LUKOIL Consolidated Statements of Stockholders' Equity and Comprehensive Income  
For the years ended December 31, 2011, 2010 and 2009  
(Millions of US dollars, unless otherwise noted)

	2011		2010		2009	
	Stockholders' equity	Comprehensive income	Stockholders' equity	Comprehensive income	Stockholders' equity	Comprehensive income
<b>Common stock</b>						
Balance as of January 1	15		15		15	
<b>Balance as of December 31</b>	<b>15</b>		<b>15</b>		<b>15</b>	
<b>Treasury stock</b>						
Balance as of January 1	(3,683)		(282)		(282)	
Stock purchased	(398)		(3,664)		–	
Stock disposed	–		263		–	
<b>Balance as of December 31</b>	<b>(4,081)</b>		<b>(3,683)</b>		<b>(282)</b>	
<b>Equity-linked notes</b>						
Balance as of January 1	(980)		–		–	
Equity-linked notes purchased	–		(980)		–	
<b>Balance as of December 31</b>	<b>(980)</b>		<b>(980)</b>		–	
<b>Additional paid-in capital</b>						
Balance as of January 1	4,700		4,699		4,694	
Premium on non-outstanding shares issued	–		1		–	
Effect of stock compensation plan	98		98		20	
Convertible bonds issue	–		113		–	
Changes in non-controlling interests	–		(141)		(15)	
Treasury stock disposed	–		(70)		–	
<b>Balance as of December 31</b>	<b>4,798</b>		<b>4,700</b>		<b>4,699</b>	
<b>Retained earnings</b>						
Balance as of January 1	59,212		51,634		45,983	
Net income	10,357	10,357	9,006	9,006	7,011	7,011
Dividends on common stock	(1,629)		(1,428)		(1,360)	
<b>Balance as of December 31</b>	<b>67,940</b>		<b>59,212</b>		<b>51,634</b>	
<b>Accumulated other comprehensive loss, net of tax</b>						
Balance as of January 1	(67)		(75)		(70)	
Pension benefits:						
Prior service cost	22	22	12	12	(4)	(4)
Actuarial (loss) gain	(9)	(9)	(4)	(4)	1	1
Unrecognized loss on available-for-sale securities	–	–	–	–	(2)	(2)
<b>Balance as of December 31</b>	<b>(54)</b>		<b>(67)</b>		<b>(75)</b>	
Total comprehensive income		10,370		9,014		7,006
<b>Total OAO LUKOIL stockholders' equity as of December 31</b>	<b>67,638</b>		<b>59,197</b>		<b>55,991</b>	
<b>Non-controlling interests</b>						
Balance as of January 1	411		388		670	
(Net loss) net income attributable to non-controlling interests	(531)		113		58	
Changes in non-controlling interests	(52)		(90)		(340)	
<b>Balance as of December 31</b>	<b>(172)</b>		<b>411</b>		<b>388</b>	
<b>Total equity as of December 31</b>	<b>67,466</b>		<b>59,608</b>		<b>56,379</b>	

The accompanying notes are an integral part of these consolidated financial statements.

OAO LUKOIL Consolidated Statements of Stockholders' Equity and Comprehensive Income  
 For the years ended December 31, 2011, 2010 and 2009  
 (Millions of US dollars, unless otherwise noted)

	Share activity		
	2011	2010	2009
	(thousands of shares)	(thousands of shares)	(thousands of shares)
<b>Common stock, issued</b>			
Balance as of January 1	850,563	850,563	850,563
<b>Balance as of December 31</b>	<b>850,563</b>	<b>850,563</b>	<b>850,563</b>
<b>Treasury stock</b>			
Balance as of January 1	(69,208)	(3,836)	(3,836)
Purchase of treasury stock	(6,893)	(68,912)	–
Disposal of treasury stock	–	3,540	–
<b>Balance as of December 31</b>	<b>(76,101)</b>	<b>(69,208)</b>	<b>(3,836)</b>

The accompanying notes are an integral part of these consolidated financial statements.

OAO LUKOIL Consolidated Statements of Cash Flows For the years ended December 31, 2011, 2010 and 2009  
(Millions of US dollars)

	Note	2011	2010	2009
<b>Cash flows from operating activities</b>				
<b>Net income attributable to OAO LUKOIL</b>		<b>10,357</b>	<b>9,006</b>	<b>7,011</b>
Adjustments for non-cash items:				
Depreciation, depletion and amortization		4,473	4,154	3,937
Equity share in income of affiliates, net of dividends received		185	316	(213)
Dry hole write-offs		417	225	117
Loss on disposals and impairments of assets		1,663	363	381
Deferred income taxes		615	247	72
Non-cash currency translation gain		(214)	(44)	(57)
Non-cash investing activities		(6)	(67)	(20)
All other items – net		(447)	167	138
Changes in operating assets and liabilities:				
Trade accounts receivable		(758)	(2,285)	(1,171)
Inventories		(1,420)	(813)	(1,719)
Accounts payable		885	1,508	96
Taxes payable		177	274	292
Other current assets and liabilities		(413)	490	19
<b>Net cash provided by operating activities</b>		<b>15,514</b>	<b>13,541</b>	<b>8,883</b>
<b>Cash flows from investing activities</b>				
Acquisition of licenses		(25)	(15)	(40)
Capital expenditures		(8,249)	(6,596)	(6,483)
Proceeds from sale of property, plant and equipment		156	128	91
Purchases of investments		(101)	(137)	(216)
Proceeds from sale of investments		79	126	478
Sale of subsidiaries and equity method affiliates, net of cash disposed		227	130	92
Acquisitions of subsidiaries and equity method affiliates (including advances related to acquisitions), net of cash acquired		(2,860)	(932)	(2,473)
<b>Net cash used in investing activities</b>		<b>(10,773)</b>	<b>(7,296)</b>	<b>(8,551)</b>
<b>Cash flows from financing activities</b>				
Net movements of short-term borrowings		(633)	(213)	(1,281)
Proceeds from issuance of long-term debt		1	2,515	5,467
Principal repayments of long-term debt		(1,372)	(2,267)	(2,697)
Dividends paid on Company common stock		(1,714)	(1,471)	(1,337)
Dividends paid to non-controlling interest stockholders		(116)	(85)	(85)
Financing received from non-controlling interest stockholders		3	18	20
Purchase of Company's stock		(398)	(3,664)	–
Sale of Company's stock		–	193	–
Purchase of equity-linked notes		–	(980)	–
Purchases of non-controlling interest (including advances related to acquisitions)		(34)	(192)	(372)
<b>Net cash used in financing activities</b>		<b>(4,263)</b>	<b>(6,146)</b>	<b>(285)</b>
Effect of exchange rate changes on cash and cash equivalents		(93)	(5)	(12)
<b>Net increase in cash and cash equivalents</b>		<b>385</b>	<b>94</b>	<b>35</b>
Cash and cash equivalents at beginning of year		2,368	2,274	2,239
<b>Cash and cash equivalents at end of year</b>	3	<b>2,753</b>	<b>2,368</b>	<b>2,274</b>
Supplemental disclosures of cash flow information				
Interest paid		683	718	520
Income taxes paid		2,508	2,126	1,575

The accompanying notes are an integral part of these consolidated financial statements.

**NOTE 1.**  
**ORGANIZATION AND ENVIRONMENT**

The primary activities of OAO LUKOIL (the “Company”) and its subsidiaries (together, the “Group”) are oil exploration, production, refining, marketing and distribution. The Company is the ultimate parent entity of this vertically integrated group of companies.

The Group was established in accordance with Presidential Decree 1403, issued on November 17, 1992. Under this decree, on April 5, 1993, the Government of the Russian Federation transferred to the Company 51% of the voting shares of fifteen enterprises. Under Government Resolution 861 issued on September 1, 1995, a further nine enterprises were transferred to the Group during 1995. Since 1995, the Group has carried out a share exchange program to increase its shareholding in each of the twenty-four founding subsidiaries to 100%.

From formation, the Group has expanded substantially through consolidation of its interests, acquisition of new companies and establishment of new businesses.

**Business and economic environment**

The accompanying financial statements reflect management’s assessment of the impact of the business environment in the countries in which the Group operates on the operations and the financial position of the Group. The future business environments may differ from management’s assessment.

**Basis of preparation**

These consolidated financial statements have been prepared by the Company in accordance with accounting principles generally accepted in the United States of America (“US GAAP”).

**NOTE 2.**  
**SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Principles of consolidation**

These consolidated financial statements include the financial position and results of the Company, controlled subsidiaries of which the Company directly or indirectly owns more than 50% of the voting interest, unless minority stockholders have substantive participating rights, and variable interest entities where the Group is determined to

be the primary beneficiary. Other significant investments in companies of which the Company directly or indirectly owns between 20% and 50% of the voting interest and over which it exercises significant influence but not control, are accounted for using the equity method of accounting. Investments in companies of which the Company directly or indirectly owns more than 50% of the voting interest but where minority stockholders have substantive participating rights are accounted for using the equity method of accounting. Undivided interests in oil and gas joint ventures are accounted for using the proportionate consolidation method. Investments in other companies are recorded at cost. Equity investments and investments in other companies are included in “Investments” in the consolidated balance sheet.

**Use of estimates**

The preparation of financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Significant items subject to such estimates and assumptions include the carrying value of oil and gas properties and other property, plant and equipment, goodwill impairment assessment, asset retirement obligations, deferred income taxes, valuation of financial instruments, and obligations related to employee benefits. Eventual actual amounts could differ from those estimates.

**Revenue**

Revenues are recognized when title passes to customers at which point the risks and rewards of ownership are assumed by the customer and the price is fixed or determinable. Revenues include excise on petroleum products sales and duties on export sales of crude oil and petroleum products.

Revenues from non-cash sales are recognized at the fair market value of the crude oil and petroleum products sold.

**Foreign currency translation**

The Company maintains its accounting records in Russian rubles. The Company’s functional currency is the US dollar and the Group’s reporting currency is the US dollar.

For the majority of operations in the Russian Federation and outside the Russian Federation, the US dollar is the functional currency. Where the US dollar is the functional currency, monetary assets and liabilities have been translated into US dollars at the rate prevailing at each balance sheet date.

Non-monetary assets and liabilities have been translated into US dollars at historical rates. Revenues, expenses and cash flows have been translated into US dollars at rates which approximate actual rates at the date of the transaction. Translation differences resulting from the use of these rates are included in the consolidated statement of income.

For certain other operations, where the US dollar is not the functional currency and the economy is not highly inflationary, assets and liabilities are translated into US dollars at year-end exchange rates and revenues and expenses are translated at average exchange rates for the year. Resulting translation adjustments are reflected as a separate component of comprehensive income.

In all cases, foreign currency transaction gains and losses are included in the consolidated statement of income.

As of December 31, 2011, 2010 and 2009, exchange rates of 32.20, 30.48 and 30.24 Russian rubles to the US dollar, respectively, have been used for translation purposes.

#### **Cash and cash equivalents**

Cash and cash equivalents include all highly liquid investments with an original maturity of three months or less.

#### **Cash with restrictions on immediate use**

Cash funds for which restrictions on immediate use exist are accounted for within other non-current assets.

#### **Accounts receivable**

Accounts receivable are recorded at their transaction amounts less provisions for doubtful debts. Provisions for doubtful debts are recorded to the extent that there is a likelihood that any of the amounts due will not be collected. Non-current receivables are discounted to the present value of expected cash flows in future periods using the original discount rate.

#### **Inventories**

The cost of finished goods and purchased products is determined using the first-in, first-out cost method (FIFO). The cost of all other inventory categories is determined using an "average cost" method.

#### **Investments**

Debt and equity securities are classified into one of three categories: trading, available-for-sale, or held-to-maturity.

Trading securities are bought and held principally for the purpose of selling in the near term. Held-to-maturity securities are those securities in which a Group company has the ability and intent to hold until maturity. All securities not included in trading or held-to-maturity are classified as available-for-sale.

Trading and available-for-sale securities are recorded at fair value. Held-to-maturity securities are recorded at cost, adjusted for the amortization or accretion of premiums or discounts. Unrealized holding gains and losses on trading securities are included in the consolidated statement of income. Unrealized holding gains and losses, net of the related tax effect, on available-for-sale securities are reported as a separate component of comprehensive income until realized. Realized gains and losses from the sale of available-for-sale securities are determined on a specific identification basis. Dividends and interest income are recognized in the consolidated statement of income when earned.

A permanent decline in the market value of any available-for-sale or held-to-maturity security below cost is accounted for as a reduction in the carrying amount to fair value. The impairment is charged to the consolidated statement of income and a new cost base for the security is established. Premiums and discounts are amortized or accreted over the life of the related held-to-maturity or available-for-sale security as an adjustment to yield using the effective interest method and such amortization and accretion is recorded in the consolidated statement of income.

#### **Property, plant and equipment**

Oil and gas properties are accounted for using the successful efforts method of accounting whereby property acquisitions, successful exploratory wells, all development costs (including development dry holes and the Group's share of operators' expenses during the development stage of production sharing and risk service contracts), and support equipment and facilities are capitalized. Unsuccessful exploratory wells are expensed when a well is determined to be non-productive. Other exploratory expenditures, including geological and geophysical costs are expensed as incurred.

The Group continues to capitalize costs of exploratory wells and exploratory-type stratigraphic wells for more than one year after the completion of drilling if the well has found a sufficient quantity of reserves to justify its completion as a producing well and the Company is making sufficient progress towards assessing the reserves and the economic and operating viability of the project. If these conditions are not met or if information that raises substantial doubt about the economic or operational viability of the

project is obtained, the well would be assumed impaired, and its costs, net of any salvage value, would be charged to expense.

Depreciation, depletion and amortization of capitalized costs of oil and gas properties is calculated using the unit-of-production method based upon proved reserves for the cost of property acquisitions and proved developed reserves for exploration and development costs.

Production and related overhead costs are expensed as incurred.

Depreciation of assets not directly associated with oil production is calculated on a straight-line basis over the economic lives of such assets, estimated to be in the following ranges:

Buildings and constructions	5–40 Years
Machinery and equipment	5–20 Years

In addition to production assets, certain Group companies also maintain and construct social assets for the use of local communities. Such assets are capitalized only to the extent that they are expected to result in future economic benefits to the Group. If capitalized, they are depreciated over their estimated economic lives.

Significant unproved properties are assessed for impairment individually on a regular basis and any estimated impairment is charged to expense.

#### Asset retirement obligations

The Group records the fair value of liabilities related to its legal obligations to abandon, dismantle or otherwise retire tangible long-lived assets in the period in which the liability is incurred. A corresponding increase in the carrying amount of the related long-lived asset is also recorded. Subsequently, the liability is accreted for the passage of time and the related asset is depreciated using the unit-of-production method.

#### Goodwill and other intangible assets

Goodwill represents the excess of the cost of an acquired entity over the net of the fair value amounts assigned to assets acquired and liabilities assumed. It is assigned to reporting units as of the acquisition date. Goodwill is not amortized, but is tested for impairment at least on an annual basis and between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. The impairment test requires estimating the fair value of a reporting unit and comparing it with its carrying

amount, including goodwill assigned to the reporting unit. If the estimated fair value of the reporting unit is less than its net carrying amount, including goodwill, then the goodwill is written down to its implied fair value.

Intangible assets with indefinite useful lives are tested for impairment at least annually. Intangible assets that have limited useful lives are amortized on a straight-line basis over the shorter of their useful or legal lives.

#### Impairment of long-lived assets

Long-lived assets, such as oil and gas properties (other than unproved properties), other property, plant, and equipment, and purchased intangibles subject to amortization, are assessed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset group may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset group to the estimated undiscounted future cash flows expected to be generated by that group. If the carrying amount of an asset group exceeds its estimated undiscounted future cash flows, an impairment charge is recognized by writing down the carrying amount to the estimated fair value of the asset group, generally determined as discounted future net cash flows. Assets to be disposed of are separately presented in the balance sheet and reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated. The assets and liabilities of a disposed group classified as held for sale are presented separately in the appropriate asset and liability sections of the balance sheet.

#### Income taxes

Deferred income tax assets and liabilities are recognized in respect of future tax consequences attributable to temporary differences between the carrying amounts of existing assets and liabilities for the purposes of the consolidated financial statements and their respective tax bases and in respect of operating loss and tax credit carryforwards. Deferred income tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to reverse and the assets to be recovered and liabilities settled. The effect on deferred income tax assets and liabilities of a change in tax rates is recognized in the consolidated statement of income in the reporting period which includes the enactment date.

The ultimate realization of deferred income tax assets is dependent upon the generation of future taxable income in the reporting periods in which the originating expenditure becomes deductible. In assessing the realizability

of deferred income tax assets, management considers whether it is more likely than not that the deferred income tax assets will be realized. In making this assessment, management considers the scheduled reversal of deferred income tax liabilities, projected future taxable income, and tax planning strategies.

An income tax position is recognized only if the uncertain position is more likely than not of being sustained upon examination, based on its technical merits. A recognized income tax position is measured at the largest amount that is greater than 50% likely of being realized. Changes in recognition or measurement are reflected in the period in which the change in judgment occurs. The Company records interest and penalties relating to income tax in income tax expense in the consolidated statements of income.

#### **Interest-bearing borrowings**

Interest-bearing borrowings from third parties (except convertible notes) are initially recorded at the value of net proceeds received. Any difference between the net proceeds and the redemption value is amortized at a constant rate over the term of the borrowing. Amortization is included in the consolidated statement of income and the carrying amounts are adjusted as amortization accumulates.

For borrowings from related parties (except convertible notes) issued with an interest rate lower than the market interest rate, the Group determines book value using market interest rate. The resulting difference is allocated to additional paid-in capital and is amortized at a constant rate over the term of the borrowings. Amortization is included in the consolidated statement of income each year and the carrying amounts are adjusted as amortization accumulates.

For convertible notes issued with a cash conversion option, the Group allocates the proceeds from issuance between a liability component and an equity component. The Group records the equity component at an amount equal to the difference between the proceeds received and the fair value of the liability component, measured as the fair value of a similar liability that does not have an associated equity component. The Group recognizes the interest cost in subsequent periods at its borrowing rate for non-convertible debt.

If borrowings are repurchased or settled before maturity, any difference between the amount paid and the carrying amount is recognized in the consolidated statement of income in the period in which the repurchase or settlement occurs.

#### **Pension benefits**

The expected costs in respect of pension obligations of Group companies are determined by an independent actuary. Obligations in respect of each employee are accrued over the reporting periods during which the employee renders service in the Group.

The Group recognizes the funded status of the postretirement defined benefit plan in the consolidated balance sheet with corresponding adjustments to accumulated other comprehensive income. The adjustment to accumulated other comprehensive income represents the net unrecognized actuarial gains and unrecognized prior service costs. These amounts are subsequently recognized as net periodic benefit cost. Further, actuarial gains and losses that arise in subsequent periods and are not recognized as net periodic benefit cost in the same periods are recognized as a component of other comprehensive income. These amounts are subsequently recognized as a component of net periodic benefit cost on the same basis as the amounts recognized in accumulated other comprehensive income.

#### **Treasury stock**

Purchases by Group companies of the Company's outstanding stock are recorded at cost and classified as treasury stock within Stockholders' equity. Shares shown as Authorized and Issued include treasury stock. Shares shown as Outstanding do not include treasury stock.

#### **Earnings per share**

Basic earnings per share is computed by dividing net income available to common stockholders of the Company by the weighted-average number of shares of common stock outstanding during the reporting period. A calculation is carried out to establish if there is potential dilution in earnings per share if convertible securities were to be converted into shares of common stock or contracts to issue shares of common stock were to be exercised. If there is such dilution, diluted earnings per share is presented.

#### **Contingencies**

Certain conditions may exist as of the balance sheet date, which may result in losses to the Group but the impact of which will only be resolved when one or more future events occur or fail to occur.

If a Group company's assessment of a contingency indicates that it is probable that a material loss has been incurred and the amount of the liability can be estimated, then the estimated liability is accrued and charged to the con-



solidated statement of income. If the assessment indicates that a potentially material loss is not probable, but is reasonably possible, or is probable, but cannot be estimated, then the nature of the contingent liability, together with an estimate of the range of possible loss, is disclosed in the notes to the consolidated financial statements. Loss contingencies considered remote or related to unasserted claims are generally not disclosed unless they involve guarantees, in which case the nature of the guarantee is disclosed.

#### **Environmental expenditures**

Estimated losses from environmental remediation obligations are generally recognized no later than completion of remedial feasibility studies. Group companies accrue for losses associated with environmental remediation obligations when such losses are probable and reasonably estimable. Such accruals are adjusted as further information becomes available or circumstances change. Costs of expected future expenditures for environmental remediation obligations are not discounted to their present value.

#### **Use of derivative instruments**

The Group's derivative activity is limited to certain petroleum products marketing and trading operations and hedging of commodity price risks. Currently this activity involves the use of futures and swaps contracts together with purchase and sale contracts that qualify as derivative instruments. The Group accounts for these activities under the mark-to-market methodology in which the derivatives are revalued each accounting period. Resulting realized and unrealized gains or losses are presented in the consolidated statement of income on a net basis. Unrealized gains and losses are carried as assets or liabilities on the consolidated balance sheet.

#### **Share-based payments**

The Group accounts for liability classified share-based payment awards to employees at fair value on the date of grant and as of each reporting date. Expenses are recognized over the vesting period. Equity classified share-based payment awards to employees are valued at fair value on the date of grant and expensed over the vesting period.

#### **Comparative amounts**

Certain prior period amounts have been reclassified to conform with the current period's presentation.

#### **Changes in accounting policy**

In April 2011, the FASB issued Accounting Standards Update ("ASU") No. 2011-02, *"A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring,"* which amends Topic 310 of the Codification. This ASU provides additional guidance in considering whether a restructuring constitutes a troubled debt restructuring and helps creditors in determining whether a creditor has granted a concession and whether a debtor is experiencing financial difficulties. ASU No. 2011-02 is effective starting from the first interim or annual period beginning on or after June 15, 2011. The Group adopted the requirements of ASU No. 2011-02 starting from the third quarter of 2011. This adoption did not have a material impact on the Group's results of operations, financial position or cash flows and did not require additional disclosures.

In January 2010, the FASB issued ASU No. 2010-06, *"Improving Disclosures about Fair Value Measurements,"* which requires reporting entities to make new disclosures about recurring or nonrecurring fair-value measurements including significant transfers into and out of Level 1 and Level 2 fair-value measurements and to present separately information about purchases, sales, issuances, and settlements on a gross basis in the reconciliation of Level 3 fair-value measurements. This ASU also clarifies existing fair-value measurement disclosure guidance about the level of disaggregation, inputs, and valuation techniques. The Group fully adopted the requirements of ASU No. 2010-06 starting from the first quarter of 2011. This adoption did not have a material impact on the Group's results of operations, financial position or cash flows.

#### **Recent accounting pronouncements**

In December 2011, the FASB issued ASU No. 2011-12, *"Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05."* This ASU defers changes that relate to the presentation to reclassification adjustments out of accumulated other comprehensive income in ASU No. 2011-05, *"Presentation of Comprehensive Income,"* until the FASB is able to reconsider those paragraphs. Entities should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU No. 2011-05. ASU No. 2011-12 is effective at the same time as the ASU No. 2011-05: for public entities for fiscal years, and interim periods within those years, beginning after December 15, 2011 and should be ap-

plied retrospectively. The Group will apply the provisions of ASU No. 2011-12 starting from the first quarter of 2012 and does not expect any material impact on its results of operations, financial position or cash flows.

In December 2011, the FASB issued ASU No. 2011-11, *"Disclosures about Offsetting Assets and Liabilities."* This ASU requires entities to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. The scope includes derivatives, sale and repurchase agreements and reverse sale and repurchase agreements, and securities borrowing and securities lending arrangements. ASU No. 2011-11 is effective for annual reporting periods on or after January 1, 2013, and interim periods within those annual periods, and should be applied retrospectively. The Group is evaluating the effect of the adoption of ASU No. 2011-11 and does not expect any material impact on its results of operations, financial position or cash flows.

In September 2011, the FASB issued ASU No. 2011-08, *"Testing Goodwill for Impairment,"* which allows an entity to use a qualitative approach to test goodwill for impairment. This ASU permits an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount and hence whether it is necessary to perform the two-step goodwill impairment test as required by the provisions of Topic 350 of the Codification. ASU No. 2011-08 is effective for annual and interim goodwill impairment tests performed for the fiscal years beginning after December 15, 2011. The Group will apply the provisions of ASU No. 2011-08 starting from the first quarter of 2012 and does not expect

any material impact on its results of operations, financial position or cash flows.

In June 2011, the FASB issued ASU No. 2011-05, *"Presentation of comprehensive income,"* which amends Topic 220 of the Codification. This ASU increases the prominence of other comprehensive income in financial statements. Under this ASU, an entity will have the option to present the components of net income and comprehensive income in either one or two statements. The ASU eliminates the option in US GAAP to present other comprehensive income in the statement of changes in equity. ASU No. 2011-05 is effective for public entities for fiscal years, and interim periods within those years, beginning after December 15, 2011 and should be applied retrospectively. The Group will apply the provisions of ASU No. 2011-05 starting from the first quarter of 2012.

In May 2011, the FASB issued ASU No. 2011-04, *"Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in US GAAP and IFRSs,"* which amends Topic 820 of the Codification. This ASU provides guidance for fair value measurements and disclosure requirements and clarifies the Board's intent about the application of existing fair value measurement requirements. The new standard does not extend the use of fair value but, rather, provides guidance about how fair value should be applied where it already is required or permitted under US GAAP. ASU No. 2011-04 is effective for public entities during interim and annual periods beginning after December 15, 2011 and should be applied prospectively. The Group will apply the provisions of ASU No. 2011-04 starting from the first quarter of 2012 and does not expect any material impact on its results of operations, financial position or cash flows.

**NOTE 3.**  
**CASH AND CASH EQUIVALENTS**

	As of December 31, 2011	As of December 31, 2010
Cash held in Russian rubles	1,152	367
Cash held in US dollars	1,224	1,259
Cash held in other currencies	271	418
Cash held in related party banks in Russian rubles	83	320
Cash held in related party banks in other currencies	23	4
<b>Total cash and cash equivalents</b>	<b>2,753</b>	<b>2,368</b>

**NOTE 4.**  
**NON-CASH TRANSACTIONS**

The consolidated statement of cash flows excludes the effect of non-cash transactions, which are described in the following table:

	Year ended December 31, 2011	Year ended December 31, 2010	Year ended December 31, 2009
Non-cash investing activity	6	67	20
Non-cash acquisitions	–	–	100
<b>Total non-cash transactions</b>	<b>6</b>	<b>67</b>	<b>120</b>

The following table shows the effect of non-cash transactions on investing activity:

	Year ended December 31, 2011	Year ended December 31, 2010	Year ended December 31, 2009
Net cash used in investing activity	10,773	7,296	8,551
Non-cash acquisitions	–	–	100
Non-cash investing activity	6	67	20
<b>Total investing activity</b>	<b>10,779</b>	<b>7,363</b>	<b>8,671</b>

**NOTE 5.**  
**ACCOUNTS RECEIVABLE, NET**

	As of December 31, 2011	As of December 31, 2010
Trade accounts receivable (net of provisions of \$179 million and \$182 million as of December 31, 2011 and 2010, respectively)	7,209	6,748
Current VAT and excise recoverable	1,333	1,149
Other current accounts receivable (net of provisions of \$54 million and \$50 million as of December 31, 2011 and 2010, respectively)	379	322
<b>Total accounts receivable, net</b>	<b>8,921</b>	<b>8,219</b>

**NOTE 6.**  
**INVENTORIES**

	As of December 31, 2011	As of December 31, 2010
Crude oil and petroleum products	6,265	5,093
Materials for extraction and drilling	321	356
Materials and supplies for refining	57	37
Other goods, materials and supplies	890	745
<b>Total inventories</b>	<b>7,533</b>	<b>6,231</b>

**NOTE 7.**  
**INVESTMENTS**

	As of December 31, 2011	As of December 31, 2010
Investments in equity method affiliates and joint ventures	4,887	4,529
Long-term loans to equity method affiliates and joint ventures	1,001	990
Other long-term investments	64	118
<b>Total long-term investments</b>	<b>5,952</b>	<b>5,637</b>

**Investments in "equity method" affiliates and joint ventures**

The summarized financial information below is in respect of equity method affiliates and corporate joint ventures.

The companies are primarily engaged in crude oil exploration, production, marketing and distribution operations in the Russian Federation, crude oil production and marketing in Kazakhstan, and refining operations in Europe.

	Year ended December 31, 2011		Year ended December 31, 2010		Year ended December 31, 2009	
	Total	Group's share	Total	Group's share	Total	Group's share
Revenues	32,770	4,777	24,348	3,672	5,139	2,275
Income before income taxes	13,832	1,005	9,187	675	1,305	478
Less income taxes	(4,241)	(315)	(2,682)	(203)	(407)	(127)
<b>Net income</b>	<b>9,591</b>	<b>690</b>	<b>6,505</b>	<b>472</b>	<b>898</b>	<b>351</b>

	As of December 31, 2011		As of December 31, 2010	
	Total	Group's Share	Total	Group's Share
Current assets	7,379	1,406	7,462	1,359
Property, plant and equipment	19,064	5,587	18,053	5,099
Other non-current assets	1,454	462	989	350
<b>Total assets</b>	<b>27,897</b>	<b>7,455</b>	<b>26,504</b>	<b>6,808</b>
Short-term debt	1,100	223	701	57
Other current liabilities	3,703	668	2,844	551
Long-term debt	7,461	1,069	7,809	1,079
Other non-current liabilities	1,581	608	1,805	592
<b>Net assets</b>	<b>14,052</b>	<b>4,887</b>	<b>13,345</b>	<b>4,529</b>

In April 2011, the Company and OAO ANK Bashneft signed an agreement to establish a joint venture and to develop two oil fields named after R.Trebs and A.Titov, located in the Nenets Autonomous District of Russia. According to the agreement, the mineral rights for the development of the fields were re-issued by OAO ANK Bashneft in favor of its 100% subsidiary OOO Bashneft-Polus. In December 2011, the Company acquired 25.1% of OOO Bashneft-Polus for approximately \$153 million, and OOO Bashneft-Polus acquired 29 exploration wells located on these fields from a Group company for \$60 million. The parties agreed to transport oil extracted from the fields via the Group's transportation infrastructure and to consider the exploitation of certain other nearby infrastructure owned by the Group.

In April 2011, the Group acquired an additional 11% interest in the joint venture which operates the ISAB refining complex (Priolo, Italy) for approximately €241 million (\$342 mil-

lion). The acquisition was based on an option, which was partially executed in accordance with the initial agreement on the establishment of the joint venture signed in 2008. This agreement gave the second investor – ERG S.p.A. ("ERG") a step-by-step put option to sell its remaining share in the joint venture to the Group. As a result the Group's interest in the joint venture was increased from 49% to 60%. Based on the agreement, ERG and the Company still have equal participation rights. Therefore the Group continues to use the equity method of accounting for this joint venture. In January 2012, the Group received a notice that the Board of Directors of ERG decided to exercise its option to sell to the Group a further 20% interest in the joint venture. The transaction is expected to be finalized in the second quarter of 2012 in the amount of €400 million (\$526 million), excluding inventory. Thus, the Group's stake in the joint venture will be increased from 60% to 80% and the Group will then obtain control.

**NOTE 8.**  
**PROPERTY, PLANT AND EQUIPMENT AND ASSET RETIREMENT OBLIGATIONS**

	At cost		Net	
	As of December 31, 2011	As of December 31, 2010	As of December 31, 2011	As of December 31, 2010
Exploration and Production:				
Russia	54,269	51,797	34,415	32,973
International	8,138	7,114	6,376	5,624
Total	62,407	58,911	40,791	38,597
Refining, Marketing, Distribution and Chemicals:				
Russia	12,133	11,062	7,395	7,208
International	6,903	6,883	4,282	4,511
Total	19,036	17,945	11,677	11,719
Power generation and other:				
Russia	4,890	4,589	4,026	3,970
International	406	440	309	343
Total	5,296	5,029	4,335	4,313
<b>Total property, plant and equipment</b>	<b>86,739</b>	<b>81,885</b>	<b>56,803</b>	<b>54,629</b>

The Company performs a regular annual impairment test of its assets. The test is based on geological models and development programs, which are revised on a regular basis at least annually. The fair value of tested assets is determined using the present value of the expected cash flows. Fair value measurements models used in the impairment tests were Level 3 (unobservable inputs) fair value measurements.

In 2005, the Company and ConocoPhillips formed a joint venture on the basis of OOO Narianmarneftegaz ("NMNG"), a Group subsidiary. The purpose of the joint venture is to develop oil reserves in the Timan-Pechora region of the Russian Federation (refer to Note 17. Consolidation of Variable Interest Entity). In 2008, NMNG started crude oil production on the Yuzhnoye Khylichuyu oil field, the major field of the joint venture. As of December 31, 2008, proved oil reserves on this oil field were estimated to be approximately 505 million barrels. During 2010, oil production start-

ed to fall below expected levels due to a number of unanticipated geological reasons. As of December 31, 2011, proved oil reserves were estimated to be approximately 142 million barrels. During the year ended December 31, 2011, the Company recognized an impairment loss on NMNG's exploration and production assets in the total amount of \$1,175 million.

Additionally during the year ended December 31, 2011, the Company recognized an impairment loss of \$175 million for assets related to international refining, marketing and distribution segment.

During the year ended December 31, 2010, the Company recognized an impairment loss of \$164 million for its exploration and production assets in the Western Siberia, Timan-Pechora and Central European regions of Russia and \$29 million for international marketing and distribution assets.

The following tables set out values of property, plant and equipment measured at fair value on a nonrecurring basis in periods subsequent to their initial recognition:

	Fair value	Level 3 fair value measurements	Before-tax loss
<b>Year ended December 31, 2011</b>			
Property, plant and equipment	1,195	1,195	1,350
<b>Year ended December 31, 2010</b>			
Property, plant and equipment	120	120	193

As of December 31, 2011 and 2010, the asset retirement obligations amounted to \$2,126 million and \$1,798 million, respectively, of which \$6 million and \$10 million was included in "Other current liabilities" in the consolidated balance sheets as of each balance sheet date.

During 2011 and 2010, asset retirement obligations changed as follows:

	2011	2010
Asset retirement obligations as of January 1	1,798	1,199
Accretion expense	158	124
New obligations	172	190
Changes in estimates of existing obligations	173	314
Spending on existing obligations	(5)	(6)
Property dispositions	(5)	(4)
Foreign currency translation and other adjustments	(165)	(19)
<b>Asset retirement obligations as of December 31</b>	<b>2,126</b>	<b>1,798</b>

The asset retirement obligations incurred during 2011 and 2010 were Level 3 (unobservable inputs) fair value measurements.

#### NOTE 9. SUSPENDED WELLS

Net changes in capitalized exploratory suspended wells during 2011, 2010 and 2009 were as follows:

	2011	2010	2009
Balance as of January 1	405	406	337
Additions pending the determination of proved reserves	97	156	124
Charged to expenses	-	(94)	(36)
Reclassification to proved properties	(33)	(63)	(19)
<b>Balance as of December 31</b>	<b>469</b>	<b>405</b>	<b>406</b>

Aging of capitalized suspended exploratory well costs were as follows:

	As of December 31, 2011	As of December 31, 2010	As of December 31, 2009
<b>Exploratory well costs capitalized</b>			
for a period of one year or less	78	148	124
for two years	144	72	122
for three years	72	89	86
for four years	82	82	58
for five years or more	93	14	16
for a period of greater than one year	391	257	282
<b>Total exploratory well costs capitalized</b>	<b>469</b>	<b>405</b>	<b>406</b>
Number of projects that have exploratory well costs capitalized for a period greater than one year	14	11	15

Aging of the exploratory wells that have been capitalized for more than one year since completion of drilling as of December 31, 2011:

Project name (field name)	Location	As of December 31, 2011	Years wells drilled
Block A	Saudi Arabia	255	2007-2010
Cape Three Points Deep Water	Ghana	92	2010
Aral	Uzbekistan	5	2010
Vinnikovskoe	European Russia	7	2008-2010
Centralno-Astrakhanskoe	European Russia	6	2008-2009
Gabishevskoe	European Russia	5	2008-2009
8 projects of less than \$4 million each	European Russia	21	2004-2010
<b>Total of 14 projects</b>		<b>391</b>	

Capitalized exploratory well costs of \$255 million are related to two fields in the Block A area in Saudi Arabia, represented by four wells drilled in 2007-2010. The wells were suspended pending final assessment of the operational and economic viability of the project. During 2011, to assess the required technology for the development and extraction of the tight gas reservoirs, the Group engaged an international engineering survey company to evaluate recompletion options for the wells, to prove the commercialization potential of the appraisal area and to optimize the stimulation technology for its development. These evaluations were completed in December 2011. As a result of these evaluations, the Group will submit an implementation plan for consider-

ation and approval by the Saudi Arabian Government. A decision is expected during 2012.

Capitalized exploratory well costs of \$92 million related to block "Cape Three Points Deep Water" in Ghana are represented by one exploratory well. During 2011, an appraisal well was drilled, but it was found unsuccessful and was written off. Currently the Group plans to continue evaluating the development plan for this project and the second appraisal well will be drilled in 2012.

The Company is evaluating the development plans for other projects.



**NOTE 10.**  
**GOODWILL AND OTHER INTANGIBLE ASSETS**

The carrying value of goodwill and other intangible assets as of December 31, 2011 and 2010 was as follows:

	As of December 31, 2011	As of December 31, 2010
Amortized intangible assets		
Software	389	391
Licenses and other assets	343	409
Goodwill	612	646
<b>Total goodwill and other intangible assets</b>	<b>1,344</b>	<b>1,446</b>

During the year ended December 31, 2011, the Company recognized an impairment of goodwill related to the refining, marketing and distribution segment.

**NOTE 11.**  
**SHORT-TERM BORROWINGS AND CURRENT PORTION OF LONG-TERM DEBT**

	As of December 31, 2011	As of December 31, 2010
Short-term borrowings from third parties	118	728
Short-term borrowings from related parties	30	66
Current portion of long-term debt	1,644	1,331
<b>Total short-term borrowings and current portion of long-term debt</b>	<b>1,792</b>	<b>2,125</b>

Short-term borrowings from third parties are unsecured and include amounts repayable in US dollars of \$56 million and \$609 million, amounts repayable in Euros of \$17 million and \$29 million, amounts repayable in other currencies of \$45

million and \$90 million as of December 31, 2011 and 2010, respectively. The weighted-average interest rate on short-term borrowings from third parties was 4.93% and 1.87% per annum as of December 31, 2011 and 2010, respectively.

**NOTE 12.**  
**LONG-TERM DEBT**

	As of December 31, 2011	As of December 31, 2010
Long-term loans and borrowings from third parties (including loans from banks in the amount of \$1,120 million and \$2,071 million as of December 31, 2011 and 2010, respectively)	2,652	3,764
6.375% non-convertible US dollar bonds, maturing 2014	897	896
2.625% convertible US dollar bonds, maturing 2015	1,412	1,388
6.356% non-convertible US dollar bonds, maturing 2017	500	500
7.250% non-convertible US dollar bonds, maturing 2019	596	595
6.125% non-convertible US dollar bonds, maturing 2020	998	998
6.656% non-convertible US dollar bonds, maturing 2022	500	500
7.10% Russian ruble bonds, maturing 2011	–	262
13.35% Russian ruble bonds, maturing 2012	776	820
9.20% Russian ruble bonds, maturing 2012	311	328
7.40% Russian ruble bonds, maturing 2013	186	197
Capital lease obligations	116	152
<b>Total long-term debt</b>	<b>8,944</b>	<b>10,400</b>
Current portion of long-term debt	(1,644)	(1,331)
<b>Total non-current portion of long-term debt</b>	<b>7,300</b>	<b>9,069</b>

**Long-term loans and borrowings**

Long-term loans and borrowings from third parties include amounts repayable in US dollars of \$834 million and \$1,707 million, amounts repayable in Euros of \$284 million and \$369 million, amounts repayable in Russian rubles of \$1,514 million and \$1,667 million, and amounts repayable in other currencies of \$20 million and \$21 million as of December 31, 2011 and 2010, respectively. This debt has maturity dates from 2012 through 2038. The weighted-average interest rate on long-term loans and borrowings from third parties was 5.39% and 4.50% per annum as of December 31, 2011 and 2010, respectively. A number of long-term loan agreements contain certain financial covenants which are being met by the Group. Approximately 10% of total long-term loans and borrowings from third parties are secured by export sales and property, plant and equipment.

A Group company has an unsecured syndicated loan agreement with an outstanding amount of \$315 million as of December 31, 2011, with maturity dates up to 2013. The loan was arranged by ABN AMRO Bank, Banco Bilbao Vizcaya Argentaria, BNP Paribas, The Bank of Tokyo-Mitsubishi UFJ, ING Bank, Mizuho Corporate Bank and WestLB. Borrowings under this agreement bear interest from three month LIBOR plus 0.85% to three month LIBOR plus 0.95% per annum.

The Company has an unsecured syndicated loan agreement with the European Bank for Reconstruction and Development with an outstanding amount of \$173 million as of December 31, 2011, maturing up to 2017. Borrowings under this agreement bear interest from six month LIBOR plus 0.45% to six month LIBOR plus 0.65% per annum.

A Group company has a secured loan agreement, arranged by Credit Suisse, supported by an Overseas Private Investment Corporation guarantee, with an outstanding amount of \$136 million as of December 31, 2011. Borrowings under this agreement bear interest at six month LIBOR plus 4.8% per annum and have maturity dates up to 2015.

A Group company has an unsecured loan agreement with Citibank with an outstanding amount of \$102 million as of December 31, 2011, maturing up to 2019. Borrowings under this agreement bear interest at euribor plus 0.125% per annum.

Group companies have a number of loan agreements denominated in Russian rubles with ConocoPhillips, the Group's former related party, with an outstanding amount of \$1,508 million as of December 31, 2011. This amount includes \$1,335 million loaned by ConocoPhillips to NMNG (refer to Note 17. Consolidation of Variable Interest Entity).

Borrowings under these agreements bear interest at fixed rates ranging from 6.8% to 8.0% per annum and have maturity dates up to 2038. Financing under these agreements is used to develop oil production and distribution infrastructure in the Timan-Pechora region of the Russian Federation.

As of December 31, 2011, the Group has a number of other loan agreements with fixed rates with a number of banks and other organizations totaling \$78 million, maturing from 2012 to 2017. The weighted average interest rate under these loans was 4.17% per annum.

As of December 31, 2011, the Group has a number of other floating rate loan agreements with a number of banks and other organizations totaling \$340 million, maturing from 2012 to 2018. The weighted average interest rate under these loans was 1.78% per annum.

#### **US dollar convertible bonds**

In December 2010, a Group company issued unsecured convertible bonds totaling \$1.5 billion with a coupon yield of 2.625% and maturity in June 2015. The bonds were placed at face value. The bonds are convertible into LUKOIL ADRs (each representing one ordinary share of the Company) and have a conversion price of \$73.3912 per ADR. Bondholders have the right to convert the bonds into LUKOIL ADRs during the period starting from 40 days after the issue date and ending 6 dealing days before the maturity date. The issuer has the right to redeem the bonds after December 31, 2013.

#### **US dollar non-convertible bonds**

In November 2010, a Group company issued two tranches of non-convertible bonds totaling \$1.0 billion with a coupon yield of 6.125% and maturity in 2020. The first tranche totaling \$800 million was placed at a price of 99.081% of the bond's face value with a resulting yield to maturity of 6.250%. The second tranche totaling \$200 million was placed at a price of 102.44% of the bond's face value with a resulting yield to maturity of 5.80%. These tranches have a half year coupon period.

In November 2009, a Group company issued two tranches of non-convertible bonds totaling \$1.5 billion. The first tranche totaling \$900 million with a coupon yield of 6.375% per annum was placed with a maturity of 5 years at a price of 99.474% of the bond's face value with a resulting yield to maturity of 6.500%. The second tranche totaling \$600 million with a coupon yield of 7.250% per annum was placed with a maturity of 10 years at a price of 99.127% of the bond's face value with a resulting yield to maturity of 7.375%. These tranches have a half year coupon period.

In June 2007, a Group company issued non-convertible bonds totaling \$1 billion. \$500 million were placed with a maturity of 10 years and a coupon yield of 6.356% per annum. Another \$500 million were placed with a maturity of 15 years and a coupon yield of 6.656% per annum. All bonds were placed at their face value and have a half year coupon period.

#### **Russian ruble bonds**

In December 2009, the Company issued 10 million stock exchange bonds with a face value of 1,000 Russian rubles each. The bonds were placed at face value with a maturity of 1,092 days. The bonds have a 182 days' coupon period and bear interest at 9.20% per annum.

In August 2009, the Company issued 25 million stock exchange bonds with a face value of 1,000 Russian rubles each. The bonds were placed at face value with a maturity of 1,092 days. The bonds have a 182 days' coupon period and bear interest at 13.35% per annum.

In December 2006, the Company issued 14 million non-convertible bonds with a face value of 1,000 Russian rubles each. Eight million bonds were placed with a maturity of 5 years and a coupon yield of 7.10% per annum and six million bonds were placed with a maturity of 7 years and a coupon yield of 7.40% per annum. All bonds were placed at their face value and have a half year coupon period. In December 2011, the Company redeemed all issued bonds with a maturity of five years in accordance with the conditions of bond issue.

#### **Maturities of long-term debt**

Annual maturities of total long-term debt during the next five years, including the portion classified as current, are \$1,644 million in 2012, \$512 million in 2013, \$1,092 million in 2014, \$1,551 million in 2015, \$95 million in 2016 and \$4,050 million thereafter.

#### **NOTE 13. TAXES**

The Group is taxable in a number of jurisdictions within and outside of the Russian Federation and, as a result, is subject to a variety of taxes as established under the statutory provisions of each jurisdiction.

The total cost of taxation to the Group is reported in the consolidated statement of income as "Total income tax expense" for income taxes, as "Excise and export tariffs" for excise taxes, export tariffs and petroleum products sales taxes and

as "Taxes other than income taxes" for other types of taxation. In each category taxation is made up of taxes levied at various rates in different jurisdictions.

Starting on January 1, 2009, operations in the Russian Federation are subject to a Federal income tax rate of 2.0% and a regional income tax rate that varies from 13.5% to 18.0% at the discretion of the individual regional administration. The Group's foreign operations are subject to taxes at the tax rates applicable to the jurisdictions in which they operate.

As of January 1, 2011 and 2010, and during 2011, 2010 and 2009, the Group did not have any unrecognized tax benefits and thus, no interest and penalties related to unrecognized tax benefits were accrued. The Group's policy is to record interest and penalties related to unrecognized tax benefits as components of income tax expense. In addition, the Group does not expect that the amount of unrecognized tax benefits will change significantly within the next 12 months.

The Company and its Russian subsidiaries file standalone income tax returns in Russia. With a few exceptions, income tax returns in Russia are open to examination by the Russian tax authorities for tax years beginning in 2009.

Until January 1, 2012, there were no provisions in the tax legislation of the Russian Federation to permit the Group to reduce taxable profits of a Group company by offsetting tax losses of another Group company against such profits. Tax losses may be fully or partially used to offset taxable profits in the same company in any of the ten years following the year of loss.

Starting from January 1, 2012, if certain conditions are met, taxpayers will be able to pay income tax as a consolidated taxpayers' group ("CTG"). This allows taxpayers to offset taxable losses generated by certain participants of a CTG against taxable profits of other participants of the CTG. During 2012, certain Group companies are going to meet the legislative requirements and pay income tax as a CTG.

Losses generated by a taxpayer before joining a CTG are not available for offset against taxable profits of other participants of the CTG. However, if a taxpayer leaves a CTG, such losses again become available for offset against future profits generated by the same taxpayer. The expiration period of the losses is extended to take account of any time spent within a CTG when the losses were unavailable for use.

Domestic and foreign components of income before income taxes were:

	Year ended December 31, 2011	Year ended December 31, 2010	Year ended December 31, 2009
Domestic	12,561	10,569	9,013
Foreign	558	901	50
<b>Income before income taxes</b>	<b>13,119</b>	<b>11,470</b>	<b>9,063</b>

Domestic and foreign components of income taxes were:

	Year ended December 31, 2011	Year ended December 31, 2010	Year ended December 31, 2009
Current			
Domestic	2,159	1,693	1,677
Foreign	519	411	245
Current income tax expense	2,678	2,104	1,922
Deferred			
Domestic	581	299	98
Foreign	34	(52)	(26)
Deferred income tax expense	615	247	72
<b>Total income tax expense</b>	<b>3,293</b>	<b>2,351</b>	<b>1,994</b>

The following table is a reconciliation of the amount of income tax expense that would result from applying the Russian combined statutory income tax rate of 20% applicable to the Company to income before income taxes to total income taxes:

	Year ended December 31, 2011	Year ended December 31, 2010	Year ended December 31, 2009
Income before income taxes	13,119	11,470	9,063
Notional income tax at the Russian statutory rate	2,624	2,294	1,813
Increase (reduction) in income tax due to:			
Non-deductible items, net	693	266	252
Foreign rate differences	169	(4)	68
Domestic regional rate differences	(328)	(226)	(251)
Change in valuation allowance	135	21	112
<b>Total income tax expense</b>	<b>3,293</b>	<b>2,351</b>	<b>1,994</b>

Taxes other than income taxes were:

	Year ended December 31, 2011	Year ended December 31, 2010	Year ended December 31, 2009
Mineral extraction tax	11,594	7,864	5,452
Social taxes and contributions	587	429	399
Property tax	573	518	470
Other taxes and contributions	164	167	153
<b>Taxes other than income taxes</b>	<b>12,918</b>	<b>8,978</b>	<b>6,474</b>

Deferred income taxes are included in the consolidated balance sheets as follows:

	As of December 31, 2011	As of December 31, 2010
Other current assets	127	77
Deferred income tax assets – non-current	591	676
Other current liabilities	(216)	(85)
Deferred income tax liabilities – non-current	(2,790)	(2,417)
<b>Net deferred income tax liability</b>	<b>(2,288)</b>	<b>(1,749)</b>

The following tables set out the tax effects of each type of temporary differences which give rise to deferred income tax assets and liabilities:

	As of December 31, 2011	As of December 31, 2010
Accounts receivable	5	42
Long-term liabilities	398	387
Inventories	13	1
Property, plant and equipment	207	263
Accounts payable	5	14
Operating loss carry forwards	646	527
Other	229	161
Total gross deferred income tax assets	1,503	1,395
Less valuation allowance	(553)	(418)
<b>Deferred income tax assets</b>	<b>950</b>	<b>977</b>
Property, plant and equipment	(2,870)	(2,513)
Accounts payable	(39)	(2)
Accounts receivable	(91)	(30)
Long-term liabilities	(38)	(61)
Inventories	(63)	(57)
Investments	(33)	(15)
Other	(104)	(48)
<b>Deferred income tax liabilities</b>	<b>(3,238)</b>	<b>(2,726)</b>
<b>Net deferred income tax liability</b>	<b>(2,288)</b>	<b>(1,749)</b>

As a result of acquisitions during 2011 the Group recognized a net deferred tax liability of \$34 million.

As of December 31, 2011, retained earnings of foreign subsidiaries included \$17,398 million for which deferred taxation has not been provided because remittance of the earnings has been indefinitely postponed through reinvestment and, as a result, such amounts are considered to be indefinitely invested. It is not practicable to estimate the amount of additional taxes that might be payable on such undistributed earnings.

In accordance with Topic 830, "Foreign currency matters" of the Codification and Topic 740, "Income Taxes" of the Codification deferred tax assets and liabilities are not recognized for the changes in exchange rate effects resulting from the translation of transactions and balances from the Russian ruble to the US dollar using historical exchange rates. Also, in accordance with Topic 740 of the Codification, no deferred tax assets or liabilities are recognized for the

effects of the related statutory indexation of property, plant and equipment.

Based upon the levels of historical taxable income and projections for future taxable income over the periods in which the deferred income tax assets are deductible, management believes it is more likely than not that Group companies will realize the benefits of the deductible temporary differences and loss carry forwards, net of existing valuation allowances as of December 31, 2011 and 2010.

As of December 31, 2011, the Group had operating loss carry forwards of \$2,189 million of which \$24 million expire during 2012, \$124 million expire during 2013, \$2 million expire during 2014, \$3 million expire during 2015, \$250 million expire during 2016, \$22 million expire during 2017, \$80 million expire during 2018, \$3 million expire during 2019, \$3 million expire during 2020, \$682 million expire during 2021, \$882 million expire during 2035 and \$114 million have an indefinite carry forward.

**NOTE 14.**  
**PENSION BENEFITS**

The Company sponsors a postretirement benefits program. The primary component of the post employment and post retirement benefits program is a defined benefit pension plan that covers the majority of the Group's employees. This plan is administered by a non-state pension fund, LUKOIL-GARANT, and provides pension benefits primarily based on years of service and final remuneration levels. The Company also provides several long-term employee benefits such as a death-in-service benefit and lump-sum payments upon retirement of a defined benefit nature and other defined benefits to certain old age and disabled pensioners who have not vested any pensions under the pension plan.

The Company's pension plan primarily consists of a defined benefit plan enabling employees to contribute a portion of their salary to the plan and at retirement to receive a lump sum amount from the Company equal to all past contributions made by the employee (up to 2% of annual salary up to October 1, 2010 and up to 4% of annual salary in further periods). Employees also have the right to receive upon retirement the benefits accumulated under the previous pension plan that was replaced in December 2003. These benefits have been fixed and included in the benefit obligation as of December 31, 2011 and 2010. The amount was determined primarily based on a formula including past pensionable service and relative salaries as of December 31, 2003.

The Company uses December 31 as the measurement date for its post employment and post retirement benefits program. An independent actuary has assessed the benefit obligations as of December 31, 2011 and 2010.

The following table provides information about the benefit obligations and plan assets as of December 31, 2011 and 2010. The benefit obligations below represent the projected benefit obligation of the pension plan.

	2011	2010
<b>Benefit obligations</b>		
Benefit obligations as of January 1	296	291
Effect of exchange rate changes	(14)	(2)
Service cost	15	16
Interest cost	22	23
Plan amendments	(4)	6
Actuarial loss	-	2
Acquisitions	-	3
Benefits paid	(52)	(40)
Curtailement gain	(3)	(3)
<b>Benefit obligations as of December 31</b>	<b>260</b>	<b>296</b>

	2011	2010
<b>Plan assets</b>		
Fair value of plan assets as of January 1	112	108
Effect of exchange rate changes	(6)	(1)
Return on plan assets	2	6
Employer contributions	49	39
Benefits paid	(52)	(40)
<b>Fair value of plan assets as of December 31</b>	<b>105</b>	<b>112</b>
Funded status	(155)	(184)
<b>Amounts recognized in the consolidated balance sheet as of December 31, 2011 and 2010</b>		
Accrued benefit liabilities included in "Other long-term liabilities"	(128)	(144)
Accrued benefit liabilities included in "Other current liabilities"	(27)	(40)

Weighted average assumptions used to determine benefit obligations as of December 31, 2011 and 2010:

	2011	2010
Discount rate	7.80%	7.80%
Rate of compensation increase	7.30%	7.70%

Weighted average assumptions used to determine net periodic benefit costs for the year ended December 31, 2011 and 2010:

	2011	2010
Discount rate	7.80%	8.70%
Rate of compensation increase	7.70%	8.10%
Expected rate of return on plan assets	8.95%	10.07%

Included in accumulated other comprehensive loss as of December 31, 2011 and 2010, are the following before-tax amounts that have not yet been recognized in net periodic benefit cost:

	2011	2010
Unamortized prior service cost	61	84
Unrecognized actuarial gain	4	(6)
<b>Total costs</b>	<b>65</b>	<b>78</b>

Amounts recognized in other comprehensive loss during the year ended December 31, 2011 and 2010:

	2011	2010
Additional loss arising during the period	9	4
Additional prior service cost from plan amendment	(4)	6
Re-classified prior service cost amortization	(18)	(18)
<b>Net amount recognized for the period</b>	<b>(13)</b>	<b>(8)</b>



The real returns on bonds and equities are based on what is observed in the international markets over extended periods of time. In the calculation of the expected return on assets no use is made of the historical returns LUKOIL-GARANT has achieved.

In addition to the plan assets, LUKOIL-GARANT holds assets in the form of an insurance reserve. The purpose of this insurance reserve is to satisfy pension obligations should the plan assets not be sufficient to meet pension obliga-

tions. The Group's contributions to the pension plan are determined without considering the assets in the insurance reserve.

The plans are funded on a discretionary basis through a solidarity account, which is held in trust with LUKOIL-GARANT. LUKOIL-GARANT does not allocate separately identifiable assets to the Group or its other third party clients. All funds of plan assets and other individual pension accounts are managed as a pool of investments.

The asset allocation of the investment portfolio maintained by LUKOIL-GARANT for the Group and its clients was as follows:

Type of assets	As of December 31, 2011	As of December 31, 2010
Eurobonds	4%	-
Russian corporate bonds	28%	37%
Russian municipal bonds	-	2%
Bank deposits	44%	41%
Equity securities of Russian issuers	6%	5%
Shares of OAO LUKOIL	2%	1%
Shares in investment funds	13%	13%
Other assets	3%	1%
	100%	100%

The investment strategy employed by LUKOIL-GARANT includes an overall goal to attain a maximum investment return, while guaranteeing the principal amount invested. The strategy is to invest with a medium-term perspective while maintaining a level of liquidity through proper allocation of investment assets. Investment policies include rules and limitations to avoid concentrations of investments.

The investment portfolio is primarily comprised of investments: bank deposits, securities with fixed yield and equity securities. The securities with fixed yield include mainly high yield corporate bonds with low and medium risk ratings. Maturities range from one to three years.

Components of net periodic benefit cost were as follows:

	Year ended December 31, 2011	Year ended December 31, 2010	Year ended December 31, 2009
Service cost	15	16	17
Interest cost	22	23	23
Less expected return on plan assets	(10)	(11)	(10)
Amortization of prior service cost	17	18	2
Curtailment gain	(2)	(3)	(11)
<b>Total net periodic benefit cost</b>	<b>42</b>	<b>43</b>	<b>21</b>

Total employer contributions for 2012 are expected to be \$38 million. An amount of \$13 million before-tax is included in other comprehensive income and expected to be recognized in the net periodic benefit cost in 2012.

The following benefit payments, which reflect expected future services, as appropriate, are expected to be paid:

	2012	2013	2014	2015	2016	5-year period 2012-2016	5-year period 2017-2021
Pension benefits	56	13	14	15	13	111	53
Other long-term employee benefits	26	14	14	14	14	82	62
<b>Total expected benefits to be paid</b>	<b>82</b>	<b>27</b>	<b>28</b>	<b>29</b>	<b>27</b>	<b>193</b>	<b>115</b>

## NOTE 15. STOCKHOLDERS' EQUITY

### Common stock

	As of December 31, 2011 (thousands of shares)	As of December 31, 2010 (thousands of shares)
Authorized and issued common stock, par value of 0.025 Russian rubles each	850,563	850,563
Treasury stock	(76,101)	(69,208)
<b>Outstanding common stock</b>	<b>774,462</b>	<b>781,355</b>

### Dividends and dividend limitations

Profits available for distribution to common stockholders in respect of any reporting period are determined by reference to the statutory financial statements of the Company prepared in accordance with the laws of the Russian Federation and denominated in Russian rubles. Under Russian Law, dividends are limited to the net profits of the reporting year as set out in the statutory financial statements of the Company. These laws and other legislative acts governing the rights of shareholders to receive dividends are subject to various interpretations.

The Company's net profits were 139,853 million Russian rubles, 45,148 million Russian rubles and 66,926 million Russian rubles respectively for 2010, 2009 and 2008, pursuant to the statutory financial statements, which at the US dollar exchange rates as of December 31, 2010, 2009 and 2008, amounted to \$4,589 million, \$1,493 million and \$2,278 million, respectively.

At the annual stockholders' meeting on June 23, 2011, dividends were declared for 2010 in the amount of 59.00 Russian rubles per common share, which at the date of the meeting was equivalent to \$2.11. Dividends payable of \$10 million and \$13 million are included in "Other current liabilities" in the consolidated balance sheets as of December 31, 2011 and 2010, respectively.

At the annual stockholders' meeting on June 24, 2010, dividends were declared for 2009 in the amount of 52.00 Russian rubles per common share, which at the date of the meeting was equivalent to \$1.68.

At the annual stockholders' meeting on June 25, 2009, dividends were declared for 2008 in the amount of 50.00 Russian rubles per common share, which at the date of the meeting was equivalent to \$1.61.

## Earnings per share

The calculation of diluted earnings per share for these years was as follows:

	Year ended December 31, 2011	Year ended December 31, 2010	Year ended December 31, 2009
Net income	10,357	9,006	7,011
Add back interest and accretion on 2.625% convertible US dollar bonds, maturing 2015 (net of tax at effective rate)	63	3	–
Total diluted net income	10,420	9,009	7,011
Weighted average number of outstanding common shares (thousands of shares)	778,964	822,359	846,645
Add back treasury shares held in respect of convertible debt (thousands of shares)	20,383	892	–
Weighted average number of outstanding common shares, after dilution (thousands of shares)	799,347	823,251	846,645
Earnings per share of common stock attributable to OAO LUKOIL (US dollars):			
Basic	13.30	10.95	8.28
Diluted	13.04	10.94	8.28

## NOTE 16. FINANCIAL AND DERIVATIVE INSTRUMENTS

### Fair value

The fair values of cash and cash equivalents, current accounts receivable, long-term receivables and liquid securities are approximately equal to their value as disclosed in the consolidated financial statements. The fair value of long-term receivables was determined by discounting with estimated market interest rates for similar financing arrangements.

The fair value of long-term debt differs from the amount disclosed in the consolidated financial statements. The estimated fair value of long-term debt as of December 31, 2011 and 2010 was \$8,666 million and \$10,225 million, respectively, as a result of discounting using estimated market interest rates for similar financing arrangements. These amounts include all future cash outflows associated with the long-term debt repayments, including the current portion and interest. Market interest rates mean the rates of raising long-term debt by companies with a similar credit rating for similar tenors, repayment schedules and similar other main terms. During the year ended December 31, 2011, the Group did not have significant transactions or events that

would result in nonfinancial assets and liabilities measured at fair value on a nonrecurring basis.

### Derivative instruments

The Group uses financial and commodity-based derivative contracts to manage exposures to fluctuations in foreign currency exchange rates, commodity prices, or to exploit market opportunities. Since the Group is not currently using hedge accounting, defined by Topic 815, “*Derivative and hedging*,” of the Codification, all gains and losses, realized or unrealized, from derivative contracts have been recognized in the consolidated income statement.

Topic 815 of the Codification requires purchase and sales contracts for commodities that are readily convertible to cash (e.g., crude oil, natural gas and gasoline) to be recorded on the balance sheet as derivatives unless the contracts are for quantities the Group expects to use or sell over a reasonable period in the normal course of business (i.e., contracts eligible for the normal purchases and normal sales exception). The Group does apply the normal purchases and normal sales exception to certain long-term contracts to sell oil products. This normal purchases and normal sales exception is applied to eligible crude oil and refined product commodity purchase and sales contracts; however, the Group

may elect not to apply this exception (e.g., when another derivative instrument will be used to mitigate the risk of the purchase or sale contract but hedge accounting will not be

applied, in which case both the purchase or sales contract and the derivative contract mitigating the resulting risk will be recorded on the balance sheet at fair value).

The fair value hierarchy for the Group's derivative assets and liabilities accounted for at fair value on a recurring basis was:

	As of December 31, 2011				As of December 31, 2010			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
<b>Assets</b>								
Commodity derivatives	–	575	–	575	–	226	–	226
<b>Total assets</b>	–	575	–	575	–	226	–	226
<b>Liabilities</b>								
Commodity derivatives	–	(599)	–	(599)	–	(264)	–	(264)
<b>Total liabilities</b>	–	(599)	–	(599)	–	(264)	–	(264)
<b>Net liabilities</b>	–	(24)	–	(24)	–	(38)	–	(38)

The derivative values above are based on an analysis of each contract as the fundamental unit of account as required by Topic 820, "Fair Value Measurements and Disclosures," of the Codification; therefore, derivative assets and liabilities with the same counterparty are not reflected net where the legal right of offset exists. Gains or losses from contracts in one level may be offset by gains or losses on contracts in another level or by changes in values of physical contracts or positions that are not reflected in the table above.

#### Commodity derivative contracts

The Group operates in the worldwide crude oil, refined product, natural gas and natural gas liquids markets and is

exposed to fluctuations in the prices for these commodities. These fluctuations can affect the Group's revenues as well as the cost of operating, investing and financing activities. Generally, the Group's policy is to remain exposed to the market prices of commodities. However, the Group uses futures, forwards, swaps and options in various markets to balance physical systems, meet customer needs, manage price exposures on specific transactions, and do a limited, immaterial amount of trading not directly related to the Group's physical business. These activities may move the Group's profile away from market average prices.

The fair value of commodity derivative assets and liabilities as of December 31, 2011 was:

	As of December 31, 2011
<b>Assets</b>	
Accounts receivable	575
<b>Liabilities</b>	
Accounts payable	(599)

Hedge accounting has not been used for items in the table.

As required under Topic 815 of the Codification the amounts shown in the preceding table are presented gross (i.e., without netting assets and liabilities with the same counterparty where the right of offset and intent to net exist). Derivative assets and liabilities resulting from eligible commodity contracts have been netted in the consolidated balance sheet and are recorded as accounts receivable in the amount of \$39 million and accounts payable in the amount of \$63 million.

Financial results from commodity derivatives were included in the consolidated income statements in "Cost of purchased crude oil, gas and products". Realized losses were \$667 million and unrealized gains were \$10 million for the year ended December 31, 2011 and realized losses were \$235 million and unrealized gains were \$3 million for the year ended December 31, 2010.

As of December 31, 2011, the net position of outstanding commodity derivative contracts, primarily to manage price exposure on underlying operations, was not significant.

#### Currency exchange rate derivative contracts

The Group has foreign currency exchange rate risk resulting from its international operations. The Group does not comprehensively hedge the exposure to currency rate changes, although the Group selectively hedges certain foreign currency exchange rate exposures, such as firm commitments for capital projects or local currency tax payments and dividends.

The fair value of foreign currency derivatives assets and liabilities open at December 31, 2011 was not significant.

The impact from foreign currency derivatives during the year ended December 31, 2011 on the consolidated income statement was not significant. The net position of outstanding foreign currency swap contracts as of December 31, 2011 also was not significant.

#### Credit risk

The Group's financial instruments that are potentially exposed to concentrations of credit risk consist primarily of cash equivalents, over-the-counter derivative contracts and trade receivables. Cash equivalents are placed in high-quality commercial paper, money market funds and time deposits with major international banks and financial institutions.

The credit risk from the Group's over-the-counter derivative contracts, such as forwards and swaps, derives from the

counterparty to the transaction, typically a major bank or financial institution. Individual counterparty exposure is managed within predetermined credit limits and includes the use of cash-call margins when appropriate, thereby reducing the risk of significant non-performance. The Group also uses futures contracts, but futures have a negligible credit risk because they are traded on the New York Mercantile Exchange or the ICE Futures.

Certain of the Group's derivative instruments contain provisions that require the Group to post collateral if the derivative exposure exceeds a threshold amount. The Group has contracts with fixed threshold amounts and other contracts with variable threshold amounts that are contingent on the Group's credit rating. The variable threshold amounts typically decline for lower credit ratings, while both the variable and fixed threshold amounts typically revert to zero if the Group falls below investment grade. Cash is the primary collateral in all contracts; however, many contracts also permit the Group to post letters of credit as collateral.

There were no derivative instruments with such credit-risk-related contingent features that were in a liability position on December 31, 2011. The Group posted \$35 million in collateral in the normal course of business for the over-the-counter derivatives. If the Group's credit rating were lowered one level from its "BBB-" rating (per Standard and Poors) on December 31, 2011, and it would be below investment grade, the Group would be required to post additional collateral of \$5 million to the Group's counterparties for the over-the-counter derivatives, either with cash or letters of credit. The maximum additional collateral based on the lowest downgrade would be \$14 million in total.

#### NOTE 17. CONSOLIDATION OF VARIABLE INTEREST ENTITY

The Group and ConocoPhillips have a joint venture NMNG which develops oil reserves in the Timan-Pechora region of the Russian Federation. The Group and ConocoPhillips have equal voting rights over the joint venture's activity and effective ownership interests of 70% and 30%, respectively.

The Group originally determined that NMNG is a variable interest entity ("VIE") as the Group's voting rights are not proportionate to its ownership rights and all of NMNG's activities are conducted on behalf of the Group and ConocoPhillips, its former related party. Based on the requirements of Topic 810, "Consolidation," of the Codification, the Group performs a regular qualitative analysis as to

whether it is the primary beneficiary of this VIE. As a result the Group is still considered to be the primary beneficiary of NMNG and consolidated it.

NMNG's total assets were approximately \$3.3 billion and \$5.5 billion as of December 31, 2011 and 2010, respectively.

**NOTE 18.**  
**COMMITMENTS AND CONTINGENCIES**

**Capital expenditure, exploration and investment programs**

Under the terms of existing exploration and production license agreements in Russia the Group has to fulfill certain obligations: oil and gas exploration, wells drilling, fields development, etc., and the Group also has commitments to reach a defined level of extraction on the fields. Management believes that the Group's approved annual capital expenditure budgets fully cover all the requirements of the described license obligations.

Group companies have commitments for capital expenditure contributions in the amount of \$406 million related to various production sharing agreements over the next 26 years.

The Company signed a three-year agreement for the years 2010-2012 for drilling services with OOO Eurasia Drilling Company. The volume of these services is based on the Group's capital construction program, which is re-evaluated on an annual basis. The Group estimates the amount of capital commitment under this agreement for 2012 to be approximately \$1,521 million.

The Company signed a strategic agreement for the ongoing provision of construction, engineering and technical services with ZAO Globalstroy-Engineering. The volume of these services is based on the Group's capital construction program, which is re-evaluated on an annual basis. The Group estimates the amount of capital commitment under this agreement for 2012 to be approximately \$225 million.

The Group signed a number of agreements for the years 2012-2015 for construction of offshore platforms in the Caspian region. The Group estimates the amount of this capital commitment to be approximately \$866 million.

The Group has a commitment to execute the capital construction program of its power generation segment and under the terms of this program power plants with

a total capacity of 890 MW should be constructed. Currently the Group is approving certain amendments to the capital construction program, including its extension to the end of 2014. As of December 31, 2011, the Group estimates the amount of this commitment to be approximately \$594 million.

**Operating lease obligations**

Group companies have commitments of \$507 million primarily for the lease of vessels and petroleum distribution outlets. Operating lease expenses were \$175 million and \$155 million during the years ended December 31, 2011 and 2010, respectively. Commitments for minimum rentals under these leases as of December 31, 2011 are as follows:

	As of December 31, 2011
2012	145
2013	83
2014	74
2015	46
2016	54
beyond	105

**Insurance**

The insurance industry in the Russian Federation and certain other areas where the Group has operations is in the course of development. Management believes that the Group has adequate property damage coverage for its main production assets. In respect of third party liability for property and environmental damage arising from accidents on Group property or relating to Group operations, the Group has insurance coverage that is generally higher than insurance limits set by the local legal requirements. Management believes that the Group has adequate insurance coverage of the risks, which could have a material effect on the Group's operations and financial position.

**Environmental liabilities**

Group companies and their predecessor entities have operated in the Russian Federation and other countries for many years and, within certain parts of the operations, environmental related problems have developed. Environmental regulations are currently under consideration in the Russian Federation and other areas where the Group has

operations. Group companies routinely assess and evaluate their obligations in response to new and changing legislation.

As liabilities in respect of the Group's environmental obligations are able to be determined, they are charged against income. The likelihood and amount of liabilities relating to environmental obligations under proposed or any future legislation cannot be reasonably estimated at present and could become material. Under existing legislation, however, management believes that there are no significant unrecorded liabilities or contingencies, which could have a materially adverse effect on the operating results or financial position of the Group.

#### **Social assets**

Certain Group companies contribute to Government sponsored programs, the maintenance of local infrastructure and the welfare of their employees within the Russian Federation and elsewhere. Such contributions include assistance with the construction, development and maintenance of housing, hospitals and transport services, recreation and other social needs. The funding of such assistance is periodically determined by management and is appropriately capitalized or expensed as incurred.

#### **Taxation environment**

The taxation systems in the Russian Federation and other emerging markets where Group companies operate are relatively new and are characterized by numerous taxes and frequently changing legislation, which is often unclear, contradictory, and subject to interpretation. Often, differing interpretations exist among different tax authorities within the same jurisdictions and among taxing authorities in different jurisdictions. Taxes are subject to review and investigation by a number of authorities, which are enabled by law to impose severe fines, penalties and interest charges. In the Russian Federation a tax year remains open for review by the tax authorities during the three subsequent calendar years; however, under certain circumstances a tax year may remain open longer. Recent events within the Russian Federation suggest that the tax authorities are taking a more assertive position in their interpretation and enforcement of tax legislation. Such factors may create taxation risks in the Russian Federation and other emerging markets where Group companies operate substantially more significant than those in other countries where taxation regimes have been subject to development and clarification over long periods.

The tax authorities in each region may have a different interpretation of similar taxation issues which may result in taxation issues successfully defended by the Group in one region being unsuccessful in another region. There is some direction provided from the central authority based in Moscow on particular taxation issues.

The Group has implemented tax planning and management strategies based on existing legislation at the time of implementation. The Group is subject to tax authority audits on an ongoing basis, as is normal in the Russian environment and other republics of the former Soviet Union, and, at times, the authorities have attempted to impose additional significant taxes on the Group. Management believes that it has adequately met and provided for tax liabilities based on its interpretation of existing tax legislation. However, the relevant tax authorities may have differing interpretations and the effects on the financial statements, if the authorities were successful in enforcing their interpretations, could be significant.

#### **Litigation and claims**

On November 27, 2001, Archangel Diamond Corporation ("ADC"), a Canadian diamond development company, filed a lawsuit in the Denver District Court, Colorado against OAO Arkhangel'skgeoldobycha ("AGD"), a Group company, and the Company (together the "Defendants"). ADC alleged that the Defendants interfered with the transfer of a diamond exploration license to Almazny Bereg, a joint venture between ADC and AGD. ADC claimed compensatory damages of \$1.2 billion and punitive damages of \$3.6 billion. On October 15, 2002, the District Court dismissed the lawsuit for lack of personal jurisdiction. This ruling was upheld by the Colorado Court of Appeals on March 25, 2004. On November 21, 2005, the Colorado Supreme Court affirmed the lower courts' ruling that no specific jurisdiction exists over the Defendants.

By virtue of this finding, AGD (the holder of the diamond exploration license) was dismissed from the lawsuit. The Colorado Supreme Court found, however, that the trial court made a procedural error by failing to hold an evidentiary hearing before making its ruling concerning general jurisdiction regarding the Company and remanded the case to the Colorado Court of Appeals to consider whether the lawsuit should have been dismissed on alternative grounds (i.e., *forum non conveniens*). The Colorado Court of Appeals declined to dismiss the case based on *forum non conveniens* and the case was remanded to the District Court. In June 2009, three creditors of ADC filed an Involuntary Bankruptcy Petition putting ADC into bankruptcy. In November 2009, after adding a claim,

ADC removed the case from the District Court to the US Bankruptcy Court. On October 28, 2010, the Bankruptcy Court granted the Company's Motion for Remand and Abstention and remanded the case to the Denver District Court. On October 20, 2011, the Denver District Court dismissed all claims in the lawsuit against the Company. ADC has filed a notice of appeal. No briefing schedule has been established. Management does not believe that the ultimate resolution of this matter will have a material adverse effect on the Group's financial condition.

On January 6, 2012, ADC filed a lawsuit in the US District Court for the District of Colorado (federal court) reasserting almost identical claims asserted in the aforementioned lawsuit and dismissed by the Denver District Court (state court) notwithstanding ADC's appeal of the state court's decision. The time within which the Company is required to respond has not expired. The Company plans to seek dismissal of the case and vigorously defend the matter. Management does not believe that the ultimate resolution of this matter will have a material adverse effect on the Group's financial condition.

As of the date the financial statements were available to be issued approximately 100 claims in relation to a violation of the anti-monopoly regulation were initiated against several Group companies in Russia and abroad. The Group companies were accused of violations primarily involving abuse of their dominant market position and execution of coordinated actions in oil products retail markets.

On February 9, 2011, the Federal Anti-monopoly Service of the Russian Federation ("FAS of Russia") filed a case against the three largest Russian oil companies, including the Company, accusing them of abuse of their dominant position in the oil products market. The decision accusing the Company in establishing monopolistically high prices on diesel fuel during the period October 2010 – December 2010 was issued on August 9, 2011. The case in establishing monopolistically high prices on jet fuel was separated into an individual proceeding and its hearing is scheduled for March 20, 2012. On December 28, 2011, FAS of Russia defined fines against the Company and the Group's refinery plants in the amount of \$19 million. The decision was not contested and the fines were paid on February 17, 2012. The Group accrued a provision for this amount in the consolidated financial statements as of December 31, 2011.

The Group is involved in cost recovery disputes with the Republic of Kazakhstan. The Group's share of the claim is approximately \$295 million. Management is of the view that substantially all of the amounts subject to dispute are in fact recoverable under the Final Production Sharing Agree-

ment. Management believes that the ultimate resolution of the claim will not have a material adverse impact on the Group's operating results or financial condition.

The Group is involved in various other claims and legal proceedings arising in the normal course of business. While these claims may seek substantial damages against the Group and are subject to uncertainty inherent in any litigation, management does not believe that the ultimate resolution of such matters will have a material adverse impact on the Group's operating results or financial condition.

#### NOTE 19. RELATED PARTY TRANSACTIONS

In the rapidly developing business environment in the Russian Federation, companies and individuals have frequently used nominees and other forms of intermediary companies in transactions. The senior management of the Company believes that the Group has appropriate procedures in place to identify and properly disclose transactions with related parties in this environment and has disclosed all of the relationships identified which it deemed to be significant. Related party sales and purchases of oil and oil products were primarily to and from affiliated companies and the Company's shareholder ConocoPhillips. Related party processing services were provided by affiliated refineries. As a result of the purchase of the Company's shares by a Group company from ConocoPhillips in September 2010, ConocoPhillips ceased to be a related party of the Group by the end of the third quarter of 2010.

Below are related party transactions not disclosed elsewhere in the financial statements. Refer also to Notes 3, 7, 11, 14, 17 and 20 for other transactions with related parties.

Sales of oil and oil products to related parties were \$1,298 million, \$2,383 million and \$1,152 million for the years ended December 31, 2011, 2010 and 2009, respectively.

Other sales to related parties were \$54 million, \$134 million and \$69 million for the years ended December 31, 2011, 2010 and 2009, respectively.

Purchases of oil and oil products from related parties were \$374 million, \$521 million and \$862 million for the years ended December 31, 2011, 2010 and 2009, respectively.

Purchases of processing services from related parties were \$901 million, \$719 million and \$539 million for the years ended December 31, 2011, 2010 and 2009, respectively.



Other purchases from related parties were \$73 million, \$39 million and \$28 million for the years ended December 31, 2011, 2010 and 2009, respectively.

Amounts receivable from related parties, including advances, were \$415 million and \$419 million as of December 31, 2011 and 2010, respectively. Amounts payable to related parties were \$115 million and \$114 million as of December 31, 2011 and 2010, respectively.

#### NOTE 20. COMPENSATION PLAN

Since December 2009, the Company has a compensation plan to certain members of management for the period from 2010 to 2012, which is based on assigned shares and provides compensation consisting of two parts. The first part represents annual bonuses that are based on the number of assigned shares and the amount of dividend per share. The payment of these bonuses is contingent on the Group meeting certain financial KPIs in each financial year. The second part is based upon the Company's common stock appreciation from 2010 to 2012, with rights vesting after the date of the compensation plan's termination. The number of assigned shares is approximately 17.3 million.

For the first part of the share plan the Group recognizes a liability based on expected dividends and the number of assigned shares.

The second part of the share plan is classified as equity settled. The grant date fair value of the plan was estimated at \$295 million using the Black-Scholes-Merton option-pricing model, assuming a risk-free interest rate of 8.0% per annum, an expected dividend yield of 3.09% per annum, an expected term of three years and a volatility factor of 34.86%. The expected volatility factor was estimated based on the historical volatility of the Company's shares for the previous five year period up to January 2010.

As of December 31, 2011, there was \$98 million of total unrecognized compensation cost related to unvested benefits. This cost is expected to be recognized periodically by the Group up to December 2012.

During the period from 2007 to 2009, the Company had a compensation plan available to certain members of management. Its conditions were similar to the conditions of the new compensation plan introduced in December 2009. The number of assigned shares was approximately 15.5 mil-

lion shares. Because of an unfavorable market situation the conditions for exercising the second part of this share plan were not met and therefore no payments or share transfers to employees took place by the end of the compensation plan.

Related to these plans the Group recorded \$137 million, \$129 million and \$105 million of compensation expenses during 2011, 2010 and 2009, respectively, of which \$98 million, \$98 million and \$20 million, respectively, are recognized as an increase in additional paid-in capital. As of December 31, 2011 and 2010, \$28 million and \$33 million related to these plans are included in "Other current liabilities" of the consolidated balance sheets, respectively. The total recognized tax benefits related to these accruals were \$20 million, \$21 million and \$21 million during the years ended December 31, 2011, 2010 and 2009.

#### NOTE 21. SEGMENT INFORMATION

Presented below is information about the Group's operating and geographical segments for the years ended December 31, 2011, 2010 and 2009, in accordance with Topic 280, "Segment reporting," of the Codification.

The Group has the following operating segments – exploration and production; refining, marketing and distribution; chemicals; power generation and other business segments. These segments have been determined based on the nature of their operations. Management on a regular basis assesses the performance of these operating segments. The exploration and production segment explores for, develops and produces primarily crude oil. The refining, marketing and distribution segment processes crude oil into refined products and purchases, sells and transports crude oil and refined petroleum products. The chemicals segment refines and sells chemical products. The power generation segment produces steam and electricity, distributes them and provides related services. The activities of the other business operating segment include businesses beyond the Group's traditional operations.

Geographical segments are based on the area of operations and include two segments: Russia and International. Geographical segments presentation has been changed starting from the three-month period ended March 31, 2011, due to a change in the Company's management reporting system.

Operating segments

2011	Exploration and production	Refining, marketing and distribution	Chemicals	Power generation	Other	Elimination	Consolidated
Sales							
Third parties	3,449	126,665	1,944	1,472	120	–	133,650
Inter-segment	41,409	1,884	500	1,520	2,467	(47,780)	–
Total sales	44,858	128,549	2,444	2,992	2,587	(47,780)	133,650
Operating expenses	4,347	3,975	459	2,098	2,029	(3,853)	9,055
Depreciation, depletion and amortization	2,865	1,248	63	224	129	(56)	4,473
Interest expense	732	709	20	47	505	(1,319)	694
Income tax expense	2,106	1,060	43	(5)	10	79	3,293
Net income (net loss)	6,665	3,687	(27)	(127)	(370)	529	10,357
Total assets	60,311	62,173	1,488	4,220	21,201	(58,201)	91,192
Capital expenditures	6,629	1,354	89	196	224	–	8,492

2010	Exploration and production	Refining, marketing and distribution	Chemicals	Power generation	Other	Elimination	Consolidated
Sales							
Third parties	3,012	99,064	1,331	1,416	133	–	104,956
Inter-segment	33,511	1,182	271	1,277	1,937	(38,178)	–
Total sales	36,523	100,246	1,602	2,693	2,070	(38,178)	104,956
Operating expenses	3,965	3,771	294	1,901	1,628	(3,261)	8,298
Depreciation, depletion and amortization	2,773	1,033	40	183	126	(1)	4,154
Interest expense	806	859	26	38	405	(1,422)	712
Income tax expense	1,449	874	37	(14)	4	1	2,351
Net income (net loss)	6,139	3,330	101	(167)	(317)	(80)	9,006
Total assets	57,280	56,908	1,249	4,338	15,390	(51,148)	84,017
Capital expenditures	4,908	1,320	76	420	120	–	6,844

2009	Exploration and production	Refining, marketing and distribution	Chemicals	Power generation	Other	Elimination	Consolidated
Sales							
Third parties	2,257	76,096	1,576	1,087	67	–	81,083
Inter-segment	22,096	955	162	1,065	725	(25,003)	–
Total sales	24,353	77,051	1,738	2,152	792	(25,003)	81,083
Operating expenses							
Operating expenses	3,266	3,472	515	1,475	452	(1,840)	7,340
Depreciation, depletion and amortization							
Depreciation, depletion and amortization	2,612	936	41	198	150	–	3,937
Interest expense	886	1,205	14	52	381	(1,871)	667
Income tax expense	1,221	821	12	(7)	6	(59)	1,994
Net income (net loss)	5,456	2,268	(74)	(162)	(147)	(330)	7,011
Total assets	55,033	56,286	1,371	4,041	14,250	(51,962)	79,019
Capital expenditures	4,626	1,316	113	283	196	–	6,534

#### Geographical segments

	2011	2010	2009
Sales of crude oil within Russia	1,571	956	735
Export of crude oil and sales of crude oil by foreign subsidiaries	32,522	26,342	19,914
Sales of petroleum products within Russia	15,242	10,928	8,101
Export of petroleum products and sales of petroleum products by foreign subsidiaries	76,335	60,018	46,888
Sales of chemicals within Russia	914	728	514
Export of chemicals and sales of chemicals by foreign subsidiaries	1,095	642	574
Other sales within Russia	3,213	2,881	2,235
Other export sales and other sales by foreign subsidiaries	2,758	2,461	2,122
<b>Total sales</b>	<b>133,650</b>	<b>104,956</b>	<b>81,083</b>

2011	Russia	International	Elimination	Consolidated
Sales				
Third parties	24,674	108,976	–	133,650
Inter-segment	39,567	143	(39,710)	–
Total sales	64,241	109,119	(39,710)	133,650
Operating expenses				
Operating expenses	6,999	2,094	(38)	9,055
Depletion, depreciation and amortization				
Depletion, depreciation and amortization	3,692	781	–	4,473
Interest expense	338	477	(121)	694
Income taxes	2,715	554	24	3,293
Net income	9,769	4	584	10,357
Total assets	73,150	34,384	(16,342)	91,192
Capital expenditures	6,516	1,976	–	8,492

2010	Russia	International	Elimination	Consolidated
Sales				
Third parties	17,615	87,341	–	104,956
Inter-segment	34,599	37	(34,636)	–
Total sales	52,214	87,378	(34,636)	104,956
Operating expenses	6,334	2,005	(41)	8,298
Depletion, depreciation and amortization	3,393	761	–	4,154
Interest expense	415	427	(130)	712
Income taxes	1,993	359	(1)	2,351
Net income	8,542	542	(78)	9,006
Total assets	74,033	30,225	(20,241)	84,017
Capital expenditures	5,333	1,511	–	6,844

2009	Russia	International	Elimination	Consolidated
Sales				
Third parties	13,880	67,203	–	81,083
Inter-segment	26,897	18	(26,915)	–
Total sales	40,777	67,221	(26,915)	81,083
Operating expenses	5,434	1,952	(46)	7,340
Depletion, depreciation and amortization	3,186	751	–	3,937
Interest expense	448	406	(187)	667
Income taxes	1,834	219	(59)	1,994
Net income	7,511	(168)	(332)	7,011
Total assets	58,461	28,038	(7,480)	79,019
Capital expenditures	5,064	1,470	–	6,534

The Group's international sales to third parties include sales in Switzerland of \$66,884 million, \$53,245 million and \$37,724 million for the years ended December 31, 2011, 2010 and 2009, respectively. The Group's international sales to third parties include sales in the USA of \$9,496 million, \$8,595 million and

\$8,144 million for the years ended December 31, 2011, 2010 and 2009, respectively. These amounts are attributed to individual countries based on the jurisdiction of subsidiaries making the sale.

## NOTE 22. SUBSEQUENT EVENTS

In accordance with the requirements of Topic 855, "Subsequent events," of the Codification, the Group evaluated subsequent events through the date the financial statements

were available to be issued. Therefore subsequent events were evaluated by the Group up to February 24, 2012.

This section provides unaudited supplemental information on oil and gas exploration and production activities in accordance with Topic 932, *"Disclosures About Oil and Gas Producing Activities,"* of the Codification in six separate tables:

- I. Capitalized costs relating to oil and gas producing activities
- II. Costs incurred in oil and gas property acquisition, exploration, and development activities
- III. Results of operations for oil and gas producing activities
- IV. Reserve quantity information
- V. Standardized measure of discounted future net cash flows
- VI. Principal sources of changes in the standardized measure of discounted future net cash flows

Amounts shown for equity companies represent the Group's share in its exploration and production affiliates, which are accounted for using the equity method of accounting.

#### I. CAPITALIZED COSTS RELATING TO OIL AND GAS PRODUCING ACTIVITIES

As of December 31, 2011	International	Russia	Total consolidated companies	Group's share in equity companies
Unproved oil and gas properties	659	583	1,242	166
Proved oil and gas properties	7,479	52,939	60,418	2,315
Accumulated depreciation, depletion, and amortization	(1,762)	(19,527)	(21,289)	(718)
Net capitalized costs	6,376	33,995	40,371	1,763

As of December 31, 2010	International	Russia	Total consolidated companies	Group's share in equity companies
Unproved oil and gas properties	536	302	838	274
Proved oil and gas properties	6,578	50,662	57,240	2,111
Accumulated depreciation, depletion, and amortization	(1,490)	(18,530)	(20,020)	(597)
Net capitalized costs	5,624	32,434	38,058	1,788

As of December 31, 2009	International	Russia	Total consolidated companies	Group's share in equity companies
Unproved oil and gas properties	545	305	850	285
Proved oil and gas properties	5,826	47,237	53,063	1,998
Accumulated depreciation, depletion, and amortization	(1,201)	(16,460)	(17,661)	(454)
Net capitalized costs	5,170	31,082	36,252	1,829

## II. COSTS INCURRED IN OIL AND GAS PROPERTY ACQUISITION, EXPLORATION, AND DEVELOPMENT ACTIVITIES

Year ended December 31, 2011	International	Russia	Total consolidated companies	Group's share in equity companies
Acquisition of properties – proved	–	41	41	–
Acquisition of properties – unproved	70	164	234	–
Exploration costs	507	358	865	8
Development costs	968	4,726	5,694	123
Total costs incurred	1,545	5,289	6,834	131

Year ended December 31, 2010	International	Russia	Total consolidated companies	Group's share in equity companies
Acquisition of properties – proved	113	–	113	–
Acquisition of properties – unproved	–	15	15	122
Exploration costs	199	220	419	16
Development costs	685	3,686	4,371	115
Total costs incurred	997	3,921	4,918	253

Year ended December 31, 2009	International	Russia	Total consolidated companies	Group's share in equity companies
Acquisition of properties – proved	–	17	17	1,154
Acquisition of properties – unproved	–	23	23	97
Exploration costs	221	162	383	11
Development costs	549	3,726	4,275	146
Total costs incurred	770	3,928	4,698	1,408

### III. RESULTS OF OPERATIONS FOR OIL AND GAS PRODUCING ACTIVITIES

The Group's results of operations for oil and gas producing activities are presented below. In accordance with Topic 932 of the Codification, sales and transfers to Group companies are based on market prices. Income taxes are based on statutory rates. The results of operations exclude corporate overhead and interest costs.

Year ended December 31, 2011	International	Russia	Total consolidated companies	Group's share in equity companies
Revenue				
Sales	2,656	25,232	27,888	1,924
Transfers	–	13,981	13,981	14
Total revenues	2,656	39,213	41,869	1,938
Production costs (excluding production taxes)	(242)	(3,298)	(3,540)	(93)
Exploration expense	(439)	(93)	(532)	(2)
Depreciation, depletion, and amortization, and valuation provision	(324)	(2,511)	(2,835)	(125)
Taxes other than income taxes	(460)	(23,817)	(24,277)	(640)
Related income taxes	(531)	(1,817)	(2,348)	(407)
Total results of operations for producing activities	660	7,677	8,337	671

Year ended December 31, 2010	International	Russia	Total consolidated companies	Group's share in equity companies
Revenue				
Sales	1,926	19,956	21,882	1,350
Transfers	–	12,278	12,278	13
Total revenues	1,926	32,234	34,160	1,363
Production costs (excluding production taxes)	(218)	(3,023)	(3,241)	(113)
Exploration expense	(240)	(96)	(336)	(2)
Depreciation, depletion, and amortization, and valuation provision	(306)	(2,504)	(2,810)	(127)
Taxes other than income taxes	(257)	(17,872)	(18,129)	(321)
Related income taxes	(314)	(1,813)	(2,127)	(275)
Total results of operations for producing activities	591	6,926	7,517	525

Year ended December 31, 2009	International	Russia	Total consolidated companies	Group's share in equity companies
Revenue				
Sales	1,472	13,870	15,342	824
Transfers	–	11,850	11,850	17
Total revenues	1,472	25,720	27,192	841
Production costs (excluding production taxes)	(195)	(2,592)	(2,787)	(98)
Exploration expense	(147)	(71)	(218)	(10)
Depreciation, depletion, and amortization, and valuation provision	(323)	(2,278)	(2,601)	(105)
Taxes other than income taxes	(206)	(12,830)	(13,036)	(186)
Related income taxes	(198)	(1,399)	(1,597)	(203)
Total results of operations for producing activities	403	6,550	6,953	239

#### IV. RESERVE QUANTITY INFORMATION

Proved reserves are the estimated quantities of oil and gas reserves which geological and engineering data demonstrate will be recoverable with reasonable certainty in future years from known reservoirs under existing economic and operating conditions. In accordance with Topic 932 of the Codification existing economic and operating conditions are based on the 12-months average price and the year-end costs. Proved reserves do not include additional quantities of oil and gas reserves that may result from applying secondary or tertiary recovery techniques not yet tested and determined to be economic.

Proved developed reserves are the quantities of proved reserves expected to be recovered through existing wells with existing equipment and operating methods.

Due to the inherent uncertainties and the necessarily limited nature of reservoir data, estimates of reserves are inher-

ently imprecise, require the application of judgment and are subject to change as additional information becomes available.

Management has included within proved reserves significant quantities which the Group expects to produce after the expiry dates of certain of its current production licenses in the Russian Federation. The Subsoil Law of the Russian Federation states that, upon expiration, a license is subject to renewal at the initiative of the license holder provided that further exploration, appraisal, production or remediation activities are necessary and provided that the license holder has not violated the terms of the license. Since the law applies both to newly issued and old licenses and the Group has currently renewed nearly 50% of its licenses, management believes that licenses will be renewed upon their expiration for the remainder of the economic life of each respective field.



Estimated net proved oil and gas reserves and changes thereto for the years ended December 31, 2011, 2010 and 2009, are shown in the tables set out below.

Millions of barrels	Consolidated subsidiaries			Group's share in equity companies
	International	Russia	Total	
<b>Crude oil</b>				
January 1, 2009	404	13,838	14,242	216
Revisions of previous estimates	(85)	(636)	(721)	15
Purchase of hydrocarbons in place	–	39	39	102
Extensions and discoveries	37	503	540	–
Production	(27)	(673)	(700)	(20)
Sales of reserves	–	(17)	(17)	–
December 31, 2009	329	13,054	13,383	313
Revisions of previous estimates	(4)	(292)	(296)	(5)
Purchase of hydrocarbons in place	62	–	62	–
Extensions and discoveries	10	550	560	10
Production	(26)	(658)	(684)	(24)
December 31, 2010	371	12,654	13,025	294
Revisions of previous estimates	(12)	233	221	7
Purchase of hydrocarbons in place	–	7	7	–
Extensions and discoveries	4	515	519	1
Production	(26)	(623)	(649)	(22)
<b>December 31, 2011</b>	<b>337</b>	<b>12,786</b>	<b>13,123</b>	<b>280</b>
Proved developed reserves				
December 31, 2009	186	8,442	8,628	199
December 31, 2010	207	8,401	8,608	182
<b>December 31, 2011</b>	<b>197</b>	<b>8,397</b>	<b>8,594</b>	<b>178</b>

The minority interest share included in the above total proved reserves was 163 million barrels, 187 million barrels and 242 million barrels as of December 31, 2011, 2010 and 2009, respectively. The minority interest share included in

the above proved developed reserves was 96 million barrels, 132 million barrels and 135 million barrels as of December 31, 2011, 2010 and 2009, respectively. Substantially all minority interests relate to the reserves in the Russian Federation.

Billions of cubic feet	Consolidated subsidiaries			Group's share in equity companies
	International	Russia	Total	
<b>Natural gas</b>				
January 1, 2009	6,806	22,273	29,079	174
Revisions of previous estimates	(294)	(6,081)	(6,375)	(3)
Purchase of hydrocarbons in place	–	13	13	130
Extensions and discoveries	294	164	458	–
Production	(175)	(436)	(611)	(15)
December 31, 2009	6,631	15,933	22,564	286
Revisions of previous estimates	(35)	1,214	1,179	11
Extensions and discoveries	98	226	324	4
Production	(187)	(540)	(727)	(26)
December 31, 2010	6,507	16,833	23,340	275
Revisions of previous estimates	(487)	273	(214)	25
Purchase of hydrocarbons in place	–	1	1	–
Extensions and discoveries	240	309	549	1
Production	(189)	(565)	(754)	(27)
<b>December 31, 2011</b>	<b>6,071</b>	<b>16,851</b>	<b>22,922</b>	<b>274</b>
Proved developed reserves				
December 31, 2009	2,002	5,636	7,638	157
December 31, 2010	2,715	6,024	8,739	143
<b>December 31, 2011</b>	<b>3,250</b>	<b>6,065</b>	<b>9,315</b>	<b>163</b>

The minority interest share included in the above total proved reserves was 32 billion cubic feet, 31 billion cubic feet and 36 billion cubic feet as of December 31, 2011, 2010 and 2009, respectively. The minority interest share included in the

above proved developed reserves was 22 billion cubic feet, 21 billion cubic feet and 23 billion cubic feet as of December 31, 2011, 2010 and 2009, respectively. Substantially all minority interests relate to the reserves in the Russian Federation.

## V. STANDARDIZED MEASURE OF DISCOUNTED FUTURE NET CASH FLOWS

The standardized measure of discounted future net cash flows, related to the above oil and gas reserves, is calculated in accordance with the requirements of Topic 932 of the Codification. Estimated future cash inflows from production are computed by applying the 12-months average price for oil and gas to year-end quantities of estimated net proved reserves. Adjustments in this calculation for future price changes are limited to those required by contractual arrangements in existence at the end of each reporting year. Future development and production costs are those estimated future expenditures necessary to develop and produce year-end estimated proved reserves based on year-end cost indices, assuming continuation of year-end economic conditions. Estimated future income taxes are calculated by applying appropriate year-end statutory tax rates. These rates reflect allowable deductions and tax credits and are applied to estimated future pre-tax net cash flows, less the tax bases of related assets. Discounted future net cash flows

have been calculated using a ten percent discount factor. Discounting requires a year-by-year estimate of when future expenditures will be incurred and when reserves will be produced.

The information provided in the tables set out below does not represent management's estimate of the Group's expected future cash flows or of the value of the Group's proved oil and gas reserves. Estimates of proved reserve quantities are imprecise and change over time as new information becomes available. Moreover, probable and possible reserves, which may become proved in the future, are excluded from the calculations. The arbitrary valuation, prescribed under Topic 932 of the Codification, requires assumptions as to the timing and amount of future development and production costs. The calculations should not be relied upon as an indication of the Group's future cash flows or of the value of its oil and gas reserves.

As of December 31, 2011	International	Russia	Total consolidated companies	Group's share in equity companies
Future cash inflows	51,665	616,290	667,955	25,773
Future production and development costs	(26,242)	(416,403)	(442,645)	(12,897)
Future income tax expenses	(6,056)	(35,768)	(41,824)	(2,896)
Future net cash flows	19,367	164,119	183,486	9,980
Discount for estimated timing of cash flows (10% p.a.)	(10,930)	(97,394)	(108,324)	(5,145)
Discounted future net cash flows	8,437	66,725	75,162	4,835
Minority share in discounted future net cash flows	–	937	937	–

OAo LUKOIL Supplementary Information on Oil and Gas Exploration and Production Activities (Unaudited)  
(Millions of US dollars, except as indicated)

<b>As of December 31, 2010</b>	<b>International</b>	<b>Russia</b>	<b>Total consolidated companies</b>	<b>Group's share in equity companies</b>
Future cash inflows	40,871	432,401	473,272	18,629
Future production and development costs	(23,193)	(313,375)	(336,568)	(9,503)
Future income tax expenses	(3,843)	(19,775)	(23,618)	(2,107)
Future net cash flows	13,835	99,251	113,086	7,019
Discount for estimated timing of cash flows (10% p.a.)	(8,641)	(60,808)	(69,449)	(3,656)
Discounted future net cash flows	5,194	38,443	43,637	3,363
Minority share in discounted future net cash flows	–	963	963	–

<b>As of December 31, 2009</b>	<b>International</b>	<b>Russia</b>	<b>Total consolidated companies</b>	<b>Group's share in equity companies</b>
Future cash inflows	31,025	385,266	416,291	14,816
Future production and development costs	(18,778)	(254,811)	(273,589)	(7,692)
Future income tax expenses	(2,337)	(22,285)	(24,622)	(1,489)
Future net cash flows	9,910	108,170	118,080	5,635
Discount for estimated timing of cash flows (10% p.a.)	(6,468)	(66,015)	(72,483)	(3,013)
Discounted future net cash flows	3,442	42,155	45,597	2,622
Minority share in discounted future net cash flows	–	1,370	1,370	–

**VI. PRINCIPAL SOURCES OF CHANGES IN THE STANDARDIZED MEASURE  
OF DISCOUNTED FUTURE NET CASH FLOWS**

<b>Consolidated companies</b>	<b>2011</b>	<b>2010</b>	<b>2009</b>
Discounted present value as at January 1	43,637	45,597	42,570
Net changes due to purchases and sales of minerals in place	39	(193)	86
Sales and transfers of oil and gas produced, net of production costs	(13,520)	(12,454)	(11,151)
Net changes in prices and production costs estimates	69,089	22,241	36,633
Net changes in mineral extraction taxes	(32,678)	(23,976)	(27,376)
Extensions and discoveries, less related costs	3,492	1,886	1,878
Previously estimated development cost incurred during the period	6,182	5,565	3,201
Revisions of previous quantity estimates	620	(433)	(4,495)
Net change in income taxes	(7,467)	407	(1,104)
Other changes	229	(141)	70
Accretion of discount	5,539	5,138	5,285
<b>Discounted present value at December 31</b>	<b>75,162</b>	<b>43,637</b>	<b>45,597</b>

<b>Group's share in equity companies</b>	<b>2011</b>	<b>2010</b>	<b>2009</b>
Discounted present value as at January 1	3,363	2,622	1,006
Net changes due to purchases and sales of minerals in place	–	–	1,182
Sales and transfers of oil and gas produced, net of production costs	(1,203)	(927)	(547)
Net changes in prices and production costs estimates	3,820	2,296	2,129
Net changes in mineral extraction taxes	(1,720)	(985)	(1,086)
Extensions and discoveries, less related costs	8	53	3
Previously estimated development cost incurred during the period	66	120	31
Revisions of previous quantity estimates	179	(56)	137
Net change in income taxes	(365)	(294)	(442)
Other changes	267	234	95
Accretion of discount	420	300	114
<b>Discounted present value at December 31</b>	<b>4,835</b>	<b>3,363</b>	<b>2,622</b>

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

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The following report contains a discussion and analysis of the financial condition of OAO LUKOIL as of December 31, 2011 and the results of its operations for each of the years ended December 31, 2011, 2010 and 2009, and significant factors that may affect its future performance. It should be read in conjunction with our US GAAP consolidated financial statements and notes and supplemental oil and gas disclosure.

References to "LUKOIL," "the Company," "the Group," "we" or "us" are references to OAO LUKOIL and its subsidiaries and equity affiliates. All dollar amounts are in millions of US dollars, unless otherwise indicated. Tonnes of crude oil produced are translated into barrels using conversion rates characterizing the density of oil from each of our oilfields. Tonnes of crude oil purchased as well as other operational

indicators expressed in barrels were translated into barrels using an average conversion rate of 7.33 barrels per tonne. Translations of cubic meters to cubic feet were made at the rate of 35.31 cubic feet per cubic meter. Translations of barrels of crude oil into barrels of oil equivalent ("BOE") were made at the rate of 1 barrel per BOE and of cubic feet into BOE at the rate of 6 thousand cubic feet per BOE.

**This report includes forward-looking statements – words such as "believes," "anticipates," "expects," "estimates," "intends," "plans," etc. – that reflect management's current estimates and beliefs, but are not guarantees of future results. Please see "Forward-looking statement" on page 229 for a discussion of some factors that could cause actual results to differ materially.**

## KEY FINANCIAL AND OPERATIONAL RESULTS

	2011	Change to 2010, %	2010	Change to 2009, %	2009
Sales (millions of US dollars)	133,650	27.3	104,956	29.4	81,083
Net income attributable to OAO LUKOIL (millions of US dollars)	10,357	15.0	9,006	28.5	7,011
Adjusted net income attributable to OAO LUKOIL (millions of US dollars) <sup>(1)</sup>	11,312	25.6	9,006	28.5	7,011
EBITDA (millions of US dollars)	18,606	15.9	16,049	19.1	13,475
Adjusted EBITDA (millions of US dollars) <sup>(1)</sup>	19,489	21.4	16,049	19.1	13,475
Taxes other than income taxes, excise and export tariffs (millions of US dollars)	(35,135)	26.1	(27,856)	42.6	(19,532)
Earning per share of common stock attributable to OAO LUKOIL (US dollars):					
Basic	13.30	21.4	10,95	32.2	8.28
Diluted	13.04	19.1	10,94	32.1	8.28
Hydrocarbon production by the Group including our share in equity affiliates (thousands of BOE)	780,980	(4.4)	817,335	1.2	807,301
Crude oil production by the Group including our share in equity affiliates (thousands of tonnes)	90,917	(5.3)	95,992	(1.7)	97,615
Gas available for sale produced by the Group including our share in equity affiliates (millions of cubic meters)	18,621	0.4	18,554	24.5	14,898
Refined products produced by the Group including our share in equity affiliates (thousands of tonnes)	62,667	(1.7)	63,770	6.2	60,057
Hydrocarbon proved reserves including our share in equity affiliates (millions of BOE)	17,269	0.1	17,255	(1.4)	17,504

<sup>(1)</sup> Adjusted for the impairment loss in OOO Narianmarneftegaz (see page 192 for details).

In 2011, our net income was \$10,357 million, which is \$1,351 million, or 15.0%, more than in 2010. At the same time, our net income for the fourth quarter of 2011 amounted to \$1,345 million, which is \$841 million, or 38.5%, less than in the fourth quarter of 2010.

The increase in our net income was mainly due to an increase in hydrocarbon prices in 2011, compared to the previous year. At the same time, our results were influenced by an increasing tax burden and the appreciation of the Russian ruble. Moreover, our net income for 2011 was materially affected by impairment loss in OOO Narian-marneftegaz in amount of \$955 million net of tax and non-controlling interest effect, recognized in the fourth quarter of 2011. On the contrary, in 2010, our net income included non-routine gains and losses in the net amount of \$132 million gain.

## BUSINESS OVERVIEW

The primary activities of OAO LUKOIL and its subsidiaries are oil exploration, production, refining, marketing and distribution. The Company is the ultimate parent entity of a vertically integrated group of companies.

OAO LUKOIL was established in accordance with Presidential Decree 1403, issued on November 17, 1992. Under this decree, on April 5, 1993, the Government of the Russian Federation transferred to the Company 51% of the voting shares of fifteen enterprises. Under Government Resolution 861 issued on September 1, 1995, a further nine enterprises were transferred to the Group during 1995. Since 1995, the Group has carried out a share exchange program to increase its shareholding in each of 24 founding subsidiaries to 100%. From formation, the Group has expanded substantially through consolidation of interests, acquisition of new companies and establishment of new businesses. Now LUKOIL is a global energy company operating through its subsidiaries in 37 countries on four continents.

LUKOIL is one of the world's largest energy companies in terms of hydrocarbon reserves that amounted to 17.3 billion BOE as of January 1, 2012 and comprised of 13.4 billion barrels of crude oil and 23.2 trillion cubic feet of gas.

Our operations are divided into four main business segments:

- **Exploration and Production** — which includes our exploration, development and production operations relating to crude oil and gas. These activities are primarily located within Russia, with additional activities in

Azerbaijan, Kazakhstan, Uzbekistan, the Middle East, South America, Northern and Western Africa and South-East Asia.

- **Refining, Marketing and Distribution** – which includes refining and transport operations, marketing and trading of crude oil, natural gas and refined products.
- **Chemicals** – which includes processing and trading of petrochemical products.
- **Power generation** – which includes generation, transportation and sales of electricity, heat and related services.

Each of our four main segments is dependent on the other, with a portion of the revenues of one segment being a part of the costs of the other. In particular, our Refining, Marketing and Distribution segment purchases crude oil from our Exploration and Production segment. As a result of certain factors considered in the “Domestic crude oil and refined products prices” section on page 200, benchmarking crude oil market prices in Russia cannot be determined with certainty. Therefore, the prices set for inter-segment purchases of crude oil reflect a combination of market factors, primarily international crude oil market prices, transportation costs, regional market conditions, the cost of crude oil refining and other factors. Accordingly, an analysis of either of these segments on a stand-alone basis could give a misleading impression of those segments’ underlying financial position and results of operations. For this reason, we do not analyze either of our main segments separately in the discussion that follows. However, we present the financial data for each in **Note 21 “Segment information”** to the consolidated financial statements.

## RECENT DEVELOPMENTS AND OUTLOOK

The following has been achieved in 2011:

### Exploration and production

4 new oil and gas fields were brought into production (2010: 11 oil and gas fields).

At the end of the year, we commenced gas production within the Gissar project in Uzbekistan, where the annual natural gas production is expected to reach 1.1 billion cubic meters.



In December, we purchased a 25.1% interest in OOO "Bashneft-Polus", a subsidiary of OAO "ANK Bashneft" ("Bashneft"), owning license and mineral rights for R. Trebs and A. Titov fields with recoverable oil reserves of 140.1 million tonnes.

### Refining

In April, the Group increased its stake in the joint venture operating the ISAB refining complex ("ISAB") from 49% to 60%.

In December, the construction of a delayed-coking unit with annual capacity of 1 million tonnes was completed at our Volgograd refinery. This increased refining depth at the refinery to 88%.

### Power generation

In April, a 110 MW combined cycle gas turbine ("CCGT") unit powered by natural gas was put into operation in Astrakhan.

These and other achievements in 2011 are described in detail further in this report.

## CHANGES IN THE GROUP STRUCTURE

In April 2011, LUKOIL and Bashneft signed an agreement to establish a joint venture and to stipulate conditions for the development of two fields named after R. Trebs and A. Titov located in Northern Timan-Pechora region. According to the agreement, in the end of December 2011, the Company purchased a 25.1% interest in OOO "Bashneft-Polus", a Bashneft subsidiary, in favor of which the license and mineral rights for R. Trebs and A. Titov fields were re-issued, for approximately \$153 million. In its turn, the joint venture purchased from a Group company 29 exploration wells located in the license area for \$60 million. The agreement also envisages the exploitation of the Group's infrastructure, including the oil export terminal in Varandey and the energy centre of the Yuzhnoye Khylochuyu field. The total recoverable oil reserves located within the license areas of R. Trebs and A. Titov fields are 140.1 million tonnes.

In April 2011, the Group acquired an 11% stake in the joint venture operating the ISAB for €241 million (approximately \$342 million) and thus increased the Group's ownership in it from 49% to 60%. This was a partial exercise of ERG S.p.A. ("ERG") option to sell its stake in the joint venture, established

in 2008. According to the agreement ERG has a put option to sell its stake in full. In January 2012, we were offered to acquire another 20% stake in the refining complex. The transaction is expected to be completed in the second quarter of 2012 in the amount of €400 million (approximately \$526 million), except for inventory cost. The transaction is subject to approval by the European regulating authorities.

In January 2010, the Company signed an agreement to develop the West Qurna-2 field located in the south of Iraq. The parties to the agreement are the Iraqi state-owned South Oil Company and the contracting consortium formed by the Iraqi state-owned North Oil Company, the Company and Norway's Statoil ASA. The Company's share in the project is 56.25%. The West Qurna-2 field has recoverable crude oil reserves of about 12.9 billion barrels.

As a part of the expansion of its presence in Kazakhstan, in December 2009, the Group acquired the remaining 46.0% interest in its equity affiliate LUKARCO B.V. ("LUKARCO") for \$1.6 billion, thereby increasing the ownership stake to 100%. LUKARCO is a holding company, which owns a 5.0% share in Tengizchevroil, a joint venture which develops the Tengiz and Korolevskoe fields in Kazakhstan, and a 12.5% share in Caspian Pipeline Consortium ("CPC"), which carries Kazakhstani and Russian oil to Novorossiysk marine terminal. Therefore, the Group increased the ownership in Tengizchevroil from 2.7% to 5.0% and the ownership in CPC from 6.75% to 12.5%. The first installment in the amount of \$300 million was paid in December 2009. \$800 million were paid in December 2010 and the remaining amount – in December 2011.

## IMPAIRMENT OF ASSETS IN OOO NARIANMARNEFTEGAZ

In 2005, the Company and ConocoPhillips, within their strategic partnership, established a joint venture based on a Group subsidiary OOO Narianmarneftegaz ("NMNG") to develop oilfields located in Northern Timan-Pechora region of Russia. The Group's share in joint venture is 70%, LUKOIL and ConocoPhillips run NMNG on a 50/50 basis. In 2008, NMNG commenced commercial production at the Yuzhnoye Khylochuyu oilfield, joint venture's major oilfield. As of December 31, 2008, proved reserves of the oilfield were estimated to be approximately 505 million barrels. In 2009 and 2010, the crude oil production from the field amounted to 7.0 and 6.9 million tonnes, respectively. In 2010, the production from the oilfield began to decline due to some unexpected geological reasons and it only

reached 3.3 million tonnes in 2011. As of December 31, 2011, crude oil reserves decreased significantly and amounted to approximately 142 million barrels. In 2011, as a result of respective analysis the Company recognized an impairment loss regarding upstream and other assets of NMNG in amount of \$1,261 million. An impact on our net income net of ConocoPhillip's share in the impairment loss and deferred tax assets write-off amounted to \$955 million and an impact on our EBITDA amounted to \$883 million.

## RESOURCE BASE

The table below summarizes the net oil-equivalent proved reserves of consolidated subsidiaries and our share in equity affiliates under SEC standards (until the economic limit of commercial production is reached) that have been derived or extracted from our reserve reports audited by Miller and Lents, Ltd., our independent reservoir engineers, as of January 1, 2012 and 2011.

Changes in 2011					
(millions of BOE)	January 1, 2012	Production <sup>(1)</sup>	Extensions, discoveries and changes in structure	Revision of previous estimates	January 1, 2011
Western Siberia	9,711	(439)	307	(18)	9,861
Timan-Pechora	2,550	(134)	97	54	2,533
Ural region	2,169	(100)	22	214	2,033
Volga region	974	(33)	140	22	845
Other in Russia	224	(15)	9	7	223
Outside Russia	1,641	(81)	44	(82)	1,760
<b>Proved oil and gas reserves</b>	<b>17,269</b>	<b>(802)</b>	<b>619</b>	<b>197</b>	<b>17,255</b>
<b>Probable oil and gas reserves</b>	<b>8,415</b>				<b>8,455</b>
<b>Possible oil and gas reserves</b>	<b>3,939</b>				<b>3,167</b>

<sup>(1)</sup> Gas production shown before own consumption.

The Company's proved reserves as of January 1, 2012 amount to 17,269 million BOE and comprise of 13,403 million barrels of crude oil and 23,196 billion cubic feet of gas.

In 2011, proved reserves growth as a result of geological exploration, production drilling and acquisitions, totaled 619 million BOE. Revision of previous estimates contributed 197 million BOE to the increase.

Significant progress was achieved in 2011 in the preparation and commissioning of a number of new fields of the Company, which allowed the Group to transfer 170 million BOE from the contingent resources category to the category of proved reserves. At the same time, rapid production drop at the Yuzhnoye Khylochuyu oilfield, as compared to the earlier forecasts, led to a decrease in the proved reserves by 147 million BOE.

## OPERATIONAL HIGHLIGHTS

### HYDROCARBON PRODUCTION

We undertake exploration for, and production of, crude oil and natural gas in Russia and internationally. In Russia our major oil producing subsidiaries are OOO LUKOIL-Western Siberia, OOO LUKOIL-Komi and OOO LUKOIL-Perm. Also

we have a consolidated joint venture with ConocoPhillips, OOO Narianmarneftegaz, in the Northern Timan-Pechora region. Exploration and production outside of Russia is performed by our 100% subsidiary LUKOIL-Overseas, that has stakes in PSA's and other projects in Kazakhstan, Azerbaijan, Uzbekistan, Iraq, Saudi Arabia, Columbia, Ghana, Vietnam and Cote d'Ivoire.

The table below summarizes the results of our exploration and production activities.

	2011	2010	2009
	(thousand BOE per day)		
Daily production of hydrocarbons, including the Company's share in equity affiliates, including:	2,140	2,239	2,212
- crude oil	1,840	1,940	1,972
- natural and petroleum gas <sup>(1)</sup>	300	299	240
	(US dollar per BOE)		
Hydrocarbon extraction expenses	4.71	4.12	3.56
- in Russia	4.70	4.11	3.53
- outside Russia	4.85	4.29	3.99
	(millions of US dollars)		
Hydrocarbon extraction expenses	3,540	3,241	2,787
- in Russia	3,298	3,023	2,592
- outside Russia	242	218	195
Exploration expenses	532	336	218
- in Russia	93	96	71
- outside Russia	439	240	147
Mineral extraction tax	11,594	7,864	5,452
- in Russia	11,502	7,795	5,399
- outside Russia	92	69	53

<sup>(1)</sup> Gas available for sale (excluding gas produced for our own consumption).

**Crude oil production.** In 2011, our daily crude oil production decreased to 1,840 thousand barrels, or by 5.2%, compared to 2010. We produced (including the Company's

share in equity affiliates) 671.4 million barrels, or 90.9 million tonnes of crude oil.

The following table represents our crude oil production in 2011 and 2010 by major regions.

(thousands of tonnes)	Change to 2010				
	2011	Total, %	Change in structure	Organic change	2010
Western Siberia	49,102	(3.6)	–	(1,832)	50,934
Timan-Pechora	17,547	(17.1)	–	(3,628)	21,175
Ural region	12,805	3.4	–	420	12,385
Volga region	3,203	9.8	–	287	2,916
Other in Russia	1,952	(3.4)	–	(69)	2,021
Crude oil produced in Russia	84,609	(5.4)	–	(4,822)	89,431
Crude oil produced internationally	3,413	(1.4)	–	(47)	3,460
<b>Total crude oil produced by consolidated subsidiaries</b>	<b>88,022</b>	<b>(5.2)</b>	<b>–</b>	<b>(4,869)</b>	<b>92,891</b>
<b>Our share in crude oil produced by equity affiliates:</b>					
in Russia	357	6.3	–	21	336
outside Russia	2,538	(8.2)	–	(227)	2 765
<b>Total crude oil produced</b>	<b>90,917</b>	<b>(5.3)</b>	<b>–</b>	<b>(5,075)</b>	<b>95,992</b>

The main oil producing region for the Company is Western Siberia where we produced 55.8% of our crude oil in 2011 (54.8% in 2010 and 55.7% in 2009). In 2011, the Western Siberian producing assets continued to mature resulting in a production decline and water cut increase. The Company undertakes efforts to stabilize production in the region.

The main reason for the production decrease in Timan-Pechora was a decrease in wells' flow rates as a result of the water cut growth and the decrease of recoverable

reserves related to reconsideration of the geological model of the Yuzhnoye Khylychuyu oilfield.

In addition to our production, we purchase crude oil in Russia and on international markets. In Russia we primarily purchase crude oil from affiliated producing companies and other producers. Then we either refine or export purchased crude oil. Crude oil purchased on international markets is normally used for trading activities, for supplying our international refineries or for processing at third party refineries.

	2011		2010		2009	
	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)
Crude oil purchases in Russia	4 010	547	2 243	306	4 442	606
Crude oil purchases internationally	151 753	20 703	156 759	21 386	150 258	20 499
<b>Total crude oil purchased</b>	<b>155 763</b>	<b>21 250</b>	<b>159 002</b>	<b>21 692</b>	<b>154 700</b>	<b>21 105</b>

Significant part of our crude oil purchases is for processing. In 2011, we purchased 12,969 thousand tonnes of crude oil

to process at our and at third party refineries, compared to 12,516 thousand tonnes in 2010.

**Gas production.** In 2011, we produced 18,621 million cubic meters of gas available for sale (including our share in equity affiliates), that is approximately on the same level as in 2010.

Our major gas production field is the Nakhodkinskoe field, where we produced 8,273 million cubic meters of natural gas in 2011 (8,146 million cubic meters in 2010). Our international natural gas production decreased by 1.9%.

## REFINING, MARKETING AND TRADING

**Refining.** We own and operate four refineries located in European Russia and three refineries located outside of Russia – in Bulgaria, Ukraine and Romania. Moreover, we have a 60% stake in the ISAB refinery complex in Italy (49% before April 1, 2011) and a 45% interest in the TRN refinery in the Netherlands.

Compared to 2010, production at our consolidated refineries decreased by 3.2%. Russian refineries decreased their production by 0.2%, while international refineries' production decreased by 17.1% mainly as a result of the shutdown of the Odessa refinery. The production of our affiliated refineries ISAB and TRN increased by 5.5% resulting from the increase of Group's share in the ISAB refinery.

We invested, and continue to invest, significant resources in our refineries aiming at taking the leading position in Russia in producing ecological fuel of high quality standards. Thus, in December 2010, we launched a catalytic cracking complex at our refinery in Nizhny Novgorod that enabled us to start production of gasoline fully compliant to the Euro-4 quality standard. Related investments amounted to approximately \$1 billion. In December 2011,

we completed construction of a delayed-coking unit with annual capacity of 1 million tonnes at our Volgograd refinery increasing refining depth to 88%.

In Russia, LUKOIL holds the leading position in production and sales of European standards motor fuel being ahead of the official terms of their obligatory implementation in the country. At our Russian refineries we produced 8,701, 8,429 and 7,266 thousand tonnes of Euro-4 and -5 diesel fuel and 6,416, 5,373, and 4,746 thousand tonnes of Euro-3, -4 and -5 gasoline in 2011, 2010 and 2009, respectively. We commenced production of Euro-5 gasoline in the end of 2010.

The share of Euro-3 and Euro-4 gasoline exceeds 90% and the share of Euro-4 and Euro-5 diesel exceeds 70% of our total domestic production. We have technological capacity to produce all our gasoline in compliance with the Euro-4 standards. Production of lower quality gasoline is stipulated by the necessity to supply the federal customers. We will be able to increase the share of Euro-4 and Euro-5 diesel to 97% of our total domestic diesel production after the launch of the new fuel hydrorefining unit at Volgograd refinery scheduled for the second half of 2012.

Along with our own production of refined products we can refine crude oil at third party refineries depending on market conditions and other factors. Before 2010, we processed crude oil at third party refineries in Russia, Belarus and Serbia primarily to supply our networks in the Ural region of Russia and in Eastern Europe, as well as for export sales. Starting from 2010, we sell our crude oil to the refineries in Ural region and purchase refined products from them. In the end of 2009, we also ceased crude oil refining in Belarus due to certain amendments in the customs legislation. In the third quarter of 2010, we began refining our crude oil at a third party refinery in Kazakhstan.

The following table summarizes key figures for our refining activities.

	2011	2010	2009
	(millions of US dollars)		
Refining expenses at the Group refineries	1,444	1,121	923
- in Russia	1,112	806	671
- outside Russia	332	315	252
Refining expenses at ISAB and TRN	890	719	543
Refining expenses at third party refineries	7	5	170
Capital expenditures	783	702	828
- in Russia	586	542	520
- outside Russia	197	160	308
	(thousand barrels per day)		
Refinery throughput at the Group refineries	1,073	1,107	1,103
- in Russia	909	908	893
- outside Russia	164	199	210
Refinery throughput at ISAB and TRN <sup>(1) (2)</sup>	230	222	155
Refinery throughput at third party refineries	5	2	77
<b>Total refinery throughput</b>	<b>1,308</b>	<b>1,331</b>	<b>1,335</b>
	(thousands of tonnes)		
Refined products produced at the Group refineries	51,055	52,762	52,376
- in Russia	43,248	43,346	42,586
- outside Russia	7,807	9,416	9,790
Production of ISAB and TRN <sup>(1)</sup>	11,612	11,008	7,681
Refined products produced at third party refineries	256	107	3,485
<b>Total refined products produced</b>	<b>62,923</b>	<b>63,877</b>	<b>63,542</b>

<sup>(1)</sup> Group's share.

<sup>(2)</sup> Including refined product processed.

**Marketing and trading.** Our marketing and trading activities mainly include wholesale and bunkering operations in Western Europe, South-East Asia, Central America and retail operations in the USA, Central and Eastern Europe, the Baltic States and other regions. In Russia we purchase refined products on occasion, primarily to manage supply chain bottlenecks.

The Group retails its refined products in 26 countries through nearly 5.7 thousand petrol stations. Most of the stations operate under the LUKOIL brand. Due to the restructuring of our retail network in the USA, the number of petrol stations decreased compared to the beginning of the year (over 6 thousand stations).

The table below summarizes figures for our trading activities.

	2011	2010	2009
	(thousands of tonnes)		
Retail sales	15,249	14,336	14,613
Wholesale sales	87,337	91,020	86,147
<b>Total refined products sales</b>	<b>102,586</b>	<b>105,356</b>	<b>100,760</b>
Refined products purchased in Russia	2,026	1,853	625
Refined products purchased internationally	45,655	45,816	41,445
<b>Total refined products purchased</b>	<b>47,681</b>	<b>47,669</b>	<b>42,070</b>

The decrease in wholesale volumes compared to 2010 was substantially outside of Russia and resulted from the shut-down of the Odessa refinery. Moreover, the increase in retail

sales on domestic market and increase in Russian refineries' inventory stock resulted in a decrease in refined products export from Russia.

**Exports of crude oil and refined products from Russia.** The volumes of crude oil exported from Russia by our subsidiaries are summarized as follows:

	2011		2010		2009	
	(thousands of barrels)	(thousands of tonnes)	(thousands of barrels)	(thousands of tonnes)	(thousands of barrels)	(thousands of tonnes)
Exports of crude oil using Transneft export routes	215,605	29,414	231,525	31,586	241,890	33,000
Exports of crude oil bypassing Transneft	38,739	5,285	65,999	9,004	66,109	9,019
<b>Total crude oil exports</b>	<b>254,344</b>	<b>34,699</b>	<b>297,524</b>	<b>40,590</b>	<b>307,999</b>	<b>42,019</b>

In 2011, our export of crude oil from Russia decreased by 14.5%, compared to 2010, and we exported 41.0% of our total domestic crude oil production (45.4% in 2010). The reduction of our export was largely caused by a decline in production (mainly from Yuzhnoye Khylochuyu oilfield).

In 2011 and 2010, almost all of the volume of crude oil exported bypassing Transneft was routed through our own export infrastructure.

In 2011, we exported from Russia 24.0 million tonnes of refined products, a decrease of 6.9%, compared to 2010, mostly due to the increase of domestic sales volumes. Primarily, we export from Russia diesel fuel, fuel oil and gas-oil. These products account for approximately 89% of our refined products export volumes.

In 2011, our revenue from export of crude oil and refined products from Russia both to Group companies and third

parties amounted to \$25,022 million and \$17,725 million, respectively (\$22,178 million for crude oil and \$14,088 million for refined products in 2010).

## POWER GENERATION

In 2011, we continued to develop the new power generation sector of our business as part of our strategic development program. This new sector encompasses all aspects of the power generation business, from generation to transmission and sale of heat and electrical power. Our power generation business sector now includes OOO LUKOIL-Volgogradenergo, OOO LUKOIL-Volgogradteploenergo, OOO LUKOIL-Kubanenergo, OOO LUKOIL-Astrakhanenergo, OOO LUKOIL-Rostovenergo, OOO LUKOIL-Stavropolenergo, OOO LUKOIL-TTK (all spun off from OOO UGK TGK-8), OOO LUKOIL-Ecoenergo (former OOO UGK TGK-8), our own power generating facilities at our

oil and gas fields and power generators in Bulgaria, Romania and Ukraine. Our total output of electrical energy was 12.6 billion kW-h in 2011 and 13.2 billion kW-h in 2010. Our total output of heat energy was approximately 15.2 million Gcal in 2011 (15.3 million Gcal in 2010).

In April 2011, we commissioned the CCGT unit with a capacity of 110 MW in Astrakhan. The CCGT unit utilizes natural gas as primary and backup fuel. LUKOIL invested over \$150 million in the project.

In 2011, we completed the construction of the CCGT unit with a capacity of 410 MW in Krasnodar. The turbine is in standby mode. The new unit increases the installed electric capacity of power plant in Krasnodar to 1,090 MW.

In 2012, we began construction of another two CCGT units in Astrakhan with a combined capacity of 235 MW. The completion is scheduled for the third quarter of 2013.

## MAIN MACROECONOMIC FACTORS AFFECTING OUR RESULTS OF OPERATIONS

### CHANGES IN THE PRICE OF CRUDE OIL AND REFINED PRODUCTS

The price at which we sell crude oil and refined products is the primary driver of the Group's revenues. During 2011, the Brent crude oil price fluctuated between \$93 and \$126 per barrel and reached its peak of \$126.7 in the beginning of April of 2011.

The crude oil price growth that started in December 2010 and continued during the first half of 2011 was caused mainly

by speculative factors as a consequence of political instability in the Middle East and Northern Africa. In the third quarter of 2011, crude oil prices stabilized, however financial tensions in Europe and the USA caused some price correction.

Substantially all the crude oil the Group exports is Urals blend. The following table shows the average crude oil and refined product prices in 2011, 2010 and 2009.

	2011	Change to 2010, %	2010	Change to 2009, %	2009
(in US dollars per barrel, except for figures in percent)					
Brent crude	111.26	39.9	79.50	28.9	61.67
Urals crude (CIF Mediterranean) <sup>(1)</sup>	109.10	39.4	78.29	27.9	61.22
Urals crude (CIF Rotterdam) <sup>(1)</sup>	109.08	39.4	78.26	28.0	61.15
(in US dollars per metric tonne, except for figures in percent)					
Fuel oil 3.5% (FOB Rotterdam)	609.51	37.8	442.35	28.0	345.72
Diesel fuel 10 ppm (FOB Rotterdam)	958.73	39.3	688.46	28.7	534.84
High-octane gasoline (FOB Rotterdam)	984.12	33.9	735.24	27.0	579.01

Source: Platts.

<sup>(1)</sup> The Company sells crude oil on foreign markets on various delivery terms. Thus, our average realized sale price of oil on international markets differs from the average prices of Urals blend on Mediterranean and Northern Europe markets.



## DOMESTIC CRUDE OIL AND REFINED PRODUCTS PRICES

Substantially all crude oil produced in Russia is produced by vertically integrated oil companies such as ours. As a result, most transactions are between affiliated entities within vertically integrated groups. Thus, there is no concept of a benchmark domestic market price for crude oil. The price of crude oil that is produced but not refined or exported by one of the vertically integrated oil companies is

generally determined on a transaction-by-transaction basis against a background of world market prices, but with no direct reference or correlation. At any time there may exist significant price differences between regions for similar quality crude oil as a result of the competition and economic conditions in those regions.

Domestic prices for refined products are determined to some extent by world market prices, but they are also directly affected by local demand and competition.

The table below represents average domestic wholesale prices of refined products in 2011, 2010 and 2009.

	2011	Change to 2010, %	2010	Change to 2009, %	2009
(in US dollars per metric tonne, except for figures in percent)					
Fuel oil	318.99	30.1	245.27	51.3	162.12
Diesel fuel	760.53	36.5	557.36	20.5	462.65
High-octane gasoline (Regular)	857.70	20.1	714.26	22.1	584.87
High-octane gasoline (Premium)	897.81	20.8	743.17	16.8	636.24

Source: InfoTEK (excluding VAT).

## CHANGES IN THE US DOLLAR-RUBLE EXCHANGE RATE AND INFLATION

A substantial part of our revenue is either denominated in US dollars or is correlated to some extent with US dollar crude oil prices, while most of our costs in the Russian Federation are settled in Russian rubles. Therefore, ruble inflation and movements of exchange rates can significantly

affect the results of our operations. In particular, the appreciation of the ruble against the US dollar generally causes our costs to increase in US dollar terms, and vice versa. The devaluation of the purchasing power of the US dollar in the Russian Federation calculated on the basis of the ruble-dollar exchange rates and the level of inflation in Russia was 12.0% in 2011, compared to 2010.

The following table gives data on inflation in Russia and the change in the ruble-dollar exchange rate.

	2011	2010	2009
Ruble inflation (CPI), %	6.1	8.7	8.9
Change of the ruble-dollar exchange rate, %	5.6	0.8	2.9
Average exchange rate for the period (ruble to US dollar)	29.39	30.37	31.72
Exchange rate at the end of the period (ruble to US dollar)	32.20	30.48	30.24

## TAX BURDEN

Given the relative size of our activities in Russia, our tax profile is largely determined by the taxes payable in Russia (based on records maintained under Russian legislation – not US GAAP). In 2011, 2010 and 2009, the tax charge on the operations in Russia was approximately 88%, 85% and 81% of our total tax charge, respectively.

Apart of income tax, fundamental taxes specific to the oil industry in Russia are mineral extraction tax, excise and export tariffs. In addition to above mentioned taxes, we are subject to a number of other taxes in Russia, including social taxes, property tax, VAT and other local and regional taxes.

The effective rates of total taxes and tariffs (total taxes, including income taxes, taxes other than on income and excise and export tariffs, divided by income before taxes

and tariffs) for 2011, 2010 and 2009, respectively, were 77%, 77% and 75%. In 2011, tax expenses in Russia were about 52% of the domestic and export sales revenue of Russian companies of the Group.

The measures that we use for tax planning and management strategies have been based on our understanding of tax legislation existing at the time of implementation of these measures. We are subject to tax authority audits on an ongoing basis, as is normal in the Russian environment, and, at times, the authorities have attempted to impose significant additional taxes on us. We believe that we have adequately met and provided for tax liabilities based on our interpretation of existing tax legislation. However, the relevant authorities may have differing interpretations and the effects could be significant.

The following table represents average enacted rates for taxes specific to the oil industry in Russia for the respective periods.

		2011 <sup>(1)</sup>	Change to 2010, %	2010 <sup>(1)</sup>	Change to 2009, %	2009 <sup>(1)</sup>
Export tariffs on crude oil	\$/tonne	409.19	49.6	273.55	52.0	179.93
Export tariffs on refined products						
Middle distillates (jet fuel), diesel fuel and gasoils	\$/tonne	274.27	39.5	196.60	47.2	133.54
Light distillates						
gasoline	\$/tonne	341.94	73.9	196.60	47.2	133.54
straight-run gasoline	\$/tonne	333.08	69.4	196.60	47.2	133.54
Liquid fuels (fuel oil)	\$/tonne	208.46	96.8	105.91	47.2	71.93
Mineral extraction tax						
Crude oil	RUR/tonne	4,456.54	44.9	3,075.76	33.6	2,302.85
Natural gas	RUR/1,000 m <sup>3</sup>	237.00	61.2	147.00	–	147.00

<sup>(1)</sup> Average values.

Tax rates set in rubles and translated at the average exchange rates are as follows:

		2011 <sup>(1)</sup>	Change to 2010, %	2010 <sup>(1)</sup>	Change to 2009, %	2009 <sup>(1)</sup>
Mineral extraction tax						
Crude oil	\$/tonne	151.65	49.7	101.28	39.5	72.59
Natural gas	\$/1,000 m <sup>3</sup>	8.06	66.5	4.84	4.5	4.63

<sup>(1)</sup> Average values.

The rates of taxes specific to the oil industry in Russia are linked to international crude oil prices and are changed in line with them. The methods to determine the rates for such taxes are presented below.

**Crude oil extraction tax rate.** The base rate is 419 rubles per metric tonne extracted and it is adjusted depending on the international market price of Urals blend and the ruble exchange rate. The tax rate is zero when the average Urals blend international market price for a tax period is less than or equal to \$15.00 per barrel. Each \$1.00 per barrel increase in the international Urals blend price over the threshold (\$15.00 per barrel) results in an increase of the tax rate by \$1.61 per tonne extracted (or \$0.22 per barrel extracted using a conversion factor of 7.33).

The base rate for 2012 and 2013 is currently set at 446 rubles and 470 rubles per metric tonne extracted, respectively. However, the rate may be amended by the authorities later on.

The crude oil extraction tax rate varies depending on the development and depletion of a particular oilfield. The tax rate is zero for extra-heavy crude oil and for crude oil produced in certain regions of Eastern Siberia, the Caspian Sea and the Nenetsky Autonomous District, depending on the period and volume of production.

The Group benefited from the application of zero tax rate to crude oil produced from certain greenfields in the Nenetsky Autonomous District, the major of which was the Yuzhnoye Khylochuyu oilfield. However, in early December 2010, we exceeded the accumulated production limit of 15 million tonnes at this field eligible for the incentive. Thus, starting from December 2010, we pay mineral extraction tax at a regular rate at the Yuzhnoye Khylochuyu oilfield.

The Group also produces crude oil from several greenfields in the Caspian Sea. In 2011, the amount of incentive was relatively insignificant, but we expect it to become sizable as the production volumes grow.

**Natural gas extraction tax rate.** The mineral extraction tax on natural gas production is calculated using a flat rate. In 2009, the rate per thousand cubic meters of natural gas

extracted was 147 rubles. In 2010 and 2011, the rate was 237 rubles. On January 1, 2012, the rate was raised to 251 rubles per thousand cubic meters.

**Crude oil export duty rate is calculated on a progressive scale.** The rate is zero when the average Urals blend international market price is less than or equal to approximately \$15.00 per barrel (\$109.50 per metric tonne). If the Urals blend price is between \$15.00 and \$20.00 per barrel (\$146.00 per metric tonne), each \$1.00 per barrel increase in the Urals blend price over \$15.00 results in an increase of the crude oil export duty rate by \$0.35 per barrel exported. If the Urals blend price is between \$20.00 and \$25.00 per barrel (\$182.50 per metric tonne), each \$1.00 per barrel increase in the Urals blend price over \$20.00 results in an increase of the crude oil export duty rate by \$0.45 per barrel exported. Each \$1.00 per barrel increase in the Urals blend price over \$25.00 per barrel results in an increase of the crude oil export duty rate no more than by \$0.65 per barrel exported. Starting from October 1, 2011, the maximum increase of export duty rate is \$0.60 per barrel for each \$1.00 per barrel increase in the Urals blend price.

The crude oil export duty rate is revised monthly on the basis of the immediately preceding one-month period of crude oil price monitoring.

A special export duty regime is in place for certain greenfields. Effective from December 2010, the list of the oilfields where the reduced rate applies also includes our Yu. Korchagin and V. Filanovsky oilfields located in the Caspian Sea.

**Export duty rates on refined products prior to 2011** were set by the Russian government. The rate of export duty depended on internal demand for refined products and international crude oil market conditions. Starting from 2011, export duty rates on refined products are calculated by multiplying the current crude oil export duty rate by a coefficient according to the table below.

	Before October 1 <sup>st</sup> , 2011	After October 1 <sup>st</sup> , 2011
Multiplier for:		
Light distillates (except for gasolines), middle distillates (jet fuel), diesel fuel and gasoils	0.670	0.660
Gasolines <sup>(1)</sup>	0.467	0.900
Liquid fuels (fuel oil)	0.467	0.660
Motor and other oils	0.467	0.660
Other products	0.467	0.660

<sup>(1)</sup> Starting from May 2011, a coefficient for gasoline export duty rate is set at 0.9.

**Crude oil and refined products exported to CIS countries,** other than Ukraine, are not subject to export duties.

tries where the Group operates, excises are paid either by producers or retailers depending on the local legislation.

**Excise on refined products.** The responsibility to pay excises on refined products in Russia is imposed on refined product producers (except for straight-run gasoline). In other coun-

Starting from 2011, excise rates on refined products in Russia were increased and tied to the ecological class of fuel. Excise tax rates for 2011, 2010 and 2009 are listed below:

		2011	Change to 2010, %	2010	Change to 2009, %	2009
Gasoline						
Low-octane gasoline not compliant to Euro-3	RUR/tonne	5,995.00	105.1	2,923.00	10.0	2,657.00
High-octane gasoline not compliant to Euro-3	RUR/tonne	5,995.00	50.2	3,992.00	10.0	3,629.00
Euro-3	RUR/tonne	5,672.00	42.1	3,992.00	10.0	3,629.00
Euro-4 and -5	RUR/tonne	5,143.00	28.8	3,992.00	10.0	3,629.00
Diesel fuel						
Below Euro-3	RUR/tonne	2,753.00	131.7	1,188.00	10.0	1,080.00
Euro-3	RUR/tonne	2,485.00	109.2	1,188.00	10.0	1,080.00
Euro-4 and -5	RUR/tonne	2,247.00	89.1	1,188.00	10.0	1,080.00
Motor oils	RUR/tonne	4,681.00	44.2	3,246.10	10.0	2,951.00
Straight-run gasoline	RUR/tonne	6,089.00	41.9	4,290.00	10.0	3,900.00

		2011	Change to 2010, %	2010	Change to к 2009, %	2009
Gasoline						
Low-octane gasoline not compliant to Euro-3	RUR/tonne	204.00	111.9	96.25	14.9	83.76
High-octane gasoline not compliant to Euro-3	RUR/tonne	204.00	55.2	131.45	14.9	114.40
Euro-3	RUR/tonne	193.01	46.8	131.45	14.9	114.40
Euro-4 and -5	RUR/tonne	175.01	33.1	131.45	14.9	114.40
Diesel fuel						
Below Euro-3	RUR/tonne	93.68	139.5	39.12	14.9	34.04
Euro-3	RUR/tonne	84.56	116.2	39.12	14.9	34.04
Euro-4 and -5	RUR/tonne	76.46	95.5	39.12	14.9	34.04
Motor oils	RUR/tonne	159.29	49.0	106.89	14.9	93.02
Straight-run gasoline	RUR/tonne	207.20	46.7	141.26	14.9	122.94

**Income tax.** Starting from January 1, 2009, the Federal income tax rate is 2.0% and the regional income tax rate varies between 13.5% and 18.0%. The Group's foreign operations are subject to taxes at the tax rates applicable to the jurisdictions in which they operate.

Until January 1, 2012, there were no provisions in the taxation legislation of the Russian Federation to permit the Group to reduce taxable profits of a Group company by offsetting tax losses of another Group company against such profits. Tax losses may be fully or partially used to offset taxable profits in the same company in any of the ten years following the year of loss.

Starting from January 1, 2012, if certain conditions are met, taxpayers will be able to pay income tax as a consolidated taxpayers' group ("CTG"). This allows taxpayers to offset taxable losses generated by certain participants of a CTG against taxable profits of other participants of the CTG. During 2012, certain Group companies are going to meet legislation requirements and pay income tax as the CTG.

Losses generated by a taxpayer before joining a CTG are not available for offset against taxable profits of other participants of the CTG. However, if a taxpayer leaves a CTG, such losses again become available for offset against future profits generated by the same taxpayer. The expiration period of the losses is extended to take account of any time spent within a CTG when the losses were unavailable for use.

## TRANSPORTATION OF CRUDE OIL AND REFINED PRODUCTS IN RUSSIA

The main Russian crude oil production regions are remote from the main crude oil and refined products markets. Therefore, access by crude oil production companies to the markets is dependent on the extent of diversification of the transport infrastructure and access to it. As a result, transportation cost is an important macroeconomic factor affecting our net income.

Transportation of crude oil produced in Russia to refineries and export destinations is performed primarily through the trunk oil pipeline system of state-owned OAO AK Transneft or by railway transport.

Transportation of refined products in Russia is performed by railway transport and the pipeline system of OAO AK Transnefteproduct. The Russian railway infrastructure is owned and operated by OAO Russian Railways. Both these companies are state-owned. We transport the major part of our refined products by railway transport.

In Russia, the gas is mostly sold at the wellhead and then transported through the Unified Gas Supply System ("UGSS"). The UGSS is responsible for gathering, transporting, dispatching and delivering substantially all natural gas supplies in Russia and is owned and operated by OAO Gazprom ("Gazprom"). The Federal Service for Tariffs of the Russian Federation regulates natural gas transportation tariffs. We are not able to sell our gas other than through UGSS.

**YEAR ENDED DECEMBER 31, 2011, COMPARED TO YEARS ENDED DECEMBER 31, 2010 AND DECEMBER 31, 2009.**

The table below presents our consolidated statements of income for the periods indicated.

	2011	2010	2009
	(millions of US dollars)		
<b>Revenues</b>			
Sales (including excise and export tariffs)	133,650	104,956	81,083
<b>Costs and other deductions</b>			
Operating expenses	(9,055)	(8,298)	(7,340)
Cost of purchased crude oil, gas and products	(59,694)	(43,250)	(31,761)
Transportation expenses	(6,121)	(5,608)	(4,830)
Selling, general and administrative expenses	(3,822)	(3,558)	(3,306)
Depreciation, depletion and amortization	(4,473)	(4,154)	(3,937)
Taxes other than income taxes	(12,918)	(8,978)	(6,474)
Excise and export tariffs	(22,217)	(18,878)	(13,058)
Exploration expense	(532)	(336)	(218)
Loss on disposals and impairments of assets	(1,663)	(363)	(381)
<b>Income from operating activities</b>	<b>13,155</b>	<b>11,533</b>	<b>9,778</b>
Interest expense	(694)	(712)	(667)
Interest and dividend income	211	174	134
Equity share in income of affiliates	690	472	351
Currency translation loss	(301)	(122)	(520)
Other non-operating income (expense)	58	125	(13)
<b>Income before income taxes</b>	<b>13,119</b>	<b>11,470</b>	<b>9,063</b>
Current income taxes	(2,678)	(2,104)	(1,922)
Deferred income taxes	(615)	(247)	(72)
<b>Total income tax expense</b>	<b>(3,293)</b>	<b>(2,351)</b>	<b>(1,994)</b>
<b>Net income</b>	<b>9,826</b>	<b>9,119</b>	<b>7,069</b>
Net loss (income) attributable to noncontrolling interests	531	(113)	(58)
<b>Net income attributable to OAO LUKOIL</b>	<b>10,357</b>	<b>9,006</b>	<b>7,011</b>
Earning per share of common stock attributable to OAO LUKOIL (in US dollars):			
Basic	13.30	10.95	8.28
Diluted	13.04	10.94	8.28

The analysis of the main financial indicators of the financial statements is provided below.

## SALES REVENUES

Sales breakdown	2011	2010	2009
	(millions of US dollars)		
Crude oil			
Export and sales on international markets other than CIS	30,132	25,251	18,276
Export and sales to CIS	2,390	1,091	1,638
Domestic sales	1,571	956	735
	<b>34,093</b>	<b>27,298</b>	<b>20,649</b>
Refined products			
Export and sales on international markets			
Wholesale	65,060	50,340	37,716
Retail	11,275	9,678	9,172
Domestic sales			
Wholesale	7,349	5,427	3,820
Retail	7,893	5,501	4,281
	<b>91,577</b>	<b>70,946</b>	<b>54,989</b>
Petrochemicals			
Export and sales on international markets	1,095	642	574
Domestic sales	914	728	514
	<b>2,009</b>	<b>1,370</b>	<b>1,088</b>
Gas and gas products			
Export and sales on international markets	1,878	1,565	1,091
Domestic sales	1,001	786	548
	<b>2,879</b>	<b>2,351</b>	<b>1,639</b>
Domestic sales of energy and related services	1,472	1,416	1,087
Other			
Sales on international markets	880	890	1,030
Domestic sales	740	685	601
	<b>1,620</b>	<b>1,575</b>	<b>1,631</b>
<b>Total sales</b>	<b>133,650</b>	<b>104,956</b>	<b>81,083</b>

Sales volumes	2011	2010	2009
	(thousands of barrels)		
Crude oil			
Export and sales on international markets other than CIS	275,696	326,669	305,273
Export and sales to CIS	45,329	23,280	39,106
Domestic sales	32,699	26,637	21,909
	<b>353,724</b>	<b>376,586</b>	<b>366,288</b>
	(thousands of tonnes)		
Crude oil			
Export and sales on international markets other than CIS	37,612	44,566	41,647
Export and sales to CIS	6,184	3,176	5,335
Domestic sales	4,461	3,634	2,989
	<b>48,257</b>	<b>51,376</b>	<b>49,971</b>
	(thousands of tonnes)		
Refined products			
Export and sales on international markets			
Wholesale	76,313	80,043	76,351
Retail	6,945	7,314	8,397
Domestic sales			
Wholesale	11,024	10,977	9,796
Retail	8,304	7,022	6,216
	<b>102,586</b>	<b>105,356</b>	<b>100,760</b>
<b>Total sales volume of crude oil and refined products</b>	<b>150,843</b>	<b>156,732</b>	<b>150,731</b>

Realized average sales prices		2011	2010	2009
Average realized price international				
Oil (excluding CIS)	(\$/barrel)	109.30	77.30	59.87
Oil (CIS)	(\$/barrel)	52.71	46.84	41.89
Refined products				
Wholesale	(\$/tonne)	852.55	628.91	493.98
Retail	(\$/tonne)	1,623.53	1,323.31	1,092.29
Average realized price within Russia				
Oil	(\$/barrel)	48.06	35.90	33.56
Refined products				
Wholesale	(\$/tonne)	666.62	494.37	389.92
Retail	(\$/tonne)	950.51	783.49	688.74



During 2011, our revenues increased by \$28,694 million, or by 27.3%, compared to 2010 (in 2010 increased by \$23,873 million, or by 29.4%, compared to 2009). Our revenues from crude oil sales increased by \$6,795 million, or by 24.9% (in 2010 increased by \$6,649 million, or by 32.2%, compared to 2009). Our revenues from sales of refined products increased by \$20,631 million, or by 29.1% (in 2010 increased by \$15,957 million, or by 29.0%, compared to 2009). In 2011, the increase in sales revenue was due to sharp increase in hydrocarbon prices, compared to 2010.

The appreciation of the ruble against the US dollar also supported our average realized prices in Russia.

### Sales of crude oil

#### 2011 vs. 2010

Our total crude oil sales revenues increased by \$6,795 million, or by 24.9%, due to growth of crude oil prices. At the same time, due to a decrease of production our sales volumes decreased by 6.1%, or by 3,119 thousand tonnes.

Compared to 2010, we significantly increased crude oil supplies to Belarus, while sales to outside the CIS decreased correspondingly.

In 2011, revenue from export of crude oil from Russia both to the Group companies and third parties amounted to \$25,022 million.

#### 2010 vs. 2009

Our total crude oil sales revenues increased by \$6,649 million, or by 32.2%, mainly due to growth of crude oil prices. Cease in crude oil refining at third party refineries in Russia and Belarus released crude oil volumes for marketing. As a result, our crude oil sales raised by 2.8% in terms of volumes.

In 2010, revenue from export of crude oil from Russia both to the Group companies and third parties amounted to \$22,178 million.

### Sales of refined products

#### 2011 vs. 2010

Our revenue from the wholesale of refined products outside of Russia increased by \$14,720 million, or by 29.2%, due to an increase in the average realized price by 35.6% in 2011. At the same time, the wholesales volumes decreased by

3,730 thousand tonnes, or by 4.7%, mainly as a result of decrease in export from Russia and the shutdown of the Odessa refinery.

Our revenue from international retail sales increased by \$1,597 million, or by 16.5%, also due to an increase in average prices by 22.7%. Retail sales volumes decreased by 369 thousand tonnes, or by 5.0%, following restructuring of our retail network in the USA. At the same time, this was partially compensated by increased retail sales volumes in Europe.

Our revenue from the wholesale of refined products on the domestic market increased by \$1,922 million, or by 35.4%, mainly due to an increase in the average realized price by 34.8%. The increase of sales volumes was not significant.

Our revenue from retail sales in Russia increased by \$2,392 million, or by 43.5%, due to an increase in prices and sales volumes. Our retail volumes in Russia increased by 18.3% following significant increase of domestic demand.

In 2011, our revenue from the export of refined products from Russia both to Group companies and third parties amounted to \$17,725 million.

#### 2010 vs. 2009

In 2010, our revenue from the wholesale of refined products outside of Russia increased by \$12,624 million, or by 33.5%, due to increased average realized price by 27.3%. The decrease in output at our refineries in Bulgaria due to overhaul and in Ukraine due to refinery stand-by and termination of processing activities in Russia were almost fully compensated by commencement of crude oil refining at TRN in September 2009. At the same time, expansion of trading activities led to an increase in wholesales volumes by 4.8%.

In 2010, our revenue from international retail sales increased by \$506 million, or by 5.5%. Positive effect from the increase of average retail prices by 21.2% was partially offset by 12.9% sales volumes decrease, that reflects restructuring of our retail network in the USA.

In 2010, our revenue from the wholesale of refined products on the domestic market increased by \$1,607 million, or by 42.1%, mainly due to an increase in the average realized price by 26.8%. Sales volumes increased by 1,181 thousand tonnes, or by 12.1%. This was primarily due to a decrease in refined products export to Belarus.

In 2010, our revenue from retail sales in Russia increased by \$1,220 million, or by 28.5%, due to an increase both in volumes, being a result of higher average daily sales per petrol station, and in prices. In 2010, our retail sales revenue was 50.3% of total refined products sales in Russia (in 2009 – 52.8%).

In 2010, our revenue from export of refined products from Russia both to Group companies and third parties amounted to \$14,088 million.

### Sales of petrochemical products

#### 2011 vs. 2010

In 2011, our revenue from sales of petrochemical products increased by \$639 million, or by 46.6%, mainly as a result of an increase in international sales volumes. In the fourth quarter of 2010, we commenced production at our petrochemical plant Karpatnaftochim Ltd. in Ukraine after modernization and construction of a chlorine and caustic production line. Our realized prices increased by 11.8%.

#### 2010 vs. 2009

In 2010, our revenue from sales of petrochemical products increased by \$282 million, or by 25.9%. Outside of Russia, decrease in sales volumes due to decreased refining and trading was compensated by price growth. The growth of domestic sales revenue was largely a result of increase in realized prices and the effect of the real ruble appreciation against the US dollar.

### Sales of gas and gas products

#### 2011 vs. 2010

Sales of gas and gas refined products increased by \$528 million, or by 22.5%, in 2011. Wholesale gas refined products sales revenue increased by \$364 million, or by 43.6%, primarily as a result of an increase in sales prices. Retail gas products revenue increased by \$112 million, or by 22.1%, also due to price growth.

Natural gas sales revenue increased by \$30 million, or by 3.6%.

#### 2010 vs. 2009

In 2010, sales of gas and gas refined products increased by \$712 million, or by 43.4%. Gas refined products sales revenue increased by \$424 million, or by 40.8%, primarily as a result

of an increase in sales prices. Retail gas product revenue increased up to \$506 million, or by 22.2%, due to price growth. Retail revenue represented 37.8% and 44.0% of our total gas product revenue in 2010 and 2009, respectively.

Natural gas sales revenue amounted to \$835 million – an increase of 46.2%, compared to 2009. Our domestic natural gas sales revenue significantly increased as a result of increased sales to Gazprom, the major purchaser of our natural gas produced in the Russian Federation. In 2010, we sold 8,146 million cubic meters of natural gas to Gazprom (5,936 million cubic meters in 2009). The average realized price increased by 4.5% to \$34.9 per 1,000 cubic meters as a result of the ruble appreciation.

In 2010, natural gas sales revenue outside of Russia increased by \$174 million mostly as a result of a revision of sale prices related to the Shakh-Deniz field for 2008-2010 which led to additional revenue of \$101 million, recognized in the third quarter of 2010.

### Domestic sales of energy and related services

We sell substantially all our energy and related services domestically. International sales are relatively insignificant.

#### 2011 vs. 2010

In 2011, our revenue from sales of electricity, heat and related services increased by \$56 million, or by 4.0%. This growth was a result of an increase in tariff rates and the ruble appreciation. At the same time, in the second half 2011, the revenue of our energy segment decreased significantly due to the reduction of resale operations.

#### 2010 vs. 2009

In 2010, our revenue from sales of electricity, heat and related services increased by \$329 million, or by 30.3%, as we continued to develop the new power generation segment as part of our strategic development program. The ruble appreciation also contributed to the increase of this revenue.

### Sales of other products

Other sales include non-petroleum sales through our retail network, transportation services, rental revenue, crude oil extraction services, and other revenue of our production and marketing companies from sales of goods and services not related to our primary activities.

## 2011 vs. 2010

In 2011, other sales increased by \$45 million, or by 2.9%. The sales of goods and other products from our retail stations increased to \$700 million, or by 15.5%. At the same time, transportation services provided to third parties decreased compared to 2010.

## 2010 vs. 2009

In 2010, our other sales decreased by \$56 million, or by 3.4%. A decrease of transportation services provided abroad was partially compensated by higher non-petroleum retail revenue. During 2010, sales of goods and other products from our retail stations amounted to \$606 million, an increase of \$38 million compared to 2009.

## OPERATING EXPENSES

Operating expenses include the following:

	2011	2010	2009
	(millions of US dollars)		
Hydrocarbon extraction expenses	3,540	3,241	2,787
Own refining expenses	1,444	1,121	923
Refining expenses at third parties and affiliated refineries	897	724	713
Expenses for crude oil transportation to refineries	1,060	1,048	955
Power generation and distribution expenses	617	654	450
Petrochemical expenses	317	221	127
Other operating expenses	1,180	1,289	1,385
<b>Total operating expenses</b>	<b>9,055</b>	<b>8,298</b>	<b>7,340</b>

The method of allocation of operating expenses above differs from the approach used in preparing the data for **Note 21 "Segment information"** to our consolidated financial statements. Expenditures in the segment reporting are grouped depending on the segment to which a particular company belongs. Operating expenses for the purposes of this analysis are grouped based on the nature of the costs incurred.

In 2011, our operating expenses increased by \$757 million, or by 9.1%, mainly as a result of the ruble appreciation by 12.0%, increased power supply and repair costs and increase in consumption and cost of additives.

### Hydrocarbon extraction expenses

Our extraction expenses include expenditures related to repairs of extraction equipment, labor costs, expenses on artificial stimulation of reservoirs, fuel and electricity costs, property insurance of extraction equipment and other similar costs.

## 2011 vs. 2010

In 2011, our extraction expenses increased by \$299 million, or by 9.2%. Our average hydrocarbon extraction cost increased from \$4.12 per BOE to \$4.71 per BOE, or by 14.3%, compared to 2010.

The increase was mainly a result of the real ruble appreciation against the US dollar and increased expenses for power supply, repairs and labor costs.

## 2010 vs. 2009

In 2010, our extraction expenses increased by \$454 million, or by 16.3%. This was due to increase in expenses for power supply, general increase in expenses and the effect of the real ruble appreciation against the US dollar. Our average hydrocarbon extraction cost increased from \$3.56 to \$4.12 per BOE, or by 15.7%, compared to 2009.

## Own refining expenses

### 2011 vs. 2010

Our own refining expenses increased by \$323 million, or by 28.8%, in 2011.

Refining expenses at our domestic refineries increased by 38.0%, or by \$306 million. This increase was a result of an increase in consumption and cost of additives, increased power supply costs, higher expenses on repairs and the ruble appreciation against the US dollar.

Refining expenses at our international refineries increased by 5.4%, or by \$17 million. Despite the decrease of production volumes at our Bulgarian and Romanian refineries, higher energy costs and overhauls resulted in an overall increase of the refining expenses outside of Russia. We continued to incur operating expenses at our dormant refinery in Odessa although at a significantly lower level than in 2010 as we had to keep production facilities on line.

### 2010 vs. 2009

In 2010, our refining expenses increased by \$198 million, or by 21.5%.

Refining expenses at our domestic refineries increased by 20.1%, or by \$135 million, mainly as a result of the real ruble appreciation against the US dollar, increase in power supply costs and higher consumption of additives.

Refining expenses at our international refineries increased by 25.0%, or by \$63 million, mainly as a result of increased power supply costs.

### Refining expenses at third party and affiliated refineries

Along with our own production of refined products we have the ability to refine crude oil at third party and affiliated refineries both in Russia and abroad.

### 2011 vs. 2010

In 2011, refining expenses at third party and affiliated refineries increased by \$173 million, or by 23.9%. This was due to the increase of our share in ISAB from 49% to 60% since April, 2011, resulting in the increase of our share of costs. Increased energy costs, appreciation of euro to the US dollar and overhauls performed at the ISAB complex

in the first quarter of 2011 also contributed to the increase of expenses.

### 2010 vs. 2009

As opposed to 2009, we did not process crude oil on third party refineries during 2010 in Russia and Belarus. Nevertheless, the commencement of crude oil refining at TRN in late September 2009 almost fully compensated for that. As a result, the overall decrease of throughput at third party and affiliated refineries including refined products processed was 2.8%, compared to 2009. At the same time, in 2010, refining expenses at third party and affiliated refineries increased by 1.5%, compared to 2009, because processing costs at our refineries in Western Europe are higher than at the refineries in Russia or Belarus. Starting from the third quarter of 2010, we also refined crude oil on a third party refinery in Kazakhstan.

## Petrochemical expenses

### 2011 vs. 2010

In 2011, operating expenses of our petrochemical plants increased by \$96 million, or by 43.4%, due to an increase in production volumes as a result of the commencement of production at our petrochemical plant Karpatnaftochim Ltd. in Ukraine in the fourth quarter of 2010 after modernization and construction of a chlorine and caustic production line. Additionally, the increased consumption of raw materials due to the changes in product mix and ruble appreciation contributed to the increase of expenses.

### 2010 vs. 2009

In 2010, operating expenses of our petrochemical plants increased by \$94 million, or by 74.0%. Expenses in Russia were impacted by increased production, increased cost of raw materials and ruble appreciation to the US dollar.

### Expenses for crude oil transportation to refineries

Expenses for crude oil transportation to refineries include pipeline, railway, freight and other costs related to delivery of the Group's own crude oil to refineries for further processing.

### 2011 vs. 2010

Expenses for crude oil transportation to refineries in 2011 didn't change significantly. The increase in transportation

tariffs compared to 2010 and the effect of ruble appreciation was compensated for by a decrease in volumes of own supply to refineries.

#### **2010 vs. 2009**

Expenses for crude oil transportation to refineries increased in 2010 by \$93 million, or by 9.7%, due to an increase in transportation tariffs and as a result of a real ruble appreciation in Russia (see Transportation expenses below). Moreover, in 2010, we significantly increased volumes of own crude oil supplies to TRN.

### **Power generation and distribution expenses**

#### **2011 vs. 2010**

Power generation and distribution expenses decreased by \$37 million, or by 5.7%.

#### **2010 vs. 2009**

Power generation and distribution expenses increased by \$204 million, or by 45.3%, following expansion of our power generating business and as a result of the real ruble appreciation in Russia.

### **Other operating expenses**

Other operating expenses include expenses of the Group's upstream and downstream enterprises that do not relate to their core activities, namely rendering of transportation and extraction services, operating expenses of our gas processing plants, costs of other services provided and goods sold by our marketing companies, and of non-core businesses of the Group.

#### **2011 vs. 2010**

In 2011, other operating expenses decreased by \$109 million, or by 8.5%. The decrease was a result of a lower volume of transportation services provided outside of Russia and the decrease of rental activities as a result of the restructuring of our retail network in the USA.

#### **2010 vs. 2009**

In 2010, our other operating expenses decreased by \$96 million, or by 6.9%, mainly due to decrease of volume of transportation services provided abroad.

### **COST OF PURCHASED CRUDE OIL, GAS AND PRODUCTS**

Cost of purchased crude oil, gas and products includes cost of crude oil and refined products purchased for trading or refining, gas and fuel oil to supply our power generation entities and the result of hedging of international crude oil and refined products sales.

#### **2011 vs. 2010**

Cost of purchased crude oil, gas and products increased by \$16,444 million in 2011, or by 38.0%, due to an increase in crude oil and refined products prices.

In 2011, we recognized a \$657 million expense from hedging, compared to a \$232 million expense in 2010.

#### **2010 vs. 2009**

In 2010, cost of purchased crude oil, gas and products increased by \$11,489 million, or by 36.2%, due to an increase in crude oil and refined products prices and increase in volumes of refined products purchases.

In 2010, we recognized a \$232 million expense from hedging, compared to a \$781 million expense in 2009.

### **TRANSPORTATION EXPENSES**

#### **2011 vs. 2010**

Our transportation expenses increased by \$513 million, or by 9.1%. This increase was primarily related to Russia and resulted from the ruble appreciation, increased tariffs and change in supply directions.

Our actual transportation expenses related to crude oil and refined products deliveries to various export destinations, weighted by volumes transported, changed in 2011, compared to 2010, as follows: crude oil pipeline tariffs increased by 14.1%, railway tariffs for refined products transportation increased by 6.9%, crude oil freight rates decreased by 3.5%, and refined products freight rates decreased by 9.2%.

#### **2010 vs. 2009**

In 2010, our transportation expenses increased by \$778 million, or by 16.1%. This was primarily due to increase

of ruble denominated pipeline and railway transportation tariffs in Russia, which was emphasized by the ruble appreciation.

Our actual transportation expenses related to crude oil and refined products deliveries to various export destinations, weighted by volumes transported, changed in 2010, compared to 2009, as follows: crude oil pipeline tariffs increased by 23.3%, railway tariffs for refined products transportation increased by 21.1%, crude oil freight rates decreased by 7.8%, and refined products freight rates increased by 23.8%.

## SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

Selling, general and administrative expenses include distribution costs, payroll costs (excluding extraction entities' and refineries' production staff costs), insurance costs (except for property insurance related to extraction and refinery equipment), costs of maintenance of social infrastructure, movement in bad debt provision and other expenses.

### 2011 vs. 2010

Our selling, general and administrative expenses increased by \$264 million, or by 7.4%. This increase was driven mainly by higher selling expenses both in Russia and abroad. Expenses in Russia were also affected by the real ruble appreciation. At the same time, the decrease of provisions for bad debts partially offset the adverse effect of the above mentioned factors.

### 2010 vs. 2009

In 2010, our selling, general and administrative expenses increased by \$252 million, or by 7.6%, substantially due to the effect of ruble appreciation on selling, general and administrative expenses in Russia and salary indexation.

## EXPLORATION EXPENSES

### 2011 vs. 2010

Our exploration expense increased by \$196 million, or by 58.3%. Dry hole costs amounted to \$417 million in 2011, compared to \$225 million in 2010.

In 2011, dry hole costs were mostly related to our overseas projects, namely \$181 million in Ghana, \$149 million in Cote d'Ivoire, \$27 million in Vietnam and \$17 million in Kazakstan. Dry hole costs in Russia included \$28 million and \$10 million related to projects in Komi Republic and in Western Siberia, respectively.

### 2010 vs. 2009

During 2010, exploration expense increased by \$118 million, or by 54.1%. Dry hole costs increased by \$108 million to \$225 million.

In 2010, we charged to expense cost of dry wells in Columbia and Cote d'Ivoire in amount of \$112 million and \$68 million, respectively. Dry hole write-offs in Russia amounted to \$42 million in 2010.

## EQUITY SHARE IN INCOME OF AFFILIATES

The Group has investments in equity method affiliates and corporate joint ventures. These companies are primarily engaged in crude oil exploration, production, marketing and distribution operations in the Russian Federation, crude oil production and marketing in Kazakhstan and refining operations in Europe. Our largest affiliates are Turgai Petroleum and Tengizchevroil, exploration and production companies operating in Kazakhstan, and ISAB and TRN refineries.

### 2011 vs. 2010

Our share in income of affiliates increased by \$218 million, or by 46.2%, in 2011, mostly due to increase in income of Tengizchevroil.

### 2010 vs. 2009

At the end of 2009, we increased our share in LUKARCO from 54% to 100%, thus increasing our stake in Tengizchevroil, an exploration and production joint-venture in Kazakhstan, to 5%. Largely as a result of this, our share in income of affiliates increased by \$121 million, or by 34.5%.

## TAXES OTHER THAN INCOME TAXES

	2011	2010	2009
	(millions of US dollars)		
<b>In Russia</b>			
Mineral extraction taxes	11,502	7,795	5,399
Social security taxes and contributions	480	327	330
Property tax	538	479	438
Other taxes	77	93	92
<b>Total in Russia</b>	<b>12,597</b>	<b>8,694</b>	<b>6,259</b>
<b>International</b>			
Mineral extraction taxes	92	69	53
Social security taxes and contributions	107	102	69
Property tax	35	39	32
Other taxes	87	74	61
<b>Total internationally</b>	<b>321</b>	<b>284</b>	<b>215</b>
<b>Total</b>	<b>12,918</b>	<b>8,978</b>	<b>6,474</b>

### 2011 vs. 2010

In 2011, taxes other than income taxes increased by 43.9%, or by \$3,940 million. This was mainly due to an increase in mineral extraction taxes in Russia as a result of the rise of the tax rate following the increase of international crude oil prices.

In 2011, application of decreased rate for depleted oilfields and zero rate for the fields with extra heavy crude oil and the greenfields led to \$1,161 million tax reduction (\$1,313 million in 2010). The major oilfield where we benefited from zero extraction tax rate was the Yuzhnoye Khylichuyu field. In early December 2010, accumulated volume of production from this field exceeded the incentive level of 15 million tonnes and since that moment we have been paying extraction tax in full.

The increase in social security taxes and contributions in Russia was due to tax legislation amendments.

### 2010 vs. 2009

In 2010, taxes other than income taxes increased by \$2,504 million, or 38.7%, mainly due to an increase in mineral extraction taxes in Russia. This is explained by an increase in the tax rate following the increase of international crude oil prices.

Application of zero tax rate for crude oil produced in Timan-Pechora and decreased rate for depleted oilfields led to approximately \$1,313 million tax reduction (about \$961 million in 2009).

## EXCISE AND EXPORT TARIFFS

	2011	2010	2009
	(millions of US dollars)		
<b>In Russia</b>			
Excise tax and sales taxes on refined products	1,710	951	763
Crude oil export tariffs	11,714	10,513	6,251
Refined products export tariffs	5,028	3,574	2,306
<b>Total in Russia</b>	<b>18,452</b>	<b>15,038</b>	<b>9,320</b>
<b>International</b>			
Excise tax and sales taxes on refined products	3,445	3,700	3,524
Crude oil export tariffs	319	136	107
Refined products export tariffs	1	4	107
<b>Total internationally</b>	<b>3,765</b>	<b>3,840</b>	<b>3,738</b>
<b>Total</b>	<b>22,217</b>	<b>18,878</b>	<b>13,058</b>

### 2011 vs. 2010

Export tariffs increased by \$2,835 million, or by 19.9%, in 2011. The effect of increase of crude oil and refined products tariff rates was partially compensated for by a decrease in crude oil export volumes by 14.5% and refined products export volumes by 6.9%, compared to 2010.

Starting from 2011, excise rates on refined products in Russia were increased and tied to the ecological class of fuel. Despite the fact that the Company produces high quality ecological motor fuel subject to lower excise rates compared to fuel of lower quality, average excise rates roughly doubled for us compared to 2010.

Starting from December, 2010 the Group applies reduced export duty rate for the crude oil produced from the Yu. Korchagin field in the Caspian Sea, however due to relatively small amount of crude oil export from that field the effect of this incentive on our 2011 and 2010 financial results was insignificant.

### 2010 vs. 2009

In spite of a decrease in crude oil and refined products export volumes, export tariffs increased by \$5,456 million,

or by 62.2%, due to an increase in tariff rates in Russia as a result of international crude oil prices growth. The increase in excises in Russia resulted from the ruble appreciation, increase of excise rate and increase in sales volumes.

## OTHER NON-OPERATING INCOME (EXPENSE)

### 2011 vs. 2010

In 2011, other non-operating income included the effect of the recalculation of the extraction tax incentive by certain Group companies for prior periods in the total amount of \$433 million.

### 2010 vs. 2009

In 2010, other non-operating income included a \$438 million gain related to successful settlement of a corporate dispute between a Group company and a CNPC group company regarding Turgai Petroleum, and a \$111 million expense related to provisions accrued in respect of claims to the Group companies by Federal Antimonopoly Service of the Russian Federation ("FAS of Russia").



## LOSS ON DISPOSALS AND IMPAIRMENTS OF ASSETS

### 2011 vs. 2010

Loss on disposals and impairments of assets for 2011 mainly included an impairment loss related to certain upstream and other assets of NMNG in amount of \$1,261 million. For details please refer to “Impairment of assets in OOO Narianmarneftegaz” section on page 192.

Additionally, in 2011, the Company recognized an impairment loss of \$175 million for international refining, marketing and distribution assets.

### 2010 vs. 2009

In 2010, loss on disposals and impairments of assets amounted to \$363 million, compared to \$381 million in 2009.

As a result of an impairment test performed in December 2010, we recognized an impairment loss of \$163 million for certain upstream properties in the Timan-Pechora, Western Siberia and Central European regions of Russia; and an impairment loss of \$29 million related to certain our European downstream assets. We also wrote off goodwill related to our Turkish downstream subsidiary in amount of \$114 million due to a change in market conditions mostly caused by legislative changes.

## INCOME TAXES

### 2011 vs. 2010

In 2011, our total income tax expense increased by \$942 million, or by 40.1%. At the same time, our income before income tax increased by \$1,649 million, or by 14.4%.

In 2011, our effective income tax rate was 25.1%, compared to 20.5% in 2010, while the maximum statutory rate for the Russian Federation is 20%.

The high level of the effective income tax rate in 2011 was mostly due to a \$1,261 million non-taxable impairment loss in NMNG. For details please refer to “Impairment of assets in OOO Narianmarneftegaz” section on page 192.

### 2010 vs. 2009

In 2010, our total income tax expense increased by \$357 million, or by 17.9%. Income before income tax increased by \$2,407 million, or by 26.6%.

In 2010, our effective income tax rate was 20.5%, compared to 22.0% in 2009.

## RECONCILIATION OF NET INCOME TO EBITDA (EARNINGS BEFORE INTEREST, INCOME TAXES, DEPRECIATION AND AMORTIZATION)

	2011	2010	2009
	(millions of US dollars)		
<b>Net income</b>	<b>10,357</b>	<b>9,006</b>	<b>7,011</b>
Add back:			
Income tax expense	3,293	2,351	1,994
Depreciation and amortization	4,473	4,154	3,937
Interest expense	694	712	667
Interest and dividend income	(211)	(174)	(134)
<b>EBITDA</b>	<b>18,606</b>	<b>16,049</b>	<b>13,475</b>
Impairment loss in NMNG net of noncontrolling interest <sup>(1)</sup>	883	–	–
<b>Adjusted EBITDA</b>	<b>19,489</b>	<b>16,049</b>	<b>13,475</b>

<sup>(1)</sup> For details please refer to “Impairment of assets in OOO Narianmarneftegaz” section on page 192.

EBITDA is a non-US GAAP financial measure. EBITDA is defined as net income before interest, taxes and depreciation and amortization. The Company believes that EBITDA provides useful information to investors because it is an indicator of the strength and performance of our business operations, including our ability to finance capital expenditures, acquisitions and other investments and our ability to incur and service debt. While depreciation and amortization are considered as operating costs under US GAAP, these expenses primarily represent the non-cash

current period allocation of costs associated with long-lived assets acquired or constructed in prior periods. The EBITDA calculation is commonly used as a basis for some investors, analysts and credit rating agencies to evaluate and compare the periodic and future operating performance and value of companies within the oil and gas industry. EBITDA should not be considered in isolation as an alternative to net income, operating income or any other measure of performance under US GAAP. EBITDA does not include our need to replace our capital equipment over time.

## LIQUIDITY AND CAPITAL RESOURCES

	2011	2010	2009
	(millions of US dollars)		
Net cash provided by operating activities	15,514	13,541	8,883
Net cash used in investing activities	(10,773)	(7,296)	(8,551)
Net cash used in by financing activities	(4,263)	(6,146)	(285)

### OPERATING ACTIVITIES

Our primary source of cash flow is funds generated from our operations. During 2011, cash generated from operating activities was \$15,514 million, which is 14.6% more than in 2010, mainly due to the increase in sales revenues. On the other hand, our operating cash flows were affected by an increase in working capital by \$1,529 million, compared to January 1, 2011.

The increase of working capital was mainly caused by:

- \$1,420 million increase in inventory
- \$346 million net increase in tax accounts receivable and payable

At the same time, this negative effect was partially offset by a \$180 million net decrease in VAT receivable and payable.

### INVESTING ACTIVITIES

The increase in cash used in investing activities mainly resulted from an increase in payments for acquisitions.

In 2011, we made an advance payment of \$1,760 million for expected acquisition of certain upstream assets, a final payment of \$500 million within the acquisition of LUKARCO, a payment of \$342 million for 11% share in ISAB and a payment of \$153 million for a 25.1% share in OOO "Bashneft-Polus".

Capital expenditures increased by \$1,653 million, or by 25.1%, compared to 2010.

### FINANCING ACTIVITIES

In 2011, net movements of short-term and long-term debt generated an outflow of \$2,004 million, compared to an inflow of \$35 million in 2010.

As a result, our indebtedness as at December 31, 2011 amounted to \$9,092 million that represents an 18.8% decrease compared to January 1, 2011. Compared to the beginning of the year, our net debt decreased by 28.2% to \$6,339 million.

### CREDIT RATING

Standard & Poor's Ratings Services affirmed its long-term corporate credit rating and all debt ratings on the Company at BBB- with stable outlook.

Moody's affirmed the Company's long-term corporate family rating and long-term issuer rating of Baa2 with stable outlook.

Fitch Ratings affirmed the Company's long-term issuer default rating of BBB- with stable outlook.

## ANALYSIS OF CAPITAL EXPENDITURES

	2011	2010	2009
	(millions of US dollars)		
<b>Capital expenditures <sup>(1)</sup></b>			
Exploration and production			
Russia	5,084	3,911	3,855
International	1,545	997	770
Total exploration and production	6,629	4,908	4,625
Refining, marketing and distribution			
Russia	1,030	944	808
International	324	375	508
Total refining, marketing and distribution	1,354	1,319	1,316
Chemicals			
Russia	55	27	13
International	34	49	100
Total chemicals	89	76	113
Power generation and distribution	196	420	283
Other	224	121	197
<b>Total capital expenditures</b>	<b>8,492</b>	<b>6,844</b>	<b>6,534</b>
<b>Acquisitions of subsidiaries and associates <sup>(2)</sup></b>			
Exploration and production			
Russia	252	–	–
International	2,260	922	300
Total exploration and production	2,512	922	300
Refining, marketing and distribution			
Russia	10	7	212
International	342	3	2,069 <sup>(3)</sup>
Total refining, marketing and distribution	352	10	2,281
Power generation and distribution	–	–	10
Other	–	–	1
Less cash acquired	(4)	–	(19)
<b>Total acquisitions</b>	<b>2,860</b>	<b>932</b>	<b>2,573</b>

<sup>(1)</sup> Including non-cash transactions and prepayments.

<sup>(2)</sup> Including prepayments related to acquisitions and non-cash transactions.

<sup>(3)</sup> Including \$100 million of non-cash part of consideration for acquisition of TRN.

Our capital expenditures, including non-cash transactions, amounted to \$8,492 million, which is 24.1% more than in 2010. Capital expenditures in exploration and production segment increased by \$1,721 million, or by 35.1%.

In Russia, we increased the investments in drilling, field development and construction of gas transportation facilities in Western Siberia and petroleum gas utilization program

in Western Siberia and Komi Republic. Moreover, our capital expenditures were affected by ruble appreciation.

In our international projects, we significantly increased volumes of exploration drilling in Western Africa, namely Ghana, Cote d'Ivoire and Sierra-Leone. Moreover, we significantly increased investments in our gas production projects in Uzbekistan.

The table below shows our exploration and production capital expenditures in promising new production regions.

	2011	2010	2009
	(millions of US dollars)		
Northern Timan-Pechora	278	285	385
Yamal	372	162	131
Caspian region <sup>(1)</sup>	555	370	532
Ghana	216	87	73
Cote d'Ivoire	227	92	31
Iraq	203	172	–
Uzbekistan	480	286	201
<b>Total</b>	<b>2,331</b>	<b>1,454</b>	<b>1,353</b>

<sup>(1)</sup> Russian and international projects.

## CONTRACTUAL OBLIGATIONS, OTHER CONTINGENCIES AND OFF BALANCE SHEET ARRANGEMENTS

### CAPITAL COMMITMENTS AND CONTRACTUAL OBLIGATIONS

Under the terms of existing exploration and production license agreements in Russia the Group has to fulfill certain obligations: oil and gas exploration, wells drilling, fields development, etc., and the Group also has commitments to reach a defined level of extraction on the fields. Management believes that the Group's approved annual capital expenditure budgets fully cover all the requirements of the described license obligations.

Group companies have commitments for capital expenditure contributions in the amount of \$406 million related to various production sharing agreements over the next 26 years.

The Company signed a three-year agreement for the years 2010-2012 for drilling services with OOO Eurasia Drilling Company. The volume of these services is based on the Group's capital construction program, which is re-evaluated on an annual basis. The Group estimates the amount of capital commitment under this agreement for 2012 to be approximately \$1,521 million.

The Company signed a strategic agreement for the ongoing provision of construction, engineering and technical services with ZAO Globalstroy-Engineering. The volume of these services is based on the Group's capital construction program, which is re-evaluated on an annual basis. The Group estimates the amount of capital commitment under this agreement for 2012 to be approximately \$225 million.

The Group has a commitment to execute the capital construction program of its power generation segment and under the terms of this program power plants with a total capacity of 890 MW should be constructed. Currently the Group is approving certain amendments to the capital construction program, including its extension by the end of 2014. As of December 31, 2011, the Group estimates the amount of this commitment to be approximately \$594 million.

The Group signed a number of agreements for the years 2012-2015 for construction of the offshore platforms in the Caspian Sea. The Group estimates the amount of this capital commitment to be approximately \$866 million.

The following table displays our total contractual obligations and other commitments.

(millions of US dollars)	Total	2012	2013	2014	2015	2016	After
<b>On balance sheet</b>							
Short term debt	148	148	–	–	–	–	–
Long-term bank loans and borrowings	1,120	455	267	130	118	76	74
Long-term non-bank loans and borrowings	1,532	40	32	39	21	19	1 381
6.375% Non-convertible US dollar bonds, maturing 2014	897	–	–	897	–	–	–
2.625% Convertible US dollar bonds, maturing 2015	1,412	–	–	–	1,412	–	–
6.356% Non-convertible US dollar bonds, maturing 2017	500	–	–	–	–	–	500
7.250% Non-convertible US dollar bonds, maturing 2019	596	–	–	–	–	–	596
6.125% Non-convertible US dollar bonds, maturing 2020	998	–	–	–	–	–	998
6.656% Non-convertible US dollar bonds, maturing 2022	500	–	–	–	–	–	500
13.35% Russian ruble bonds, maturing 2012	776	776	–	–	–	–	–
9.20% Russian ruble bonds, maturing 2012	311	311	–	–	–	–	–
7.40% Russian ruble bonds, maturing 2013	186	–	186	–	–	–	–
Capital lease obligations	116	62	27	27	–	–	–
<b>Total</b>	<b>9,092</b>	<b>1,792</b>	<b>512</b>	<b>1,093</b>	<b>1,551</b>	<b>95</b>	<b>4,049</b>
<b>Off balance sheet</b>							
Operating lease obligations	507	145	83	74	46	54	105
Capital commitments in PSAs	406	258	57	57	2	2	30
Capital commitments of power generating segment	594	436	112	46	–	–	–
Obligation under contract with OOO Eurasia Drilling Company	1,521	1,521	–	–	–	–	–
Obligation under contract with ZAO Globalstroy-Engineering	225	225	–	–	–	–	–
Obligation under contracts for the development of the V. Filanovsky oilfield	866	64	596	191	15	–	–

## LITIGATION AND CLAIMS

On November 27, 2001, Archangel Diamond Corporation (“ADC”), a Canadian diamond development company, filed a lawsuit in the Denver District Court, Colorado against OAO Arkhangelskgeoldobycha (“AGD”), a Group company, and the Company (together the “Defendants”). ADC alleged that the Defendants interfered with the transfer of a diamond exploration license to Almazny Bereg, a joint venture between ADC and AGD. ADC claimed compensatory damages of \$1.2 billion and punitive damages of \$3.6 billion. On October 15, 2002, the District Court dismissed the lawsuit for lack of personal jurisdiction. This ruling was upheld by the Colorado Court of Appeals on March 25, 2004. On November 21, 2005, the Colorado Supreme Court affirmed the lower courts’ ruling that no specific jurisdiction exists over the Defendants.

By virtue of this finding, AGD (the holder of the diamond exploration license) was dismissed from the lawsuit. The Colorado Supreme Court found, however, that the trial court made a procedural error by failing to hold an evidentiary hearing before making its ruling concerning general jurisdiction regarding the Company and remanded the case to the Colorado Court of Appeals to consider whether the lawsuit should have been dismissed on alternative grounds (i.e., forum non conveniens). The Colorado Court of Appeals declined to dismiss the case based on forum non conveniens and the case was remanded to the District Court. In June 2009, three creditors of ADC filed an Involuntary Bankruptcy Petition putting ADC into bankruptcy. In November 2009, after adding a claim, ADC removed the case from the District Court to the US Bankruptcy Court. On October 28, 2010, the Bankruptcy Court granted the Company’s Motion for Remand and Abstention and remanded the case to the Denver District Court. On October 20, 2011, the Denver District Court dismissed all claims in the lawsuit against the Company. ADC has filed a notice of appeal. No briefing schedule has been established. Management does not believe that the ultimate resolution of this matter will have a material adverse effect on the Group’s financial condition.

On January 6, 2012, ADC filed a lawsuit in the US District Court for the District of Colorado (federal court) reasserting almost identical claims asserted in the aforementioned lawsuit and dismissed by the Denver District Court (state court) notwithstanding ADC’s appeal of the state court’s decision. The time within which the Company is required

to respond has not expired. The Company plans to seek dismissal of the case and vigorously defend the matter. Management does not believe that the ultimate resolution of this matter will have a material adverse effect on the Group’s financial condition.

As of the date the financial statements were available to be issued approximately 100 claims in relation to a violation of the anti-monopoly regulation were initiated against several Group companies in Russia and abroad. The Group companies were accused of violations primarily involving abuse of their dominant market position and execution of coordinated actions in oil products retail markets.

On February 9, 2011, the Federal Anti-monopoly Service of the Russian Federation (“FAS of Russia”) filed a case against the three largest Russian oil companies, including the Company, accusing them of abuse of their dominant position in the oil products market. The decision accusing the Company in establishing monopolistically high prices on diesel fuel during the period October 2010 – December 2010 was issued on August 9, 2011. The case in establishing monopolistically high prices on jet fuel was separated into an individual proceeding and its hearing is scheduled for March 20, 2012. On December 28, 2011, FAS of Russia defined fines against the Company and the Group’s refinery plants in the amount of \$19 million. The decision was not contested and the fines were paid on February 17, 2012. The Group accrued a provision for this amount in the consolidated financial statements as of December 31, 2011.

The Group is involved in cost recovery disputes with the Republic of Kazakhstan. The Group’s share of the claim is approximately \$295 million. Management is of the view that substantially all of the amounts subject to dispute are in fact recoverable under the Final Production Sharing Agreement. Management believes that the ultimate resolution of the claim will not have a material adverse impact on the Group’s operating results or financial condition.

The Group is involved in various other claims and legal proceedings arising in the normal course of business. While these claims may seek substantial damages against the Group and are subject to uncertainty inherent in any litigation, management does not believe that the ultimate resolution of such matters will have a material adverse impact on the Group’s operating results or financial condition.



## CRITICAL ACCOUNTING POLICIES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to select appropriate accounting policies and to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. See **Note 2** “Summary of significant accounting policies” to our consolidated financial statements for descriptions of the Company’s major accounting policies. Certain of these accounting policies involve judgments and uncertainties to such an extent that there is a reasonable likelihood that materially different amounts would have been reported under different conditions, or if different assumptions had been used.

### BUSINESS COMBINATIONS

#### Purchase price allocation

Accounting for the acquisition of a business requires the allocation of the purchase price to the various assets and liabilities of the acquired business. For most assets and liabilities, purchase price allocation is accomplished by recording the asset or liability at its estimated fair value. The most difficult estimations of individual fair values are those involving property, plant and equipment and identifiable intangible assets. We use all available information to make these fair value determinations and, for major business acquisitions, typically engage an outside appraisal firm to assist in the fair value determination of the acquired long-lived assets. We have, if necessary, up to one year after the acquisition closing date to finish these fair value determinations and finalize the purchase price allocation.

#### Principles of consolidation

Our consolidated financial statements include the financial position and results of the Company, controlled subsidiaries of which the Company directly or indirectly owns more than 50% of the voting interest, unless minority interest shareholders have substantive participating rights, and variable interest entities where the Group is determined to be the primary beneficiary. Other significant investments in companies of which the Company directly or indirectly owns between 20% and 50% of the voting interest and over which it exercises significant influence but not control, are accounted for using the equity method of accounting. Investments in companies of which the Company directly

or indirectly owns more than 50% of the voting interest but where minority interest shareholders have substantive participating rights are accounted for using the equity method of accounting. Undivided interests in oil and gas joint ventures are accounted for using the proportionate consolidation method. Investments in other companies are recorded at cost.

### REVENUE RECOGNITION

Revenues are recognized when title passes to customers at which point the risks and rewards of ownership are assumed by the customer and the price is fixed or determinable. Revenues include excise on petroleum products sales and duties on export sales of crude oil and petroleum products.

Revenues from non-cash sales are recognized at the fair market value of the crude oil and petroleum products sold.

### SUCCESSFUL EFFORTS ACCOUNTING FOR OIL AND GAS ACTIVITIES

Accounting for oil and gas activities is subject to special accounting rules that are unique to the oil and gas industry. Property acquisitions, successful exploratory wells, all development costs (including development dry holes and the Group’s share of operators’ expenses during the development stage of production sharing and risk service contracts) and support equipment and facilities are capitalized. Artificial stimulation and well work-over costs are included in operating expenses as incurred.

#### Property acquisition costs

For individually significant undeveloped properties, management periodically performs impairment test based on exploration and drilling efforts to date. For undeveloped properties that individually are relatively small, management exercises judgment and determines a periodic property impairment charge as required that is reported in loss on disposals and impairments of assets.

#### Exploratory costs

For exploratory wells, drilling costs are temporarily capitalized, or “suspended”, on the balance sheet, pending a judgmental determination of whether potentially econo-

mic oil and gas reserves have been discovered by the drilling effort. If a judgment is made that the well did not encounter potentially economic oil and gas quantities, the well costs are expensed as a dry hole and are reported in exploration expense. Exploratory wells that are judged to have discovered potentially economic quantities of oil and gas and that are in areas where a major capital expenditure would be required before production could begin, remain capitalized on the balance sheet as long as additional exploratory appraisal work is under way or firmly planned. There is no periodic impairment assessment of suspended exploratory well costs. Management continuously monitors the results of the additional appraisal drilling and seismic work and expenses the suspended well costs as dry holes when it judges that the potential field does not warrant further exploratory efforts in the near term.

Other exploratory expenditures, including geological and geophysical costs are expensed as incurred.

### PROVED OIL AND GAS RESERVES

Due to the inherent uncertainties and the necessarily limited nature of reservoir data, estimates of reserves are inherently imprecise, require the application of judgment and are subject to change as additional information becomes available. The estimates are made using all available geological and reservoir data as well as historical production data. Estimates are reviewed and revised as appropriate. Revisions occur as a result of changes in prices, costs, fiscal regimes, reservoir performance or a change in the Company's plans.

Proved oil and gas reserves are the estimated quantities of crude oil, natural gas liquids including condensate and natural gas that geological and engineering data demonstrate with reasonable certainty can be recovered in future years from known reservoirs under existing economic and operating conditions. Reserves are considered proved if they can be produced economically as demonstrated by either actual production or conclusive formation tests. Proved reserves do not include additional quantities of oil and gas reserves that may result from applying secondary or tertiary recovery techniques not yet tested and determined to be economic. The proved reserves include volumes which are recoverable up to and after license expiry dates. Proved developed reserves are the quantities of proved reserves expected to be recovered through existing wells with existing equipment and operating methods.

Management has included within proved reserves significant quantities which the Group expects to produce after

the expiry dates of certain of its current production licenses in the Russian Federation. The Subsoil Law of the Russian Federation states that, upon expiration, a license is subject to renewal at the initiative of the license holder provided that further exploration, appraisal, production or remediation activities are necessary and provided that the license holder has not violated the terms of the license. Since the law applies both to newly issued and old licenses and the Group has currently renewed nearly 50% of its licenses, management believes that licenses will be renewed upon their expiration for the remainder of the economic life of each respective field.

### IMPAIRMENT OF LONG-LIVED ASSETS

Long-lived assets, such as oil and gas properties (other than unproved properties), other property, plant, and equipment, and purchased intangibles subject to amortization, are assessed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset group may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset group to the estimated undiscounted future cash flows expected to be generated by that group. If the carrying amount of an asset group exceeds its estimated undiscounted future cash flows, an impairment charge is recognized by writing down the carrying amount to the estimated fair value of the asset group, generally determined as discounted future net cash flows. Assets to be disposed of are separately presented in the balance sheet and reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated. The assets and liabilities of a disposed group classified as held for sale are presented separately in the appropriate asset and liability sections of the balance sheet.

### DEFERRED INCOME TAXES

Deferred income tax assets and liabilities are recognized in respect of future tax consequences attributable to temporary differences between the carrying amounts of existing assets and liabilities for the purposes of the consolidated financial statements and their respective tax bases and in respect of operating loss and tax credit carryforwards. Deferred income tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to reverse and the assets be recovered and liabilities settled. The effect on deferred income tax assets and liabilities

of a change in tax rates is recognized in the consolidated statement of income in the reporting period which includes the enactment date.

The ultimate realization of deferred income tax assets is dependent upon the generation of future taxable income in the reporting periods in which the originating expenditure becomes deductible. In assessing the realizability of deferred income tax assets, management considers whether it is more likely than not that the deferred income tax assets will be realized. In making this assessment, management considers the scheduled reversal of deferred income tax liabilities, projected future taxable income, and tax planning strategies.

An income tax position is recognized only if the uncertain position is more likely than not of being sustained upon examination, based on its technical merits. A recognized income tax position is measured at the largest amount that is greater than 50% likely of being realized. Changes in recognition or measurement are reflected in the period in which the change in judgment occurs.

#### ASSET RETIREMENT OBLIGATIONS

Under various laws, contracts, permits and regulations, the Group has legal obligations to remove tangible equipment and restore the land or seabed at the end of operations at production sites. The largest asset retirement obligations of the Group relate to wells and oil and gas production facilities and pipelines. The Group records the fair value of liabilities associated with such obligations when incurred. Estimating the future asset retirement obligations costs necessary for this accounting calculation involves significant estimates and judgments by management. Most of these obligations are many years in the future and the contracts and regulations often have vague descriptions of what removal practices and criteria will have to be met when the removal event actually occurs. Asset removal technologies and costs are constantly changing, as well as political, environmental, safety and public relations considerations.

#### CONTINGENCIES

Certain conditions may exist as of balance sheet dates that may result in losses, but the impact of which will only be resolved when one or more future events occur or fail to occur. The Group is required to both determine whether a loss is probable based on judgment and interpretation of laws and regulations and determine whether the loss can be reasonably estimated. If our assessment of a contingency indicates that it is probable that a material loss will arise, and the amount of the liability can be estimated, then the estimated liability is accrued and charged to the consolidated statement of income. If our assessment indicates that a potentially material loss is not probable, but is only reasonably possible, or is probable but cannot be estimated, then the nature of the contingent liability is disclosed in the notes to our consolidated financial statements. Loss contingencies considered remote are generally not disclosed unless they involve guarantees, in which case the nature of the guarantee is disclosed. The Company's management continually monitor known and potential contingent matters and make appropriate charges to the consolidated statement of income when warranted by circumstance.

#### USE OF DERIVATIVE INSTRUMENTS

The Group's derivative activity is limited to certain petroleum products marketing and trading operations hedging of commodity price risks. Currently this activity involves the use of futures and swaps contracts together with purchase and sale contracts that qualify as derivative instruments. The Group accounts for these activities under the mark-to-market methodology in which the derivatives are revalued each accounting period. Resulting realized and unrealized gains or losses are presented in the consolidated statement of income on a net basis. Unrealized gains and losses are carried as assets or liabilities on the consolidated balance sheet.

## RECENT ACCOUNTING PRONOUNCEMENTS

In April 2011, the FASB issued Accounting Standards Update (“ASU”) No. 2011-02, “A Creditor’s Determination of Whether a Restructuring Is a Troubled Debt Restructuring,” which amends Topic 310 of the Codification. This ASU provides additional guidance in considering whether a restructuring constitutes a troubled debt restructuring and helps creditors in determining whether a creditor has granted a concession and whether a debtor is experiencing financial difficulties. ASU No. 2011-02 is effective starting from the first interim or annual period beginning on or after June 15, 2011. The Group adopted the requirements of ASU No. 2011-02 starting from the third quarter of 2011. This adoption did not have a material impact on the Group’s results of operations, financial position or cash flows and did not require additional disclosures.

In January 2010, the FASB issued ASU No. 2010-06, “Improving Disclosures about Fair Value Measurements,” which requires reporting entities to make new disclosures about recurring or nonrecurring fair-value measurements including significant transfers into and out of Level 1 and Level 2 fair-value measurements and to present separately information about purchases, sales, issuances, and settlements on a gross basis in the reconciliation of Level 3 fair-value measurements. This ASU also clarifies existing fair-value measurement disclosure guidance about the level of disaggregation, inputs, and valuation techniques. The Group fully adopted the requirements of ASU No. 2010-06 starting from the first quarter of 2011. This adoption did not have a material impact on the Group’s results of operations, financial position or cash flows.

In December 2011, the FASB issued ASU No. 2011-12, “Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05.” This ASU defers changes that relate to the presentation to reclassification adjustments out of accumulated other comprehensive income in ASU No. 2011-05, “Presentation of Comprehensive Income,” until the FASB is able to reconsider those paragraphs. Entities should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU No. 2011-05. ASU No. 2011-12 is effective at the same time as the ASU No. 2011-05: for public entities for fiscal years, and interim periods within those years, beginning after December 15, 2011 and should be applied retrospectively. The Group will apply the provisions

of ASU No. 2011-12 starting from the first quarter of 2012 and does not expect any material impact on its results of operations, financial position or cash flows.

In December 2011, the FASB issued ASU No. 2011-11, “Disclosures about Offsetting Assets and Liabilities.” This ASU requires entities to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. The scope includes derivatives, sale and repurchase agreements and reverse sale and repurchase agreements, and securities borrowing and securities lending arrangements. ASU No. 2011-11 is effective for annual reporting periods on or after January 1, 2013, and interim periods within those annual periods, and should be applied retrospectively. The Group is evaluating the effect of the adoption of ASU No. 2011-11 and does not expect any material impact on its results of operations, financial position or cash flows.

In September 2011, the FASB issued ASU No. 2011-08, “Testing Goodwill for Impairment,” which allows an entity to use a qualitative approach to test goodwill for impairment. This ASU permits an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount and hence whether it is necessary to perform the two-step goodwill impairment test as required by the provisions of Topic 350 of the Codification. ASU No. 2011-08 is effective for annual and interim goodwill impairment tests performed for the fiscal years beginning after December 15, 2011. The Group will apply the provisions of ASU No. 2011-08 starting from the first quarter of 2012 and does not expect any material impact on its results of operations, financial position or cash flows.

In June 2011, the FASB issued ASU No. 2011-05, “Presentation of comprehensive income,” which amends Topic 220 of the Codification. This ASU increases the prominence of other comprehensive income in financial statements. Under this ASU, an entity will have the option to present the components of net income and comprehensive income in either one or two statements. The ASU eliminates the option in US GAAP to present other comprehensive income in the statement of changes in equity. ASU No. 2011-05 is effective for public entities for fiscal years, and interim periods within those years, beginning after December 15, 2011 and should be applied retrospectively. The Group will apply the provisions of ASU No. 2011-05 starting from the first quarter of 2012.

In May 2011, the FASB issued ASU No. 2011-04, "Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in US GAAP and IFRSs," which amends Topic 820 of the Codification. This ASU provides guidance for fair value measurements and disclosure requirements and clarifies the Board's intent about the application of existing fair value measurement requirements. The new standard does not extend the use of fair value but, rather, provides guid-

ance about how fair value should be applied where it already is required or permitted under US GAAP. ASU No. 2011-04 is effective for public entities during interim and annual periods beginning after December 15, 2011 and should be applied prospectively. The Group will apply the provisions of ASU No. 2011-04 starting from the first quarter of 2012 and does not expect any material impact on its results of operations, financial position or cash flows.

## FORWARD-LOOKING STATEMENTS

Certain statements in this document are not historical facts and are “forward-looking.” We may from time to time make written or oral forward-looking statements in reports to shareholders and in other communications. Examples of such forward-looking statements include, but are not limited to:

- statements of our plans, objectives or goals, including those related to products or services
- statements of future economic performance
- statements of assumptions underlying such statements
- the effects of, and changes in, Russian government policy
- the effects of competition in the geographic and business areas in which we conduct operations
- the effects of changes in laws, regulations, taxation or accounting standards or practices
- our ability to increase market share for our products and control expenses

Forward looking statements that may be made by us from time to time (but that are not included in this document) may also include projections or expectations of revenues, income (or loss), earnings (or loss) per share, dividends, capital structure or other financial items or ratios. Words such as “believes,” “anticipates,” “expects,” “estimates,” “intends” and “plans” and similar expressions are intended to identify forward-looking statements but are not the exclusive means of identifying such statements. By their very nature, forward-looking statements involve inherent risks and uncertainties, both general and specific, and risks exist that the predictions, forecasts, projections and other forward-looking statements will not be achieved. You should be aware that a number of important factors could cause actual results to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward-looking statements.

These factors include:

- inflation, interest rate and exchange rate fluctuations
- the price of oil

- acquisitions or divestitures
- technological changes
- our success at managing the risks of the aforementioned factors.

This list of important factors is not exhaustive. When relying on forward-looking statements, you should carefully consider the foregoing factors and other uncertainties and events, especially in light of the political, economic, social and legal environment in which we operate. Such forward-looking statements speak only as of the date on which they are made, and, subject to any continuing obligations under the Listing Rules of the U.K. Listing Authority, we do not undertake any obligation to update or revise any of them, whether as a result of new information, future events or otherwise. We do not make any representation, warranty or prediction that the results anticipated by such forward-looking statements will be achieved, and such forward-looking statements represent, in each case, only one of many possible scenarios and should not be viewed as the most likely or standard scenario.

## Reference Information

The most complete and up-to-date information about LUKOIL can always be found on the Company's website: [www.lukoil.ru](http://www.lukoil.ru) (Russian) or [www.lukoil.com](http://www.lukoil.com) (English).

The site also provides information about trends and results of LUKOIL's business, as well as accurate and up-to-date information about events concerning the Company and the whole spectrum of LUKOIL activities, including details of the Company's social and environmental policies.

The Investor Center section of the site presents the company's financial and industrial results, dividend history, share prices, a calculator for investors, a shareholder tool-box, presentations for investors, and Company reports.

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### PUBLISHED REPORTS

Electronic versions of the following reports are available on the Company web site:

1. Report on Company Business.
2. Consolidated Financial Accounts.
3. Quarterly Consolidated Financial Accounts.
4. Management Discussion and Analysis of Financial Situation and Results of Operations
5. Analyst DataBook.
6. Fact book.

### CONCEPTS AND ABBREVIATIONS USED IN THE REPORT

Mentions of 'OAO LUKOIL', 'LUKOIL Group', 'the Group', 'LUKOIL', 'the Company', 'we' and 'our' are equivalent for the purposes of this Report and refer to LUKOIL Group of companies, to LUKOIL and/or its subsidiary enterprises, depending upon the context in which the terms are used.

The average ruble/dollar exchange rate for 2011 (29.39 rubles/dollar) is used in conversion of ruble figures for expression in dollars, unless otherwise indicated.

Figures for reserves and production of oil include oil, gas condensate and gas liquids.

'Regions' with a capital 'R' refers to administrative divisions of the Russian Federation, 'regions' with a small 'r' refers to general geographical divisions.

'Reference fuel' is a rough measure to enable comparisons between different types of fuel, based on their energy content. 1 tonne of reference fuel = one tonne of crude oil = 1,000 cubic meters of natural gas.

### ABBREVIATIONS

boe – barrels of oil equivalent (1 boe = 6,000 cubic feet of gas)

km – kilometer

ppm – parts per million

PSA – production sharing agreement

RTS – Russian Trading System

MICEX – Moscow Interbank Currency Exchange

[www.lukoil.com](http://www.lukoil.com)