

ОАО АК TRANSNEFT

**MANAGEMENT'S DISCUSSION AND ANALYSIS
OF THE GROUP'S FINANCIAL POSITION
AND RESULTS OF ITS OPERATIONS**

FOR THE SIX MONTHS ENDED 30 JUNE 2012





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(in millions of Russian roubles, if not stated otherwise)

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The following analysis provides an overview of the financial position of OAO AK Transneft and its subsidiaries (hereinafter – the “Group”) as at 30 June 2012 and results of operations for the six months ended 30 June 2012, compared to the six months ended 30 June 2011, as well as other important factors which could affect the future results of the Group. This analysis should be read in conjunction with the Consolidated interim condensed financial statements prepared in accordance with International financial reporting standards (hereinafter – “IFRS”) for the six months ended 30 June 2012.

Key financial and operating results

	Six months ended 30 June 2012	Six months ended 30 June 2011	Change, %
Revenue, mln. RUB	361,293	325,894	10.9
Profit for the period, mln. RUB	95,360	130,512	(26.9)
EBITDA, mln. RUB	171,181	145,370	17.8
EBITDA margin, %*	60.5%	56.6%	x
Oil delivered to consignees, mln. tons	238.1	232.7	2.4
including			
Russian oil refineries, mln. tons	117.7	114.9	2.4
transshipment into the CPC-R system, mln. tons	0.2	1.2	(83.3)
exports to FSU countries, mln. tons	14.2	13.9	2.2
exports to ROW, mln. tons	106.0	102.7	3.2
Oil products delivered to consignees, mln. tons	12.9	15.4	(16.2)
including:			
Russia's domestic market, mln. tons	4.2	4.0	5.0
exports to the Customs Union member countries, mln. tons	1.4	1.1	27.3
exports to ROW, mln. tons	7.3	10.3	(29.1)

* Less crude oil sale and purchase operations under contracts with OAO NK Rosneft and the China National United Oil Corporation.

The Group's profit for the six months ended 30 June 2012 amounted to RUB 95.4 bn which is RUB 6.1 bn or 6.0% lower than for the six months ended 30 June 2011 which amounted to RUB 101.5 bn excluding gain from disposal of the Group's share in OOO Primorsk Trade Port in the amount of RUB 29 bn.

Furthermore, the profit for the six months ended 30 June 2012 contains net foreign currency exchange gain amounting to RUB 2.2 bn (as for the six months ended 30 June 2011 the net foreign currency exchange gain amounted to RUB 23.3 bn), net interest expense amounting to RUB 9.4 bn (RUB 4.5 bn – for the six months ended 30 June 2011), as well as loss from change in fair value of derivatives amounting to RUB 0.4 bn (for the six months ended 30 June 2011 – RUB 0.0 bn). Should these factors be excluded the profit for the six months ended 30 June 2012 would amount to RUB 103.0 bn (for the six months ended 30 June 2011 – RUB 82.7 bn) showing an increase of RUB 20.3 bn or 24.6%.



1. General information and overview of the Group's activities

The oil transporting joint stock company Transneft was established and incorporated by the Russian Government Resolution No. 810 dated 14 August 1993 under Presidential Decree No. 1403 dated 17 November 1992.

According to its Charter, OAO AK Transneft was established for the purposes of:

- promoting the technical and socio-economic interests of its shareholders, while unconditionally ensuring the Russian Federation's interests in the area of transporting oil, gas, and the products of oil & gas refining via trunk pipelines; and
- generating profit.

The main areas of OAO AK Transneft and its subsidiaries' operations are as follows:

- providing services in the area of transporting oil and oil products via trunk pipelines in the Russian Federation and outside of its territory;
- carrying out prevention, diagnostic, and emergency & recovery work on trunk pipelines;
- coordinating activities aimed at comprehensive development of the trunk pipeline network and other pipeline transport facilities;
- interacting with pipeline transport companies in other countries on matters of oil and oil products transportation in accordance with intergovernmental agreements;
- participating in scientific, technical, and innovative development of the pipeline transport, and implementing new equipment, technology, and materials;
- raising investment capital for the development of the production base, as well as the expansion and reconstruction of facilities of the Transneft system's entities; and
- organizing environmental work in areas where pipeline transport facilities are located.

The Group also provides services of oil storage in the trunk pipeline system, oil compounding, oil sales, and oil customs clearance.

OAO AK Transneft is also responsible for oil transportation planning and management on foreign territory, for exercising control of oil storage at and delivery to foreign oil receipt & delivery facilities, and for data collection and summarizing.

The Group is a natural monopoly and, as at 30 June 2012, it possesses an extensive network of trunk oil pipelines with a total length of approximately 51 thousand km and trunk oil products pipelines with a total length of some 19 thousand km.

During the six months ended 30 June 2012 the Group transported 92% of oil produced in Russia and more than 14% of oil products produced in Russia, as well as significant volumes of hydrocarbons and oil products from CIS countries.

OAO AK Transneft's key competitive advantages include:

- a monopoly position in the oil pipeline transport market;
- a low ratio of operating costs to total oil transportation volume compared to railway or water transport; and
- average level of oil transportation tariffs, compared to those in the CIS and Western Europe.



1.1. Key investment projects

OAO AK Transneft pays considerable attention to comprehensive development of its trunk pipeline network, promotion of scientific and technical progress, and implementation of new equipment and technology. OAO AK Transneft's capital investment policy is aimed at achieving system-wide targets for production base development, as well as expansion, reconstruction, and technical upgrades of pipeline transport facilities.

The Group carries out capex projects in the area of building and expanding pipeline systems, the largest of which are:

- The Eastern Siberia–Pacific Ocean pipeline system, stage two, the Skovorodino–SMNP Kozmino section (ESPO II);
- Expansion of the Eastern Siberia–Pacific Ocean pipeline system's capacity, the GNPS Taishet–NPS Skovorodino section, to 50 mln tons annually;
- The Baltic Pipeline System 2, stage one (BPS-2);
- The NPS Purpe–NPS Samotlor pipeline system;
- The Zapolyarie–Purpe pipeline;
- Expansion of the pipeline system to ensure transportation of 12 mln tons of oil annually to OOO RN-Tuapse Refinery.

1.2. Changes in the Group's investments

In March 2012 the Group acquired a significant share (26%) in OOO Nevskaya truboprovodnaya companya for US Dollars 19 million (RUB 554 at the CBR exchange rate at the date of transaction). The company is the owner of oil-loading infrastructure in the Ust-Luga seaport.

In May 2012 the Group acquired the additional share of 49% of OAO VOSTOKNEFTETRANS for the consideration of RUB 3,600 which was paid out in cash. The acquisition resulted in increase of a total share in OAO VOSTOKNEFTETRANS from 51% to 100%. As at the date of acquisition the carrying value of net assets in the Group's consolidated financial statements amounted to RUB 8,348. The Group recognized a decrease in non-controlling interests in the amount of RUB 4,090 and an increase in retained earnings amounting to RUB 490.

1.3. Environmental policy

The Group's management is fully aware of potential danger of a possible negative impact of technologically complex production activities on the environment. The main areas of the Group's environmental activities have been set out in OAO AK Transneft's ecological policy, the principles of which underlie OAO AK Transneft's ecological policy for 2010–2017, which spells out specific environmental measures.

The Group's management is fully informed of the conditions of all fixed assets and the pace of their wear and tear, and uses these data to plan reconstruction or building of new facilities. Transneft's ecological strategy contains specific seven-year programs for each of its subsidiaries.

The amount of funding of the ecological safety program, building and reconstruction of environmental facilities and acquisition of environmental protection equipment enable OAO AK Transneft to meet the strictest Russian and international environmental standards.



2. Tariffs and key macroeconomic factors affecting the Group's performance

2.1. Oil and oil products transportation tariffs

OAO AK Transneft has been providing tariff-based oil transportation services to consignors since 1992.

Tariff rates are currently calculated in accordance with the Rules of State Regulation of Fees or Their Maximum Limits for Services of Natural Monopolies with Respect to Transportation of Oil and Oil products via Trunk Pipelines, approved by a Decree of the Government of the Russian Federation of 29.12.2007 No. 980, as well as in accordance with the Regulations on Setting Fees for Services of Transportation of Oil via Trunk Pipelines, approved by an Order of the Federal Tariff Service of Russia of 17.08.2005 No. 380-e/2 and the Methodology of setting tariffs on oil products transportation via trunk pipelines of the Russian Federation of 16.10.2002 No. 70-e/5.

During the six months ended 30 June 2012, OAO AK Transneft was performing its core operations:

a) of transporting oil, by charging fees for its services in accordance with oil transportation tariff rates approved by orders of the state regulatory body for natural monopolies – the Federal Service of Tariffs of Russia (FST of Russia):

- Order of the FST of Russia of 31.08.2011 No. 202-e/2 Concerning the Setting of Fees for the Services of OAO AK Transneft for Transportation of Oil via the Trunk Pipeline System;
- Order of the FST of Russia of 29.07.2011 No. 183-e/1 Concerning the Setting of Fees for the Services of OAO AK Transneft for Transportation of Oil along the Klin-Andreapol' Route;
- Order of the FST of Russia of 29.03.2011 No. 55-e/3 Concerning the Setting of Fee Rates for OAO AK Transneft's Oil Loading Services;
- Order of the FST of Russia of 01.02.2011 No. 12-e/7 Concerning the Setting of a Fee for the Services of OAO AK Transneft for Transportation of Oil along the Makhachkala-NB Sheskharis Route;
- Order of the FST of Russia of 30.12.2010 No. 496-e/1 Concerning the Setting of Fees for the Services of OAO AK Transneft for Transportation of Transit Oil via the Trunk Pipeline System;
- Order of the FST of Russia of 26.11.2010 No. 336-e/2 Concerning the Setting of a Long-Term Fee Rate for the Services of OAO AK Transneft for Transportation of Oil along the LPDS Starolikeevo-Ryazan Oil Refinery Route of the Trunk Pipeline System for OAO TNK-BP Holding;
- Order of the FST of Russia of 29.07.2010 No. 172-e/6 Concerning the Setting of a Fee for the Services of OAO AK Transneft for Transportation of Oil via the Tikhoretsk-Tuapse Oil Refinery Pipeline Section for OAO NK Rosneft;
- Order of the FST of Russia of 29.07.2010 No. 167-e/1 Concerning the Setting of Fees for the Services of OAO AK Transneft for Transportation of Oil via the Trunk Pipeline System;
- Order of the FST of Russia of 24.11.2009 No. 324-e/4 Concerning the Setting of a Fee Rate for Oil Loading Services at the PNN Skovorodino of OAO AK Transneft's Trunk Pipeline System;
- Order of the FST of Russia of 22.12.2009 No. 455-t/1 Concerning the Setting of Fees for Sea Port Services Provided to OOO Specialized Oil Loading Sea Port Kozmino;
- Order of the FST of Russia of 05.08.2008 No. 129-e/3 Concerning the Approval of Fees for Oil Loading Services at the LPDS Krotovka of OAO AK Transneft's Trunk Pipeline System for OAO TNK-BP Holding;
- Order of the FST of Russia of 29.12.2011 No. 448-e/1 Concerning the Setting of Fees for the Services of OAO AK Transneft for Transportation of Oil via the Trunk Pipeline System;
- Order of the FST of Russia of 28.02.2012 No. 15-e/1 Concerning the Setting of Fees for the Services of OAO AK Transneft for Transportation of Oil at the Oil Base Ust-Luga and the Inclusion of Amendments to the Order of the FST of Russia of 31.08.2011 No. 202-e/2; and
- Order of the FST of Russia of 27.04.2012 No. 72-e/2 Concerning the Setting of Fees for the Services of OAO AK Transneft for Transportation of Oil along the Klin-Andreapol' Route.

b) of transporting oil products, by charging fees for its services in accordance with fee rates approved by OAO AK Transneft in accordance with orders of the state regulatory body for natural monopolies – the Federal Tariff Service of Russia (FST of Russia):

- Order of the FST of Russia of 24.12.2010 No. 471-e/1 Concerning the Setting of Fees for the Services of OAO AK Transneft and its Affiliated Entities for Transportation of oil products via the Trunk Pipeline System;



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- Order of the FST of Russia of 24.12.2010 No. 472-e/2 Concerning the Inclusion of Amendments to the Order of the FST of Russia of 23.09.2010 No. 234-e/2 Concerning Fee Rates for the Services of OOO BalttransService for Transportation of oil products from the Trunk Pipeline System in the Primorsk Commercial Seaport;
- Order of the FST of Russia of 15.02.2011 No. 23-e/3 Concerning the Setting of Fees for the Services of OAO AK Transneft and its Affiliated Entities for Transportation of Oil products via the Trunk Pipeline System, and the Inclusion of Amendments to the Order of the FST of Russia of 24.12.2010 No. 471-e/1.

During 2011 and six months ended 30 June 2012, oil transportation tariff rates increased:

- by 2.85% effective 1 September 2011;
- by 5.0% effective 1 November 2011.

2.2. Oil mining and oil products refining volumes

The dynamics of oil mining and oil products refining volumes in the Russian Federation determine the dynamics of transportation turnover via the Group's oil and oil products pipelines and therefore the Group's revenue from the relevant services.

	Six months ended 30 June 2012	Six months ended 30 June 2011	Change, %
Oil mining volume in the Russian Federation, mln tons	256.5	252.5	1.6
Oil products refining volume in the Russian Federation, mln tons	94.5	91.9	2.8

As a result of growth during the six months ended 30 June 2012 in oil mining volume in the Russian Federation by 4.0 mln tons, or 1.6%, the Group's oil transportation turnover and the Group's revenue from oil transportation services increased (ref. to subparagraph 3.1.1.).

Despite the growth in oil products refining during the six months ended 30 June 2012 in the Russian Federation by 2.6 mln tons or 2.8%, oil products transportation turnover decreased (ref. to subparagraph 3.1.1.).

2.3. The rouble's exchange rate against foreign currencies

Oil transportation services are paid for in Russian roubles except for the transit of crude oil from Azerbaijan which is set off in US Dollars.

Oil products transportation services are paid for in the following main currencies:

- in the Russian Federation: Russian roubles;
- in the Republic of Belarus and Ukraine: US dollars; and
- in the Republic of Kazakhstan: the rouble equivalent calculated at the exchange rate of the Kazakhstan tenge established by the Central Bank of the Russian Federation on the payment date.

Fluctuations of US Dollar and Kazakhstan tenge do not significantly affect the Group's operating results as the portion of revenue which is paid for in US Dollars or rouble equivalent, calculated at the Kazakhstan tenge exchange rate, established by Central Bank of Russian Federation at the date of payment, in the total revenue is relatively small.

The Group's foreign exchange exposure mainly arises on US dollar and EURO-denominated borrowings. Decrease of rouble's rate may result in additional expenses in regard to servicing and settlement of liabilities nominated in foreign currency.

The strengthening of the US dollar's purchasing power in the Russian Federation, calculated based on the rouble's exchange rates against the US dollar and the rate of inflation in the Russian Federation, amounted to 11.2% during the six months ended 30 June 2012, compared to the six months ended 30 June 2011.



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	Six months ended 30 June 2012	Six months ended 30 June 2011	Change, %
Change in the rouble's exchange rate against the US dollar, %	1.93	(7.88)	x
Average exchange rate for the period (roubles per US dollar)	30.6390	28.6242	7.0
Exchange rate at the end of the period (roubles per US dollar)	32.8169	28.0758	16.9

2.4. Inflation rates

Russia's inflation rates during the period in question were as follows:

	Six months ended 30 June 2012	Six months ended 30 June 2011	Change, pp
Rouble inflation (CPI), %	3.2	5.0	(1.8)

2.5. Taxation

Most of the Group's companies are incorporated in the Russian Federation, with their financial activity taxable under the Tax Code of the Russian Federation.

The amount of taxes accrued by the Group was as follows:

	Six months ended 30 June 2012	Six months ended 30 June 2011	Change, %
Income tax	25,237	29,151	(13.4)
Property tax	2,239	2,027	10.5
Other taxes and levies	324	177	83.1

Income tax

The federal income tax rate is 2.0%, while the regional rates range from 13.5% to 18.0%. The Group's international operations are taxable at rates established by the laws of countries where they take place.

Property tax

The property tax is assessed at a rate not exceeding 2.2% of average annual fixed asset book value. The existing legislation provides for reduction of the taxable base by the book value of trunk pipeline facilities as well as of any structures constituting an integral technological part of these facilities.

Other taxes and levies

Other taxes mainly include the transport tax, the land tax, special-purpose levies established by local authorities, and other taxes and levies.



3. Analysis of the Group's performance

The table below presents consolidated statement of comprehensive income for the periods showed therein.

Revenue by type of Operations	Six months ended 30 June 2012	Six months ended 30 June 2011	Absolute change	Change, %
Revenue				
Revenue from oil transportation services	245,158	220,524	24,634	11.2
Revenue from crude oil sales	83,033	75,028	8,005	10.7
Other revenue	33,102	30,342	2,760	9.1
Operating expenses	(230,821)	(219,608)	(11,213)	5.1
Operating profit	130,472	106,286	24,186	22.8
Exchange gains	81,638	46,348	35,290	76.1
Exchange losses	(79,466)	(23,008)	(56,458)	3.5 times
Interest income	5,117	7,211	(2,094)	(29.0)
Interest expense	(14,483)	(11,734)	(2,749)	23.4
Net change in fair value of derivatives	(374)	-	(374)	x
Share of profit from associates and jointly controlled entities	1,356	31,260	(29,904)	(95.7)
Profit before income tax	124,260	156,363	(32,103)	(20.5)
Current income tax	(25,237)	(29,151)	3,914	(13.4)
Deferred income tax	(3,663)	3,300	(6,963)	-
Income tax expense	(28,900)	(25,851)	(3,049)	11.8
Profit for the period	95,360	130,512	(35,152)	(26.9)
Other comprehensive (loss)/ income after tax	(15)	287	(302)	x
Total comprehensive income	95,345	130,799	(35,454)	(27.1)
Profit attributable to:				
Shareholders of OAO AK Transneft	93,244	129,936	(36,692)	(28.2)
Non-controlling interests	2,116	576	1,540	3.7 times
Total comprehensive income attributable to:				
Shareholders of OAO AK Transneft	93,299	130,223	(36,994)	(28.4)
Non-controlling interests	2,116	576	1,540	3.7 times



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3.1. Revenue

Revenue by type of operations	Six months ended 30 June 2012	Share of Total Revenue, %	Six months ended 30 June 2011	Share of total revenue, %	Absolute change	Change, %
Revenue from crude oil transportation services	245,158	67.8	220,524	67.6	24,634	11.2
Exports and sales in international markets, except the CIS	143,527	39.7	117,008	35.9	26,519	22.7
Exports and sales in the CIS	7,653	2.1	7,214	2.2	439	6.1
Domestic sales	93,978	26.0	96,302	29.5	(2,324)	(2.4)
Revenue from oil products transportation services	14,800	4.1	16,915	5.2	(2,115)	(12.5)
Revenue from oil compounding services	3,093	0.9	2,354	0.7	739	31.4
Other revenue	7,309	2.0	5,882	1.8	1,427	24.3
Total revenue (less revenue from sales of crude oil and oil products)	270,360	74.8	245,675	75.4	24,685	10.0
Revenue from export sales of crude oil	78,390	21.7	68,884	21.1	9,506	13.8
Revenue from sales of crude oil in the domestic market	4,643	1.3	6,144	1.9	(1,501)	(24.4)
Revenue from sales of oil products	7,900	2.2	5,191	1.6	2,709	52.2
Total revenue	361,293	100.0	325,894	100.0	35,399	10.9

During the six months ended 30 June 2012, the Group's revenue increased by RUB 35,399 mln, or 10.9%, attributable mainly to an increase in revenue from oil transportation services and revenue from sales of crude oil and oil products, including oil sales to China National United Oil Corporation. Without taking into account crude oil sales and oil products sales, revenue for the six months ended 30 June 2012, amounted to RUB 270,360 mln, which is RUB 24,685 mln, or 10.0%, higher than for the six months ended 30 June 2011.

3.1.1. Oil and oil products transportation services

An increase in revenue from oil transportation services by RUB 24,634 mln, or 11.2%, was driven by the following factors:

- growth in oil transportation tariffs (paragraph 2.1);
- growth in turnover by 1.1% (559,873.2 mln tons x km for the six months ended 30 June 2012; 553,858.7 mln tons x km for the six months ended 30 June 2011).



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A decrease in revenue from oil products transportation services by 12.5% was driven by the decrease in the oil products transportation turnover by 19.6% (for the six months ended 30 June 2012 – 16,107.4 mln tons x km; and 20,039.0 mln tons x km in the six months ended 30 June 2011) due to restriction of turnover of fuel from a mass fraction of sulfur more than 500 mg / kg (Government Decree on 07.09.2011 № 748).

3.1.2. Revenue from sales of crude oil and oil products

A decrease in revenue from sales of crude oil in the domestic market by RUB 1,501 mln, or 24.4%, was driven by a decrease in volume of crude oil sold by the Group.

Revenue from sales of crude oil was driven by the start of oil supplies to the People's Republic of China under a 20-year contract to supply 6 mln tons of crude oil annually effective January 1, 2011. This contract was signed as a collateral for a loan obtained from the China Development Bank. The respective oil volumes are being purchased from OAO NK Rosneft.

Growth in revenue from sales of marketable oil products for the six months ended 30 June 2012 by RUB 2,709 mln, or by 52.2%, was driven by growth in volumes of marketable oil products sales by the Group's companies.

3.1.3. Revenue from oil compounding services

An increase in revenue from oil compounding services was a result of the following:

- growth in oil compounding volumes by 3.1% (23,191.83 thousand tons for the six months ended 30 June 2012; 22,491.76 thousand tons for the six months ended 30 June 2011), and
- growth in oil compounding specific revenue by 27.4% (RUB 133.39 per ton for the six months ended 30 June 2012; RUB 104.67 per ton* for the six months ended 30 June 2011).

3.1.4. Other revenue

Other revenue includes revenue from oil and oil products storage services, information services related to oil transportation, property leasing, and insurance services, as well as other services.

* calculated based revenue received from compounding of one ton of oil



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3.2. Operating expenses

Operating expenses for the six months ended 30 June 2012, and the six months ended 30 June 2011, are detailed in the table below:

Operating expense line items	Six months ended 30 June 2012	Share of total expenses, %	Six months ended 30 June 2011	Share of total expenses, %	Absolute change	Change, %
Staff costs	48,853	21.2	44,487	20.3	4,366	9.8
Energy	15,738	6.8	18,049	8.2	(2,311)	(12.8)
Transportation of oil using railways	16,548	7.2	14,081	6.4	2,467	17.5
Materials	7,352	3.2	8,157	3.7	(805)	(9.9)
Repairs services and maintenance of relevant technical condition of pipeline	4,553	2.0	4,625	2.1	(72)	(1.6)
Insurance expenses	2,521	1.1	1,580	0.7	941	59.6
Taxes (except income tax)	2,496	1.0	2,214	1.0	282	12.7
Other operating expenses	1,414	0.6	8,071	3.7	(6,657)	(82.5)
Total operating expenses (net of depreciation and amortization and cost of crude oil and oil products sold)	99,475	43.1	101,264	46.1	(1,789)	(1.8)
Depreciation and amortization	40,709	17.6	39,084	17.8	1,625	4.2
Cost of export crude oil sales (including export custom duties)	78,674	34.1	69,243	31.5	9,431	13.6
Cost of crude oil sold in the domestic market	4,463	1.9	5,228	2.4	(765)	(14.6)
Cost of oil products sold	7,500	3.2	4,789	2.2	2,711	56.6
Total operating expenses	230,821	100.0	219,608	100.0	11,213	5.1

For the six months ended 30 June 2012, compared to the six months ended 30 June 2011, the amount of operating expenses (less depreciation and amortization and cost of crude oil and oil products sold) decreased by RUB 1,789 mln, or 1.8%, while total operating expenses increased by RUB 11,213 mln, or 5.1%.

An increase in the Group's total operating expenses was driven by the following factors:

- growth in cost of crude oil sold by RUB 9,431 mln, attributable to oil supplies to the People's Republic of China effective January 1, 2011, under a crude supply contract (ref. paragraph 3.2.6.);
- growth in cost of crude oil products sold by RUB 2,711 mln, or by 56.6%, attributable to increased volumes of marketable oil products sales by the Group's companies (ref. paragraph 3.2.6.).



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After applying deflation rates, operating expenses for the six months ended 30 June 2012, and for the six months ended 30 June 2011, were as follows:

Operating expense line items	Deflation rates (2012 to 2011)	Six months ended 30 June 2012 (deflated to 2011)	Share of total expenses, %	Six months ended 30 June 2011	Share of total expenses, %	Absolute change	Change, %
Staff costs	6.0	46,088	21.4	44,487	20.3	1,601	3.6
Energy	4.5	15,058	7.0	18,049	8.2	(2,991)	(16.6)
Transportation of oil using railways	4.4	15,857	7.4	14,081	6.4	1,776	12.6
Materials	5.8	6,946	3.2	8,157	3.7	(1,211)	(14.8)
Repairs services and maintenance of relevant technical condition of pipeline	7.7	4,228	2.0	4,625	2.1	(397)	(8.6)
Insurance expenses	5.8	2,382	1.1	1,580	0.7	802	50.8
Taxes (except income tax)	5.9	2,358	1.1	2,214	1.0	144	6.5
Other operating expenses	5.8	1,336	0.6	8,071	3.7	(6,735)	(83.4)
Total operating expenses (net of depreciation and amortization and cost of crude oil and oil products sold)	X	94,253	43.8	101,264	46.1	(7,011)	(6.9)
Depreciation and amortization	X	40,709	18.9	39,084	17.8	1,625	4.2
Cost of export crude oil sales	13.6	69,260	32.2	69,243	31.5	17	0.0
Cost of crude oil sold in the domestic market	13.6	3,929	1.8	5,228	2.4	(1,299)	(24.8)
Cost of oil products sold	6.5	7,039	3.3	4,789	2.2	2,250	47.0
Total operating expenses	X	215,190	100.0	219,608	100.0	(4,418)	(2.0)

The deflation rates used are based on scenarios prepared by the Ministry of Economic Development for devising socio-economic development scenarios for 2012-2014, as well as on 2011-2012 inflation rates.



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Unit costs analysed by segments Oil transportation and Oil products transportation based on indicators developed under the Russian Accounting Standards

The Group's management analyzes expenses broken down by the Oil transportation, Oil products transportation and Oil sales to the People's Republic of China segments based on indicators developed under the Russian Accounting Standards (RAS) without adjustment entries for compliance with the IFRS.

	Oil transportation services	Oil products transportation services	Adjustment entries	Total operating expenses*
For the six months ended 30 June 2012				
Operating expenses, RUB mln	100,085	8,588	(9,198)	99,475
Cargo turnover, mln tons x km	559,873	16,107	-	-
For the six months ended 30 June 2011				
Operating expenses, RUB mln	91,978	8,403	883	101,264
Cargo turnover, mln tons x km	553,859	20,039	-	-

*Operating expenses were reported net of depreciation and amortization and cost of crude oil and oil products sold.

Unit costs per 100 tons x km for each of the segments are based on operating expenses calculated under the Russian Accounting Standards (RAS) without adjustment entries for compliance with the IFRS and cargo turnover. Deflated unit costs are calculated using deflation rate for deflating operating expenses (net of depreciation and amortization and cost of crude oil and oil products sold).

Unit costs of oil and oil products transportation per 100 tons x km for the six months ended 30 June 2012, and for the six months ended 30 June 2011, were as follows:

	For the six months ended 30 June 2012	For the six months ended 30 June 2011	Absolute change in unit costs, RUB per 100 tons x km	Change in unit costs, RUB per 100 tons x km, %
Oil transportation services				
Unit costs per 100 tons x km, RUB	17.88	16.61	1.27	7.6
Deflated unit costs per 100 tons x km, RUB	16.98		0.25	1.5
Oil products transportation services				
Unit costs per 100 tons x km, RUB	53.32	41.93	11.39	27.2
Deflated unit costs per 100 tons x km, RUB	50.30		8.37	20.0

3.2.1. Staff costs

Staff costs comprise wages, accrual of provision for annual bonus, provision for unused vacation, pension contributions, insurance premiums, staff training, social security expenses and other remuneration.

The increase in staff costs for the six months ended 30 June 2012 as compared to the six months ended 30 June 2011 in the amount of RUB 4,366 or by 9.8% was influenced by:

- an increase of average employee headcount for 4.1% related primarily to construction and operation of new oil pipelines, as well as facilities that are an integral part of the process:

	Six months ended 30 June 2012	Six months ended 30 June 2011	Change, %
Average employee headcount (people)	108,297	104,053	4.1

- indexation of wages and salaries during 2011 and from 1 January 2012 according to growth in consumer prices.

OAO AK Transneft has set the protection of the life and health of its employees as well as the creation of safe working conditions for them as its highest priority. One of the key tasks of social policy is to create conditions for effective work and social protection of workers.



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The non-state pension fund which offers different corporate plan options including corporate pension payments is an important part of the social policy.

	Six months ended 30 June 2012	Six months ended 30 June 2011	Absolute change	Change, %
Employers' contributions to NPF Transneft* in favor of employees	3,248	3,329	(82)	(2.5)

3.2.2. Energy

Energy expenses for the six months ended 30 June 2012, decreased by RUB 2,311 mln, or 12.8%, due to optimization in tariffs for consumed energy.

3.2.3. Transportation of oil using railways

The amount of expenses on transportation of oil using railways as for the six months ended 30 June 2012 increased on RUB 2,467 or 17.5% as compared to the previous period. This category of expenses represents expenditures on a complete set of services related to oil transportation by railways, including preparation and delivery of railway cars for oil loading, oil transportation by railway along the Skovorodino–SMNP Kozmino section, delivery of railway cars for oil unloading, and return of empty railway cars to Skovorodino.

3.2.4. Materials

Expenses on materials for the six months ended 30 June 2012, decreased by RUB 805 mln, or 9.9%, due to expansion of operations.

3.2.5. Repairs services and maintenance of relevant technical condition of pipeline

A decrease in these expenses for the six months ended 30 June 2012, amounted to RUB 72 mln, or 1.6% compared to the six months ended 30 June 2011.

3.2.6. Cost of crude oil and oil products sold

The cost of crude oil sold for export for the six months ended 30 June 2012, amounted to RUB 78,674 mln, including custom duties in the amount of RUB 38,740 mln, which was a result of the start of oil supplies to the People's Republic of China (ref. to paragraph 3.1.2.). These expenses are related to the cost of oil purchased from OAO NK Rosneft under a contract signed in April 2009.

The cost of marketable oil products sold increased due to growth in the Group companies' oil products sales volumes.

3.2.7. Insurance expenses

Insurance expenses increased on RUB 941 or 59.6% for the six months ended 30 June 2012 as compared to the six months ended 30 June 2011. These expenses represent the Group's expenditures on insurance companies' services, including expenses on insurance operations of ZAO SK Transneft and OOO SOT-TRANS. The increase in expenses was attributed to expansion of operations provided to legal entities and individuals who are not part of the Group and related reinsurance costs and formation of insurance reserves as well as expansion of insurance coverage of the Group's companies.

3.2.8. Taxes (except income tax)

The Group's other taxes include primarily the property tax, which amounted to RUB 2,239 mln for the six months ended 30 June 2012. The property tax is assessed at a rate not exceeding 2.2% of average annual fixed asset book value.

3.2.9. Other operating expenses

Other expenses include the results related to fixed assets disposals, income from posting oil surpluses, charity spending, fines and penalties received and paid, as well as other operating expenses.

OAO AK Transneft implements a policy of transparency with regard to its charity spending by disclosing detailed information on its website.

3.2.10. Share of profit from associates and jointly controlled entities

The Group holds a number of financial investments in associated and jointly controlled entities reported on an equity method basis. The decrease in the Group's share of profit from associates and jointly controlled entities

* NPF Transneft – Non-state pension fund Transneft



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for the six months ended 30 June 2012 compared to the relative period in 2011, was mainly attributed to the sale in January 2011 of Transneft Group's 50% stake in OOO Primorsk Trade Port (total income from the transaction amounted to RUB 29,034 mln).

3.2.11. Interest income and expenses

Interest income is generated from depositing available cash in bank accounts as well as investing in fixed-income securities.

A decrease in interest income for the six months ended 30 June 2012, by RUB 2,094 mln, or by 29.0%, was driven by a substantial decrease in the amount of income generated by investing temporarily available cash and cash equivalents (ref. to Para 5).

Interest income	Six months ended 30 June 2012	Six months ended 30 June 2011	Absolute change	Change, %
Interest income from cash and equivalents	3,605	7,822	(4,217)	(53.9)
Interest income from other financial assets	3,511	1,623	1,888	116.3
Other interest income	177	110	67	60.9
Total interest receivable	7,293	9,555	(2,262)	(23.7)
Less interest income on the temporary investment of borrowings	(2,176)	(2,344)	168	(7.2)
Total interest income recognized in the consolidated statement of comprehensive income	5,117	7,211	(2,094)	(29.0)

The amount of interest expenses is composed of:

- interest payable on a USD 10bn loan obtained from the China Development Bank at a variable LIBOR-linked rate with a 20-year maturity repayable in equal installments starting in the sixth year from the moment of issue;
- interest payable on Eurobonds issued by the Group in 2007-2008 for a total of USD 3,450 mln and 700 mln Euros; and
- interest payable on series 01-03 non-convertible interest-bearing documentary bonds for a total of RUB 135,000 mln.

During June 2012 the Group repaid in full and on time two Eurobonds issues in the amount of USD 500 mln and 700 mln Euros.

Accrued interest expenses and amounts of capitalized interest expenses for the relevant periods were as follows:

Interest expenses	Six months ended 30 June 2012	Six months ended 30 June 2011	Absolute change	Change, %
Interest expenses on loans and borrowings	17,448	16,047	1,401	8.7
Interest expenses regarding the dismantlement provision	3,614	4,370	(756)	(17.3)
Other interest expenses	309	292	17	5.8
Total interest expenses	21,371	20,709	662	3.2
Less finance costs to be capitalized	(6,888)	(8,975)	2,087	(23.3)
Total accrued interest recognized in the consolidated statement of comprehensive income	14,483	11,734	2,749	23.4



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During the six months ended 30 June 2012, interest in the amount of RUB 4,712 was capitalized as part of cost of assets under construction (for the six months ended 30 June 2011 – RUB 6,631) including:

- interest expenses to be capitalized in the amount of RUB 6,888 (for the six months ended 30 June 2011 – RUB 8,975);
- interest income to be excluded from interest expenses to be capitalized in the amount of RUB 2,176 (for the six months ended 30 June 2011 – RUB 2,344).

3.2.12. Foreign currency exchange gains and losses

The sum of foreign currency exchange gains and losses and their growth for the six months ended 30 June 2012, compared to the six months ended 30 June 2011, was a result of changes in the exchange rates of the US dollar and the Euro to the Russian rouble during the relative periods.

Due to a restatement of assets and liabilities denominated in foreign currencies at the end of every month, positive and negative currency-translation changes results, which are presented in the reporting in detail.

The currency-translation differences occurring with the fluctuation of foreign-currency exchange rates against the rouble were primarily driven by foreign-currency-denominated liabilities (USD and euro-denominated loans and borrowings facilities) and assets which value is expressed in foreign currencies (bank loans and balances on foreign-currency-denominated bank accounts).

The most pronounced effect on the sum total of currency-translation differences were differences for foreign-currency-denominated loans and borrowings facilities:

Currency-translation effect for foreign-currency-denominated loans and borrowings facilities	Six months ended 30 June 2012	Six months ended 30 June 2011
Gains	46,042	41,428
Losses	55,076	8,796

The dynamic of currency-translation effects presented in the table was driven by weakening of the rouble against the US dollar and the Euro for the six months ended 30 June 2012 and the six months ended 30 June 2011.

3.3. Reconciliation of profit and EBITDA

	Six months ended 30 June 2012	Six months ended 30 June 2011	Change, %
Profit for the period	95,360	130,512	(26.9)
Increased (decreased) by:			
income tax	28,900	25,851	11.8
depreciation and amortization	40,709	39,084	4.2
net change in fair value of derivatives	374	-	x
interest expenses	14,483	11,734	23.4
interest and dividend income	(5,117)	(7,211)	(29.0)
exchange gains	(81,638)	(46,348)	76.1
exchange losses	79,466	23,008	245.4
share of profit from associates and jointly controlled entities*	(1,356)	(31,260)	(95.7)
EBITDA	171,181	145,370	17.8
EBITDA margin**, %	60.5%	56.6%	x

*Including a RUB 29.0bn income from the sale of the Group's stake in OOO Primorsk Trade Port during the six months ended 30 June 2011.

**Less crude oil sale and purchase operations under contracts with OAO NK Rosneft and the China National United Oil Corporation.

EBITDA is a useful indicator for investors, as it reflects the Group's operating performance, including its ability to finance capital expenditures, company acquisitions, and other investments, as well as its ability to raise and service borrowings and loans. Some investors, analysts, and rating agencies tend to use EBITDA as a basis for estimating and projecting the efficiency and value of oil & gas companies. This indicator should not be considered separately, as an alternative to net income, operating income, or any other of Group's performance indicators reported in its consolidated financial statements.



4. Cash flow analysis

	Six months ended 30 June 2012	Six months ended 30 June 2011	Absolute change	Change, %
Cash flows generated from operating activities	81,599	68,828	12,771	18.6
Cash flows used in investing activities	(102,779)	(170,282)	67,503	(39.6)
Free cash flows	(21,180)	(101,454)	80,274	(79.1)
Cash flows (used in)/generated from financing activities	(49,703)	312	(50,015)	x
Net cash flows	(70,883)	(101,142)	30,259	(29.9)
Change in cash and cash equivalents due to deviation of currency exchange rate	(223)	(6,191)	5,968	(96.4)
Net decrease in cash and cash equivalents	(71,106)	(107,333)	36,227	(33.8)

4.1. Operating activities

Cash received from operating activities is the Group's main source of cash. The net cash generated from operating activities amounted to RUB 81,599 mln for the six months ended 30 June 2012, which is 18.6% (or RUB 12,771 mln) higher than for the six months ended 30 June 2011.

This dynamics was driven by an increase in cash received from customers due to growth in tariffs and cargo turnover by RUB 34,761 mln, while payments to suppliers and contractors increased by RUB 28,010 mln. The key drivers of the increase in cash received from operating activities was an increase in income tax payment by RUB 7,475 mln and an increase in cash received from the recovery of VAT and other taxes from the budget by RUB 11,739 mln.

4.2. Investing activities

The primary factors resulting in a general increase in cash used in investment activities by 39.6% or by RUB 67,503 mln for the six months ended 30 June 2012, as compared to the six months ended 30 June 2011, were:

- a decrease by RUB 31,775 mln or 27.1% in purchases of fixed assets and capital investment in accordance with key investment projects (ref. to paragraph 1.1.);
- a decrease by RUB 32,400 mln or by 62.2% in cash used in purchase-and-sale transactions in regards to promissory notes for the purpose of investing of temporarily available funds (which amounted to RUB 19,694 mln for the six months ended 30 June 2012, and RUB 52,094 mln for the six months ended 30 June 2011);
- a decrease in the amount of loans issued by RUB 5,021 (to OOO Nevskaya truboprovodnaya company in the amount of RUB 200 mln for the six months ended 30 June 2012, the loan provided to Omirico Ltd in the amount of USD 173.5 mln (RUB 5,221 mln at the exchange rate of the Central Bank of the Russian Federation at the date of operation) for the six months ended 30 June 2011).

4.3. Financing activities

The outflow of cash amounted to RUB 49,703 mln for the six months ended 30 June 2012, which was a result of repayment of Eurobonds in the amount of USD 500 mln and 700 mln of Euros (which is equivalent to RUB 46,192), as well as an acquisition of non-controlling interest in OAO VOSTOKNEFTETRANS (49%) for RUB 3,600. The outflow of cash amounted to RUB 312 for the six months ended 30 June 2011.



4.4. Disclosure of cash flows from operating activities using indirect method

Cash flows received from operating activities using the indirect method are disclosed in the table below in addition to the consolidated statements of cash flows prepared using the direct method and disclosed in the consolidated financial statements prepared in accordance with IFRS for the six months ended 30 June 2012.

Under the indirect method, the net cash flow from operating activities is determined by adjusting profit or loss for the effects of:

- (a) changes during the period in inventories and operating receivables and payables;
- (b) non-cash items such as depreciation, provisions, deferred taxes, unrealized foreign currency gains and losses, and undistributed profits of associates;
- (c) all other items for which the cash effects are investing or financing cash flows.

	Six Months Ended 30 June 2012	Six Months Ended 30 June 2011
Operating activities		
Profit before tax	124,260	156,363
<i>Adjustments for:</i>		
Depreciation and amortization	40,709	39,084
Loss from disposal of property, plant and equipment	(122)	678
Interest income and share of profit from associates and jointly controlled entities	(6,473)	(38,471)
Interest expenses	14,483	11,734
Profit from currency-translation	(2,172)	(23,340)
Other operating expenses	(3,981)	6,716
Operating profit before changes in working capital	166,704	152,764
Changes in operating assets and liabilities:		
Increase in inventories	(3,992)	(8,456)
Increase in trade and other receivables relating to operating activity	(7,964)	(30,179)
Decrease in trade and other payables, and accruals relating to operating activity	(22,334)	(311)
Cash flows from operating activities before payment of income tax expense and interest	132,414	113,818
Income tax paid	(48,517)	(29,205)
Income tax refunds	12,437	600
Interest paid	(14,735)	(16,385)
Cash flows received from operating activities	81,599	68,828



5. Liquidity analysis

	30 June 2012	31 December 2011	Change, %
Current assets	433,331	442,892	(2.2)
including:			
cash and cash equivalents	74,440	145,546	(48.9)
short-term bank promissory notes*	188,475	177,760	6.0
Current liabilities	121,858	180,483	(32.5)
Net working capital	311,473	262,409	18.7
Current ratio	3.6	2.5	44.0
Quick ratio**	2.5	2.0	25.0
Debt / EBITDA	1.8	2.1	(14.3)
Debt / Equity	0.8	1.0	(12.6)

* During the six months ended 30 June 2012 the Group purchased long-term zero-coupon notes which are to be repaid not earlier than 3rd quarter of 2013 and carrying value of RUB 18,578 (at the CBR exchange rate effective as at 30 June 2012).

Short-term bank promissory-notes consist of promissory notes by banks with investment-grade international credit ratings (99.5%), banks with credit ratings of BB+/Ba1/BB+, BB/Ba2/BB, BB-/Ba3/BB- (0.5%) per the S&P/Moody's/Fitch classification. Thus, short-term bank promissory notes consist of highly reliable or reliable financial instruments.

**Quick ratio = (Cash and cash equivalents + Current financial assets + Short-term receivables) / Current liabilities

The amount of RUB 71,106 mln decrease of cash and cash equivalents as at 30 June 2012 compared to the balances of cash and cash equivalents as at 31 December 2011 was a result of repayment of Eurobonds in the amount of USD 500 mln and 700 mln of Euros (RUB equivalent of 46,192 mln), as well as purchase during the six months ended 30 June 2012 of short-term and long-term discount and interest-bearing notes which are included in non-current and current other financial assets in the consolidated interim condensed statement of financial position. As at 30 June 2012 these promissory notes amounted to RUB 207,053 mln (as at 31 December 2011 – RUB 177,760 mln) and which changed in the amount of RUB 29,293 mln.