

Management's discussion and analysis of financial condition and results of operations

The following report contains a discussion and analysis of the financial condition of OAO LUKOIL as of June 30, 2014 and the results of its operations for the three and six month periods ended June 30, 2014 and 2013, as well as significant factors that may affect its future performance. It should be read in conjunction with our interim US GAAP consolidated financial statements and notes thereto.

References to "LUKOIL," "the Company," "the Group," "we" or "us" are references to OAO LUKOIL and its subsidiaries and equity affiliates. All dollar amounts are in millions of US dollars, unless otherwise indicated. Tonnes of crude oil and natural gas liquids produced are translated into barrels using conversion rates characterizing the density of crude oil from each of our oilfields and actual density of liquids produced at our gas processing plants. Tonnes of crude oil purchased as well as other operational indicators expressed in barrels were translated into barrels using an average conversion rate of 7.33 barrels per tonne. Translations of cubic meters to cubic feet were made at the rate of 35.31 cubic feet per cubic meter. Translations of barrels of crude oil into barrels of oil equivalent ("BOE") were made at the rate of 1 barrel per BOE and of cubic feet – at the rate of 6 thousand cubic feet per BOE.

This report includes forward-looking statements – words such as "believes," "anticipates," "expects," "estimates," "intends," "plans," etc. – that reflect management's current estimates and beliefs, but are not guarantees of future results.

Key financial and operational results

	2 nd quarter of		Change,	1 st half of		Change,
	2014	2013	%	2014	2013	%
	(millions of US dollars)					
Sales	38,205	35,053	9.0	73,886	68,823	7.4
Net income attributable to OAO LUKOIL	2,389	2,104	13.5	4,122	4,685	(12.0)
Adjusted net income attributable to OAO LUKOIL ⁽¹⁾	2,389	2,104	13.5	4,642	4,685	(0.9)
EBITDA	5,437	4,359	24.7	9,432	9,134	3.3
Adjusted EBITDA ⁽¹⁾	5,437	4,359	24.7	9,952	9,134	9.0
Taxes other than income taxes, excise and export tariffs	(8,747)	(9,183)	(4.7)	(17,680)	(18,067)	(2.1)
Earning per share of common stock attributable to OAO LUKOIL (US dollars):						
Basic	3.16	2.79	13.5	5.46	6.21	(12.0)
Diluted	3.10	2.73	13.4	5.35	6.08	(12.0)
Hydrocarbon production by the Group including our share in equity affiliates (thousands of BOE)	210,444	199,522	5.5	409,740	397,136	3.2
Daily hydrocarbon production by the Group including our share in equity affiliates (thousands of BOE)	2,313	2,193	5.5	2,264	2,194	3.2
Crude oil and natural gas liquids produced by the Group including our share in equity affiliates (thousands of barrels)	182,202	169,998	7.2	351,876	336,613	4.5
Gas available for sale produced by the Group including our share in equity affiliates (millions of cubic meters)	4,799	5,017	(4.3)	9,833	10,284	(4.4)
Refined products produced by the Group including our share in equity affiliates (thousands of tonnes)	15,709	15,968	(1.6)	31,094	30,961	0.4

⁽¹⁾Adjusted for loss on disposal of assets and dry whole related write-offs.

In the second quarter of 2014, our net income increased by \$285 million, or by 13.5%, and our EBITDA increased by \$1,078 million, or by 24.7%, compared to the second quarter of 2013. Our net income for the first half of 2014 was affected by a loss on the expected disposal of our share in Caspian Investment Resources Ltd. in the amount of \$358 million and write-offs related to our exploration projects in Africa in the amount of \$162 million, both booked in the first quarter. Adjusted for these non-recurring losses, our net income remained nearly on the level of the first half of 2013. At the same time, our adjusted EBITDA increased by \$818 million, or by 9.0%. Our EBITDA in the second quarter and the first half of 2014 was impacted by commencement of cost compensation at West Qurna-2 project in Iraq.

Business overview

The primary activities of OAO LUKOIL and its subsidiaries are oil exploration, production, refining, marketing and distribution. The Company is the ultimate parent entity of a vertically integrated group of companies.

OAO LUKOIL was established in accordance with Presidential Decree No. 1403, issued on November 17, 1992. Under this decree, on April 5, 1993, the Government of the Russian Federation transferred to the Company 51% of the voting shares of fifteen enterprises. Under Government Resolution No. 861 issued on September 1, 1995, a further nine enterprises were transferred to the Group during 1995. Since 1995, the Group has carried out a share exchange program to increase its shareholding in each of 24 founding subsidiaries to 100%. From formation, the Group has expanded substantially through consolidation of interests, acquisition of new companies and establishment of new businesses. Now LUKOIL is a global energy company operating through its subsidiaries in 39 countries on four continents.

LUKOIL is one of the world's largest energy companies in terms of hydrocarbon reserves that amounted to 17.4 billion BOE as of January 1, 2014 and comprised of 13.5 billion barrels of crude oil and 23.6 trillion cubic feet of gas.

Our operations are divided into four main business segments:

- **Exploration and Production** – which includes our exploration, development and production operations relating to crude oil and gas. These activities are primarily located within Russia, with additional activities in Azerbaijan, Kazakhstan, Uzbekistan, the Middle East, South America, Northern and Western Africa, Norway and Romania.
- **Refining, Marketing and Distribution** – which includes refining and transport operations, marketing and trading of crude oil, natural gas and refined products.
- **Chemicals** – which includes processing and trading of petrochemical products.
- **Power generation** – which includes generation, transportation and sales of electricity, heat and related services.

Each of our four main segments is dependent on the other, with a portion of the revenues of one segment being a part of the costs of the other. In particular, our Refining, Marketing and Distribution segment purchases crude oil from our Exploration and Production segment. As a result of certain factors considered in the “Domestic crude oil and refined products prices” section on page 9, benchmarking crude oil market prices in Russia cannot be determined with certainty. Therefore, the prices set for inter-segment purchases of crude oil reflect a combination of market factors, primarily international crude oil market prices, transportation costs, regional market conditions, the cost of crude oil refining and other factors. Accordingly, an analysis of either of these segments on a stand-alone basis could give a misleading impression of those segments' underlying financial position and results of operations. For this reason, we do not analyze either of our main segments separately in the discussion that follows. However, we present the financial data for each in Note 20 “Segment information” to our interim consolidated financial statements.

Recent developments

Changes in Group structure

On August 11, 2014, in line with the strategy to optimize downstream portfolio a Group company signed an agreement with AMIC Energy Management GmbH to sell 100% of the Group's interest in LUKOIL Ukraine, a distribution company operating in Ukraine. Closing of the transaction is subject to customary approvals by regulatory authorities.

On August 1, 2014, in line with the strategy to optimize its downstream operations Group companies signed agreements with Slovnaft Česká Republica, Spol. s.r.o. and Norm Benzinkút Kft to sell 100% of shares in LUKOIL Slovakia s.r.o., LUKOIL Hungary Ltd. and LUKOIL Czech Republic s.r.o. These transactions' closing is subject to a number of conditions and is expected before the end of 2014. The selling price consists of two components: fixed component of approximately €100 million and variable component which depends on the amount of the working capital of the abovementioned companies as at the completion date and is subject to certain adjustments.

On April 15, 2014, a Group company entered into a contract with a Sinopec group company, to sell for \$1.2 billion the Group's 50% interest in Caspian Investment Resources Ltd., an exploration and production company operating in Kazakhstan. The transaction's closing is subject to a number of conditions, including approval by the Kazakhstan state authorities, and is expected before the end of 2014.

In December 2013, after approval by European regulatory authorities, the Group acquired the remaining 20% interest in the joint venture which operates the ISAB refinery complex (ISAB) for €446 million (approximately \$613 million) after final adjustments, increasing its stake in the joint venture from 80% to 100%. This transaction was exercised in line with the initial agreement on the establishment of the joint venture signed in 2008. This agreement gave the second investor, ERG S.p.A., a step-by-step put option to sell its share in the joint venture to the Group. The Group obtained control over ISAB in September 2012, when within this agreement, it acquired a 20% interest in the joint venture for €494 million (approximately \$621 million) and increased its stake to 80%.

In April 2013, after approval by the Federal Anti-monopoly Service, in line with the strategy to increase crude oil production in Russia the Company purchased 100% of the shares of ZAO Samara-Nafta for \$2.1 billion after final adjustments. ZAO Samara-Nafta is an exploration and production company operating in the Samara and Uljanovsk regions of the Russian Federation.

In April-May 2013, Group companies acquired the remaining 50% of the shares of ZAO Kama-oil, an exploration and production company operating in the Perm region of the Russian Federation, for \$400 million increasing the Group's ownership to 100%. As a result of this acquisition, the Group obtained control over ZAO Kama-oil and consolidated it.

West Qurna-2 project

On December 12, 2009, a consortium of a Group company and Statoil won the tender for development of the West Qurna-2 field in Iraq, one of the largest crude oil fields discovered in the world, with estimated recoverable oil reserves of 12.9 billion barrels (1.8 billion tonnes). The service agreement for West Qurna-2 field development and production was signed on January 31, 2010 and then ratified by the Ministry cabinet of the Iraq Republic. After Statoil withdrew from the West Qurna-2 project in May 2012, the parties of the project are Iraq's state-owned South Oil Company and a consortium of contractors, consisting of a Group company (75% interest) and state-owned North Oil Company (25% interest).

The Group launched the "Mishrif Early Oil" stage on the West Qurna-2 field and reached the planned production of 120 thousand barrels per day in March 2014. According to the service agreement, costs are compensated after this level of production is achieved and maintained during any 90 days within a 120-day period. In June 2014, we met this term. Therefore, in the second quarter of 2014, the Group accrued revenue from the West Qurna-2 project in total amount of \$1,179 million consisting of cost recovery of \$1,163 million and remuneration fee of \$16 million. Attributable amount of 1,781 thousand tonnes of crude oil (12,218 thousand barrels) was included in Group's production for the period, that represents approximately 65% of total production from the field of 2,757 thousand tonnes (18,913 thousand barrels). Positive impact of cost compensation on Group's EBITDA for the second quarter and the first half of 2014 amounted to \$1,017 million.

The project's target production level is 1.2 million barrels per day and the total term of the contract is 25 years.

The Group is exposed to political, economic and legal risks due to its operations in Iraq. Management monitors the risks associated with the projects in Iraq and believes that there is no adverse effect on the Group's financial condition that can be reasonably estimated at present.

Operational highlights

Hydrocarbon production

The table below summarizes the results of our exploration and production activities.

	2 nd quarter of		1 st half of	
	2014	2013	2014	2013
Crude oil and natural gas liquids production⁽¹⁾	(thousand BOE per day)			
Consolidated subsidiaries				
Western Siberia	970	999	976	1,004
Timan-Pechora	306	297	308	301
Ural region	308	293	308	292
Volga region	135	124	135	105
Other in Russia	38	38	37	38
Total in Russia	1,757	1,751	1,764	1,740
Iraq ⁽²⁾	134	–	67	–
Other outside Russia	61	64	62	65

Total outside Russia	195	64	129	65
Total consolidated subsidiaries	1,952	1,815	1,893	1,805
Our share in equity affiliates				
in Russia	10	7	9	7
outside Russia	40	46	42	48
Total share in equity affiliates	50	53	51	55
Total crude oil and natural gas liquids	2,002	1,868	1,944	1,860
Natural gas production available for sale⁽³⁾				
Consolidated subsidiaries				
Western Siberia	185	185	186	190
Timan-Pechora	15	14	14	13
Ural region	16	15	18	17
Volga region	6	6	6	6
Total in Russia	222	220	224	226
Total outside Russia	81	96	87	99
Total consolidated subsidiaries	303	316	311	325
Share in equity affiliates				
in Russia	1	1	1	1
outside Russia	7	8	8	8
Total share in production of equity affiliates	8	9	9	9
Total natural gas available for sale	311	325	320	334
Total daily hydrocarbon production	2,313	2,193	2,264	2,194
			(US dollar per BOE)	
Hydrocarbon extraction expenses	6.13	5.59	5.70	5.44
- in Russia	5.65	5.60	5.46	5.47
- outside Russia	9.46	5.51	7.90	5.08
			(millions of US dollars)	
Hydrocarbon extraction expenses	1,259	1,078	2,270	2,087
- in Russia	1,015	999	1,957	1,937
- outside Russia	244	79	313	150
Exploration expenses	64	75	269	138
- in Russia	38	55	123	98
- outside Russia	26	20	146	40
Mineral extraction tax	3,070	3,030	6,169	6,043
- in Russia	3,055	3,010	6,136	6,006
- outside Russia	15	20	33	37

⁽¹⁾ Natural gas liquids produced at the Group gas processing plants.

⁽²⁾ Compensation oil that represents approximately 65% of production from the West Qurna-2 field.

⁽³⁾ Including petroleum gas sold to third parties.

We undertake exploration for, and production of, crude oil and natural gas in Russia and internationally. In Russia, our major oil producing subsidiaries are OOO LUKOIL-Western Siberia, OOO LUKOIL-Komi and OOO LUKOIL-PERM. Exploration and production outside of Russia is performed by our 100% subsidiary LUKOIL-Overseas Holding GmbH. This has stakes in PSA's and other projects in Kazakhstan, Azerbaijan, Uzbekistan, Romania, Iraq, Saudi Arabia, Egypt, Ghana, Cote d'Ivoire, Vietnam, Venezuela, and Norway.

Crude oil production. In the first half of 2014, we produced (including the Company's share in equity affiliates) 46.9 million tonnes, or 344.7 million barrels, of crude oil.

The following table represents our crude oil production in the first half of 2014 and 2013 by major regions.

(thousands of tonnes)	Change to 2013				1 st half of 2013
	1 st half of 2014	Total, %	Change in structure	Organic change	
Western Siberia	23,377	(2.9)	–	(707)	24,084
Timan-Pechora	7,697	2.3	–	175	7,522
Ural region	7,184	4.9	34	299	6,851
Volga region	3,260	33.0	657	152	2,451
Other in Russia	939	(0.1)	–	(1)	940
Crude oil produced in Russia	42,457	1.5	691	(82)	41,848

Iraq ⁽¹⁾	1,781	–	–	1,781	–
Other outside of Russia	1,473	(5.8)	–	(91)	1,564
Crude oil produced internationally	3,254	108.1	–	1,690	1,564
Total crude oil produced by consolidated subsidiaries	45,711	5.3	691	1,608	43,412
Our share in crude oil produced by equity affiliates:					
in Russia	207	15.6	(17)	45	179
outside Russia	971	(12.8)	–	(143)	1,114
Total crude oil produced	46,889	4.9	674	1,510	44,705

⁽¹⁾ Compensation oil that represents approximately 65% of production from the West Qurna-2 field.

The main oil producing region for the Company is Western Siberia where we produced 51.1% of our crude oil in the first half of 2014 (55.5% in the first half of 2013).

Crude oil production in Western Siberia continued to decline due to natural depletion of reserves and an increase in water cut. Nevertheless, this was compensated for by the acquisitions of new upstream properties, development of greenfields, successful employment of new technologies and an increase in drilling footage. As a result, our daily domestic crude oil and natural gas liquids production volumes increased by 1.5%, compared to the first half of 2013.

The structural increase in our domestic production was a result of the acquisition of a 100.0% share of ZAO Samara-Nafta and an increase in the Group's ownership in ZAO Kama-oil from 50.0% to 100.0% during the second quarter of 2013. At the same time, the transfer of ZAO Kama-oil from affiliates to subsidiaries led to some structural decrease in the affiliates' production in Russia.

The increase in our international production was a result of commencement of commercial production at the West Qurna-2 oilfield.

In addition to our production, we purchase crude oil in Russia and on international markets. In Russia, we primarily purchase crude oil from affiliated producing companies and other producers. Then we either refine or export purchased crude oil. Crude oil purchased on international markets is normally used for trading activities, for supplying our international refineries or for processing at third party refineries.

	2 nd quarter of			
	2014		2013	
	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)
Purchases in Russia	1,129	154	946	129
Purchases for trading internationally	32,809	4,476	10,673	1,456
Purchases for refining internationally	21,719	2,963	17,129	2,337
Total crude oil purchased	55,657	7,593	28,748	3,922

	1 st half of			
	2014		2013	
	(thousand of barrels)	(thousand of tonnes)	(thousand of barrels)	(thousand of tonnes)
Purchases in Russia	3,262	445	1,151	157
Purchases for trading internationally	56,199	7,667	14,125	1,927
Purchases for refining internationally	38,497	5,252	32,523	4,437
Total crude oil purchased	97,958	13,364	47,799	6,521

A significant part of our crude oil purchases is for processing. Compared to the first half of 2013, our purchases for processing at international refineries increased by 18.4% as a result of the increase of crude oil refining at ISAB. Moreover, in the first half of 2014, our purchases for trading were almost four times as much as in the first half of 2013, when the level of such purchases was abnormally low.

Production of gas and natural gas liquids. During the first half of 2014, we produced 9,833 million cubic meters (57.9 million BOE) of gas available for sale (including our share in equity affiliates), that is 4.4% less than in the first half of 2013.

Our major gas production field is the Nakhodkinskoe field, where we produced 4,131 million cubic meters of natural gas in the first half of 2014 (4,116 million cubic meters in the first half of 2013). Our international gas production decreased by 12.3%, compared to the first half of 2013, largely due to lower production volumes in Uzbekistan.

In the first half of 2014, the output of natural gas liquids at the Group gas processing plants in Western Siberia, Ural and Volgograd regions of Russia was 7.2 million BOE, compared to 6.5 million BOE in the first half of 2013.

Refining, marketing and trading

Refining. We own and operate four refineries located in European Russia and three refineries located outside of Russia – in Bulgaria, Romania and Italy. Moreover, we have a 45% interest in the Zeeland refinery in the Netherlands.

In December 2013, the Group increased its stake in ISAB to 100% after acquisition of the remaining 20% share. Initially, in December 2008, the Group acquired a 49% interest in ISAB, then increased its interest to 60% in April 2011 and to 80% in September 2012, when control over the refinery was obtained and ISAB became our consolidated subsidiary, rather than an equity affiliate.

Compared to the first half of 2013, the total volume of refined products produced by the Group (including our share in production at the Zeeland refinery) didn't change significantly. Production volumes at our Russian refineries increased by 1.6%, largely due to an increase of production volumes at our refinery in Perm region against the background of relatively low production volumes in the first half of 2013. Production at our international refineries decreased by 2.0%. Sharp decrease in production at the Zeeland refinery by 38.3% due to low refining margins and overhaul in the second quarter of 2014 outweighed the increase of production at ISAB.

Along with our own production of refined products we can refine crude oil at third party refineries depending on market conditions and other factors. In the periods considered, we processed our crude oil at third party refineries in Belarus and Kazakhstan. At the same time, the volume of our crude oil processing at the third party refineries in Belarus in the first half of 2014 was lower than in the first half of 2013.

The following table summarizes key figures for our refining activities.

	2 nd quarter of		1 st half of	
	2014	2013	2014	2013
	(thousand barrels per day)			
Refinery throughput at the Group refineries	1,269	1,223	1,247	1,198
- in Russia	902	888	912	896
- outside Russia ⁽¹⁾	367	335	335	302
Refinery throughput at the Zeeland refinery ⁽¹⁾	34	101	60	97
Refinery throughput at third party refineries	41	46	29	45
Total refinery throughput	1,344	1,370	1,336	1,340
	(thousands of tonnes)			
Production of the Group refineries in Russia	10,743	10,605	21,547	21,217
Production of the Group refineries outside Russia	4,543	4,104	8,059	7,331
Production of the Zeeland refinery	423	1,259	1,488	2,413
Refined products produced by the Group including our share in the Zeeland refinery	15,709	15,968	31,094	30,961
Refined products produced at third party refineries	463	535	648	1,029
Total refined products produced	16,172	16,503	31,742	31,990
	(millions of US dollars)			
Refining expenses at the Group refineries	518	555	998	1,063
- in Russia	272	291	502	550
- outside Russia	246	264	496	513
Refining expenses at affiliated refineries outside of Russia	33	61	90	118
Refining expenses at third party refineries	19	22	26	42
Capital expenditures	799	395	1,198	974
- in Russia	613	258	814	692
- outside Russia	186	137	384	282

⁽¹⁾ Including refined product processed.

Marketing and trading. Our marketing and trading activities mainly include wholesale and bunkering operations in Western Europe, South-East Asia, Central America and retail operations in the USA, Central and Eastern Europe, the Baltic States and other regions. In Russia, we purchase refined products on occasion, primarily to manage supply chain bottlenecks.

The Group retails its refined products in 27 countries through nearly 5.6 thousand petrol stations (including franchisees). Most of the stations operate under the LUKOIL brand.

The table below summarizes figures for our trading activities.

	2 nd quarter of		1 st half of	
	2014	2013	2014	2013
	(thousands of tonnes)			
Retail sales	3,990	3,919	7,628	7,465
Wholesale sales	25,070	27,036	49,605	50,908
Total refined products sales	29,060	30,955	57,233	58,373
Refined products purchased in Russia	382	469	819	1,099
Refined products purchased internationally	14,532	15,901	29,210	29,441
Total refined products purchased	14,914	16,370	30,029	30,540

In August 2014, in line with the strategy to optimize its downstream operations, Group companies signed agreements with third parties to sell 100% of shares in LUKOIL Ukraine, LUKOIL Slovakia s.r.o., LUKOIL Hungary Ltd. and LUKOIL Czech Republic s.r.o. that together operate approximately 380 petrol stations.

During the first half of 2014, political and economic uncertainty in Ukraine has been increasing. As at June 30, 2014, the Group owns downstream assets in Ukraine, consisting of a network of about 240 petrol stations, a petrochemical plant, lubricants distributors, and a jet fuel supplier. Though the Group's assets and operations in Ukraine are not material (in the first half of 2014, revenues that were derived from our operations in Ukraine comprised less than 1% of our total revenues), the Group monitors the situation and assesses the risks associated with its operations in Ukraine. Management believes that there are no potential losses that can be identified and reasonably estimated with respect to situation in Ukraine at present.

Exports of crude oil and refined products from Russia. The volumes of crude oil and refined products exported from Russia by our subsidiaries are summarized as follows:

	2 nd quarter of		2013	
	2014	2013	2013	2013
	(thousands of barrels)	(thousands of tonnes)	(thousands of barrels)	(thousands of tonnes)
Exports of crude oil using Transneft export routes	43,372	5,917	49,228	6,716
Exports of crude oil bypassing Transneft	10,870	1,483	12,669	1,728
Total crude oil exports	54,242	7,400	61,897	8,444
Exports of refined products		6,122		6,173

	1 st half of		2013	
	2014	2013	2013	2013
	(thousands of barrels)	(thousands of tonnes)	(thousands of barrels)	(thousands of tonnes)
Exports of crude oil using Transneft export routes	84,911	11,584	95,906	13,084
Exports of crude oil bypassing Transneft	22,950	3,131	22,482	3,067
Total crude oil exports	107,861	14,715	118,388	16,151
Exports of refined products		12,446		12,140

During the first half of 2014, the volume of our crude oil export from Russia decreased by 8.9%, compared to the first half of 2013, and we exported 34.7% of our total domestic crude oil production (38.6% – during the first half of 2013). The decrease of crude oil export was a result of higher sales in Russia and increased throughput at our domestic refineries.

All the volume of crude oil exported that bypassed Transneft in the periods considered was routed through our own export infrastructure.

During the first half of 2014, the Company exported 600 thousand tonnes of light crude oil through the Eastern Siberia – Pacific Ocean pipeline. This allowed us to preserve the premium quality of crude oil and thus increased the efficiency of export, compared to export to traditional Western markets.

During the first half of 2014, the volume of our exported refined products from Russia increased by 2.5%, compared to the first half of 2013. Primarily, we export from Russia diesel fuel, fuel oil and gasoil. These products accounted for approximately 83% of our exported refined products volumes.

During the first half of 2014, our revenue from export of crude oil and refined products from Russia both to Group companies and third parties amounted to \$10,590 million and \$9,337 million, respectively (\$11,350 million for crude oil and \$8,952 million for refined products in the first half of 2013).

Main macroeconomic factors affecting our results of operations

Changes in the price of crude oil and refined products

The price at which we sell crude oil and refined products is the primary driver of the Group's revenues. During the first half of 2014, the Brent crude oil price fluctuated between \$103 and \$115 per barrel and reached its peak of \$115.32 in the middle of June.

Substantially all the crude oil the Group exports is Urals blend. The following table shows the average crude oil and refined product prices in the first half of 2014 and 2013.

	2 nd quarter of		Change,	1 st half of		Change,
	2014	2013	%	2014	2013	%
	(in US dollars per barrel, except for figures in percent)					
Brent crude	109.67	102.43	7.1	108.93	107.50	1.3
Urals crude (CIF Mediterranean) ⁽¹⁾	108.04	102.34	5.6	107.42	106.70	0.7
Urals crude (CIF Rotterdam) ⁽¹⁾	107.30	101.89	5.3	106.76	106.21	0.5
	(in US dollars per metric tonne, except for figures in percent)					
Fuel oil 3.5% (FOB Rotterdam)	579.13	580.30	(0.2)	575.19	596.69	(3.6)
Diesel fuel 10 ppm (FOB Rotterdam)	922.01	889.35	3.7	923.37	931.71	(0.9)
High-octane gasoline (FOB Rotterdam)	1,021.17	957.59	6.6	989.69	999.06	(0.9)

Source: Platts.

⁽¹⁾ The Company sells crude oil on foreign markets on various delivery terms. Thus, our average realized sale price of oil on international markets differs from the average prices of Urals blend on Mediterranean and Northern Europe markets.

Domestic crude oil and refined products prices

Substantially all crude oil produced in Russia is produced by vertically integrated oil companies such as ours. As a result, most transactions are between affiliated entities within vertically integrated groups. Thus, there is no concept of a benchmark domestic market price for crude oil. The price of crude oil that is produced but not refined or exported by one of the vertically integrated oil companies is generally determined on a transaction-by-transaction basis against a background of world market prices, but with no direct reference or correlation. At any time there may exist significant price differences between regions for similar quality crude oil as a result of the competition and economic conditions in those regions.

Domestic prices for refined products are determined to some extent by world market prices, but they are also directly affected by local demand and competition.

The table below represents average domestic wholesale prices of refined products in the first half of 2014 and 2013.

	2 nd quarter of		Change,	1 st half of		Change,
	2014	2013	%	2014	2013	%
	(in US dollars per metric tonne, except for figures in percent)					
Fuel oil	285.11	302.48	(5.7)	271.34	332.42	(18.4)
Diesel fuel	800.33	817.59	(2.1)	803.55	861.39	(6.7)
High-octane gasoline (Regular)	866.02	790.42	9.6	837.70	805.95	3.9
High-octane gasoline (Premium)	892.76	847.14	5.4	867.65	856.26	1.3

Source: InfoTEK (excluding VAT).

Changes in the US dollar-ruble exchange rate and inflation

A substantial part of our revenue is either denominated in US dollars or is correlated to some extent with US dollar crude oil prices, while most of our costs in the Russian Federation are settled in Russian rubles. Therefore, ruble inflation and movements of exchange rates can significantly affect the results of our operations. In particular, an appreciation of the ruble against the US dollar generally causes our costs to increase in US dollar terms, and vice versa. The appreciation of the purchasing power of the US dollar in the Russian Federation calculated on the basis of the ruble-dollar exchange rates and the level of inflation in Russia was 5.1% in the first half of 2014, compared to the first half of 2013.

The following table gives data on inflation in Russia and the change in the ruble-dollar exchange rate.

	2 nd quarter of		1 st half of	
	2014	2013	2014	2013
Ruble inflation (CPI), %	2.4	1.6	4.8	3.5
Average exchange rate for the period (ruble to US dollar)	35.00	31.61	34.98	31.02
Exchange rate at the end of the period (ruble to US dollar)	33.63	32.71	33.63	32.71

Tax burden

The following table represents average enacted rates for taxes specific to the oil industry in Russia for the respective periods.

		2 nd quarter of		Change, %
		2014	2013	
Export tariffs on crude oil	\$/tonne	382.63	379.72	0.8
Export tariffs on refined products				
Middle distillates (jet fuel), liquid fuels (fuel oil) and gasoils	\$/tonne	252.52	250.59	0.8
Light distillates	\$/tonne	344.33	341.75	0.8
Diesel fuel	\$/tonne	248.65	250.59	(0.8)
Mineral extraction tax				
Crude oil	RUR/tonne	6,135.44	4,954.00	23.8
Natural gas	RUR/1,000 m ³	471.00	265.00	77.7

		1 st half of		Change, %
		2014	2013	
Export tariffs on crude oil	\$/tonne	386.65	393.09	(1.6)
Export tariffs on refined products				
Middle distillates (jet fuel), liquid fuels (fuel oil) and gasoils	\$/tonne	255.16	259.43	(1.6)
Light distillates	\$/tonne	347.94	353.79	(1.7)
Diesel fuel	\$/tonne	251.94	259.43	(2.9)
Mineral extraction tax				
Crude oil	RUR/tonne	6,107.12	5,104.08	19.7
Natural gas	RUR/1,000 m ³	471.00	265.00	77.7

Tax rates set in rubles and translated at the average exchange rates are as follows:

		2 nd quarter of		Change, %
		2014	2013	
Mineral extraction tax				
Crude oil	\$/tonne	175.30	156.71	11.9
Natural gas	\$/1,000 m ³	13.46	8.38	60.6

		1 st half of		Change, %
		2014	2013	
Mineral extraction tax				
Crude oil	\$/tonne	174.59	164.56	6.1
Natural gas	\$/1,000 m ³	13.46	8.54	57.6

The rates of taxes specific to the oil industry in Russia are linked to international crude oil prices and are changed in line with them. The methods to determine the rates for such taxes are presented below.

Crude oil extraction tax rate is determined by adjusting the base rate depending on the international market price of Urals blend and the ruble-dollar exchange rate. The tax rate is zero when the average Urals blend international market price for a tax period is less than or equal to \$15.00 per barrel. Each \$1.00 per barrel increase in the international Urals blend price over the threshold (\$15.00 per barrel) results in an increase of the tax rate by \$1.80 per tonne extracted (or \$0.25 per barrel extracted using a conversion factor of 7.33) above the base rate.

During the first half of 2014, the base rate was 493 rubles per metric tonne extracted (470 rubles in the first half of 2013).

The crude oil extraction tax rate varies depending on the development and depletion of a particular oilfield. The tax rate is zero for extra-heavy crude oil and for crude oil produced in certain regions of Eastern Siberia, the Caspian Sea, the Nenetsky Autonomous District and some other regions, depending on the period and volume of production.

The Group produces crude oil in the Caspian Sea and benefits from the application of a zero extraction tax rate. We also produce extra-heavy crude oil in Timan-Pechora.

Natural gas extraction tax rate. The mineral extraction tax on natural gas produced by independent producers in Russia is calculated using a flat rate. For the first half of 2014, the rate was set at 471 rubles per thousand cubic meters (265 rubles per thousand cubic meters in the first half of 2013).

Crude oil export duty rate is calculated on a progressive scale. The rate is zero when the average Urals blend international market price is less than or equal to approximately \$15.00 per barrel (\$109.50 per metric tonne). If the Urals blend price is between \$15.00 and \$20.00 per barrel (\$146.00 per metric tonne), each \$1.00 per barrel increase in the Urals blend price over \$15.00 results in an increase of the crude oil export duty rate by \$0.35 per barrel exported. If the Urals blend price is between \$20.00 and \$25.00 per barrel (\$182.50 per metric tonne), each \$1.00 per barrel increase in the Urals blend price over \$20.00 results in an increase of the crude oil export duty rate by \$0.45 per barrel exported. Each \$1.00 per barrel increase in the Urals blend price over \$25.00 per barrel results in an increase of the crude oil export duty rate no more than by \$0.65 per barrel exported. Starting from October 1, 2011 to December 31, 2013, the maximum increase of export duty rate was \$0.60 per barrel for each \$1.00 per barrel increase in the Urals blend price. Starting from January 1, 2014 to December 31, 2014, the maximum increase of export duty rate is \$0.59 per barrel for each \$1.00 per barrel increase in the Urals blend price.

The crude oil export duty rate is revised monthly on the basis of the immediately preceding one-month period of crude oil price monitoring.

A special export duty regime is in place for certain greenfields. The list of the oilfields where the reduced rate is applied includes our Yu. Korchagin and V. Filanovsky oilfields located in the Caspian Sea and extra-heavy crude oil fields in Timan-Pechora.

Export duty rates on refined products are calculated by multiplying the current crude oil export duty rate by a coefficient according to the table below.

	From January 1, 2014 to December 31, 2014	Prior to January 1, 2014
Multiplier for:		
Light distillates (except for gasolines), middle distillates (jet fuel), gasolins, liquid fuels (fuel oil), motor and other oils, other products	0.660	0.660
Diesel fuel	0.650	0.660
Gasolines	0.900	0.900

Crude oil and refined products exported to the member countries of the Customs Union – Belarus and Kazakhstan, are not subject to export duties.

Excise on refined products. The responsibility to pay excises on refined products in Russia is imposed on refined product producers (except for straight-run gasoline). Only domestic sales volumes are subject to excises.

In other countries where the Group operates, excises are paid either by producers or retailers depending on the local legislation.

Excise rates on refined products in Russia are tied to the ecological class of fuel. Excise tax rates for the first half of 2014 and 2013 are listed below:

		2 nd quarter of		Change,	1 st half of		Change,
		2014	2013	%	2014	2013	%
Gasoline							
Below Euro-3	RUR/tonne	11,110.00	10,100.00	10.0	11,110.00	10,100.00	10.0
Euro-3	RUR/tonne	10,725.00	9,750.00	10.0	10,725.00	9,750.00	10.0
Euro-4	RUR/tonne	9,916.00	8,560.00	15.8	9,916.00	8,560.00	15.8
Euro-5	RUR/tonne	6,450.00	5,143.00	25.4	6,450.00	5,143.00	25.4
Diesel fuel							
Below Euro-3	RUR/tonne	6,446.00	5,860.00	10.0	6,446.00	5,860.00	10.0
Euro-3	RUR/tonne	6,446.00	5,860.00	10.0	6,446.00	5,860.00	10.0
Euro-4	RUR/tonne	5,427.00	4,934.00	10.0	5,427.00	4,934.00	10.0
Euro-5	RUR/tonne	4,767.00	4,334.00	10.0	4,767.00	4,334.00	10.0
Motor oils	RUR/tonne	8,260.00	7,509.00	10.0	8,260.00	7,509.00	10.0
Straight-run gasoline	RUR/tonne	11,252.00	10,229.00	10.0	11,252.00	10,229.00	10.0

		2 nd quarter of		Change,	1 st half of		Change,
		2014	2013	%	2014	2013	%
Gasoline							
Below Euro-3	\$/tonne	317.43	325.63	(2.5)	317.61	325.63	(2.5)
Euro-3	\$/tonne	306.43	314.34	(2.5)	306.60	314.34	(2.5)
Euro-4	\$/tonne	283.32	275.98	2.7	283.48	275.98	2.7
Euro-5	\$/tonne	184.29	165.81	11.1	184.39	165.81	11.2
Diesel fuel							
Below Euro-3	\$/tonne	184.17	188.93	(2.5)	184.28	188.93	(2.5)
Euro-3	\$/tonne	184.17	188.93	(2.5)	184.28	188.93	(2.5)
Euro-4	\$/tonne	155.06	159.07	(2.5)	155.15	159.07	(2.5)
Euro-5	\$/tonne	136.20	139.73	(2.5)	136.28	139.73	(2.5)
Motor oils	\$/tonne	236.00	242.09	(2.5)	236.13	242.09	(2.5)
Straight-run gasoline	\$/tonne	321.49	329.79	(2.5)	321.67	329.79	(2.5)

Income tax. The federal income tax rate is 2.0% and the regional income tax rate varies between 13.5% and 18.0%. The Group's foreign operations are subject to taxes at the tax rates applicable to the jurisdictions in which they operate.

Until January 1, 2012, there were no provisions in the taxation legislation of the Russian Federation to permit the Group to reduce taxable profits of a Group company by offsetting tax losses of another Group company against such profits. Tax losses could be fully or partially used to offset taxable profits in the same company in any of the ten years following the year of loss.

Starting from January 1, 2012, if certain conditions are met, taxpayers are able to pay income tax as a consolidated taxpayers' group ("CTG"). This allows taxpayers to offset taxable losses generated by certain participants of a CTG against taxable profits of other participants of the CTG. Certain Group companies met the legislative requirements and pay income tax as a CTG starting from the first quarter of 2012.

Losses generated by a taxpayer before joining a CTG are not available for offset against taxable profits of other participants of the CTG. However, if a taxpayer leaves a CTG, such losses again become available for offset against future profits generated by the same taxpayer. The expiration period of the losses is extended for any time spent within a CTG when the losses were unavailable for use.

Transportation of crude oil and refined products in Russia

The main Russian crude oil production regions are remote from the main crude oil and refined products markets. Therefore, access by crude oil production companies to the markets is dependent on the extent of diversification of the transport infrastructure and access to it. As a result, transportation cost is an important macroeconomic factor affecting our net income.

Transportation of crude oil produced in Russia to refineries and export destinations is performed primarily through the trunk oil pipeline system of the state-owned company, OAO AK Transneft, or by railway transport.

Transportation of refined products in Russia is performed by railway transport and the pipeline system of OAO AK Transneftproduct. The Russian railway infrastructure is owned and operated by OAO Russian Railways. Both these companies are state-owned. We transport the major part of our refined products by railway transport.

In Russia, gas is mostly sold at the wellhead and then transported through the Unified Gas Supply System (“UGSS”). The UGSS is responsible for gathering, transporting, dispatching and delivering substantially all natural gas supplies in Russia and is owned and operated by OAO Gazprom. The Federal Service for Tariffs of the Russian Federation regulates natural gas transportation tariffs. We are not able to sell our gas other than through UGSS.

Three and six months ended June 30, 2014, compared to three and six months ended June 30, 2013

The table below sets forth data from our consolidated statements of comprehensive income for the periods indicated.

	2 nd quarter of		1 st half of	
	2014	2013	2014	2013
	(millions of US dollars)			
Revenues				
Sales (including excise and export tariffs)	38,205	35,053	73,886	68,823
Costs and other deductions				
Operating expenses	(2,558)	(2,516)	(4,867)	(4,966)
Cost of purchased crude oil, gas and products	(18,871)	(16,462)	(36,114)	(31,565)
Transportation expenses	(1,557)	(1,562)	(3,110)	(3,212)
Selling, general and administrative expenses	(1,015)	(972)	(1,871)	(1,838)
Depreciation, depletion and amortization	(2,485)	(1,444)	(3,997)	(2,813)
Taxes other than income taxes	(3,408)	(3,396)	(6,854)	(6,779)
Excise and export tariffs	(5,339)	(5,787)	10,826	(11,288)
Exploration expense	(64)	(75)	(269)	(138)
Gain (loss) on disposals and impairments of assets	1	17	(414)	10
Income from operating activities	2,909	2,856	5,564	6,234
Interest expense	(155)	(121)	(295)	(218)
Interest and dividend income	63	58	120	119
Equity share in income of affiliates	91	139	273	297
Currency translation gain (loss)	2	(257)	(268)	(396)
Other non-operating (expense) income	(39)	168	(119)	181
Income before income taxes	2,871	2,843	5,275	6,217
Current income taxes	(541)	(658)	(1,346)	(1,304)
Deferred income taxes	70	(90)	208	(233)
Total income tax expense	(471)	(748)	(1,138)	(1,537)
Net income	2,400	2,095	4,137	4,680
Net (income) loss attributable to non-controlling interests	(11)	9	(15)	5
Net income attributable to OAO LUKOIL	2,389	2,104	4,122	4,685
Earning per share of common stock attributable to OAO LUKOIL (in US dollars):				
Basic	3.16	2.79	5.46	6.21
Diluted	3.10	2.73	5.35	6.08

The analysis of the main financial indicators of the financial statements is provided below.

Sales revenues

Sales breakdown	2 nd quarter of		1 st half of	
	2014	2013	2014	2013
	(millions of US dollars)			
Crude oil				
Export and sales on international markets other than Customs Union countries	7,230	4,983	14,188	10,082
Export and sales to Customs Union countries	460	380	996	765
Domestic sales	953	658	1,937	1,196
	8,643	6,021	17,121	12,043
Refined products				
Export and sales on international markets				
Wholesale	19,560	20,135	38,413	39,071
Retail	2,758	2,733	5,224	5,176
Domestic sales				
Wholesale	1,861	1,861	3,473	3,782
Retail	2,337	2,267	4,429	4,463
	26,516	26,996	51,539	52,492
Petrochemicals				
Export and sales on international markets	234	249	489	472
Domestic sales	39	214	171	460
	273	463	660	932
Gas and gas products				
Export and sales on international markets	538	527	1,091	1,084
Domestic sales	285	259	583	545
	823	786	1,674	1,629
Sales of energy and related services	317	296	818	785
Other				
Sales on international markets	1,426	291	1,662	551
Domestic sales	207	200	412	391
	1,633	491	2,074	942
Total sales	38,205	35,053	73,886	68,823

Sales volumes	2 nd quarter of		1 st half of	
	2014	2013	2014	2013
Crude oil	(thousands of barrels)			
Export and sales on international markets other than Customs Union countries	66,644	49,243	131,705	95,437
Export and sales to Customs Union countries	8,686	7,990	19,197	15,518
Domestic sales	19,043	14,484	39,611	25,560
	94,373	71,717	190,513	136,515
Crude oil	(thousands of tonnes)			
Export and sales on international markets other than Customs Union countries	9,092	6,718	17,968	13,020
Export and sales to Customs Union countries	1,185	1,090	2,619	2,117
Domestic sales	2,598	1,976	5,404	3,487
	12,875	9,784	25,991	18,624
Refined products	(thousands of tonnes)			
Export and sales on international markets				
Wholesale	22,228	24,335	44,366	45,578
Retail	1,637	1,694	3,122	3,163
Domestic sales				
Wholesale	2,842	2,701	5,239	5,330
Retail	2,353	2,225	4,506	4,302
	29,060	30,955	57,233	58,373

Total sales volume of crude oil and refined products	41,935	40,739	83,224	76,997
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Realized average sales prices		2nd quarter of		1st half of	
		2014	2013	2014	2013
Average realized price international					
Oil (excluding Customs Union countries)	(\$/barrel)	108.49	101.20	107.73	105.64
Oil (Customs Union countries)	(\$/barrel)	52.96	47.59	51.89	49.34
Refined products					
Wholesale	(\$/tonne)	879.93	827.45	865.79	857.23
Retail	(\$/tonne)	1,685.73	1,612.90	1,673.46	1,636.41
Average realized price within Russia					
Oil	(\$/barrel)	50.07	45.41	48.90	46.78
Refined products					
Wholesale	(\$/tonne)	654.51	689.07	662.85	709.53
Retail	(\$/tonne)	993.47	1,018.91	983.10	1,037.56

During the second quarter of 2014, our revenues increased by \$3,152 million, or by 9.0%, compared to the second quarter of 2013. Our revenues from crude oil sales increased by \$2,622 million, or by 43.5%. Our revenues from sales of refined products decreased by \$480 million, or by 1.8%.

During the first half of 2014, our revenues increased by \$5,063 million, or by 7.4%, compared to the same period of 2013. Our revenues from crude oil sales increased by \$5,078 million, or by 42.2%. Our revenues from sales of refined products decreased by \$953 million, or by 1.8%.

The changes in ruble-nominated revenues against the first half of 2013 were significantly affected by the nominal ruble devaluation by 12.8%.

Sales of crude oil

Our international sales volumes increased by 2,469 thousand tonnes, or by 31.6%, compared to the second quarter of 2013, and by 5,450 thousand tonnes, or by 36.0%, compared to the first half of 2013, as a result of increased volumes of trading. Moreover, our international realized crude oil prices increased by 8.9%, compared to the second quarter of 2013, and by 2.9%, compared to the first half of 2013. As a result, our international sales revenue increased by 43.4%, or by \$2,327 million, and by 40.0%, or by \$4,337 million, in the second quarter and the first half of 2014, respectively.

Our domestic sales volumes increased by 31.5%, compared to the second quarter of 2013, and by 55.0%, compared to the first half of 2013, due to continuing increase in domestic demand and volumes of crude oil production in Russia. As a result, in the second quarter and the first half of 2014, our domestic sales revenue increased by 44.8%, or by \$295 million, and by 62.0%, or by \$741 million, respectively.

In the second quarter and the first half of 2014, our revenue from crude oil export from Russia both to the Group companies and third parties amounted to \$5,337 million and \$10,590 million, respectively.

Sales of refined products

Compared to the same periods of 2013, our revenue from the wholesale of refined products outside of Russia decreased by \$575 million, or by 2.9%, in the second quarter of 2014 and by \$658 million, or by 1.7%, in the first half of 2014. The increase in sales prices by 6.3% in the second quarter of 2014 and by 1.0% in the first half of 2014 was outweighed by the decrease in sales volumes as a result of overhauls at our plants in Bulgaria in the first quarter of 2014 and in the Netherlands in the second quarter of 2014, as well as the decrease in trading volumes compared to the second quarter of 2013.

Compared to the second quarter and the first half of 2013, some decrease of retail volumes outside of Russia was compensated by increase in realized retail prices. As a result, our retail sales revenue didn't change significantly both to the second quarter and first half of 2013.

In the second quarter of 2014, our revenue from the wholesale of refined products on the domestic market was flat compared to the second quarter of 2013. A decrease in realized prices due to the ruble devaluation was compensated by an increase in sales volumes. In the first half of 2014, a decrease in sales volumes by 91 thousand tonnes, or by 1.7%, was emphasized by a decrease in sales prices by 6.6% caused by ruble devaluation. As a result, our wholesale refined products revenue decreased by \$309 million, or 8.2%.

Our revenue from retail sales in Russia increased by \$70 million, or by 3.1%, in the second quarter of 2014. Retail sales volumes increased by 5.8% that was partially offset by a decrease in average domestic retail prices by 2.5% as a result of ruble devaluation. In the first half of 2014, an increase in domestic sales volumes nearly offset the decrease in prices, so our domestic retail revenue didn't change significantly, compared to the first half of 2013, despite sizable ruble devaluation.

In the second quarter and the first half of 2014, our revenue from export of refined products from Russia both to Group companies and third parties amounted to \$4,617 million and \$9,337 million, respectively.

Sales of petrochemical products

Our revenue from sales of petrochemical products decreased by \$190 million, or by 41.0%, in the second quarter of 2014 and by \$272 million, or by 29.2%, in the first half of 2014. This was largely due to a significant decrease of domestic sales volumes, compared to 2013, as a result of cease of production at our plant in Stavropol region of Russia as a consequence of a fire at the plant in the end of February 2014.

Sales of gas and gas products

Sales of gas and gas refined products increased by \$37 million, or by 4.7%, in the second quarter of 2014 and by \$45 million, or by 2.8%, in the first half of 2014.

Gas products wholesales revenue increased by \$51 million, or by 19.8%, in the second quarter of 2014 and by \$60 million, or by 10.9%, in the first half of 2014. Average realized wholesale prices and sales volumes for gas products increased by 11.0% and 7.9% in the second quarter of 2014 and by 6.4% and 4.3%, in the first half of 2014, respectively.

Retail gas products revenue increased by \$13 million, or by 8.8%, in the second quarter of 2014 and by \$21 million, or by 7.7%, in the first half of 2014.

Natural gas sales revenue decreased by \$27 million, or by 7.0%, in the second quarter of 2014 and by \$36 million, or by 4.5%, in the first half of 2014. The decrease was mainly due to lower production volumes in Uzbekistan.

Sales of energy and related services

Our revenue from sales of electricity, heat and related services increased by \$21 million, or by 7.1%, in the second quarter of 2014 and by \$33 million, or by 4.2%, in the first half of 2014. The increase of sales volumes that resulted from commissioning of two combined cycle gas turbines with a combined capacity of 235 MW in Astrakhan, Russia in mid-2013 and consequent increase in volumes of power generation, compared to the second quarter and the first half of 2013, was partially offset by the effect of ruble devaluation.

Sales of other products

Other sales include non-petroleum sales through our retail network, transportation services, rental revenue, crude oil extraction services, and other revenue of our production and marketing companies from sales of goods and services not related to our primary activities.

Revenue from other sales increased by \$1,142 million in the second quarter of 2014 and by \$1,132 million in the first half of 2014. In the second quarter and the first half of 2014, other revenue included \$1,179 million related to cost compensation within the West Qurna-2 project.

Operating expenses

Operating expenses include the following:

	2nd quarter of		1st half of	
	2014	2013	2014	2013
	(millions of US dollars)			
Hydrocarbon extraction expenses	1,259	1,078	2,270	2,087
Own refining expenses	518	555	998	1,063
Refining expenses at third parties and affiliated refineries	52	83	116	160

Cost of processing operations at ISAB	–	47	–	91
Expenses for crude oil transportation to refineries	270	335	543	673
Power generation and distribution expenses	171	172	361	364
Petrochemical expenses	45	73	111	152
Other operating expenses	243	173	468	376
Total operating expenses	2,558	2,516	4,867	4,966

The method of allocation of operating expenses above differs from the approach used in preparing the data for Note 20 “Segment information” to our interim consolidated financial statements. Expenditures in the segment reporting are grouped depending on the segment to which a particular company belongs. Operating expenses for the purposes of this analysis are grouped based on the nature of the costs incurred.

The changes in ruble-nominated operating expenses against the first half of 2013 were significantly affected by the nominal ruble devaluation by 12.8%.

Compared to the respective periods of 2013, our operating expenses increased by \$42 million, or by 1.7%, in the second quarter of 2014, but decreased by \$99 million, or by 2.0%, in the first half of 2014.

Hydrocarbon extraction expenses

Our extraction expenses include expenditures related to repairs of extraction equipment, labor costs, expenses on artificial stimulation of reservoirs, fuel and electricity costs, cost of extraction of natural gas liquids, property insurance of extraction equipment and other similar costs.

Our extraction expenses increased by \$181 million, or by 16.8%, in the second quarter of 2014 and by \$183 million, or by 8.8%, in the first half of 2014. In the second quarter of 2014, our extraction expenses included \$161 million of start-up costs and production expenses related to West Qurna-2 project. In the first half of 2014, approximately \$24 million of the extraction expenses refer to ZAO Samara-Nafta, acquired in April 2013. In Russia, the increase in costs was compensated by the ruble devaluation.

Our average hydrocarbon extraction expenses increased from \$5.59 per BOE in the second quarter of 2013 to \$6.13 per BOE in the second quarter of 2014, or by 9.7%, and from \$5.44 per BOE in the first half of 2013 to \$5.70 per BOE in the first half of 2014, or by 4.8%. This was due to write-off of certain start-up costs related to commencement of commercial production at West Qurna-2 oilfield in the second quarter of 2014.

Own refining expense

Our own refining expenses decreased by \$37 million, or by 6.7%, in the second quarter of 2014, and by \$65 million, or by 6.1%, in the first half of 2014.

Refining expenses at our domestic refineries decreased by 6.5%, or by \$19 million, in the second quarter of 2014, and by \$48 million, or by 8.7%, in the first half of 2014. The effect of ruble devaluation, lower consumption and cost of additives and lower expenses for overhauls outweighed the effect of increased production volumes.

Refining expenses at our international refineries decreased by 6.8%, or by \$18 million, in the second quarter of 2014, and by 3.3%, or by \$17 million, in the first half of 2014. Sizeable increase in production volumes at ISAB against the background of low volumes of refining in the first half of 2013 due to overhauls was outweighed by the effect of the drop in electricity tariffs in Sicily and decrease in expenses of our Romanian and Bulgarian refineries due to lower expenses on overhauls.

Refining expenses at third party and affiliated refineries

Along with our own production of refined products we refine crude oil at third party and affiliated refineries both in Russia and abroad.

In the second quarter and the first half of 2014, refining expenses at third party and affiliated refineries decreased by 37.3%, or by \$31 million, and by 27.5%, or by \$44 million, respectively, as a result of significantly lower volumes of crude oil processing at third party refineries in Belarus, and the effect of ruble devaluation.

Expenses for crude oil transportation to refineries

Expenses for crude oil transportation to refineries include pipeline, railway, freight and other costs related to delivery of the Group’s own crude oil to refineries for further processing.

Our expenses for crude oil transportation to refineries decreased by \$65 million, or by 19.4%, in the second quarter of 2014 and by \$130 million, or by 19.3%, in the first half of 2014, due to significantly lower volumes of crude oil processing at third party refineries in Belarus, the decrease in supplies of own crude oil from Russia to ISAB and the effect of ruble devaluation.

Power generation and distribution expenses

During the second quarter and the first half of 2014 power generation and distribution expenses remained nearly flat compared to the respective periods of 2013. The effect of ruble devaluation outweighed the increase of expenses that resulted from the commissioning of new combined cycle gas turbines with a combined capacity of 235 MW in Astrakhan, Russia in the middle of 2013.

Other operating expenses

Other operating expenses include expenses of the Group's upstream and downstream entities that do not relate to their core activities, namely rendering of transportation and extraction services, costs of other services provided and goods sold by our production and marketing companies, and of non-core businesses of the Group.

Other operating expenses increased by \$70 million, or by 40.5%, in the second quarter of 2014, and by \$92 million, or by 24.5%, in the first half of 2014, driven largely by changes in estimates of existing asset retirement obligations.

Cost of purchased crude oil, gas and products

Cost of purchased crude oil, gas and products includes the cost of crude oil and refined products purchased for trading or refining, gas and fuel oil to supply our power generation entities and the result of hedging of crude oil and refined products sales.

Cost of purchased crude oil, gas and products increased by \$2,409 million, or by 14.6%, in the second quarter of 2014 and by \$4,549 million, or by 14.4%, in the first half of 2014, largely as a result of the increase in crude oil trading volumes.

In the second quarter of 2014, we recognized a \$182 million net loss from hedging, compared to a \$146 million net gain in the second quarter of 2013. At the same time, in the first half of 2014, we recognized a \$109 million net loss from hedging, compared to a net gain of \$81 million in the first half of 2013.

Transportation expenses

In the second quarter of 2014, our transportation expenses didn't change significantly, compared to the second quarter of the previous year. In the first half of 2014, transportation expenses decreased by \$102 million, or by 3.2%, compared to the first half of 2013, largely due to the ruble devaluation, decrease of tariffs abroad and lower volumes of crude oil export from Russia. At the same time, these factors were partially offset by rerouting of our refined products supplies.

Our actual transportation expenses related to crude oil and refined products deliveries to various export destinations, weighted by volumes transported, changed to the first half of 2013 as follows: crude oil pipeline tariffs decreased by 10.1%, railway tariffs for refined products transportation decreased by 14.5%, crude oil freight rates decreased by 12.5%, and refined products freight rates decreased by 11.3%.

Selling, general and administrative expenses

Selling, general and administrative expenses include payroll costs (excluding extraction entities' and refineries' production staff costs), insurance costs (except for property insurance related to extraction and refinery equipment), costs of maintenance of social infrastructure, movement in bad debt provision and other expenses.

Our selling, general and administrative expenses increased by \$43 million, or by 4.4%, in the second quarter of 2014 and by \$33 million, or by 1.8%, in the first half of 2014.

Depreciation, depletion and amortization

Our depreciation, depletion and amortization expenses increased by \$1,041 million, or by 72.1%, compared to the second quarter of 2013, and by \$1,184 million, or by 42.1%, compared to the first half of 2013. Our depreciation, depletion and amortization expenses for the second quarter and the first half of 2014 included \$1,005 million related to the West Qurna-2 field, where we commenced commercial production in the second quarter of 2014. The increase in depreciation, depletion and amortization expenses was driven also by our capital expenditures and the corresponding increase in value of depreciable assets and the acquisition of ZAO Samara-Nafta in April 2013.

Equity share in income of affiliates

The Group has investments in equity method affiliates and corporate joint ventures. These companies are primarily engaged in crude oil exploration, production, marketing and distribution operations in the Russian Federation, crude oil production and marketing in Kazakhstan and refining operations in the Netherlands. Our largest affiliates are Turgai Petroleum and Tengizchevroil, exploration and production companies operating in Kazakhstan, and the Zeeland Refinery in the Netherlands.

Our share in income of affiliates decreased by \$48 million, or by 34.5%, compared to the second quarter of 2013, and by \$24 million, or by 8.1%, compared to the first half of 2013. This was mainly due to the decrease in income of Turgai Petroleum, as a result of lower production volumes, and Zeeland, as a result of lower volumes of refining driven by decreased refining margins and stoppage time for overhauls.

Taxes other than income taxes

	2 nd quarter of		1 st half of	
	2014	2013	2014	2013
	(millions of US dollars)			
In Russia				
Mineral extraction taxes	3,055	3,010	6,136	6,006
Social security taxes and contributions	133	141	278	307
Property tax	125	141	249	269
Other taxes	23	33	44	52
Total in Russia	3,336	3,325	6,707	6,634
International				
Mineral extraction taxes	15	20	33	37
Social security taxes and contributions	32	30	63	60
Property tax	8	8	17	16
Other taxes	17	13	34	32
Total internationally	72	71	147	145
Total	3,408	3,396	6,854	6,779

In the second quarter and the first half of 2014, taxes other than income taxes didn't change significantly, compared to the respective periods of 2013. The effects of mineral extraction tax rate growth and the increase in domestic crude oil production were partially offset by the increase in the amount of mineral extraction tax incentive. The decrease in social security taxes and contributions, property and other taxes in Russia against the second quarter and the first half of 2013 was mainly due to the ruble devaluation.

In the second quarter and the first half of 2014, application of the reduced rate for crude oil produced from depleted oilfields and the zero rate for crude oil produced from oilfields with extra heavy crude oil and from greenfields led to \$607 million and \$1,191 million mineral extraction tax reduction, respectively (\$436 million and \$904 million in the second quarter and the first half of 2013, respectively).

Excise and export tariffs

	2 nd quarter of		1 st half of	
	2014	2013	2014	2013
	(millions of US dollars)			
In Russia				
Excise tax on refined products	500	489	917	925
Crude oil export tariffs	2,217	2,623	4,765	5,107
Refined products export tariffs	1,527	1,592	3,153	3,207
Total in Russia	4,244	4,704	8,835	9,239
International				

Excise tax and sales taxes on refined products	979	929	1,800	1,751
Crude oil export tariffs	51	59	103	121
Refined products export tariffs	65	95	88	177
Total internationally	1,095	1,083	1,991	2,049
Total	5,339	5,787	10,826	11,288

Export tariffs decreased by \$509 million, or by 11.7%, in the second quarter of 2014 and by \$503 million, or by 5.8%, in the first half of 2014. Compared to the second quarter and the first half of 2013, the volumes of crude oil export beyond the Customs Union decreased by 11.2% and 5.5%, respectively. Refined products export volumes decreased by 0.8% in the second quarter of 2014 and increased by 2.5% in the first half of 2014. This increase which was outweighed by the decrease of export tariffs rates.

Exploration expenses

In the second quarter of 2014, our exploration expenses decreased by \$11 million, while in the first half of 2014, our exploration expenses increased by \$131 million as a result of dry hole write-offs in the first quarter of 2014. Thus, dry hole costs in the first half of 2014 amounted to \$95 million that represented dry exploratory well in Cote d'Ivoire, compared to \$3 million in the first half of 2013. The rest of the increase was due to the growth in volume of seismic in Western Siberia.

Loss on disposals and impairments of assets

In April 2014, the Group entered into an agreement to sell its 50% share in Caspian Investment Resources Ltd. The loss on expected disposal of this share was estimated at \$358 million. For more details on this agreement, refer to page 3.

Moreover, in the first quarter of 2014, the Group wrote off signing bonuses related to projects in Sierra Leone and Cote d'Ivoire in the total amount of \$67 million.

Income taxes

The maximum statutory rate in Russia is 20%. Nevertheless, the actual effective income tax rate may be higher due to non-deductible expenses or lower due to certain non-taxable gains. Moreover, quarterly deviations of the effective income tax rates from the maximum statutory rate may happen due to currency translation losses and gains reported by Russian subsidiaries, that decrease or increase taxable income in the respective periods.

In the second quarter of 2014, our total income tax expense decreased by \$277 million, or by 37.0%, compared to the second quarter of 2013. At the same time, our income before income tax increased by \$28 million, or by 1.0%.

In the first half of 2014, our total income tax expense decreased by \$399 million, or by 26.0%, compared to the first half of 2013, while our income before income tax decreased by \$942 million, or by 15.2%.

In the second quarter of 2014, our effective income tax rate was 16.4%, compared to 26.3% in the second quarter of 2013. In the first half of 2014, effective income tax rate was 21.6%, compared to 24.7% in the first half of 2013.

Reconciliation of net income to EBITDA (earnings before interest, income taxes, depreciation and amortization)

	2 nd quarter of		1 st half of	
	2014	2013	2014	2013
	(millions of US dollars)			
Net income	2,389	2,104	4,122	4,685
Add back:				
Income tax expense	471	748	1,138	1,537
Depreciation and amortization	2,485	1,444	3,997	2,813
Interest expense	155	121	295	218
Interest and dividend income	(63)	(58)	(120)	(119)
EBITDA	5,437	4,359	9,432	9,134

Add back loss on disposal of assets and dry whole related write-offs	–	–	520	–
EBITDA adjusted for one-off items	5,437	4,359	9,952	9,134
Including impact of West Qurna-2 project	1,017	–	1,017	–

EBITDA is a non-US GAAP financial measure. EBITDA is defined as net income before interest, taxes and depreciation and amortization. The Company believes that EBITDA provides useful information to investors because it is an indicator of the strength and performance of our business operations, including our ability to finance capital expenditures, acquisitions and other investments and our ability to incur and service debt. While depreciation and amortization are considered as operating costs under US GAAP, these expenses primarily represent the non-cash current period allocation of costs associated with long-lived assets acquired or constructed in prior periods. The EBITDA calculation is commonly used as a basis for some investors, analysts and credit rating agencies to evaluate and compare the periodic and future operating performance and value of companies within the oil and gas industry. EBITDA should not be considered in isolation as an alternative to net income, operating income or any other measure of performance under US GAAP. EBITDA does not include our need to replace our capital equipment over time.

Liquidity and capital resources

	1 st half of	
	2014	2013
	(millions of US dollars)	
Net cash provided by operating activities	7,562	7,678
Net cash used in investing activities	(6,928)	(10,008)
Net cash provided by financing activities	362	2,642

Operating activities

Our primary source of cash flow is funds generated from our operations. During the first half of 2014, cash generated from operations didn't change significantly, compared to the first half of 2013, and amounted to \$7,562 million.

Investing activities

In the first half of 2014, the amount of cash used in investing activities decreased by 30.8% largely against the background of significant spending on the acquisition of licenses and subsidiaries in the first half of 2013.

Our capital expenditures, including non-cash transactions, amounted to \$7,722 million, which was 10.7% higher than in the first half of 2013.

	2 nd quarter of		1 st half of	
	2014	2013	2014	2013
	(millions of US dollars)			
Capital expenditures, including non-cash transactions and prepayments				
Exploration and production				
Russia	2,467	2,045	4,440	3,919
International	978	873	1,730	1,536
Total exploration and production	3,445	2,918	6,170	5,455
Refining, marketing and distribution				
Russia	681	323	908	794
International	211	166	431	325
Total refining, marketing and distribution	892	489	1,339	1,119
Chemicals				
Russia	48	31	80	34
International	–	1	–	1
Total chemicals	48	32	80	35
Power generation and distribution	70	94	78	115
Other	35	94	55	249
Total capital expenditures	4,490	3,627	7,722	6,973

Capital expenditures in the exploration and production segment increased by \$715 million, or by 13.1%, compared to the first half of 2013. In Russia, the increase related to higher volumes and the cost of production drilling in the Ural region, the Komi Republic and Western Siberia was partially outweighed by the effect of ruble devaluation. Internationally, we increased expenditures in Shakh-Deniz project in Azerbaijan and commenced exploration activities at our new projects in Ghana and Romania.

The increase of capital expenditures in domestic refining, marketing and distribution segment was due to continuing construction of a vacuum gasoil refinery complex at the Volgograd refinery and construction of a heavy residue processing complex and a power generation facility at our refinery in Perm.

Other capital expenditures mostly refer to investments of OAO Arkhangelskgeoldobycha, a Group company, involved in diamond deposits development in the Arkhangelsk region of Russia. The decrease of the respective capital expenditures was due to fulfillment of the most stages of the capital investment program at the deposits.

The table below shows our exploration and production capital expenditures in promising new production regions.

	2 nd quarter of		1 st half of	
	2014	2013	2014	2013
	(millions of US dollars)			
Yamal	218	95	294	208
Caspian region ⁽¹⁾	473	434	708	878
Ghana	149	1	151	8
Cote d'Ivoire	2	29	82	36
Iraq	425	562	801	1,019
Uzbekistan	168	163	301	259
Romania	54	2	56	3
Total	1,489	1,286	2,393	2,411

⁽¹⁾ Russian and international projects.

Moreover, in the first half of 2013, a Group company paid \$835 million as a second 50% installment for the acquisition of the subsoil rights for the site that includes the Imilorskoye, West Imilorskoye and Istochnoye fields in Western Siberia. The first 50% payment was made in December 2012.

	2 nd quarter of		1 st half of	
	2014	2013	2014	2013
	(millions of US dollars)			
Acquisitions of subsidiaries and associates⁽¹⁾				
Exploration and production				
Russia	13	2,387	13	2,390
International	52	–	63	–
Total exploration and production	65	2,387	76	2,390
Refining, marketing and distribution				
Russia	(365)	69	(299)	73
International	10	–	36	–
Total refining, marketing and distribution	(355)	69	(263)	73
Less cash acquired	(34)	(15)	(34)	(15)
Total acquisitions	(324)	2,441	(221)	2,448

⁽¹⁾ Including prepayments related to acquisitions and non-cash transactions.

In the first half of 2014, the Group did not make any significant acquisitions. In the first half of 2013, the Company spent \$2.1 billion for the acquisition of 100% of the shares of ZAO Samara-nafta and \$266 million as the final installment within the acquisition of 50% of the shares of ZAO Kama-oil.

Moreover, in the second quarter of 2014, we received back an advance payment in amount of \$367 million, related to planned acquisition in “Refining, marketing and distribution” segment in Russia.

Financing activities

In the first half of 2014, net movements of short-term and long-term debt generated an inflow of \$438 million, compared to an inflow of \$2,721 million in the first half of 2013.

Overview of LUKOIL's Basic Business Risks and Uncertainties

LUKOIL's governing bodies pay great attention to risk management issues to provide a reasonable guarantee for the achievement of the set objectives under the conditions characterized by uncertainties and negative impact factors. LUKOIL is constantly identifying, describing, estimating and monitoring the possible events that may affect the Company's activities, and is elaborating measures to prevent them or mitigate their negative impact to the greatest extent possible if such events do take place.

The Company seeks to actively promote risk management and is presently focusing its efforts on the improvement of a general enterprise risk management system (ERM) based on the best international practices. The Company is constantly improving the applicable regulatory methodological risk management base that establishes requirements aimed at organizing the risk management process at all stages, and defines management standards for certain risk types of utmost importance, which are uniform for all of LUKOIL Group organizations. The Risk Committee, a dedicated body under the President of LUKOIL, was set up and began its work in 2011.

The information with regard to LUKOIL's key risks is presented below. If realized, any of the below risks may adversely affect the Company's business and, in the end, its cash flow and profit. LUKOIL is committed to make every effort to monitor and prevent such events. However, if such events do occur, LUKOIL will take measures to remedy the consequences as soon as possible and minimize loss to the Company.

Macroeconomic Risks

A potential drop in the global hydrocarbon prices, lower oil refining margin (underutilization of processing capacities, growing petroleum product export from the USA, the RF and the Middle East combined with the sinking demand), foreign exchange rate fluctuations, inflation processes and tax burden increase may adversely impact the Company's financial performance and its ability to implement its scheduled capital investment programs. Frequent changes in the tax legislation, customs regulations and other regulatory documents that govern the fiscal measures applied to the RF oil industry account for significant uncertainty.

Due to the existing uncertainty in the development outlooks of most of the developed countries, 2014 global GDP growth expectations are marked by a high level of uncertainty. Major 2014 risk factors include debt problems of certain EC members, a deeper budget recession in the USA and hampered economic growth in the developing countries. Should the global economic growth rate be curtailed, there will be a drop in the demand for major energy carriers, which may adversely affect the hydrocarbon prices on the global markets.

The aggravated situation in Ukraine may cause adverse macroeconomic and other consequences in some regions of our presence, including, but not limited to, an increase in the foreign exchange rate volatility and aggravated business conditions as a whole.

The disruption of Russia's reputation in the majority of the Company's areas of presence abroad may affect consumers' attitude towards the Company's brand, which in its turn may in the short term lead to decreased retail sales.

Considerable growth of oil supply due to the development of shale oil reserves in the USA, bituminous sands in Canada, deep offshore fields and conventional fields in the Middle East, as well as the embargo lift in Iran, increased production in Iraq, removal of crude oil export ban in the USA can result in a global oil price slump. Cheap gas feed stock in the USA and the Middle East could step up the pressure on the global oil prices. The arrangements reached on Syria and Iran will also result in oil price reduction.

The Company has been employing a scenario-based approach to forecast macroeconomic indicators, which enables it to do comprehensive analyses of how LUKOIL Group's operations may be affected by macroeconomic risks. One of them is defined as a base case scenario and is used to describe the most likely macroeconomic development trends in the view of the Company's management. The other ones are best case and worst case scenarios used to assess the potential effects of changes in the macroeconomic indices on the Company.

The base case scenario assumes zero or insignificant economic growth in the developed countries in the near-term outlook, moderate growth in energy consumption by developing nations, a slight price drop in the short-term, and a further moderate oil price growth.

The worst case scenario is based on an oil price forecast that is more conservative than the base case scenario, which would be due to slowly growing consumption of energy carriers caused by the

considerably slackened growth of the global economy and stepped-up development of the non-conventional reserves (shale gas, shale oil, high-viscosity oil, etc.).

The Company is fully committed to minimizing the potential effects resulting from the realization of macroeconomic risks. The application of the worst case scenario makes it possible to identify the assets and investment projects that are most vulnerable to macroeconomic changes and to make the necessary managerial decisions including those aimed at optimization of the Company's investment project portfolio.

Country Risks

Among other things, LUKOIL has operations in a number of countries with high political and economic risks. Should they be realized, such risks may significantly complicate the Company's business or even cause the Company to suspend its operations in a certain region. In particular, the Company has launched a number of projects in Iraq, Venezuela, Cote d'Ivoire, Ghana, Egypt, and Ukraine, where political risks are considered high. OAO LUKOIL and the Austrian investment company AMIC Energy Management GmbH signed an agreement in Vienna on August 11, 2014 to sell a 100% interest in CFI LUKOIL-Ukraine owning a network of around 240 filling stations and 6 tank farms. The transaction will be closed upon its approval by competent Ukrainian authorities.

In certain countries the Company's assets and personnel are exposed to terrorist threats.

The sources of political turmoil in the midterm above all include:

- Iran, whose conflict with the western states over its nuclear program may develop into a fully blown armed confrontation;
- Iraq, characterized by a destabilized social and political situation.

Most of the Company's assets are located in Russia, where political risks are viewed as moderate. When implementing projects with high political risks, the Company applies more stringent safety requirements.

The Company seeks to diversify its operations and alongside with its activities in unstable regions has been implementing projects in Europe and the US, whose regional and political risks are viewed as minimal.

Industry-Specific Risks

Risks Associated with Access to New Hydrocarbon Sources

Competition with major Russian and transnational companies for access to new hydrocarbon sources, limitations imposed by the RF with regard to offshore operations by private companies may result in the Company's inability to gain access to new, most promising hydrocarbon fields in the future. A consequence of this risk may be that of reduction of LUKOIL's proved reserves and, therefore, lower capitalization. In the business segment of Geological Exploration&Production, OAO LUKOIL competes both with Russian and the world's leading oil and gas companies.

This risk is taken into account while elaborating the Company's development strategy, where the key element is to ensure stable development by participating in strategic alliances, by turning down low-profit projects and assets and by penetrating new markets.

Logistics Risks

While transporting its products, LUKOIL in many respects depends on the transportation capacity of the following state-owned monopolies: AK Transneft, AK Transnefteprodukt, RZhD and also Gazprom in terms of transportation of the gas produced by the Company. The Company's dependence on state-owned monopolies with regard to transporting its products may result in a material adverse impact, including the following:

- losses associated with breakages, leaks and other failures of pipeline and railway system;
- unexpected growth of expenses associated with the need to urgently look for alternative methods for hydrocarbon delivery in case of limited access to the pipeline system, or, in the worst case scenario, inability to continue operations in certain regions;
- unexpected growth of expenses associated with soaring transportation rates.

The Company aims to cooperate with state monopolies and government authorities, to make long-term contracts with consumers and to keep its share of the sales markets efficient from the point of view of LUKOIL Group's tasks and objectives.

Over the past period, supply agreements were concluded with OAO Gazprom, Sibur, Gas Group and Sovkomflot. Cooperation agreements were also concluded with Rosneft, Rosatom, Siemens AG and Enel.

In addition, the Company intends to extend gas chemistry processing capacities, which will reduce logistic and competitive risks. To be specific, the Company intends to construct a gas processing complex in Budennovsk to work on associated and dry gas from the Northern Caspian fields and also to step up petroleum gas processing capacities at OOO LUKOIL-Permneftegazpererabotka.

Petroleum Products Risks

Possible introduction of product embargo may considerably limit the Company's exports of energy resources. Competition at the sales market of petroleum products is stepped up by such factors as the consolidation and slow-down of the RF market, the recession in the European countries. All this may result in a reduced sales margin.

Risks at the Natural Gas and Associated Petroleum Gas Markets

The key risk factor in the gas production segment is the monopoly status of Gazprom as the largest buyer on the market of natural gas produced by independent oil companies, as well as dry gas which is a by-product of associated petroleum gas processing.

The Company may face the following key risks in this segment:

- Gazprom may reduce the quotas for purchasing gas from independent producing companies, which may result in limitation of the Company's gas production or closedown of a number of projects;
- Gazprom may set a low monopoly purchase price for natural and associated petroleum gas sold by independent producing companies.

The Company is making every reasonable effort to mitigate these risks and, in particular, it aims to partner up with state monopolies, enter into long-term contracts with consumers and to retain its share of the petroleum product sales markets that is reasonable in view of LUKOIL Group's tasks and objectives.

Financial Risks

Price Risks

Hydrocarbon price fluctuations may significantly affect the Company's financial performance and value. In the short term, LUKOIL expects that energy prices will become more volatile due to the unstable supply/demand balance on the global market, complicated political situation in the Middle East and Ukraine, unclear economic prospects faced by the Eurozone, and other macroeconomic factors.

LUKOIL is constantly monitoring markets of oil and petroleum products to get a comprehensive picture of the market conditions and to have a reliable base to forecast market trends. The keys to mitigate short-term price risks include the management of materials/value balance (including the redirection of the marketed volumes of oil and petroleum products from less efficient to most efficient segments), use of effective price formulas in sales contracts and, where appropriate, abandonment of fixed prices in such contracts.

The changes in the price parameters at energy markets such as energy carrier tariffs set by regulatory authorities, changed prices in the energy and power wholesale markets may considerably affect the planned volume of profit.

The Company participates in the development of pricing and regulations in the wholesale electricity market via self-regulated organizations (NP Market Council and NP Power Generator Council), which helps it contain the profit drop.

Inflation Risks

The Company is exposed to the risk of cost escalation due to inflation in the short- and mid-term prospect. The impact of this risk is most strongly felt in the field of capital expenditures, which may jeopardize successful implementation of a number of investment projects.

The Company's major focus is on cost containment and on assessing this risk while developing investment projects and making investment decisions.

Interest Rate Risks

The Company is exposed to a significant interest rate risk both in the short- and long-term, and it is most sensitive to the volatility of the European countries' interest rates. Such volatility may affect the cost of funds borrowed by the Company as well as the size of LUKOIL's cash flows.

To mitigate this risk, the Company is constantly monitoring market conditions, taking measures to improve the debt structure by reaching an optimum balance between fixed and variable interest rates, controlling the need for additional financing and outstanding debt refinancing, extending the term of debt obligations.

Liquidity Risks

OAO LUKOIL's cash flows are subject to the following risk factors:

- rapid fluctuations of energy price;
- volume of energy demand;
- amount of taxes, duties and customs payments;
- Company's credit ratings;
- cost escalation.

Another risk against the background of the reduced cash flows is that of limited access to funding on the capital market.

The specified risks may affect the Company's liquidity.

LUKOIL Group's liquidity is managed on a centralized basis, but there's also an efficient global system in place to manage LUKOIL Group's liquidity, which includes an automated system of concentrating and re-distributing the funds, corporate dealing and also rolling cash-flow forecasts. The liquidity indicators are monitored on a continuous basis.

Currently, LUKOIL has investment ratings from all the three international rating agencies. Routine monitoring is conducted to ensure compliance of its financial indicators with the rating agencies' requirements. The sanctions imposed by the US and the EU against Russia in the first six months of 2014 due to the adverse developments in Ukraine have caused a drop of Russia's sovereign rating down to BBB- according to S&P and a subsequent drop of the Company's rating down to the same level (BBB-). The Company's ratings awarded by the other two agencies have remained unaltered: Moody's - Baa2; Fitch - BBB. Considering the direct interdependence between the Company's rating and the country's sovereign rating due to the fact that normally a company's rating cannot be higher than the sovereign rating of the country, the forecast for possible rating changes entirely depends on further political developments.

Foreign Exchange Risks

In the short- and mid-term, the Company is subject to foreign exchange risks since it operates in a number of countries. The exchange rate of the Russian ruble to the US dollar produces the greatest impact on transaction results, since the Company's export proceeds are denominated in dollars, while the major costs are incurred in Russia and are denominated in rubles.

As part of the centralized approach to management of the treasury operations and liquidity of LUKOIL Group, the risks associated with unfavorable changes in the exchange rates are generally consolidated at the corporate center level. In a number of cases currency risks at trading floors are minimized due to the financial-derivative operations conducted as part of the corporate dealing process. Moreover, to mitigate its foreign exchange risks, it has been granting loans to LUKOIL Group's entities, denominating the loans in local currencies as part of inter-group financing.

Credit Risks

The Company's most significant credit risks include first of all the risk of failure by its counterparties to perform their obligations in terms of payment for the products supplied by the Company.

In order to mitigate these risks, the Company focuses on partnerships with the counterparties that have high credit ratings, accepts letters of credit and guarantees issued by reputable banks, sometimes demands

prepayment for the products supplied. In addition, it utilizes tools to limit the credit risks of a given counterparty.

Another group of credit risks includes risks associated with contractor banks' activities and potential impairment of their financial stability. In order to mitigate these risks, the Company is involved in centralized treasury operations, part of which are aimed at fund raising, investment and operations involving currency exchange and financial derivatives. The credit ratings of contractor banks are monitored on a regular basis.

Legal Risks

Tax Risks

In line with the legislation on taxes and dues, in November of 2013 the Company submitted its first Notification on 2012 Controlled Transactions to the tax authorities. The Russian FTS may make a decision on tax inspection of the transaction prices specified in the Notification. Due to a great number of uncertainties in Section V.1 of the RF Tax Code and to the lack of the respective law enforcement practice, there are risks associated with:

- the likelihood that the Russian FTS may challenge the pricing methods used by the Company for taxation purposes;
- the procedure for the special inspection of the prices, including the scope and profoundness of the requested documents and information.

The above factors testify to the likelihood of possible claims, which in its turn may result in additional charges of the profit tax on the income (expenses) that arises in relation to the controlled transactions.

To eliminate the risk of the tax authorities challenging the Company's methods used to determine the price compliance with the market level, the Company has engaged outside consultants, i.e. international consulting companies with global practical experience in transfer-pricing legislation; a corporate information system, "Register of Controlled Transactions", has been commissioned and work is underway to conclude pricing agreements on 2013 transactions with the Russian FTS.

The risk of increased tax burden upon the Company is also growing due to the additional federal budget expenditures and the increased budget deficit in connection with the situation in Ukraine.

Risks of Currency Exchange/Export Regulation

The Company is party to the external economic relations; a portion of LUKOIL's assets and liabilities is denominated in a foreign currency and, consequently, the changes in the exchange/export control may affect the Company's activities.

Despite the fact that in recent years the state policy has been aimed at liberalization of the currency legislation, LUKOIL does not take off the option of more rigorous laws in the field of exchange/export control, given a global recession.

The Company is continuously monitoring the amendments to the applicable legislation of the Russian Federation, conducts systematic analysis and appraisal of the legislative initiatives and takes them into account while conducting business, which helps minimize the risks linked to possible legislative changes.

Risks of Customs Regulation

LUKOIL still has to consider the risk of more rigorous customs controls and customs duties (cancellation of the effective incentive rates for a number of fields), which may adversely impact the financial performance of LUKOIL Group and its organizations.

The Company is continuously monitoring amendments to the applicable RF legislation and takes them into account in its everyday activities, which helps minimize the risks associated with the above changes.

Risks Associated with Changes of the Russian legislation on Joint-Stock Companies and Securities Markets

Possible changes to the Russian regulatory acts in the area of corporate governance (particularly, the amendments to the first section of the RF Civil Code to come into effect from September 01, 2014), including those related to the structure and competences of the regulatory bodies of a joint-stock company, may lead to changes in the Company's corporate structure and corporate-governance procedures, which may have an adverse impact on the Company's decision-making process and performance.

The Company is constantly monitoring legislation changes in this field and participates in preliminary discussions on the proposed changes initiated by the professional community in order to provide detailed explanations as to OAO LUKOIL's attitude towards the risks and uncertainties associated with the new legislative initiatives.

The Company is taking measures to ensure the participation of its representatives in the activities focused on the development of efficient solutions in the area of practical application of the effective legislative innovations related to corporate governance and taxation.

Risks Associated with Circulation of the Company's Securities

The Company's securities circulate on regulated markets in Russia and abroad. Changes in the requirements to the issuers on the part of the regulatory authorities for securities and stock exchanges, as well as the changes in the listing structure, may induce the Company to amend its corporate-governance procedures and assume extra obligations as to information disclosure and shareholder relations. The Company's failure to ensure compliance with these requirements and fulfill the required obligations, may entail transfer of the Company's securities to lower listing segments, including delisting, which may have an adverse impact on the liquidity and cost of the securities.

The Company monitors changes in the listing rules and other requirements of stock exchanges and regulatory authorities to the issuers whose securities are allowed to circulate. The Company's representatives participate in the working meetings and other issuer events arranged by stock exchanges and other organizations that provide consulting and educational services to the issuers of the securities circulating on regulated markets. The Company also seeks to introduce the best global practice in corporate governance and shareholder relations.

Geological Risks

Risks of Exploratory Drilling/New Field Discoveries

The Company's business is exposed to the risk that while implementing new projects, and exploratory drilling, we might not discover any productive (commercially efficient) oil and gas reserves, and/or that the discovered reserves will be considerably below the initially expected level. In this event, the Company may have to incur additional expenses or even cease operations in a number of license areas.

OAO LUKOIL performs activities to manage this risk at the level sufficient for prompt risk response, i.e. it conducts additional seismic and geological exploration operations, processes seismic materials and improves the 3D field seismic observation techniques.

Risks Associated with Subsurface Use and Licensing

The effective Russian laws on subsurface use and licensing of exploration and production activities, as well as their practical application, expose oil companies to a number of risks. The most important are the following:

- risk of refusal to grant a right to subsurface use to a legal entity that discovered a field of federal significance or a field located in the subsurface area of federal significance;
- risk of refusal to accept bidding documents for participation in competitive sales/auctions from subsurface users of LUKOIL Group companies;
- risk of a lengthy term of approval of design documents for wildcat construction;
- risk of the emergence of conditions that prevent or substantially impede the performance of license agreements.

The Company is constantly monitoring changes in the legislation and in the field of subsurface use and licensing, forwarding proposals to update the applicable regulatory framework.

To ensure timely decision-making on participation of LUKOIL Group in the bidding procedures for subsoil use rights, OGPCs (oil and gas producing companies) create a list of sites associated with the Unallocated Subsoil Stock which are of interest to the Company. Permanent working groups have been established to develop the application documents to participate in the bidding procedures and re-register licenses. Moreover, the Company has a "Subsoil Use" information system in place, which makes it possible to monitor the existing subsoil-use practices, prepare reports and perform analyses. The Company seeks to closely cooperate with the regulating agencies in order to inform them in due course of possible

problems caused by changes in the laws and obtain prompt information for timely decisions with regard to subsurface use.

HSE risks

The Company is exposed to the risk of failure of technical equipment at hazardous production facilities, which may result in accidents, shutdown, harmful emissions, negative environmental impact, fire and occupational injuries, including those occurring as a result of offshore oil and gas field development. The said risk may result in unscheduled shutdowns of the production capacities and, consequently, failure to receive the expected level of operating income.

In order to mitigate these risks the Company has created and is successfully implementing an industrial safety system, including:

- use of corporate standards, including without limitation those governing environmental safety matters;
- corporate supervision over the condition of equipment and devices;
- dedicated training of experts;
- diagnostics (non-destructive inspection) and monitoring of equipment parameters;
- assessment of workplaces based on working conditions;
- repairs and timely replacement of equipment;
- building up a reserve for continuous preparedness of emergency-response teams and resources;
- other measures to minimize accident rates at LUKOIL's production facilities.

The LUKOIL industrial safety system provides for regular monitoring of the condition of process units, taking preventive measures to avoid production accidents. LUKOIL's industrial safety system has been certified to meet the requirements of ISO 14001 and OHSAS 18001.

Construction Risks

While implementing investment projects, the Company has to face both the risk of untimely commissioning of operational assets and the risk resulting from the increased costs associated with the implementation of the above projects.

The key factors of these risks are represented by planning errors, contractor activities, risks associated with the condition of infrastructure, as well as those resulting from limited access to technologies and introduction of product embargoes .

LUKOIL pays maximum attention to managing this risk by carefully preparing its projects, selecting reliable suppliers and contractors, and obtaining guarantees of performance from them, as well as by building partnerships with infrastructure operators (state-owned monopolies and bodies of power of the Russian Federation constituents).

Risk Associated with Lack of Qualified Personnel

The growing global deficit of specialists and general aging of employees in the oil and gas industry induce foreign companies to pay attention to the Russian labor market. This increases the risk of greater demand and better remuneration for such specialists in Russia. It may possibly result in increased labor and remuneration costs or the need to upgrade the production process in order to cut the number of service personnel. This may affect the Company's performance.

To mitigate the negative impact of the above risk, LUKOIL focuses on integrated development of the personnel potential. The Company has created and replenishes the personnel reserve consisting of the more experienced and promising employees; great attention is paid to the recruitment of young specialists and graduates.

Responsibility statement

I hereby confirm that to the best of my knowledge:

(a) the set of financial statements, which has been prepared in accordance with US GAAP, gives a true and fair view of the assets, liabilities, financial position and profit or loss of the undertakings included in the consolidation as a whole as required by the Disclosure and Transparency Rules ('DTR') 4.2.4R,

(b) the interim management report includes a fair review of the information required by DTR 4.2.7R, being an indication of the important events that have occurred during the first six months of the financial year and their impact on the set of financial statements, and a description of the principal risks and uncertainties for the remaining six months of the financial year,

(c) the interim management report includes a fair review of the information required by DTR 4.2.8R, being related parties transactions that have taken place in the first six months of the current financial year and that have materially affected the financial position and performance of the enterprise during that period, and any changes in the related parties transactions described in the last annual report that could do so.

G. S. Fedotov,
Member of OAO LUKOIL Management Committee,
Vice-President, Economics and Planning

August 27, 2014

This half-yearly report is also available at the Company's website at <http://www.lukoil.com>.