

## **Risks and uncertainties**

In our activity, we often confront a high level of market uncertainty, along with various risks that, in certain circumstances, could impact the results of our activity. We are constantly working on assessing and accounting for these uncertainties and risks in the course of our activity, taking into account the fact that their timely and accurate identification is of the utmost importance for implementing OAO “LUKOIL’s” (the Company) competitive strategy. We believe that such evaluation and accounting will promote not only the prevention of an unfavorable turn of events, but also allow us to take account of, and fully realize, possibilities that are favorable for the Company. These risks and uncertainties can be divided into the following main groups:

- sectorial and operational risks and uncertainties;
- country and regional risks and uncertainties;
- financial risks and uncertainties;
- legal risks and uncertainties;
- other risks and uncertainties.

Depending on the type of risks and uncertainties, the Company applies special measures to account for them, prevent them, mitigate their negative impact, or realize their possibilities. To ensure greater value for interested parties, this report describes the risks and uncertainties that are most urgent for the Company over the course of the coming six months and in the medium term.

Despite the fact that we have taken all measures to identify and describe the key risks and uncertainties encountered by the Company in its activity, the possibility does exist that we have failed to take into account certain risks and uncertainties or that they could arise due to an abrupt change of competitive conditions or the business environment.

## **Sectorial and operational risks and uncertainties**

### ***Risks and uncertainties connected with the price of oil, gas, oil products and petrochemical products***

The Company has active operations on the domestic and international markets as a seller of crude oil, natural gas, oil products, and petrochemical products.

The Company’s activity depends significantly on world energy prices. World prices for oil, gas, oil products, and petrochemical products are historically subject to significant fluctuations, which depend on a large number of factors:

- global economic conditions, as well as the economic and political situations in oil-producing regions;
- global supply and demand and (to a lesser degree) forecasts of future supply and demand for oil, gas, and oil products;
- the costs of exploration, development, extraction, refining and sale of oil, gas and oil products;
- the capabilities of OPEC and other oil-exporting countries to control global price levels;
- the cost and accessibility of alternative energy sources;
- the actions and resolutions of Russian and foreign state authorities, including in respect of taxation and regulation of exports and requirements on the quality of oil products and the level of harmful emissions;
- climatic conditions in Russia, where the Company produces the main part of its hydrocarbon resources, as well as in the countries that are the largest oil and gas consumers.

The Company cannot influence the factors that determine prices for oil, gas, oil products and petrochemical products. Despite the fact that energy prices have remained at a high level over the past

several years, there is a risk that they may fall in the medium and long terms. In the event of unfavorable price developments, the Company will reallocate its flows of goods, take measures to reduce current expenses, reevaluate its investment projects and accelerate the sale of inefficient assets. This will allow it to reduce the most negative effects from price-reduction and fulfill its obligations at a maximum level.

The Company is an international, vertically integrated company with a considerable level of sectorial and geographical diversification of its business, which significantly lowers the dependence of its financial results on the price volatility of oil, gas, oil products, and petrochemical products in comparison with undiversified companies with a single core activity thanks to the so-called “built-in” hedging effect.

Gas reserves in Russia comprise 82% of the Company’s total gas reserves, while gas production makes up 88% of its total gas production. OAO Gazprom is the primary buyer of the natural gas we produce in the Russian Federation. The sale of gas to domestic consumers is less profitable (due to the fact that prices on the domestic market are significantly lower than world prices) and is associated with the risk of a change in existing contractual relations with OAO Gazprom, as well as the risk of a change in OAO Gazprom’s tariff policy.

However, in connection with the liberalisation of the domestic market currently being enacted by the Russian government, a significant rise is expected in domestic prices, to a European level. Also, the Company is planning to significantly increase its reserves and its production of gas on foreign projects. This reduces price risks for the Company’s gas business.

The Federal Antimonopoly Service puts an ever-increasing pressure on the sales structures of the Company. As a result we conduct the policy of restraining retail prices. This may have a negative effect on our operating results. Restraining retail prices, however, does improve the Company’s image as a socially responsible company.

The Company is monitoring and forecasting price tendencies for various time horizons on the global and Russian oil & gas markets; this makes it possible to reduce uncertainty and increase the effectiveness of our operational and investment activity planning.

### ***Risks and uncertainties associated with the price of goods, work and services purchased***

Operating expenses are an important factor determining the company’s effectiveness in the oil & gas sector. The Company is facing a significant rise in its main expense categories:

- energy expenses, in connection with the growth of energy prices;
- the price of oil servicing, which is connected with a shortage in this market;
- salary expenses associated with the shortage of qualified workers and the gradual rise, to the level of Western Europe, of salary levels in countries in which the Company is active.

In Russia, inflation for expenses by oil companies is 15-20% (taking into account the rising exchange rate of the rouble against the dollar). The rise in expenses is one of the essential risks capable of influencing the financial results of the Company’s activity.

Despite the development of alternative capabilities for bringing oil and oil products to consumers (for example, through the construction of the Company’s own pipelines and ports), OAO “LUKOIL”, for transport, relies primarily on the mainline system of pipelines and railways of OAO AK Transneft, OAO AK Transnefteprodukt and OAO RZhD, tariffs and access to which are regulated by the state. As a result, there are risks associated with the possible restriction of the Company’s access to the pipeline and railway system. The state regulates access to export capacities and sets the principles for access, which has a direct effect on the Company’s ability to export oil and oil products.

As of today, there have been no serious interruptions in the transport of oil along OAO AK Transneft’s pipeline system; we have not sustained serious losses due to breakdowns or leaks in OAO AK Transneft’s pipeline system, and restrictions on access to OAO RZhD’s railway system have also not occurred.

Nevertheless, the Company constantly monitors the offers of suppliers, including suppliers of transportation services, and has a transparent procedure for holding tenders, which allows it to acquire the necessary materials and services at the best possible price. The Company uses its own sources of fuel and

energy in those cases when the internal production cost is lower than the price offered by independent suppliers. The Company conducts a regular analysis of all of its expense categories with the aim of optimizing them.

### ***Risks and uncertainties of investment projects***

In order to achieve the goals and tasks set out in the long-term Strategic Development Program, the Company is implementing a number of investment projects aimed at ensuring its stable long-term growth.

In implementing these projects, the Company is encountering a number of risks and uncertainties, among which the key ones are:

- possible delays in bringing new capacities on-line, associated with the shortage on the market of services from engineering and construction/installation organisations that has developed in recent years as a result of the implementation of a large number of projects in both the oil & gas and other industrial sectors and that, according to forecasts, will continue in the coming years;
- a significant increase in actual capital expenses compared to the initially planned level, which is associated with the strong price fluctuations in capital construction around the world in recent years.

These potential difficulties may hamper the implementation of our investment projects and, consequently, the financial results of our activity; they may also lead to a failure to fulfill our contractual obligations and to the necessity of making compensation payments, which would entail financial losses for us.

Work is constantly being done at the Company aimed at increasing the quality of our investment planning and the implementation of investment projects. In particular, a comprehensive risk analysis is conducted for each project under consideration, and strategies for managing identified risks are developed. These measures are taken for the purpose of putting together a portfolio of assets and projects that is optimal with regard to risk and profitability.

### ***Risks and uncertainties associated with competition***

The oil industry is distinguished by a high level of competition. The Company constantly competes with other Russian and international oil companies for the right to obtain licenses for specific deposits and access to export terminals, refining and sales capacities and sales markets for oil products. The Company may also encounter competition from suppliers of alternative energy sources, due to the continuing high prices for hydrocarbon raw materials and the possible future exhaustion of its reserves. The invention of new oil-refining technologies may require major investments in re-equipping facilities or the construction of new facilities.

### ***Environmental and technological risks and uncertainties***

Problems related to the greenhouse effect and climate change are becoming increasingly urgent for society as a whole. Activity associated with the extraction and refining of oil and gas has the potential to cause environmental harm; it is characterised by emissions of a significant amount of CO<sub>2</sub>, by the possibility of oil spills, and by other production-related disasters. A harshening of requirements on CO<sub>2</sub> and the necessity of liquidating possible production disasters may have a materially negative impact on our financial performance. Damage to the Company's reputation and the actions of state bodies could also indirectly affect our financial indicators in the event that such environmental risks are realized.

There is a risk that production in certain regions of our presence may not meet new environmental standards, which may require additional expenditures on the modernisation of production and, consequently, negatively affect the financial results of our activity.

The realisation of technological risks associated with the breakdown of production equipment may lead to a halt of production and a failure to reach established production and financial indicators.

In all business units of the Company the following Management Systems were implemented: Industrial Safety Management System, Labour and Environmental Safety Management System (all of them meet International Standards requirements). Regarding the main indicators of Industrial and Labour Safeties we are one of the best companies in Russian oil and gas industry and practically conforms with the level of the biggest international companies. Nevertheless, the Company invests heavily in insurance of its assets and third-part liability insurance. Thus, the level of insurance coverage of the Company's ecological risks amounts to \$ 15 billions.

### ***Risk of a shortage of qualified personnel***

The growing global shortage of specialists and the overall aging of workers in the oil & gas industry are forcing foreign companies to turn their attention to the Russian labour market. This increases the risk of inflation of demand and of a sharp rise in the salary of such specialists in Russia and, consequently, a rise in expenses on wages or the necessity of modernizing production with the aim of reducing service personnel, all of which could have a negative impact on the financial results of the Company's activity.

In order to minimize this risk, the Company is actively developing its internal personnel reserves, implementing integrated social programs for its employees and members of their families, and investing in the development of Russian educational institutions in the oil & gas sphere.

### **Country and regional risks**

We perform our operations in Russia and in a number of foreign countries. The Group carries out its primary activity on the extraction and refinement of oil within Russia. Despite the fact that positive changes in all social spheres have taken place in Russia in recent years – the economy has grown confidently, political stability has been achieved and successful economic reforms have been enacted – Russia remains a state with a developing political, economic and financial systems. Activity in Russia on the extraction and processing of oil and gas is connected with a number of risks.

### **Risks associated with the activity in the Russian Federation:**

#### *Political risks*

The specific features of Russia's political system are interconnected with its relatively brief period of existence and insufficient stability, which bears the following risks for the Company:

- the possibility of a change in the foreign or domestic political course by the country's leadership, which may significantly impact the investment appeal of the country as a whole, and of the Company in particular, and limit our capability to attract financing;
- the likelihood of a negative change in legislation, including tax legislation, aimed at maximizing the state budget income received from the raw materials sectors of industry;
- in the process of the reform of government bodies, various ministries and agencies regulating the Company's activity may be abolished or created, which could lead to a failure to approve, or delays in the approval of regulatory documents that impact the Company's activity;
- the possibility of conflicts between federal authorities and constituent territories of the Russian Federation;
- terrorist and crime-related risks.

#### *Economic risks*

Our activity in Russia is fraught with significant economic risks related to the specific features of Russia's current economy:

- the underdevelopment and weakness of the Russian financial system may worsen credit conditions for the Company (for more detail on financial risks, read further);
- Russia's economy is weakly diversified and depends significantly on global prices for raw materials. A significant and prolonged drop in global prices for raw materials could lead to a drop in profit for raw materials companies and, further, to an economic downturn for the entire Russian economy;
- the obsolete infrastructure of the Russian economy, which does not satisfy current requirements, exerts a considerable negative impact on the Company's capabilities for developing its oil producing and oil refining business.

In order to minimize its economic and financial risks, the Company is trying to diversify the sources of financing for its activity, attracting resources on both Russian and international financial markets; it is also expanding the geography of its activity and the selection of products it produces.

**Risks associated with activity in foreign countries:**

Risks associated with the Company's activity in foreign countries vary considerably depending on the country. One might point out the following main risk groups by country.

*Countries that were formed on the territory of the former USSR: Ukraine, Belarus, Moldova, Kazakhstan, Georgia, Azerbaijan, Uzbekistan, Estonia, Latvia, Lithuania*

The Company's risks in these countries are, at present, comparable with the risks associated with activity in Russia. Among the key risks in these countries, the following can be identified:

- the risk of the ineffectiveness of government policy;
- the risk of a change in the legislative system;
- the risk of political instability;
- the risk connected with the condition of infrastructure.

*Countries of Eastern Europe (Bulgaria, Romania, Hungary, Poland, Serbia, Macedonia, Slovakia, the Czech Republic, and Montenegro)*

The process of transition, conditioned, inter alia, by the entry of a number of these countries into the EU, carries with it significant risks connected with a change in legislation in these countries and also a change in the rules of trade between Russia and these countries. There is a risk of a rise in operating expenses connected with the minimum wage, in accordance with EU requirements. There is also a risk of intervention by state authorities in price formation for oil products. The entry of these countries in the EU also brings with it a risk that more stringent environmental demands will be made of producers in these countries, in accordance with EU standards.

*Other countries (Egypt, Iran, Iraq, Saudi Arabia, Colombia, Venezuela, Cote d'Ivoire, Ghana).*

Operations in these countries are exposed to the following risks:

- the possibility of political instability, as well as the reconsideration of contractual obligations by the leadership of these countries;
- the possibility of the suspension or termination of the Company's operations in these countries due to the introduction of international sanctions or in the event of military action;
- the existence of a terrorist threat against both our assets and employees.

## **Financial risks**

### ***Risks associated with the banking system***

The systemic crisis on world financial markets may have a negative effect on the Company's ability to work with traditional international banks and may also negatively affect the Company's business, financial position and business performance.

The Russian banking system remains immature and crisis-prone. The majority of Russian banks do not meet international banking standards, while the transparency of the Russian banking sector lags far behind international norms. The Company is forced to conduct banking operations with a limited number of solvent Russian banks.

The consequences of the emerging world financial crisis, which began in July 2007, have a material impact on the ability of both Russian and international banks to refinance their obligations and maintain the required level of liquidity.

The Company faces inflation and currency risks, as well as interest-rate and credit risks, all of which may have a negative effect on its performance.

### ***Inflation risks***

The Company encounters inflation risks which could have a negative effect on its operating performance. Acceleration of inflation rates has a negative effect on the Company's financial performance. However, the existing and forecast inflation levels are far from critical for the industry and the Company. The Company monitors the ramifications of a growth in inflation, and looks for possibilities to cut costs in order to mitigate the effect of this risk factor.

### ***Currency risks***

The Company is exposed to risks of unfavourable changes in exchange rates; this relates mainly to the strengthening of the rouble against the US dollar and the weakening of the US dollar against the euro. The reason for this is that a significant share of our income is denominated in US dollars or is tied to a certain degree to oil prices in US dollars, while the majority of our expenses in Russia are denominated in roubles and part of our expenses abroad are denominated in euro. Thus, the real appreciation of the rouble against the US dollar and the real depreciation of the US dollar against the euro leads to an increase in our costs in US dollar terms.

However, the Company's income from the sale of oil, gas, oil products and petrochemical products on the domestic Russian market are denominated in roubles and on a number of foreign markets in euros. This reduces the negative effect from the possible appreciation of the rouble against the US dollar and the depreciation of the US dollar against the euro. In addition, the currency structure of the Company's debt broadly reflects the structure of its income, which also reduces its sensitivity to exchange-rate fluctuations.

The Company monitors the potential impact of unfavourable changes in currency exchange rates on the Company's performance results, and if unfavourable changes are expected currency risks can be hedged, including through the use of "built in" hedging.

### ***Interest rate risks***

The Company is a major borrower on both the international and domestic capital markets. The Company requires these borrowings to finance its current operations and its investment projects.

The international debt market is the main source of borrowings, which is why the Company is sensitive to changes in the market value of resources on international trading floors and the actual cost of refinancing of major international banks. In view of the significant growth trend in the cost of resources on financial markets due to the current banking crisis and the emerging trend towards a growth in expenses on servicing of loans, the Company believes that there is a good chance that the cost of outside financing will continue to grow across the board.

On the other hand, our growing creditworthiness, which is reflected in the improvement in our credit ratings over recent years and the growth in the creditworthiness of Russia are important factors in decreasing our future borrowing costs.

Nevertheless, the Company will take the following actions to mitigate the consequences of a negative impact of changes in interest rates:

- optimisation of the loan portfolio to account for changing market indicators;
- increase in the share of fixed-rate instruments to a level that is acceptable for the Company;
- expansion of the group of partner banks, especially among the institutions that were least affected by the current global financial crisis;
- more extensive use of trade financing instruments (letters of credit, guarantees), which will make it possible to reduce dependence on base interest rates and the increasing cost of funding of international banks.

### ***Risks associated with the use of financial instruments***

The Company's use of derivatives is limited to participation in certain commercial transactions with oil products and hedging of price risks outside its main line of business on the physical delivery of oil and oil products. At present this activity includes futures and swap contracts, as well as sale contracts that can be classified as derivatives. We maintain a system of control over this activity, which includes authorisation procedures, keeping of accounts and monitoring of transactions with derivatives.

### ***Liquidity and cash flow risk***

Our cash flows are exposed to many factors. On the one hand, the growth in prices for energy resources facilitates the growth in our revenue, but on the other hand the export customs duties on oil and oil products, which are tied to the cost of Urals oil, increases our tax expenses. The combination of rouble appreciation and inflation costs (which are denominated primarily in roubles) and the need to increase capital expenses to support production and ensure sustained growth decrease our free operating cash flow.

Our stable financial position is confirmed by our high corporate credit ratings from the three leading rating agencies: Moody's (Baa2), S&P (BBB-) and Fitch (BBB-), which enhances our ability to receive loans and the lending terms on international financial markets.

The Company's good liquidity indicators and ability to raise funds on both the Russian and international financial markets reduces the Company's liquidity risk.

### ***Credit risks***

The Company is exposed to risks that counterparties will not discharge their obligations to pay for the goods delivered. In order to reduce credit risks, the Company tries to work with counterparties that have a high credit rating; in addition, there are restrictions on the maximum risk per counterparty. The Company forms doubtful debt provisions based on the likelihood that accounts receivable will not be paid. To reduce credit risks, letters of credit and guarantees from reputable banks and sureties are used and in a number of cases the Company requires advance payment for products to be delivered.

## **Legal risks and uncertainties**

### ***Risks and uncertainties associated with changes in currency regulation***

The Company is a party to foreign trade relations, and part of our assets and liabilities are denominated in a foreign currency; accordingly, a change in currency regulation could have an effect on the Company's performance results.

However, we believe that the emerging trend towards a liberalisation of currency regulation reduces the risk of the appearance of negative consequences for the Company related to subsequent changes in currency legislation.

### ***Risks and uncertainties associated with changes in the rules on customs control and duties***

The Company is exposed to risks associated with changes in the rules on customs control and duties. In particular, a possible increase in export customs duties on oil and oil products could have a negative effect on the Company's financial performance. The Company constantly monitors changes in effective Russian legislation and takes them into account in its activity, which allows it to minimise the risks associated with these changes.

### ***Risks and uncertainties associated with legislation on the subsoil***

There are the following risks: the risk of introduction of possible restrictions on participation in tenders and auctions to obtain subsoil usage rights and the risk of a possible change in requirements on

licensing subsoil use as well as a possible increase in the number of cases when licenses are terminated or suspended.

Our licenses could be suspended or recalled prior to their expiration date in connection with a possible violation of licensing terms, late payment, or for other reasons. This may have a negative effect on the Company's operations and the value of its assets.

The Company continuously analyses and assesses the legislative initiatives of the relevant ministries and departments on the subsoil and licensing of certain types of activity, and takes these initiatives into account in its activity, which allows it to minimise the risks associated with possible changes in legislation.

We believe that the legal risks associated with a change in requirements on licensing of our main line of business will not have a critical impact on our financial performance, since we have all the necessary funds and equipment, perform our operations in compliance with effective Russian legislative norms, ensure adherence with requirements and take all possible measures to comply with industrial safety standards based on the provisions of Russian legislation on the operation of especially dangerous production facilities, and industrial and occupational safety requirements.

### ***Risks and uncertainties associated with changes in tax legislation***

The Company's operations are taxable in various jurisdictions both inside the Russian Federation and abroad. The Company pays a number of taxes established in accordance with the requirements of each jurisdiction. Most of the Company's income is taxable in Russia.

Russian tax legislation has not existed as long as that of countries with a more developed market economy and therefore it is not uncommon that the state's application of tax legislation is unclear or contradictory. This leads to the existence of more substantial tax risks in Russia than in any country with a more mature tax system. The Russian tax system is currently undergoing reforms. If new types of taxes are introduced or if changes are made to the procedures for paying existing taxes, the Company may be forced to pay higher taxes, which may have a negative effect on its operations.

The tax planning and control measures we use are based on our understanding of the tax legislation in effect at the time of performance of these measures. We are subjected to regular audits by the tax authorities, which is a common occurrence in Russia. In some cases the authorities attempt to charge us significant additional taxes. We believe that we duly perform our tax obligations, based on our understanding of effective tax legislation. However, the relevant authorities may have differing interpretations of the provisions of effective tax legislation and the effects could be significant.

The Company constantly monitors changes to tax legislation, assesses and forecasts their possible impact on its operations and takes them into account in its activity.

### ***Risks of non-compliance with capital market requirements***

We are a public company. Our securities are listed on Russian and foreign stock exchanges. As a result, we must adhere to a significant number of regulatory requirements on the Russian and foreign capital markets. There is a risk that OAO "LUKOIL" will be unable to meet certain capital market requirements, which would lead to sanctions on the part of the regulatory bodies. Despite the fact that, according to our estimates, the amount of these sanctions would not be critical to our financial results, it could have a negative effect on our reputation and the value of our securities. In order to mitigate this risk, we actively cooperate with the regulatory bodies and use the services of professional consultants to interpret certain provisions of regulatory acts.

### **Other risks**

If the Company's organisations are unable to discover and develop additional hydrocarbon reserves, the level of reserves and volume of production may decrease from current indicators, which would have a negative effect on the Company's operating performance and financial position.

Information on the Company's reserves consists of estimated data and depends on a number of variables and assumptions. The actual output of deposits, the profitability of production, and development costs may differ from estimates, and these differences may be material.

If the Company is unable to successfully integrate newly acquired organisations, this may slow rates of growth and cause harm to its operations and financial position.

In certain cases, the provisions of Russian law may hold the Company liable for the obligations of its subsidiaries.

There are risks of direct or indirect losses from improper or unsound internal processes, employee actions and management systems (operating risks).

Our organisations are involved in a number of court cases that relate to the Company's operations. Despite the fact that these court cases have the potential to cause significant losses for the Company, there are currently no grounds to believe that their end result will have a material effect on the Company's performance results.

### **Risk management procedures**

Key business processes have been singled out for risk management purposes at the Company, and modern risk management techniques have been integrated into these processes.

The Company performs systematic monitoring of possible risk events during the performance of current operations and investment projects. Various means of reacting to risks are used:

- risk avoidance – rejection of a risky project;
- risk mitigation – preventative measures to either fully eliminate risk or to reduce potential losses and the likelihood of their occurrence;
- risk transfer – hedging, insurance, sureties, guarantees, involvement of partners in the project, reduction of the Company's share in a project;
- risk retention – creation of a financial reserve to cover insignificant losses of equity.

A centralised risk management system has been implemented at a number of major Company subsidiaries which covers all business processes and functional areas of the subsidiary's activity, making effective risk management possible and minimising the impact of risks on the subsidiary's performance results.

The effective centralised cash management system used by the Company's treasury makes it possible to minimise liquidity risks.

There is a Company division which manages and coordinates risk management process centrally. A corporate-wide risk management system at the Company is currently being developed.

The goal of these measures is to prevent or reduce the possible damage from identified risks, in order to increase the Company's capitalisation, improve its credit rating, increase the effectiveness of trade activity and hedging, ensure the optimal use of capital based on the ratio of risk and return and meet the requirements of the regulatory bodies on disclosure of the relevant information.