

**OAO AK TRANSNEFT
MANAGEMENT'S DISCUSSION AND ANALYSIS
OF THE GROUP'S FINANCIAL POSITION AND
RESULTS OF ITS OPERATIONS
FOR THE YEAR ENDED 31 DECEMBER 2011**

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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 December 2011 and results of operations for the year ended 31 December 2011, compared to the year ended 31 December 2010, 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 financial statements prepared in accordance with International financial reporting standards (hereinafter – “IFRS”) for the year ended 31 December 2011.

Key financial and operating results

	Year ended 31 December 2011	Year ended 31 December 2010	Change, %
Revenue, mln. RUB	670,270	447,532	49.7
Profit for the period, mln. RUB	191,218	124,909	53.1
EBITDA, mln. RUB	291,189	238,892	21.9
EBITDA margin, %*	55.3%	53.4%	x
Oil delivered to consignees, mln. tons including	471.7	465.6	1.3
Russian oil refineries, mln. tons	233.4	226.1	3.2
transshipment into the CPC-R system, mln. tons	1.3	3.6	(64.5)
exports to FSU countries, mln. tons	29.0	25.7	12.8
exports to ROW, mln. tons	208.0	210.2	(1.0)
Oil products delivered to consignees, mln. tons including:	29.3	30.4	(3.7)
Russia's domestic market, mln. tons	8.6	8.7	(0.5)
exports to the Customs Union member countries, mln.	2.2	1.1	100.0
exports to ROW, mln. tons	18.4	20.6	(10.7)

* 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 year ended 31 December 2011 amounted to RUB 191.2 bn which is RUB 66.3 bn or 53.1% higher than for the year ended 31 December 2010. The positive dynamics of the profit for the year ended 31 December 2011 was mainly a result of increase of oil transportation tariffs as well as growth of oil turnover. Furthermore, the profit for the year ended 31 December 2011 contains a gain from disposal of the Group's share in OOO Primorsk Trade Port in the amount of RUB 29 bn, net foreign currency exchange gain amounting to RUB 3.8 bn (as for the year ended 31 December 2010 the net foreign currency exchange loss amounted to RUB 0.1 bn), as well as net interest income amounting to RUB 12.2 bn (RUB 14.1 bn – for the year ended 31 December 2010). Should these factors be excluded the profit for the year ended 31 December 2011 would amount to RUB 158.4 bn (for the year ended 31 December 2010 – RUB 124.8 bn) showing an increase of RUB 33.6 bn or 26.9%.

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 December 2011, 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 year ended 31 December 2011 the Group transported 92% of oil produced in Russia and more than 16% 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 operations structure, as well as the Group's internal restructuring in order to optimize business processes and cash flows

In accordance with OAO AK Transneft's Order of July 16, 2010, No. 94 Concerning Centralization of Contracting Work on Oil Products Transportation and Storage within OAO AK Transneft, the operating pattern of interaction with counterparties has been modified in order to streamline business processes: starting from 2011, oil products transportation and storage contracts are managed by OAO AK Transneft, with financial flows subsequently distributed among the Group's entities directly involved in oil products transportation and storage under an agency agreement with OAO AK Transneftproduct and contracts with subsidiaries.

The change in the operating pattern had no effect on the performance reported in the consolidated financial statements. Given that the Group's management normally analyzes data broken down to individual legal entities which operations are summarized in two separate reporting segments – Oil transportation and Oil products transportation – revenue from oil products transportation services is reported in the FY2011 consolidated financial statements as part of the Oil products transportation segment data, the same as it was reported in 2010.

1.3. Changes in the Group's investments

In January 2011, Omirico Ltd, a company jointly controlled by the Group, sold 100% of its stakes in OOO Primorsk Trade Port (hereinafter, PTP) to OAO Novorossiysk Trade Sea Port (hereinafter, NMTP) for USD 2,153 mln (RUB 64,406 mln at the exchange rate of the Central Bank of the Russian Federation at the date of the transaction.) The RUB 29,034 mln income recognized by the Group from this transaction was reflected in the consolidated statement of comprehensive income in the Share in Profit from associates and jointly controlled entities line item.

Simultaneously, Omirico Ltd indirectly acquired a controlling (50.1%) equity stake in NMTP. As a result of this transaction, the Group obtained an effective interest in NMTP equal to 25.05%. As at 31 December 2011, the book value of the Group's investment in NMTP was RUB 33,484 mln. The general operating activity of NMTP and its subsidiaries is the provision of stevedore and additional port services, as well as the servicing of seagoing vessels.

1.4. 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 year ended 31 December 2011, 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 Sheskhari 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;

During 2011 and 2010, oil transportation tariff rates increased:

- by 3.3% effective 1 August 2010;
- by 9.9% effective 1 December 2010;
- 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.

	Year ended 31 December 2011	Year ended 31 December 2010	Change, %
Oil mining volume in the Russian Federation, mln tons	511.3	505.0	1.3
Oil products refining volume in the Russian Federation, mln tons	185.4	185.1	0.1

As a result of growth during the year ended 31 December 2011 in oil mining and oil products refining volumes in the Russian Federation by 6.3 mln tons, or 1.2%, and by 0.3 mln tons, or 0.1%, respectively, the Group's oil and oil products transportation turnover and the Group's revenue from oil and oil products transportation services increased (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 0.4% during the year ended 31 December 2011, compared to year ended 31 December 2010.

	Year ended 31 December 2011	Year ended 31 December 2010	Change, %
Change in the rouble's exchange rate against the US dollar, %	5.64	0.77	x
Average exchange rate for the period (roubles per US dollar)	29.3874	30.3692	(3.23)
Exchange rate at the end of the period (roubles per US dollar)	32.1961	30.4769	5.64

2.4. Inflation rates

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

	Year ended 31 December 2011	Year ended 31 December 2010	Change, pp
Rouble inflation (CPI,) %	6.1	8.8	(2.7)

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:

	Year ended 31 December 2011	Year ended 31 December 2010	Change, %
Income tax	44,140	25,800	71.1
Property tax	3,925	3,885	1.0
Other taxes and levies	868	920	(5.7)

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.

	Year ended 31 December 2011	Year ended 31 December 2010	Absolute change, 2011-2010	Change, %
Revenue				
Revenue from oil transportation services	455,752	386,144	69,608	18.0
Revenue from crude oil sales	152,108	8,084	144,024	18.8x
Other revenue	62,410	53,304	9,106	17.1
Operating expenses	(457,848)	(280,609)	(177,239)	63.2
Operating profit	212,422	166,923	45,499	27.3
Exchange gains	129,375	65,004	64,371	99.0
Exchange losses	(125,589)	(64,878)	(60,711)	93.6
Interest income	9,884	6,764	3,120	46.1
Interest expense	(22,049)	(20,873)	(1,176)	5.6
Share of profit from associates and jointly controlled entities	31,486	4,568	26,918	6.9x
Profit before income tax	235,529	157,508	78,021	49.5
Current income tax	(44,500)	(25,799)	(18,701)	72.5
Deferred income tax	189	(6,800)	6,989	-
Income tax expense	(44,311)	(32,599)	(11,712)	35.9
Profit for the period	191,218	124,909	66,309	53.1
Other comprehensive (loss)/ income after tax	(56)	49	(105)	-
Total comprehensive income	191,162	124,958	66,204	53.0
Profit attributable to:				
Shareholders of OAO AK				
Transneft	188,105	118,617	69,488	58.6
Non-controlling interests	3,113	6,292	(3,179)	(50.5)
Total comprehensive income attributable to:				
Shareholders of OAO AK				
Transneft	188,049	118,666	69,383	58.5
Non-controlling interests	3,113	6,292	(3,179)	(50.5)

3.1. Revenue

Revenue by type of operations	Year ended 31 December 2011	Share of total revenue, %	Year ended 31 December 2010	Share of total revenue, %	Absolute change, 2011-2010	Change, %
Revenue from crude oil transportation services						
Exports and sales in international markets, except the CIS	243,905	36.4	210,482	47	33,423	15.9
Exports and sales in the CIS	13,731	2.0	11,409	2.6	2,322	20.4
Domestic sales	198,116	29.6	164,253	36.7	33,863	20.6
	455,752	68.0	386,144	86.3	69,608	18.0
Revenue from oil products transportation services	31,068	4.6	30,605	6.8	463	1.5
Revenue from oil compounding services	4,861	0.7	4,053	0.9	808	19.9
Other revenue	13,810	2.1	13,272	3.0	538	4.1
Total revenue (less revenue from sales of crude oil and oil products)						
	505,491	75.4	434,074	97.0	71,417	16.5
Revenue from export sales of crude oil	143,639	21.4	-	-	143,639	-
Revenue from sales of crude oil in the domestic market	8,469	1.3	8,084	1.8	385	4.8
Revenue from sales of oil products	12,671	1.9	5,374	1.2	7,297	2.4x
Total revenue	670,270	100.0	447,532	100.0	222,738	49.8

During the year ended 31 December 2011, the Group's revenue increased by RUB 222,738 mln, or 49.8%, attributable mainly to an increase in revenue from oil and oil products 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 year ended 31 December 2011, amounted to RUB 505,491 mln, which is RUB 71,417 mn, or 16.5%, higher than for the year ended 31 December 2010.

3.1.1. Oil and oil products transportation services

An increase in revenue from oil transportation services by RUB 69,608 mln, or 18.0%, was driven by the following factors:

- growth in oil transportation tariffs (paragraph 2.1);
- growth in turnover by 1.6% (1,115,583.4 mln tons x km for the year ended 31 December 2011; 1,097,952.1 mln tons x km for the year ended 31 December 2010).

An increase in revenue from oil products transportation services by 1.5% was driven by the following factors:

- growing transportation tariffs;
- decrease in the oil products transportation turnover by 2.4% (for the year ended 31 December 2011 – 36,950.6 mln tons x km; and 37,858.9 mln tons x km in the year ended 31 December 2010) in connection by 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

An increase in revenue from sales of crude oil by RUB 385 mln, or 4.8%, was driven by an increase in volume of crude oil sold by the Group.

Growth in revenue from sales of marketable oil for the year ended 31 December 2011, by RUB 143,639 mln including custom duties amounting to RUB 66,889 mln, 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 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. The above growth in revenue from sales of marketable oil resulted in an increase of its share in total revenue by 21.4% of the Group's total sales revenue for the year ended 31 December 2011.

Growth in revenue from sales of marketable oil products for the year ended 31 December 2011, by RUB 7,297 mln, or by 2.4x, 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:

change in revenue directly from oil compounding services amounting to RUB 674 mln which was driven by the following factors:

- slight growth in oil compounding volumes by 1.5% (45,144.79 thousand tons for the year ended 31 December 2011; 44,482.64 thousand tons for the year ended 31 December 2010), and
- growth in oil compounding specific revenue by approximately 15% (RUB 104.72 per ton for the year ended 31 December 2011; RUB 91.04 per ton * for the year ended 31 December 2010);

formation of revenue from preserving oil quality in the amount of RUB 134 mln during 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

3.2. Operating expenses

Operating expenses for the year ended 31 December 2011, and the year ended 31 December 2010, are detailed in the table below:

Operating expense line items	Year ended 31 December 2011	Share of total expenses, %	Year ended 31 December 2010	Share of total expenses, %	Absolute change, 2011-2010	Change, %
Staff costs	100,687	22.0	81,741	29.1	18,946	23.2
Energy	34,187	7.5	31,961	11.4	2,226	7.0
Oil transportation by railways	29,764	6.5	29,593	10.5	171	0.6
Materials	16,460	3.6	16,029	5.7	431	2.7
Repairs services and maintenance of relevant technical condition of pipeline	11,554	2.5	12,236	4.4	(682)	(5.6)
Insurance expenses	4,839	1.1	3,158	1.1	1,681	53.2
Taxes (except income tax)	4,604	1.0	4,204	1.5	400	9.5
Other operating expenses	13,141	2.8	17,266	6.2	(4,125)	(23.9)
Total operating expenses (net of D&A and cost of crude oil and oil products sold)	215,236	47.0	196,188	69.9	19,048	9.7
Depreciation and amortization	78,767	17.2	71,969	25.7	6,798	9.4
One-time expenses not associated with operating activity	1,192	0.3	-	-	1,192	-
Cost of export crude oil sales	143,358	31.3	-	-	143,358	-
Cost of crude oil sold in the domestic market	7,348	1.6	7,659	2.7	(311)	(4.1)
Cost of oil products sold	11,947	2.6	4,793	1.7	7,154	2.5x
Total operating expenses	457,848	100.0	280,609	100.0	177,239	63.2

For the year ended 31 December 2011, compared to the year ended 31 December 2010, the amount of operating expenses (less depreciation & amortization and cost of marketable oil and oil products sold) increased by RUB 19,048 mln, or 9.7%, while total operating expenses increased by RUB 177,239 mln, or 63.2%.

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

- growth in cost of marketable oil sold less export duties by RUB 143,358 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 marketable oil products sold by RUB 7,154 mln, or by 2.5x times, attributable to increased volumes of marketable oil products sales by the Group's companies (ref. paragraph 3.2.6.); and
- growth in depreciation charges by RUB 6,798 mln, or 9.4%, attributable mainly to the commissioning in the end of 2010 of the Skovorodino–Chinese-border oil pipeline, a number of facilities of the Eastern Siberia–Pacific Ocean pipeline system.

After applying deflation rates, operating expenses for the year ended 31 December 2011, and for the year ended 31 December 2010, were as follows:

OAO AK TRANSNEFT

Management's discussion and analysis of the Group's financial position and results of its operations for the year ended 31 December 2011

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

Operating expense line items	Deflation rates (2011 to 2010)	Year ended 31 December 2011 (deflated to 2010)	Share of total expenses, %	Year ended 31 December 2010	Share of total expenses, %	Absolute change, 2011-2010	Change, %
Staff costs	8.6	92,714	22.6	81,741	29.1	10,973	13.4
Energy	13.3	30,174	7.4	31,961	11.4	(1,787)	(5.6)
Oil transportation by railways	13.2	26,293	6.4	29,593	10.5	(3,300)	(11.2)
Materials	18.8	13,855	3.4	16,029	5.7	(2,174)	(13.6)
Repairs services and maintenance of relevant technical condition of pipeline	8.2	10,678	2.6	12,236	4.4	(1,558)	(12.7)
Insurance expenses	18.8	4,073	1.0	3,158	1.1	915	29.0
Taxes (except income tax)	18.8	3,875	0.9	4,204	1.5	(329)	(7.8)
Other operating expenses	18.8	11,061	2.7	17,266	6.2	(6,205)	(35.9)
Total operating expenses (net of D&A and cost of marketable oil and oil products sold)	X	192,723	47.0	196,188	69.9	(3,465)	(1.8)
Depreciation and amortization	X	78,767	19.2	71,969	25.6	6,798	9.4
One-time expenses not associated with operating activity	X	1,192	0.3	-	-	1,192	-
Cost of export crude oil sales	18.8	120,672	29.5	-	-	120,672	-
Cost of crude oil sold in the domestic market	18.8	6,185	1.5	7,659	2.7	(1,474)	(19.2)
Cost of oil products sold	18.8	10,056	2.5	4,793	1.7	5,263	2.1x
Total operating expenses	X	409,595	100.0	280,609	100.0	128,986	46.0

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 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.

Unit costs of oil and oil products transportation per 100 tons x km for the year ended 31 December 2011, and for the year ended 31 December 2010, were as follows:

	Oil transportation services	Oil products transportation services	Adjustment entries	Total operating expenses*
For the year ended 31 December 2011				
Operating expenses, RUB mln	202,500	17,519	(4,783)	215,236
Cargo turnover, mln tons x km	1,115,583	36,951	-	-
For the year ended 31 December 2010				
Operating expenses, RUB mln	185,177	15,190	(4,179)	196,188
Cargo turnover, mln tons x km	1,097,952	37,859	-	-

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

	For the year ended 31 December 2011	For the year ended 31 December 2010	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	18.15		1.28	7.6
Deflated unit costs per 100 tons x km, RUB	16.21	16.87	(0.66)	(3.9)
Oil products transportation services				
Unit costs per 100 tons x km, RUB	47.41		7.29	18.2
Deflated unit costs per 100 tons x km, RUB	42.33	40.12	2.21	5.5

Deflated unit costs of oil transportation per 100 tons x km for the year ended 31 December 2011, thus decreased by RUB 0.66, or 3.9%, compared to deflated unit costs for the year ended 31 December 2010. Deflated unit costs of oil products transportation per 100 tons x km for the year ended 31 December 2011, increased by RUB 2.21, or 5.5%, compared to deflated unit costs for the year ended 31 December 2010.

3.2.1. Staff costs

Staff costs comprise wages, accrual of reserve for unused vacation, pension contributions, insurance premiums, and social security expenses. The growth in staff costs is attributed first and foremost to an increase in premiums for mandatory social security insurance as a result of an increase in insurance premiums from 26% to 34% in total in 2011 and of a 9% adjustment of wages effective January 1, 2011 and an increase of the average employee headcount by 4.3%.

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 11.7% on average during the year ended 31 December 2011, while the average employee headcount increased by 4.3%.

	Year ended 31 December 2011	Year ended 31 December 2010	Change, %
Average employee headcount (people)	104,926	100,587	4.3
Average monthly wage (RUB thousand)	64.9	58.0	11.9
Labor productivity (including administrative and management personnel) RUB thousand /person	4,818	4,315	11.7

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

	Year ended 31 December 2011	Year ended 31 December 2010	Absolute change, 2011-2010	Change, %
Employers' contributions to NPF Transneft* in favor of employees	6,749	5,768	981	17.0

Key management personnel compensation

	Year ended 31 December 2011	Year ended 31 December 2010	Absolute change, 2011-2010	Change, %
Salaries and bonuses	1,022	1,018	4	0.4
Termination benefits	18	12	6	50.0
Other	17	10	7	70.0
	1,057	1,040	17	1.6

Payments to the main managerial personnel in 2011 remained at level of payments of 2010. Thus in 2011 in comparison with 2010 as a part of payments on a salary there was an increase in compensations, work-related in the region of the Far North and the districts equated to them, for key managers of the subsidiaries performing operation of a pipeline system "Eastern Siberia-Pacific Ocean".

Growth of the payments connected with dismissal, is caused by change of heads of separate subsidiaries.

Other payments in 2011 increased, generally as a result of growth of compensations of expenses on moving, payments elevating when moving, and compensations of commercial hiring of housing.

As a key management personnel, information about the payments to which was disclosed in the financial statements, are recognized members of the Board of Directors and the Board of OAO AK Transneft, as well as CEOs of subsidiaries recognized the most significant in the implementation of productive activities of the Group, as well as their families' members.

Total number of the persons who have received payments as the key management personnel, comprised 64 persons during 2011, during 2010 - 64 persons.

Contributions to the NPF Transneft for benefit of the key management personnel

	Year ended 31 December 2011	Year ended 31 December 2010	Absolute change, 2011-2010	Change, times
Contribution to NPF Transneft	289	35	254	8.3x

The increase in 2011 contributions to the NPF Transneft due to the transfer to the fund the present value of future pension payments in connection with reaching retirement age in accordance with the terms of contracts of non-state pension provision. These payments will be made after the right to receive pension in accordance with established rules of NPF Transneft.

3.2.2. Electric power

Electric power expenses for the year ended 31 December 2011, increased by RUB 2,226 mln, or 7.0%, due to growth in approved electric power rates, as well as increase in energy consumption due to the growth of turnover (ref. to Para 3.1.1).

3.2.3. Oil transportation by railway

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.

* NPF Transneft – Non-state pension fund Transneft

3.2.4. Materials

Expenses on materials for the year ended 31 December 2011, increased by RUB 431 mln, or 2.7%, due to expansion of operations.

3.2.5. Pipeline network repairs and maintenance

A decrease in these expenses for the year ended 31 December 2011, by RUB 682 mln, or 5.6%, was attributed to growth of use of services of subsidiaries.

3.2.6. Cost of crude oil and oil products sold

The cost of marketable oil sold for export for the year ended 31 December 2011, amounted to RUB 143,358 mln, including customs duties in the amount of RUB 66,889 mln, which is a result of the start of oil supplies to the People's Republic of China. 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 3,925 mln for the year ended 31 December 2011. 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 growth in the Group's share of profit from associates and jointly controlled entities for the year ended 31 December 2011, was attributed mainly 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) (refer to Para 1.3).

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.

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An increase in interest income for the year ended 31 December 2011, by RUB 3,120 mln, or by 46.1%, was driven by a substantial decrease in the amount of income generated by investing temporarily available borrowed funds, as shown in the table below:

Interest income	Year ended 31 December 2011	Year ended 31 December 2010	Absolute change, 2011- 2010	Change, %
Interest income from cash and equivalents	11,941	13,516	(1,575)	(11.7)
Interest income from other financial assets	3,865	2,851	1,014	35.6
Other interest income	254	108	146	2.4x
Total interest receivable	16,060	16,475	(415)	(2.5)
less interest income on the temporary investment of borrowings	(6,176)	(9,711)	3,535	(36.4)
Total interest income recognized in the consolidated income statement	9,884	6,764	3,120	46.1

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.

The increase in interest expenses for the year ended 31 December 2011 was driven by an increase of interest expense in regards to dismantlement provision.

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

Interest expenses	Year ended 31 December 2011	Year ended 31 December 2010	Absolute change, 2011-2010	Change, %
Interest expenses on loans and borrowings	34,836	34,704	132	0.4
Provisions for asset retirement obligations: unwinding of the present value discount	8,741	6,840	1,901	27.8
Other interest expenses	585	704	(119)	(16.9)
Total interest expenses	44,162	42,248	1,914	4.5
Less finance costs to be capitalised	(22,113)	(21,375)	(738)	3.5
Total accrued interest recognized in the consolidated income statement	22,049	20,873	1,176	5.6

During the year ended 31 December 2011, interest in the amount of RUB 15,937 was capitalised as part of cost of assets under construction (for the year ended 31 December 2010 – RUB 11,665) including interest expenses to be capitalised in the amount of RUB 22,113 (for the year ended 31 December 2010 – RUB 21,375) and interest income on the temporary investment of borrowings in the amount of RUB 6,176 (for the year ended 31 December 2010 – RUB 9,710).

3.2.12. Foreign currency exchange gains and losses

The sum of foreign currency exchange gains and losses and their growth for the year ended 31 December 2011, compared to the year ended 31 December 2010, is a result of changes in the exchange rates of the US dollar and the euro to the Russian rouble during the year ended 31 December 2011.

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	Year ended 31 December 2011	Year ended 31 December 2010
Gains	75,297	47,879
Losses	99,153	47,577

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 year ended 31 December 2011. During the year ended 31 December 2010, a strengthening of the rouble against those currencies resulted in significant positive currency-translation effects for the period.

Currency-translation differences occurring as a result of taking out foreign-currency-denominated loans are included in loan-servicing expenses to the extent that they compensate for lower interest payments. Currency-translation differences occurring as a result of taking out foreign-currency-denominated loans are capitalized as part of the value of investment assets in an amount not exceeding the difference between interest payments that could have been made on similar rouble-denominated loans taken out by the Group and the Group's actual interest expenditures on such loans. The sum of capitalized currency-translation differences for the year ended 31 December 2011 was RUB 9,503 mln and RUB 2,326 mln for the same period in 2010.

3.3. Reconciliation of profit for the year and EBITDA

	Year ended 31 December 2011	Year ended 31 December 2010	Change, %
Profit for the period	191,218	124,909	53.1
Increased (decreased) by:			
income tax	44,311	32,599	35.9
depreciation and amortization	78,767	71,969	9.4
interest expenses	22,049	20,873	5.6
interest and dividend income	(9,884)	(6,764)	46.1
exchange gains	(129,375)	(65,004)	99.0
exchange losses	125,589	64,878	93.6
share of profit from associates and jointly controlled entities*	(31,486)	(4,568)	6.9x
EBITDA	291,189	238,892	21.9
EBITDA margin**, %	55.3%	53.4%	x

*Including a RUB 29.0bn income from the sale of the Group's stake in OOO Primorsk Trade Port.

**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

	Year ended 31 December 2011	Year ended 31 December 2010	Absolute change, 2011- 2010	Change, %
Cash flows from operating activities	171,611	194,676	(23,065)	(11.8)
Cash flows used in investing activities	(312,340)	(220,739)	91,601	41.5
Cash flows generated from/(used in) financing activities	(1,291)	29,335	(30,626)	-

4.1. Operating activities

Cash received from operating activities is the Group's main source of cash. It amounted to RUB 171,611 mln for the year ended 31 December 2011, which is 11.8% (or RUB 23,065 mln) less than for the year ended 31 December 2010.

This dynamics was driven by an increase in cash received from customers due to growth in tariffs and cargo turnover by RUB 203,213 mln, while payments to suppliers and contractors increased by RUB 185,441 mln. The key drivers of the decrease in cash received from operating activities was an increase in income tax payment by RUB 25,916 mln and a decrease in cash received from the recovery of VAT and other taxes from the budget by RUB 19,919 mln.

Excluding the effect of reducing the recovery of VAT from the budget in the amount of RUB 19,919 mln normalized cash flows from operating activities for the year ended 31 December 2011 amounts to RUB 191,530 mln, which allows to maintain consistently high levels of cash generated from operating activities.

4.2. Investing activities

The primary factors resulting in a general increase in cash used in investment activities by RUB 91,601 mln, or 41.5% for the year ended 31 December 2011, as compared to the same period for the previous year, were:

- a decrease by RUB 15,593 mln or 7% in purchases of fixed assets and capital investment in accordance with key investment projects (refer to Para 1.1);
- an increase by RUB 99,617 mln or in 9 times 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 112,078 mln for the year ended 31 December 2011, and RUB 12,461mln for the year ended 31 December 2010);
- as well as RUB 5,902 mln loan issued for the year ended 31 December 2011, including 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).

4.3. Financing activities

The outflow of cash was a result of a change in amounts owed under short-term and long-term credits and loans amounted to RUB 1,291mln for the year ended 31 December 2011, compared to a RUB 29,335 mln inflow for the year ended 31 December 2010. The change in financing cash flow by a total amount of RUB 30,626 mln was driven by receipt of the next tranche from China Development Bank amounting to USD 1.0 bn.

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 year ended 31 December 2011.

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.

	<u>Year ended</u> <u>31 December 2011</u>	<u>Year ended</u> <u>31 December 2011</u>
Operating activities		
Profit before tax	235,529	157,508
<i>Adjustments for:</i>		
Depreciation and amortization	78,767	71,969
Loss from disposal of property, plant and equipment	2,220	1,012
Interest income and share of profit from associates and jointly controlled entities	(41,370)	(11,332)
Interest expense	22,049	20,873
Profit from currency-translation	(3,786)	(133)
Other operating income	(3,155)	(4,761)
Operating profit before changes in working capital	290,254	235,136
Changes in operating assets and liabilities:		
Increase in inventories	(4,731)	(3,156)
(Increase)/decrease in trade and other receivables	(37,066)	5,885
Increase in trade and other payables	9,194	16,783
Cash flows from operating activities before payment of income tax expense and interest	257,651	254,648
Income tax paid	(50,776)	(24,860)
Interest paid	(35,264)	(35,112)
Cash flows received from operating activities	171,611	194,676

5. Liquidity analysis

	31 December 2011	31 December 2011	Change, %
Current assets	442,892	415 148	6.7
including:			
cash and equivalents	145,546	283,864	(48.7)
short-term bank promissory notes*	177,760	48,241	3.7x
Current liabilities	180,483	111,168	62.0
Net working capital	262,409	303,980	(13.7)
Current ratio	2.5	3.7	(32.4)
Quick ratio**	2.0	3.2	(37.5)
Debt / EBITDA	2.1	2.4	(14.7)
Debt / Equity	0.6	0.7	(16.1)

* 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 decrease in net working capital and liquidity ratios was caused by continued implementation of the investment program and by using available cash for building qualified assets (refer to Para 1.1), as well as by reclassification into current liabilities of a portion of bond issues redeemable within 12 months after the reporting date.

The decrease of cash and cash equivalents for the year ended 31 December 2011 compared to the year ended 31 December 2010 in the amount of RUB 138,107 mln was a result of purchase during 2011 of short-term discount and interest-bearing notes which are included in other current financial assets in the consolidated statement of financial position. As at 31 December 2011 these promissory notes amounted to RUB 177,760 mln (as at 31 December 2010 – RUB 48,241 mln) and which changed in the amount of RUB 129,519 mln.

The breakdown of information regarding the maturity terms of contractual financial liabilities (financial liabilities nominated in foreign currencies was calculated at the exchange rate of the Central Bank of the Russian Federation) including interest payments is shown below:

	Cash flows relating to concluded contracts							More than 5 years
	Net book value	Total	2012	2013	2014	2015	2016	
Loans and borrowings	605,311	815,687	84,074	52,555	84,808	186,132	35,696	372,422
Trade and other payables	44,601	44,601	44,601	-	-	-	-	-
	649,912	860,288	128,675	52,555	84,808	186,132	35,696	372,422

The structure of the debt maturity of the RUB nonconvertible interest bearing documentary bonds amounting to RUB 135,000 mln is presented based on possible maturity dates of the offer which is 2015.