

**OAO AK TRANSNEFT  
MANAGEMENT'S DISCUSSION AND ANALYSIS  
OF THE GROUP'S FINANCIAL POSITION AND  
RESULTS OF ITS OPERATIONS  
FOR THE THREE MONTHS ENDED 31 MARCH 2012**

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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 31 March 2012 and results of operations for the three months ended 31 March 2012, compared to the three months ended 31 March 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 three months ended 31 March 2012.

### Key financial and operating results

	Three months ended 31 March 2012	Three months ended 31 March 2011	Change, %
Revenue, mln. RUB	181,350	160,110	13.3
Profit for the period, mln. RUB	59,842	85,458	(30.0)
EBITDA, mln. RUB	84,366	70,572	19.5
EBITDA margin, %*	59.8	55.7	x
Oil delivered to consignees, mln. tons including	118.8	115.0	3.3
Russian oil refineries, mln. tons	59.4	56.7	4.8
transshipment into the CPC-R system, mln. tons	0.1	0.9	(88.9)
exports to FSU countries, mln. tons	7.4	6.3	17.5
exports to ROW, mln. tons	51.9	51.1	1.6
Oil products delivered to consignees, mln. tons including:	6.8	7.7	(11.7)
Russia's domestic market, mln. tons	1.7	1.7	-
exports to the Customs Union member countries, mln.	0.7	0.5	40.0
exports to ROW, mln. tons	4.4	5.5	(20.0)

\* 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 three months ended 31 March 2012 amounted to RUB 59.8 bn which is RUB 3.3 bn or 5.8% higher than for the three months ended 31 March 2011 (excluding gain from disposal of the Group's share in OOO Primorsk Trade Port in the amount of RUB 29 bn for the three months ended 31 March 2011). The positive dynamics of the profit for the three months ended 31 March 2012 was mainly a result of increase of oil transportation tariffs as well as growth of oil turnover. Furthermore, the profit for the three months ended 31 March 2012 contains net foreign currency exchange gain amounting to RUB 17.3 bn (as for the three months ended 31 March 2011 the net foreign currency exchange gain amounted to RUB 20.7 bn), net interest income amounting to RUB 5.0 bn (RUB 2.3 bn – for the three months ended 31 March 2011), as well as gain from change in fair value of derivatives amounting to RUB 0.6 bn (for the three months ended 31 March 2011 – RUB 0.0 bn). Furthermore, the profit for the three months ended 31 March 2011 contains a gain from disposal of the Group's share in OOO Primorsk Trade Port in the amount of RUB 29 bn. Should these factors be excluded the profit for the three months ended 31 March 2012 would amount to RUB 46.9 bn (for the three months ended 31 March 2011 – RUB 38.1 bn) showing an increase of RUB 8.8 bn or 23.1%.

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

The open joint-stock company Joint-Stock Oil Transportation Company Transneft was established and incorporated by the Russian Government Resolution No. 810 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 31 March 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 three months ended 31 March 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.

### **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 three months ended 31 March 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 LDPS 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; and
- 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.

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. 473-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;
- 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 23.09.2011 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;

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

During 2011 and three months ended 31 March 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.

	Three months ended 31 March 2012	Three months ended 31 March 2011	Change, %
Oil mining volume in the Russian Federation, mln tons	128.4	125.4	2.4
Oil products refining volume in the Russian Federation, mln tons	48.4	45.8	5.7

As a result of growth during the three months ended 31 March 2012 in oil mining volume in the Russian Federation by 3.0 mln tons, or 2.4%, 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 three months ended 31 March 2012 in the Russian Federation by 2.6 mln tons or 5.7%, 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 weakening 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 0.7% during the three months ended 31 March 2012, compared to three months ended 31 March 2011.

	Three months ended 31 March 2012	Three months ended 31 March 2011	Change, %
Change in the rouble's exchange rate against the US dollar, %	(8.91)	(6.72)	x
Average exchange rate for the period (roubles per US dollar)	30.2642	29.2698	3.40
Exchange rate at the end of the period (roubles per US dollar)	29.3282	28.4290	3.16

## 2.4. Inflation rates

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

	Three months ended 31 March 2012	Three months ended 31 March 2011	Change, pp
Rouble inflation (CPI,) %	1.5	3.8	(2.3)

## 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:

	Three months ended 31 March 2012	Three months ended 31 March 2011	Change, %
Income tax	19,703	17,371	13.4
Property tax	1,102	1,033	6.7
Other taxes and levies	189	160	18.1

### *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.

	Three months ended 31 March 2012	Three months ended 31 March 2011	Absolute change, 2012-2011	Change, %
<b>Revenue</b>				
Revenue from oil transportation services	121,567	109,200	12,367	11.3
Revenue from crude oil sales	42,800	36,021	6,779	18.8
Other revenue	16,983	14,889	2,094	14.1
Operating expenses	(117,595)	(109,341)	(8,254)	7.5
<b>Operating profit</b>	<b>63,755</b>	<b>50,769</b>	<b>12,986</b>	<b>25.6</b>
Exchange gains	50,124	29,177	20,947	71.8
Exchange losses	(32,819)	(8,480)	(24,339)	287.0
Interest income	1,630	3,755	(2,125)	(56.6)
Interest expense	(6,607)	(6,077)	(530)	8.7
Net change in fair value of derivatives	584	-	584	X
Share of profit from associates and jointly controlled entities	1,950	30,438	(28,488)	(93.6)
<b>Profit before income tax</b>	<b>78,617</b>	<b>99,582</b>	<b>(20,965)</b>	<b>(21.1)</b>
Current income tax	(19,688)	(17,376)	(2,312)	13.3
Deferred income tax	913	3,252	(2,339)	(71.9)
<b>Income tax expense</b>	<b>(18,775)</b>	<b>(14,124)</b>	<b>(4,651)</b>	<b>32.9</b>
<b>Profit for the period</b>	<b>59,842</b>	<b>85,458</b>	<b>(25,616)</b>	<b>(30.0)</b>
Other comprehensive (loss)/ income after tax	(89)	158	(247)	-
<b>Total comprehensive income</b>	<b>59,753</b>	<b>85,616</b>	<b>(25,863)</b>	<b>(30.2)</b>
<b>Profit attributable to:</b>				
Shareholders of OAO AK Transneft	58,712	84,858	(26,146)	(30.8)
Non-controlling interests	1,130	600	530	88.3
<b>Total comprehensive income attributable to:</b>				
Shareholders of OAO AK Transneft	58,623	85,016	(26,393)	(31.0)
Non-controlling interests	1,130	600	530	88.3

**3.1. Revenue**

Revenue by type of operations	Three months ended 31 March 2012	Share of total revenue, %	Three months ended 31 March 2011	Share of total revenue, %	Absolute change, 2012-2011	Change, %
<b>Revenue from crude oil transportation services</b>						
Exports and sales in international markets, except the CIS	73,931	40.8	58,128	36.3	15,803	27.2
Exports and sales in the CIS	3,876	2.1	3,652	2.3	224	6.1
Domestic sales	43,760	24.1	47,420	29.6	(3,660)	(7.7)
	<b>121,567</b>	<b>67.0</b>	<b>109,200</b>	<b>68.2</b>	<b>12,367</b>	<b>11.3</b>
Revenue from oil products transportation services	8,202	4.5	8,457	5.3	(255)	(3.0)
Revenue from oil compounding services	1,550	0.9	1,159	0.7	391	33.7
Other revenue	3,028	1.7	2,860	1.8	168	5.9
<b>Total revenue (less revenue from sales of crude oil and oil products)</b>	<b>134,347</b>	<b>74.1</b>	<b>121,676</b>	<b>76.0</b>	<b>12,671</b>	<b>10.4</b>
Revenue from export sales of crude oil	40,377	22.3	33,296	20.8	7,081	21.3
Revenue from sales of crude oil in the domestic market	2,423	1.3	2,725	1.7	(302)	(11.1)
Revenue from sales of oil products	4,203	2.3	2,413	1.5	1,790	74.2
<b>Total revenue</b>	<b>181,350</b>	<b>100.0</b>	<b>160,110</b>	<b>100.0</b>	<b>21,240</b>	<b>13.3</b>

During the three months ended 31 March 2012, the Group's revenue increased by RUB 21,240 mln, or 13.3%, 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 three months ended 31 March 2012, amounted to RUB 134,347 mln, which is RUB 12,671 mln, or 10.4%, higher than for the three months ended 31 March 2011.

**3.1.1. Oil and oil products transportation services**

An increase in revenue from oil transportation services by RUB 12,367 mln, or 11.3%, was driven by the following factors:

- growth in oil transportation tariffs (paragraph 2.1);
- growth in turnover by 1.0% (277,789.8 mln tons x km for the three months ended 31 March 2012; 275,374.9 mln tons x km for the three months ended 31 March 2011).

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A decrease in revenue from oil products transportation services by 3.0% was driven by the following factors decrease in the oil products transportation turnover by 12% (for the three months ended 31 March 2012 – 7,890.99 mln tons x km; and 8,973.48 mln tons x km in the three months ended 31 March 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 302 mln, or 11.1%, 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 ОАО НК Роснефт.

Growth in revenue from sales of marketable oil products for the three months ended 31 March 2012 by RUB 1,790 mln, or by 74.2%, 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 5.4% (11,669.25 thousand tons for the three months ended 31 March 2012; 11,071.75 thousand tons for the three months ended 31 March 2011), and
- growth in oil compounding specific revenue by 26.9% (RUB 132.85 per ton for the three months ended 31 March 2012; RUB 104.67 per ton\* for the three months ended 31 March 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.

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

### 3.2. Operating expenses

Operating expenses for the three months ended 31 March 2012, and the three months ended 31 March 2011, are detailed in the table below:

Operating expense line items	Three months ended 31 March 2012	Share of total expenses, %	Three months ended 31 March 2011	Share of total expenses, %	Absolute change, 2012-2011	Change, %
Staff costs	25,514	21.7	22,479	20.6	3,035	13.5
Energy	8,654	7.4	9,770	8.9	(1,116)	(11.4)
Transportation of oil using railways	8,570	7.3	7,104	6.5	1,466	20.6
Materials	3,804	3.2	3,445	3.2	359	10.4
Repairs services and maintenance of relevant technical condition of pipeline	1,821	1.5	1,742	1.6	79	4.5
Insurance expenses	1,292	1.1	785	0.7	507	64.6
Taxes (except income tax)	1,273	1.1	1,146	1.0	127	11.1
Other operating expenses	(1,512)	(1.3)	5,435	5.0	(6,947)	-
<b>Total operating expenses (net of D&amp;A and cost of crude oil and oil products sold)</b>	<b>49,416</b>	<b>42.0</b>	<b>51,906</b>	<b>47.5</b>	<b>(2,490)</b>	<b>(4.8)</b>
Depreciation and amortization	20,611	17.5	19,807	18.1	804	4.1
Cost of export crude oil sales (including export custom duties)	41,470	35.3	33,232	30.4	8,238	24.8
Cost of crude oil sold in the domestic market	2,125	1.8	2,190	2.0	(65)	(3.0)
Cost of oil products sold	3,973	3.4	2,206	2.0	1,767	80.1
<b>Total operating expenses</b>	<b>117,595</b>	<b>100.0</b>	<b>109,341</b>	<b>100.0</b>	<b>8,254</b>	<b>7.5</b>

For the three months ended 31 March 2012, compared to the three months ended 31 March 2011, the amount of operating expenses (less depreciation & amortization and cost of crude oil and oil products sold) decreased by RUB 2,490 mln, or 4.8%, while total operating expenses increased by RUB 8,254 mln, or 7.5%.

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

- growth in cost of crude oil sold by RUB 8,238 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 1,767 mln, or by 80.1%, attributable to increased volumes of marketable oil products sales by the Group's companies (ref. paragraph 3.2.6.;) and

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

After applying deflation rates, operating expenses for the three months ended 31 March 2012, and for the three months ended 31 March 2011, were as follows:

Operating expense line items	Deflation rates (2012 to 2011)	Three months ended 31 March 2012 (deflated to 2010)	Share of total expenses, %	Three months ended 31 March 2011	Share of total expenses, %	Absolute change, 2012-2011	Change, %
Staff costs	6.0	24,070	22.0	22,479	29.5	1,591	7.1
Energy	4.5	8,281	7.6	9,770	12.8	(1,490)	(15.3)
Transportation of oil using railways	4.4	8,209	7.5	7,104	9.3	1,108	15.6
Materials	5.8	3,596	3.3	3,445	4.5	149	4.3
Repairs services and maintenance of relevant technical condition of pipeline	7.7	1,691	1.5	1,742	2.3	(51)	(2.9)
Insurance expenses	5.8	1,221	1.1	785	1.0	436	55.5
Taxes (except income tax)	5.8	1,203	1.1	1,146	1.5	57	4.9
Other operating expenses	5.9	(1,428)	(1.3)	5,435	7.1	(6,863)	-
<b>Total operating expenses (net of D&amp;A and cost of crude oil and oil products sold)</b>	<b>X</b>	<b>46,843</b>	<b>42.8</b>	<b>51,906</b>	<b>68.2</b>	<b>(5,063)</b>	<b>(9.8)</b>
Depreciation and amortization	X	20,611	18.8	19,807	26.0	804	4.1
Cost of export crude oil sales	13.6	36,505	33.3	33,232	30.4	3,276	9.9
Cost of crude oil sold in the domestic market	13.6	1,871	1.7	2,190	2.0	(319)	(14.6)
Cost of oil products sold	6.5	3,731	3.4	2,206	2.0	1,523	69.0
<b>Total operating expenses</b>	<b>X</b>	<b>109,561</b>	<b>100.0</b>	<b>109,341</b>	<b>100.0</b>	<b>221</b>	<b>0.2</b>

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.

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. Particular attention is paid to the analysis of the indicator describing unit costs per certain amount of services provided.

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Unit costs of oil and oil products transportation per 100 tons x km for the three months ended 31 March 2012, and for the three months ended 31 March 2011, were as follows:

	Oil transportation services	Oil products transportation services	Adjustment entries	Total operating expenses*
<b>For the three months ended 31 March 2012</b>				
Operating expenses, RUB mln	45,624	3,855	(63)	49,416
Cargo turnover, mln tons x km	277,790	7,891	-	-
<b>For the three months ended 31 March 2011</b>				
Operating expenses, RUB mln	43,310	3,750	4,846	51,906
Cargo turnover, mln tons x km	275,375	8,973	-	-

\*Operating expenses were reported net of D&A and cost of crude oil and oil products sold.

	For the three months ended 31 March 2012	For the three months ended 31 March 2011	Absolute change in unit costs, RUB per 100 tons x km	Change in unit costs, RUB per 100 tons x km, %
<b>Oil transportation services</b>				
Unit costs per 100 tons x km, RUB	16.42		0.69	4.4
Deflated unit costs per 100 tons x km, RUB	15.64	15.73	(0.09)	(0.6)
<b>Oil products transportation services</b>				
Unit costs per 100 tons x km, RUB	48.85		7.06	16.9
Deflated unit costs per 100 tons x km, RUB	46.53	41.79	4.74	11.3

Deflated unit costs of oil transportation per 100 tons x km for the three months ended 31 March 2012, thus decreased by RUB 0.09, or 0.6%, compared to deflated unit costs for the three months ended 31 March 2011. Deflated unit costs of oil products transportation per 100 tons x km for the three months ended 31 March 2012, increased by RUB 4.74, or 11.3%, compared to deflated unit costs for the three months ended 31 March 2011.

### 3.2.1. Staff costs

Staff costs comprise wages, accrual of provision for unused vacation, pension contributions, insurance premiums, staff training, social security expenses and other remuneration. The growth in staff costs in the comparable periods is attributed to an increase of the average employee headcount by 4.1%, as well as an inflation adjustment of wages and social security expenses.

One of the Group's priority task is the continuous search for and implementation of possibilities for growth of labor productivity, which includes available possibilities for improving labor productivity which have yet to be realized. Labor productivity grew by 6.0% on average during the three months ended 31 March 2012, while the average employee headcount increased by 4.1%.

	Three months ended 31 March 2012	Three months ended 31 March 2011	Change, %
Average employee headcount (people)	107,461	103,204	4.1
Average monthly wage (RUB thousand)	54.2	50.2	8.0
Labor productivity (including administrative and management personnel) RUB thousand /person	1,250	1,179	6.0

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.

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

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	Three months ended 31 March 2012	Three months ended 31 March 2011	Absolute change, 2012-2011	Change, %
Employers' contributions to NPF Transneft* in favor of employees	1,657	1,521	136	8.9

**3.2.2. Energy**

Energy expenses for the three months ended 31 March 2012, decreased by RUB 1,116 mln, or 11.4%, due to optimization in tariffs for consumed energy.

**3.2.3. Transportation of oil using railways**

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 three months ended 31 March 2012, increased by RUB 359 mln, or 10.4%, due to expansion of operations.

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

An increase in these expenses for the three months ended 31 March 2012, amounted to RUB 79 mln, or 4.5% compared to the three months ended 31 March 2011.

**3.2.6. Cost of crude oil and oil products sold**

The cost of crude oil sold for export for the three months ended 31 March 2012, amounted to RUB 41,470 mln, including customs duties in the amount of RUB 18,915 mln, which was a result of the start of oil supplies to the People's Republic of China (ref. to 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**

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 by the Group's insurance companies and related expenses.

**3.2.8. Taxes (except income tax)**

The Group's other taxes include primarily the property tax, which amounted to RUB 1,102 mln for the three months ended 31 March 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 asset 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 for the three months ended 31 March 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).

\* NPF Transneft – Non-state pension fund Transneft

**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 three months ended 31 March 2012, by RUB 2,125 mln, or by 56.6%, 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	Three months ended 31 March 2012	Three months ended 31 March 2011	Absolute change, 2012-2011	Change, %
Interest income from cash and equivalents	1,754	3,699	(1,945)	(52.6)
Interest income from other financial assets	1,094	1,214	(120)	(9.9)
Other interest income	84	63	21	33.3
<b>Total interest receivable</b>	<b>2,932</b>	<b>4,976</b>	<b>(2,044)</b>	<b>(41.1)</b>
less interest income on the temporary investment of borrowings	(1,302)	(1,221)	(81)	6.6
<b>Total interest income recognized in the consolidated statement of comprehensive income</b>	<b>1,630</b>	<b>3,755</b>	<b>(2,125)</b>	<b>(56.6)</b>

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 700mln Euros; and
- interest payable on series 01-03 non-convertible interest-bearing documentary bonds for a total of RUB 135,000 mln.

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

Interest expenses	Three months ended 31 March 2012	Three months ended 31 March 2011	Absolute change, 2012-2011	Change, %
Interest expenses on loans and borrowings	7,959	8,126	(167)	(2.1)
Interest expenses regarding the dismantlement provision	1,807	2,185	(378)	(17.3)
Other interest expenses	154	147	7	4.8
<b>Total interest expenses</b>	<b>9,920</b>	<b>10,458</b>	<b>(538)</b>	<b>(5.1)</b>
Less finance costs to be capitalised	(3,313)	(4,381)	1,068	(24.4)
<b>Total accrued interest recognized in the consolidated income statement</b>	<b>6,607</b>	<b>6,077</b>	<b>530</b>	<b>8.7</b>

During the three months ended 31 March 2012, interest in the amount of RUB 2,011 was capitalised as part of cost of assets under construction (for the three months ended 31 March 2011 – RUB 3,160) including:

- interest expenses to be capitalised in the amount of RUB 3,313 (for the three months ended 31 March 2011 – RUB 4,381);



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- interest income to be excluded from interest expenses to be capitalised in the amount of RUB 1,302 (for the three months ended 31 March 2011 – RUB 1,221).

### 3.2.12. Foreign currency exchange gains and losses

The sum of foreign currency exchange gains and losses and their growth for the three months ended 31 March 2012, compared to the three months ended 31 March 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	Three months ended 31 March 2012	Three months ended 31 March 2011
Gains	45,859	28,379
Losses	5,280	238

The dynamic of currency-translation effects presented in the table was driven by a significant weakening of the rouble against the dollar and euro for the three months ended 31 March 2012 and the three months ended 31 March 2011.

### 3.3. Reconciliation of profit and EBITDA

	Three months ended 31 March 2012	Three months ended 31 March 2011	Change, %
<b>Profit for the period</b>	<b>59,842</b>	<b>85,458</b>	<b>(30.0)</b>
Increased (decreased) by:			
income tax	18,775	14,124	32.9
depreciation and amortization	20,611	19,803	4.1
net change in fair value of derivatives	(584)	-	-
interest expenses	6,607	6,077	8.7
interest and dividend income	(1,630)	(3,755)	(56.6)
exchange gains	(50,124)	(29,177)	71.8
exchange losses	32,819	8,480	287.0
share of profit from associates and jointly controlled entities*	(1,950)	(30,438)	(93.6)
<b>EBITDA</b>	<b>84,366</b>	<b>70,572</b>	<b>19.5</b>
<b>EBITDA margin**, %</b>	<b>59.8</b>	<b>55.7</b>	<b>x</b>

\*Including a RUB 29.0bn income from the sale of the Group's stake in OOO Primorsk Trade Port during the three months ended 31 March 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

	Three months ended 31 March 2012	Three months ended 31 March 2011	Absolute change, 2012- 2011	Change, %
Cash flows from operating activities	58,032	41,204	16,828	40.8
Cash flows used in investing activities	(60,884)	(69,346)	8,462	(12.2)
Cash flows generated from/(used in) financing activities	(11)	(48)	37	(77.1)

##### 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 58,032 mln for the three months ended 31 March 2012, which is 40.8% (or RUB 16,828 mln) higher than for the three months ended 31 March 2011.

This dynamics was driven by an increase in cash received from customers due to growth in tariffs and cargo turnover by RUB 27,622 mln, while payments to suppliers and contractors increased by RUB 22,657 mln. The key drivers of the increase in cash received from operating activities was a decrease in income tax payment by RUB 2,465 mln and RUB 2,248 mln respectively and an increase in cash received from the recovery of VAT and other taxes from the budget by RUB 7,040 mln.

##### 4.2. Investing activities

The primary factors resulting in a general increase in cash used in investment activities by 12.2% or by RUB 8,462 mln for the three months ended 31 March 2012, as compared to the same period for the previous three months, were:

- a decrease by RUB 15,442 mln or 31.4% in purchases of fixed assets and capital investment in accordance with key investment projects (refer to Para 1.1);
- an increase by RUB 10,615 mln or by 67.5% 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 26,350 mln for the three months ended 31 March 2012, and RUB 15,735mln for the three months ended 31 March 2011);
- a decrease in the amount of loans issued (to OOO «Nevskaya truboprovodnaya companya» in the amount of RUB 200 mln for the three months ended 31 March 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 three months ended 31 March 2011).

##### 4.3. Financing activities

The outflow of cash amounted to RUB 11 mln for the three months ended 31 March 2012, (RUB 48 mln for the three months ended 31 March 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 three months ended 31 March 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.

	<b>Three months ended 31 March 2012</b>	<b>Three months ended 31 March 2011</b>
<b>Operating activities</b>		
<b>Profit before tax</b>	<b>78,617</b>	<b>99,582</b>
<i>Adjustments for:</i>		
Depreciation and amortization	20,611	19,807
Loss from disposal of property, plant and equipment	163	136
Interest income and share of profit from associates and jointly controlled entities	(3,580)	(34,193)
Interest expenses	6,607	6,077
Profit from currency-translation	(17,305)	(20,697)
Other operating expenses	3,717	5,320
<b>Operating profit before changes in working capital</b>	<b>88,830</b>	<b>76,032</b>
Changes in operating assets and liabilities:		
Increase in inventories	(2,162)	(3,636)
Increase in trade and other receivables	(1,903)	(23,330)
Increase in trade and other payables	(10,500)	13,084
<b>Cash flows from operating activities before payment of income tax expense and interest</b>	<b>74,265</b>	<b>62,150</b>
Income tax paid	(10,258)	(12,723)
Interest paid	(5,975)	(8,223)
<b>Cash flows received from operating activities</b>	<b>58,032</b>	<b>41,204</b>

**5. Liquidity analysis**

	31 March 2012	31 December 2011	Change, %
Current assets	459,746	442,892	3.8
including:			
cash and cash equivalents	135,159	145,546	(7.1)
short-term bank promissory notes*	189,659	177,760	6.7
Current liabilities	193,145	180,483	7.0
Net working capital	266,601	262,409	1.6
Current ratio	2.4	2.5	(4.0)
Quick ratio**	1.9	2.0	(5.0)
Debt / EBITDA	1.9	2.1	(9.5)
Debt / Equity	0.5	0.6	(16.7)

\* Short-term bank promissory-notes consist of promissory notes by banks with investment-grade international credit ratings (95%), banks with credit ratings of BB+/Ba1/BB+, BB/Ba2/BB, BB-/Ba3/BB- (3%) per the S&P/Moody's/Fitch classification and banks with credit ratings of B/B2/B (2%) 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 net working capital and liquidity ratios remained almost unchanged as at 31 March 2012 compared to 31 December 2011.

The amount of RUB 10,387 mln decrease of cash and cash equivalents as at 31 March 2012 compared to the balances of cash and cash equivalents as at 31 December 2011 was a result of purchase during the three months ended 31 March 2012 of short-term discount and interest-bearing notes which are included in other current financial assets in the consolidated interim condensed statement of financial position. As at 31 March 2012 these promissory notes amounted to RUB 189,659 mln (as at 31 December 2011 – RUB 177,760 mln) and which changed in the amount of RUB 11,899 mln.