

ОАО АК ТРАНСНЕФТ

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

FOR THE NINE MONTHS ENDED 30 SEPTEMBER 2012





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

Key financial and operating results

	Nine months ended 30 September 2012	Nine months ended 30 September 2011	Change, %
Revenue, mln. RUB	548,314	493,223	11.2
Profit for the period, mln. RUB	142,993	155,465	(8,0)
EBITDA, mln. RUB	246,826	221,885	11.2
EBITDA margin, %*	57.3	57.2	x
Oil delivered to consignees, mln. tons	360.0	351.9	2.3
including			
Russian oil refineries, mln. tons	179.5	174.7	2.7
transshipment into the CPC-R system, mln. tons	0.3	1.3	(76.9)
exports to FSU countries, mln. tons	21.2	22.1	(4.1)
exports to ROW, mln. Tons	159.0	153.9	3.3
Oil products delivered to consignees, mln. tons	20.6	23.3	(11.6)
including:			
Russia's domestic market, mln. tons	6.8	6.7	1.5
exports to the Customs Union member countries, mln.	1.9	1.6	18.8
exports to ROW, mln. Tons	11.9	14.9	(20.1)

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

The Group's profit for the nine months ended 30 September 2012 amounted to RUB 143.0 bn which is RUB 16.5 bn or 13.1% higher than for the nine months ended 30 September 2011 which amounted to RUB 126.5 bn excluding gain from disposal of the Group's share in OOO Primorsk Trade Port in the amount of RUB 29 bn.

Furthermore, the profit for the nine months ended 30 September 2012 contains net foreign currency exchange gain amounting to RUB 8.0 bn (as for the nine months ended 30 September 2011 - RUB 2.8 bn), net interest expense amounting to RUB 13.6 bn (RUB 8.6 bn – for the nine months ended 30 September 2011). Should these factors be excluded the profit for the nine months ended 30 September 2012 would amount to RUB 148.6 bn (for the nine months ended 30 September 2011 – RUB 132.3 bn) showing an increase of RUB 16.3 bn or 12.3%.



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

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

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

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

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

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

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

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

The Group is a natural monopoly and, as at 30 September 2012, it possesses an extensive network of trunk oil pipelines with a total length of approximately 52 thousand km and trunk oil products pipelines with a total length of some 19 thousand km.

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

OAO AK Transneft's key competitive advantages include:

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



1.1. Key investment projects

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

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

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

1.2. Changes in the Group's investments

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

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

1.3. Environmental policy

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

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

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



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

2.1. Oil and oil products transportation tariffs

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

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

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

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

- Order of the FST of Russia of 31.08.2011 No. 202-e/2 Concerning the Setting of Fees for the Services of OAO AK Transneft for Transportation of Oil via the Trunk Pipeline System;
- Order of the FST of Russia of 29.07.2011 No. 183-e/1 Concerning the Setting of Fees for the Services of OAO AK Transneft for Transportation of Oil along the Klin-Andreapol' Route;
- Order of the FST of Russia of 29.03.2011 No. 55-e/3 Concerning the Setting of Fee Rates for OAO AK Transneft's Oil Loading Services;
- Order of the FST of Russia of 01.02.2011 No. 12-e/7 Concerning the Setting of a Fee for the Services of OAO AK Transneft for Transportation of Oil along the Makhachkala–NB Sheskharis Route;
- Order of the FST of Russia of 30.12.2010 No. 496-e/1 Concerning the Setting of Fees for the Services of OAO AK Transneft for Transportation of Transit Oil via the Trunk Pipeline System;
- Order of the FST of Russia of 26.11.2010 No. 336-e/2 Concerning the Setting of a Long-Term Fee Rate for the Services of OAO AK Transneft for Transportation of Oil along the LPDS Starolikeevo–Ryazan Oil Refinery Route of the Trunk Pipeline System for OAO TNK-BP Holding;
- Order of the FST of Russia of 29.07.2010 No. 172-e/6 Concerning the Setting of a Fee for the Services of OAO AK Transneft for Transportation of Oil via the Tikhoretsk–Tuapse Oil Refinery Pipeline Section for OAO NK Rosneft;
- Order of the FST of Russia of 29.07.2010 No. 167-e/1 Concerning the Setting of Fees for the Services of OAO AK Transneft for Transportation of Oil via the Trunk Pipeline System;
- Order of the FST of Russia of 24.11.2009 No. 324-e/4 Concerning the Setting of a Fee Rate for Oil Loading Services at the PNN Skovorodino of OAO AK Transneft's Trunk Pipeline System;
- Order of the FST of Russia of 22.12.2009 No. 455-t/1 Concerning the Setting of Fees for Sea Port Services Provided to OOO Specialized Oil Loading Sea Port Kozmino;
- Order of the FST of Russia of 05.08.2008 No. 129-e/3 Concerning the Approval of Fees for Oil Loading Services at the LPDS Krotovka of OAO AK Transneft's Trunk Pipeline System for OAO TNK-BP Holding;
- Order of the FST of Russia of 29.12.2011 No. 448-e/1 Concerning the Setting of Fees for the Services of OAO AK Transneft for Transportation of Oil via the Trunk Pipeline System;
- Order of the FST of Russia of 28.02.2012 No. 15-e/1 Concerning the Setting of Fees for the Services of OAO AK Transneft for Transportation of Oil at the Oil Base Ust-Luga and the Inclusion of Amendments to the Order of the FST of Russia of 31.08.2011 No. 202-e/2;
- Order of the FST of Russia of 27.04.2012 No. 72-e/2 Concerning the Setting of Fees for the Services of OAO AK Transneft for Transportation of Oil along the Klin-Andreapol' Route;
- Order of the FST of Russia of 31.08.2012 No. 208 –e/1 Concerning the Setting of Fees for the Services of OAO AK Transneft for Transportation of Oil via the Trunk Pipeline System and the Inclusion of Amendments to the Order of the FST of Russia of 31.08.2011 No. 202-e/2;
- Order of the FST of Russia of 27.09.2012 No. 226-e/3 Concerning the Setting of Fees for the Services of OAO AK Transneft for Transportation of Oil via the Trunk Pipeline System

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



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- Order of the FST of Russia of 24.12.2010 No. 471-e/1 Concerning the Setting of Fees for the Services of OAO AK Transneft and its Affiliated Entities for Transportation of oil products via the Trunk Pipeline System;
- Order of the FST of Russia of 24.12.2010 No. 472-e/2 Concerning the Inclusion of Amendments to the Order of the FST of Russia of 23.09.2010 No. 234-e/2 Concerning Fee Rates for the Services of OOO BalttransService for Transportation of oil products from the Trunk Pipeline System in the Primorsk Commercial Seaport;
- Order of the FST of Russia of 15.02.2011 No. 23-e/3 Concerning the Setting of Fees for the Services of OAO AK Transneft and its Affiliated Entities for Transportation of Oil products via the Trunk Pipeline System, and the Inclusion of Amendments to the Order of the FST of Russia of 24.12.2010 No. 471-e/1;
- Order of the FST of Russia of 03.07.2012 No. 165-e/3 Concerning the Inclusion of Amendments to the Order of the FST of Russia of 24.12.2010 No. 471-e/1 Concerning the Setting of Fees for the Services of OAO AK Transneft and its Affiliated Entities for Transportation of oil products via the Trunk Pipeline System;

During 2011 and nine months ended 30 September 2012, oil transportation tariff rates increased:

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

2.2. Oil mining and oil products refining volumes

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

	Nine months ended 30 September 2012	Nine months ended 30 September 2011	Change, %
Oil mining volume in the Russian Federation, mln tons	386.6	381.4	1.4
Oil products refining volume in the Russian Federation, mln tons	143.0	141.5	1.0

As a result of growth during the nine months ended 30 September 2012 in oil mining volume in the Russian Federation by 5.2 mln tons, or 1.4%, the Group's oil transportation turnover and the Group's revenue from oil transportation services increased (ref. to subparagraph 3.1.1.).

Despite the growth in oil products refining during the nine months ended 30 September 2012 in the Russian Federation by 1.5 mln tons or 1.0%, oil products transportation turnover decreased (ref. to subparagraph 3.1.1.).

2.3. The rouble's exchange rate against foreign currencies

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

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

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

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

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



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	Nine months ended 30 September 2012	Nine months ended 30 September 2011	Change, %
Change in the rouble's exchange rate against the US dollar, %	(3.97)	4.59	x
Average exchange rate for the period (roubles per US dollar)	31.0984	28.7664	8.1
Exchange rate at the end of the period (roubles per US dollar)	30.9169	31.8751	(3.0)

2.4. Inflation rates

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

	Nine months ended 30 September 2012	Nine months ended 30 September 2011	Change, pp
Rouble inflation (CPI), %	5.2	4.7	0.5

2.5. Taxation

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

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

	Nine months ended 30 September 2012	Nine months ended 30 September 2011	Change, %
Income tax	42,595	34,445	23.6
Property tax	3,353	3,024	11.0
Other taxes and levies	669	616	30.1

Income tax

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

Property tax

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

Other taxes and levies

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



3. Analysis of the Group's performance

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

	Nine months ended 30 September 2012	Nine months ended 30 September 2011	Absolute Change, 2012-2011	Change, %
Revenue				
Revenue from oil transportation services	369,668	334,406	35,262	10.5
Revenue from crude oil sales	126,893	112,359	14,534	12.9
Other revenue	51,753	46,458	5,295	11.4
Operating expenses	(362,621)	(329,265)	(33,356)	10.1
Operating profit	185,693	163,958	21,735	13.3
Exchange gains	110,116	82,323	27,793	33.8
Exchange losses	(102,131)	(79,578)	(22,553)	28.3
Interest income	8,159	7,854	305	3.9
Interest expense	(21,807)	(16,431)	(5,376)	32.7
Net change in fair value of derivatives	1	-	1	x
Share of profit from associates and jointly controlled entities	2,870	30,731	(27,861)	(90.7)
Profit before income tax	182,901	188,857	(5,956)	(3.2)
Current income tax	(42,655)	(34,991)	(7,664)	21.9
Deferred income tax	2,747	1,599	1,148	71.8
Income tax expense	(39,908)	(33,392)	(6,516)	19.5
Profit for the period	142,993	155,465	(12,472)	(8.0)
Other comprehensive (loss)/ income after tax	(60)	(34)	(26)	76.5
Total comprehensive income	142,933	155,431	(12,498)	(8.0)
Profit attributable to:				
Shareholders of OAO AK Transneft	140,776	153,015	(12,239)	(8.0)
Non-controlling interests	2,217	2,450	(233)	(9.5)
Total comprehensive income attributable to:				
Shareholders of OAO AK Transneft	140,716	152,981	(12,265)	(8.0)
Non-controlling interests	2,217	2,450	(233)	(9.5)



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3.1. Revenue

Revenue By Type Of Operations	Nine months ended 30 September 2012	Share Of Total Revenue, %	Nine months ended 30 September 2011	Share Of Total Revenue, %	Absolute Change, 2012-2011	Change, %
Revenue from crude oil transportation services	369,668	67.4	334,406	67.8	35,262	10.5
Exports and sales in international markets, except the CIS	194,740	35.5	175,646	35.6	19,095	10.9
Exports and sales in the CIS	11,707	2.1	10,417	2.1	1,289	12.4
Domestic sales	163,221	29.8	148,343	30.1	14,878	10.0
Revenue from oil products transportation services	24,056	4.4	24,752	5.0	(696)	(2.8)
Revenue from oil compounding services	4,667	0.9	3,545	0.7	1,122	31.7
Other revenue	11,850	2.2	9,168	1.9	2,682	29.3
Total revenue (less revenue from sales of crude oil and oil products)	410,241	74.9	371,871	75.4	38,370	10.3
Revenue from export sales of crude oil	117,516	21.4	105,227	21.3	12,289	11.7
Revenue from sales of crude oil in the domestic market	9,377	1.7	7,132	1.5	2,245	31.5
Revenue from sales of oil products	11,180	2.0	8,993	1.8	2,187	24.3
Total revenue	548,314	100.0	493,223	100.0	55,091	11.2

During the nine months ended 30 September 2012, the Group's revenue increased by RUB 55,091 mln, or 11.2%, attributable mainly to an increase in revenue from of oil transportation services and revenue from sales of crude oil and oil products, including oil sales to China National United Oil Corporation. Without taking into account crude oil sales and oil products sales, revenue for the nine months ended 30 September 2012, amounted to RUB 410,241 mln, which is RUB 38,370 mln, or 10.3%, higher than for the nine months ended 30 September 2011.

3.1.1. Oil and oil products transportation services

An increase in revenue from oil transportation services by RUB 35,262 mln, or 10.5%, was driven by the following factors:

- growth in oil transportation tariffs (paragraph 2.1);
- growth in turnover by 1.4% (846,118.9 mln tons x km for the nine months ended 30 September 2012; 834,034.5 mln tons x km for the nine months ended 30 September 2011).



A decrease in revenue from oil products transportation services by 2.8% was driven by the decrease in the oil products transportation turnover by 14.4% (for the nine months ended 30 September 2012 – 25,057.111 mln tons x km; and 29,264.182 mln tons x km in the nine months ended 30 September 2011) due to restriction of turnover of fuel from a mass fraction of sulfur more than 500 mg / kg (Government Decree on 07.09.2011 № 748).

3.1.2. Revenue from sales of crude oil and oil products

An increase in revenue from sales of crude oil in the domestic market by RUB 2,245 mln, or 31.5%, was driven by a decrease in volume of crude oil sold by the Group.

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

Growth in revenue from sales of marketable oil products for the nine months ended 30 September 2012 by RUB 2,187 mln, or by 24.3%, was driven by growth in volumes of marketable oil products sales by the Group's companies.

3.1.3. Revenue from oil compounding services

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

- growth in oil compounding volumes by 3.3% (34,959.86 thousand tons for the nine months ended 30 September 2012; 33,850.94 thousand tons for the nine months ended 30 September 2011), and
- growth in oil compounding specific revenue by 27.7% (RUB 133.50 per ton for the nine months ended 30 September 2012; RUB 104.56 per ton* for the nine months ended 30 September 2011).

3.1.4. Other revenue

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

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



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3.2. Operating expenses

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

Operating expense line items	Nine months ended 30 September 2012	Share of total expenses, %	Nine months ended 30 September 2011	Share of total expenses, %	Absolute change, 2012-2011	Change, %
Staff costs	78,568	21.7	66,432	20.2	12,136	18.3
Energy	23,503	6.5	25,726	7.8	(2,223)	(8.6)
Transportation of oil using railways	23,686	6.5	22,352	6.8	1,334	6.0
Materials	12,687	3.5	12,040	3.7	647	5.4
Repairs services and maintenance of relevant technical condition of pipeline	9,328	2.6	7,885	2.4	1,443	18.3
Insurance expenses	4,375	1.2	3,056	0.9	1,319	43.2
Taxes (except income tax)	3,768	1.0	3,436	1.0	332	9.7
Other operating expenses	8,341	2.3	10,764	3.3	(2,423)	(22.5)
Total operating expenses (net of D&A and cost of crude oil and oil products sold)	164,256	45.3	151,691	46.1	12,565	8.3
Depreciation and amortization	61,133	16.9	57,927	17.6	3,206	5.5
Cost of export crude oil sales (including export custom duties)	117,852	32.5	104,916	31.9	12,936	12.3
Cost of crude oil sold in the domestic market	8,790	2.4	6,368	1.9	2,422	38.0
Cost of oil products sold	10,590	2.9	8,363	2.5	2,227	26.6
Total operating expenses	362,621	100.0	329,265	100.0	33,356	10.1

For the nine months ended 30 September 2012, compared to the nine months ended 30 September 2011, the amount of operating expenses (less depreciation and amortization and cost of crude oil and oil products sold) increased by RUB 12,565 mln, or 8.3%, while total operating expenses increased by RUB 33,356 mln, or 10.1%.

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

- growth in cost of crude oil sold by RUB 12,936 mln, attributable to oil supplies to the People's Republic of China effective January 1, 2011, under a crude supply contract (ref. paragraph 3.2.6.);
- growth in staff costs by RUB 12,136 mln, or by 18.3% (ref. paragraph 3.2.1.).



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

Operating Expense Line Items	Deflation Rates (2012 To 2011)	Nine months Ended 30 September 2012 (Deflated To 2011)	Share Of Total Expenses, %	Nine months Ended 30 September 2011	Share Of Total Expenses, %	Absolute Change, 2012-2011	Change, %
Staff costs	5.2	74,684	21.8	66,432	20.2	8,252	12.4
Energy	3.2	22,774	6.6	25,726	7.8	(2,952)	(11.5)
Transportation of oil using railways	4.3	22,709	6.6	22,352	6.8	357	1.6
Materials	3.6	12,246	3.6	12,040	3.7	206	1.7
Repairs services and maintenance of relevant technical condition of pipeline	7.6	8,669	2.5	7,885	2.4	784	9.9
Insurance expenses	3.6	4,223	1.2	3,056	0.9	1,167	38.2
Taxes (except income tax)	3.6	3,637	1.1	3,436	1.0	201	5.8
Other operating expenses	3.6	8,051	2.4	10,764	3.3	(2,713)	(25.2)
Total operating expenses (net of D&A and cost of crude oil and oil products sold)	X	156,993	45.8	151,691	46.1	5,302	3.5
Depreciation and amortization	X	61,133	17.9	57,927	17.6	3,206	5.5
Cost of export crude oil sales	10.9	106,269	31.0	104,916	31.9	1,353	1.3
Cost of crude oil sold in the domestic market	10.9	7,926	2.3	6,368	1.9	1,558	24.5
Cost of oil products sold	4.1	10,173	3.0	8,363	2.5	1,810	21.6
Total operating expenses	X	342,494	100.0	329,265	100.0	13,229	4.0

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



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

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

	Oil transportation services	Oil products transportation services	Adjustment entries	Total operating expenses*
For the nine months ended 30 September 2012				
Operating expenses, RUB mln	158,287	14,300	(8,331)	164,256
Cargo turnover, mln tons x km	846,119	25,057	-	-
For the nine months ended 30 September 2011				
Operating expenses, RUB mln	141,232	13,329	(2,870)	151,691
Cargo turnover, mln tons x km	834,035	29,264	-	-

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

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

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

	For the nine months ended 30 September 2012	For the nine months ended 30 September 2011	Absolute change in unit costs, RUB per 100 tons x km	Change in unit costs, RUB per 100 tons x km, %
Oil transportation services				
Unit costs per 100 tons x km, RUB	18.71	16.93	1.78	10.5
Deflated unit costs per 100 tons x km, RUB	17.82		0.89	5.3
Oil products transportation services				
Unit costs per 100 tons x km, RUB	57.07	45.55	11.52	25.3
Deflated unit costs per 100 tons x km, RUB	54.35		8.80	19.3

3.2.1. Staff costs

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

The increase in staff costs for the nine months ended 30 September 2012 as compared to the nine months ended 30 September 2011 in the amount of RUB 12,136 or 18.3% was influenced by:

- an increase of average employee headcount for 4.4% related primarily to construction and operation of new oil pipelines, as well as facilities that are an integral part of the process:

	Nine months ended 30 September 2012	Nine months ended 30 September 2011	Change, %
Average employee headcount (thousand people)	109,0	104,4	4.4

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

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



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

	Nine months ended 30 September 2012	Nine months ended 30 September 2011	Absolute change, 2012-2011	Change, %
Employers' contributions to NPF Transneft* in favor of employees	4,980	5,177	(197)	(3.8)

3.2.2. Energy

Energy expenses for the nine months ended 30 September 2012, decreased by RUB 2,223 mln, or 8.6%, due to optimization in tariffs for consumed energy.

3.2.3. Transportation of oil using railways

The amount of expenses on transportation of oil using railways as for the nine months ended 30 September 2012 increased on RUB 1,334 or 6.0% as compared to the previous period. This category of expenses represents expenditures on a complete set of services related to oil transportation by railways, including preparation and delivery of railway cars for oil loading, oil transportation by railway along the Skovorodino-SMNP Kozmino section, delivery of railway cars for oil unloading, and return of empty railway cars to Skovorodino.

3.2.4. Materials

Expenses on materials for the nine months ended 30 September 2012, increased by RUB 647 mln, or 5.4%, due to expansion of operations.

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

An increase in these expenses for the nine months ended 30 September 2012, amounted to RUB 1,443 mln, or 18.3% compared to the nine months ended 30 September 2011.

3.2.6. Cost of crude oil and oil products sold

The cost of crude oil sold for export for the nine months ended 30 September 2012, amounted to RUB 117,852 mln, including custom duties in the amount of RUB 56,705 mln, which was a result of the start of oil supplies to the People's Republic of China (ref. to 3.1.2.). These expenses are related to the cost of oil purchased from OAO NK Rosneft under a contract signed in April 2009.

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

3.2.7. Insurance expenses

Insurance expenses increased on RUB 1,319 or 43.2% for the nine months ended 30 September 2012 as compared to the nine months ended 30 September 2011. These expenses represent the Group's expenditures on insurance companies' services, including expenses on insurance operations of ZAO SK Transneft and OOO SOT-TRANS. The increase in expenses was attributed to expansion of operations provided to legal entities and individuals who are not part of the Group and related reinsurance costs and formation of insurance reserves as well as expansion of insurance coverage of the Group's companies.

3.2.8. Taxes (except income tax)

The Group's other taxes include primarily the property tax, which amounted to RUB 3,353 mln for the nine months ended 30 September 2012. The property tax is assessed at a rate not exceeding 2.2% of average annual fixed asset book value.

3.2.9. Other operating expenses

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

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

* NPF Transneft – Non-state pension fund Transneft



3.2.10. Share of profit from associates and jointly controlled entities

The Group holds a number of financial investments in associated and jointly controlled entities reported on an equity method basis. The decrease in the Group's share of profit from associates and jointly controlled entities for the nine months ended 30 September 2012 compared to the relative period in 2011, was mainly attributed to the sale in January 2011 of Transneft Group's 50% stake in OOO Primorsk Trade Port (total income from the transaction amounted to RUB 29,034 mln).

3.2.11. Interest income and expenses

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

An increase in interest income for the nine months ended 30 September 2012, by RUB 305 mln, or by 3.9%, was driven by a decrease in the amount of income generated by investing temporarily available cash and cash equivalents (ref. to Para 5).

Interest income	Nine months ended 30 September 2012	Nine months ended 30 September 2011	Absolute change, 2012-2011	Change, %
Interest income from cash and equivalents	5,031	9,869	(4,838)	(49.0)
Interest income from other financial assets	5,927	2,257	3,670	162.6
Other interest income	285	183	102	55.7
Total interest receivable	11,243	12,309	(1,066)	(8.7)
less interest income on the temporary investment of borrowings	(3,084)	(4,455)	1,371	(30.8)
Total interest income recognized in the consolidated statement of comprehensive income	8,159	7,854	305	3.9

The amount of interest expenses is composed of:

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

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



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

Interest expenses	Nine months ended 30 September 2012	Nine months ended 30 September 2011	Absolute change, 2012-2011	Change, %
Interest expenses on loans and borrowings	25,645	24,357	1,288	5.3
Interest expenses regarding the dismantlement provision	5,421	6,556	(1,135)	(17.3)
Other interest expenses	469	439	30	6.8
Total interest expenses	31,535	31,352	183	0.6
Less finance costs to be capitalised	(9,728)	(14,921)	5,193	(34.8)
Total accrued interest recognized in the consolidated income statement	21,807	16,431	5,376	32.7

During the nine months ended 30 September 2012, interest in the amount of RUB 6,644 was capitalised as part of cost of assets under construction (for the nine months ended 30 September 2011 – RUB 10,466) including:

- interest expenses to be capitalised in the amount of RUB 9,728 (for the nine months ended 30 September 2011 – RUB 14,921);
- interest income to be excluded from interest expenses to be capitalised in the amount of RUB 3,084 (for the nine months ended 30 September 2011 – RUB 4,455).

3.2.12. Foreign currency exchange gains and losses

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

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

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

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

Currency-translation effect for foreign-currency-denominated loans and borrowings facilities	Nine months ended 30 September 2012	Nine months ended 30 September 2011
Gains	72,082	47,399
Losses	56,460	68,093

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



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3.3. Reconciliation of profit and EBITDA

	Nine months ended 30 September 2012	Nine months ended 30 September 2011	Change, %
Profit for the period	142,993	155,465	(8.0)
Increased (decreased) by:			
income tax	39,907	33,392	19.5
depreciation and amortization	61,133	57,927	5.5
net change in fair value of derivatives	(1)	-	-
interest expenses	21,807	16,431	32.7
interest and dividend income	(8,159)	(7,854)	3.9
exchange gains	(110,116)	(82,323)	33.8
exchange losses	102,131	79,578	28.3
share of profit from associates and jointly controlled entities*	(2,870)	(30,731)	(90.7)
EBITDA	246,826	221,885	11.2
EBITDA margin**, %	57.3	57.2	x

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

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

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

4. Cash flow analysis

	Nine months ended 30 September 2012	Nine months ended 30 September 2011	Absolute change, 2012-2011	Change, %
Cash flows from operating activities	146,398	109,024	37,374	34.3
Cash flows used in investing activities	(152,035)	(256,264)	104,229	(40.7)
Free cash flows	(5,637)	(147,240)	141,603	(96.2)
Cash flows generated from/(used in) financing activities	(52,478)	(1,308)	(51,170)	(40.1 times)
Net cash flows	(58,115)	(148,548)	90,432	(60.9)
Change in cash due to deviation of currency exchange rate	(2,582)	2,707	5,289	x
Net decrease in cash and cash equivalents	(60,697)	(145,841)	85,144	(58.4)

4.1. Operating activities

Cash received from operating activities is the Group's main source of cash. The net cash generated from operating activities amounted to RUB 146,398 mln for the nine months ended 30 September 2012, which is 34.3% (or RUB 37,374 mln) higher than for the nine months ended 30 September 2011.

This dynamics was driven by an increase in cash received from customers due to growth in tariffs and cargo turnover by RUB 50,051 mln, while payments to suppliers and contractors increased by RUB 28,055 mln. The key drivers of the increase in cash received from operating activities was a decrease in income tax payment by RUB 2,892 mln and an increase in cash received from the recovery of VAT and other taxes from the budget by RUB 12,260 mln.



4.2. Investing activities

The primary factors resulting in a general decrease in cash used in investment activities by 40.7% or by RUB 104,229 mln for the nine months ended 30 September 2012, as compared to the same period for the previous nine months, were:

- a decrease by RUB 29,508 mln or 18.0% in purchases of fixed assets and capital investment in accordance with key investment projects (refer to Para 1.1);
- a decrease by RUB 74,437 mln or by 79.2% in cash used in purchase-and-sale transactions in regards to promissory notes for the purpose of investing of temporarily available funds (which amounted to RUB 19,515 mln for the nine months ended 30 September 2012, and RUB 93,952 mln for the nine months ended 30 September 2011);

4.3. Financing activities

The outflow of cash amounted to RUB 52,478 mln for the nine months ended 30 September 2012, which was a result of repayment of Eurobonds in the amount of USD 500 mln and 700 mln of Euros (which is equivalent to RUB 46,192 mln), as well as an acquisition of non-controlling interest in OAO VOSTOKNEFTETTRANS (49%) for RUB 3,600 mln and payment of dividends amounting to RUB 2,768 mln. The outflow of cash amounted to RUB 1,308 mln including the payment of dividends of RUB 1,166 mln for the nine months ended 30 September 2011.



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

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

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

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

	<u>Nine months ended 30 September 2012</u>	<u>Nine months ended 30 September 2011</u>
Operating activities		
Profit before tax	182,901	188,857
Adjustments for:		
Depreciation and amortization	61,133	57,927
(Profit) / loss from disposal of property, plant and equipment	257	650
Interest income and share of profit from associates and jointly controlled entities	(11,029)	(38,585)
Interest expenses	21,807	16,431
Profit from currency-translation	(7,985)	(2,745)
Others	(6,792)	(8,097)
Operating profit before changes in working capital	240,292	214,438
Changes in operating assets and liabilities:		
Increase in inventories	(4,354)	(3,523)
Increase in trade and other receivables relating to operating activity	(11,394)	(31,575)
Decrease in trade and other payables, and accruals relating to operating activity	(14,077)	(2,911)
Cash flows from operating activities before payment of income tax expense and interest	210,467	176,429
Income tax paid	(50,153)	(39,889)
Income tax refund	14,075	919
Interest paid	(27,991)	(28,435)
Cash flows received from operating activities	146,398	109,024



5. Liquidity analysis

	30 September 2012	31 December 2011	Change, %
Current assets	441,183	442,892	(0.4)
including:			
cash and cash equivalents	84,849	145,546	(41.7)
short-term bank promissory notes*	197,756	177,760	11.2
Current liabilities	136,676	180,483	(24.3)
Net working capital	304,507	262,409	16.0
Current ratio	3.2	2.5	28.0
Quick ratio**	2.4	2.0	20.0
Debt / EBITDA	1.7	2.0	(15.0)
Debt / Equity	0.5	0.6	(16.7)

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

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

The amount of RUB 60,697 mln decrease of cash and cash equivalents as at 30 September 2012 compared to the balances of cash and cash equivalents as at 31 December 2011 was a result of repayment of Eurobonds in the amount of USD 500 mln and 700 mln of Euros (RUB equivalent of 46,192 mln), as well as purchase during the nine months ended 30 September 2012 of short-term and long-term discount and interest-bearing notes which are included in non-current and current other financial assets in the consolidated interim condensed statement of financial position. As at 30 September 2012 these promissory notes amounted to RUB 197,756 mln (as at 31 December 2011 - RUB 177,760 mln) and which changed in the amount of RUB 19,996 mln.