

O A O TATNEFT  
Form 20-F  
June 26, 2006  
Table of Contents

As filed with the Securities and Exchange Commission on June 26, 2006

---

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 20-F

REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE  
ACT OF 1934

OR

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF  
1934

For the fiscal year ended December 31, 2004

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT  
OF 1934

OR

SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934

Date of event requiring this shell company report

For the transition period from N/A to N/A

Commission file number 1-14804

OAO TATNEFT

(also known as JSC TATNEFT, AO TATNEFT and TATNEFT)

(Exact name of Registrant as specified in its charter)

TATNEFT

(Translation of Registrant's name into English)

Republic of Tatarstan

Russian Federation

(Jurisdiction of incorporation or organization)

75 Lenin Street  
Almetyevsk  
Tatarstan 423450  
Russian Federation  
(Address of principal executive offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Ordinary Shares, nominal value 1 Russian ruble per share	New York Stock Exchange, Inc.*
American Depositary Shares (“ADSs”) each representing 20 Ordinary Shares	New York Stock Exchange, Inc.

\*Not for trading, but only in connection with the registration of the American Depositary Shares.

Securities registered or to be registered pursuant to Section 12(g) of the Act: None

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act: None

Indicate the number of outstanding shares of each of the issuer’s classes of capital or common stock as of the close of the period covered by the annual report.

Ordinary Shares, nominal value 1 Russian ruble per share <sup>(1)</sup>	2,178,690,700
Preferred Shares, nominal value 1 Russian ruble per share	147,508,500

<sup>(1)</sup>Including 185,559,889 Ordinary Shares held in treasury as of December 31, 2004. Under Russian law, shares held by subsidiaries may vote and receive dividends.

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act:

Yes No

If this report is an annual or transition report, indicate by checkmark if the Registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934:

Yes No

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days:

Yes No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of “accelerated filer and large accelerated filer” in Rule 12b-2 of the Exchange Act (Check one):

Large Accelerated Filer

Accelerated filer

Non-accelerated filer

Indicate by check mark which financial statement item the Registrant has elected to follow:

Item 17

Item 18

If this is an annual report, indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act):

Yes

No

## TABLE OF CONTENTS

	Page
<u>EXPLANATORY NOTE</u>	1
<u>INTRODUCTION</u>	1
<u>FORWARD-LOOKING STATEMENTS</u>	2
<u>PART I</u>	4
<u>ITEM 1—IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISORS</u>	4
<u>ITEM 2—OFFER STATISTICS AND EXPECTED TIMETABLE</u>	5
<u>ITEM 3—KEY INFORMATION</u>	6
<u>SELECTED FINANCIAL DATA</u>	6
<u>EXCHANGE RATES</u>	10
<u>CAPITALIZATION AND INDEBTEDNESS</u>	10
<u>REASONS FOR THE OFFER AND USE OF PROCEEDS</u>	10
<u>RISK FACTORS</u>	11
<u>ITEM 4—INFORMATION ON THE COMPANY</u>	39
<u>BUSINESS OVERVIEW</u>	39
<u>HISTORY AND DEVELOPMENT</u>	39
<u>ORGANIZATIONAL STRUCTURE</u>	44
<u>STRATEGY</u>	47
<u>OVERVIEW OF THE RUSSIAN OIL INDUSTRY</u>	49
<u>EXPLORATION AND PRODUCTION</u>	60
<u>TRANSPORTATION</u>	69
<u>REFINING AND MARKETING</u>	70
<u>PETROCHEMICALS</u>	74
<u>BANKING OPERATIONS</u>	75
<u>COMPETITION</u>	75
<u>ENVIRONMENTAL MATTERS</u>	77
<u>CORPORATE REORGANIZATION</u>	78
<u>RELATIONSHIP WITH TATARSTAN</u>	80
<u>PROPERTY, PLANT AND EQUIPMENT</u>	82

<u>ITEM 5—OPERATING AND FINANCIAL REVIEW AND PROSPECTS</u>	83
<u>OVERVIEW</u>	85
<u>RESULTS OF OPERATIONS</u>	90
<u>LIQUIDITY AND CAPITAL RESOURCES</u>	103
<u>CONTRACTUAL OBLIGATIONS</u>	109
<u>OFF-BALANCE SHEET ARRANGEMENTS</u>	109
<u>CRITICAL ACCOUNTING POLICIES AND ESTIMATES</u>	109
<u>RESEARCH AND DEVELOPMENT</u>	115
<u>LICENSES</u>	116
<u>TRENDS INFORMATION</u>	117
<u>ITEM 6—DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES</u>	118
<u>DIRECTORS AND SENIOR MANAGEMENT</u>	118
<u>COMPENSATION</u>	124
<u>BOARD PRACTICES</u>	125
<u>EMPLOYEES</u>	131
<u>SHARE OWNERSHIP</u>	132

i

---

	Page
<u>ITEM 7—MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS</u>	134
<u>MAJOR SHAREHOLDERS</u>	134
<u>RELATED PARTY TRANSACTIONS</u>	136
<u>INTERESTS OF EXPERTS AND COUNSEL</u>	138
<u>ITEM 8—FINANCIAL INFORMATION</u>	139
<u>CONSOLIDATED STATEMENTS AND OTHER FINANCIAL INFORMATION</u>	139
<u>EXPORT SALES</u>	139
<u>LEGAL PROCEEDINGS</u>	139
<u>DIVIDENDS AND DIVIDEND POLICY</u>	139
<u>SIGNIFICANT CHANGES</u>	140
<u>ITEM 9—THE OFFER AND LISTING</u>	141
<u>MARKETS</u>	141
<u>ITEM 10—ADDITIONAL INFORMATION</u>	147
<u>MEMORANDUM AND ARTICLES OF ASSOCIATION</u>	147
<u>MATERIAL CONTRACTS</u>	151
<u>EXCHANGE CONTROLS</u>	151
<u>TAXATION</u>	153
<u>DOCUMENTS ON DISPLAY</u>	159
<u>ITEM 11—QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u>	160
<u>ITEM 12—DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES</u>	163
<u>PART II</u>	164
<u>ITEM 13—DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES</u>	164
<u>ITEM 14—MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS</u>	165
<u>ITEM 15—CONTROLS AND PROCEDURES</u>	166

<u>ITEM 16A—AUDIT COMMITTEE FINANCIAL EXPERT</u>	<u>167</u>
<u>ITEM 16B—CODE OF ETHICS</u>	<u>168</u>
<u>ITEM 16C—PRINCIPAL ACCOUNTANT FEES AND SERVICES</u>	<u>169</u>
<u>PART III</u>	<u>170</u>
<u>ITEM 17—FINANCIAL STATEMENTS*</u>	<u>170</u>
<u>ITEM 18—FINANCIAL STATEMENTS</u>	<u>171</u>
<u>ITEM 19—EXHIBITS</u>	<u>172</u>
<u>INDEX TO CONSOLIDATED FINANCIAL STATEMENTS</u>	<u>F-1</u>
<u>APPENDIX A—TATNEFT’S BANKING OPERATIONS</u>	<u>A-1</u>

\*The registrant has responded to Item 18 in lieu of responding to Item 17.

ii

## Table of Contents

### EXPLANATORY NOTE

The filing of this annual report on Form 20-F has been delayed due to the late finalization of our U.S. Generally Accepted Accounting Principles (“U.S. GAAP”) financial statements for the year ended December 31, 2004 and time required to complete the audit of these financial statements. The audit of our U.S. GAAP financial statements for the year ended December 31, 2004 commenced only in the fall of 2005 due to the late filing of our annual report on Form 20-F for the year ended December 31, 2003, which was made with the U.S. Securities and Exchange Commission (the “SEC”) on July 14, 2005. The late filing of our annual report on Form 20-F for the year ended December 31, 2003 was caused by an investigation into certain transactions identified by our independent auditor, Ernst & Young LLC (“Ernst & Young”), in the course of the audit of our U.S. GAAP financial statements for the year ended December 31, 2003. As Ernst & Young conducted their audit for the year ended December 31, 2003, they identified weaknesses in our control environment, some of which had also been noted by ZAO PricewaterhouseCoopers Audit (“PricewaterhouseCoopers”), their predecessor, and reported in our annual reports on Form 20-F for prior periods. In addition, Ernst & Young identified certain transactions the nature and business purposes of which were not immediately apparent. Ernst & Young notified the Audit Committee of the Board of Directors (the “Audit Committee”) and advised them to retain independent counsel to conduct an investigation of these transactions. Our Audit Committee retained Kennedys as its independent legal counsel to conduct the investigation. Based on the documentation, information and evidence obtained by it, Kennedys’ investigation, completed in April 2005, found no evidence of fraud but also found that our control environment (including our maintenance of books and records and internal controls) was inadequate under the applicable requirements of the Securities Exchange Act of 1934, as amended (the “Exchange Act”). We have taken and continue to take certain remedial measures to deal with these inadequacies. See “Item 3—Risk Factors—Risks Relating to the Company—Our independent registered public accounting firm reported material weaknesses in our internal controls and we may not be able to remedy these material weaknesses or prevent future weaknesses” and “Item 15—Controls and Procedures.”

We revised our estimate of the net oil reserves as of January 1, 2005, as set out in the revised report issued by Miller and Lents, Ltd. (“Miller and Lents”) on March 20, 2006 (the “Revised Reserves Report”), furnished to the SEC on Form 6-K on March 28, 2006. The revised report reflected a change in our oil price to U.S.\$17.47 per barrel (rather than the price of U.S.\$21.53 per barrel that had previously been used) and a change in the ownership interest in our Stepnoozerskoye and Yelginskoye fields. As a result, the estimate of our total proved reserves, previously 5,962.6 million barrels (“mmbbl”), was revised to 5,801.1 mmbbl through the economic lives of our licensed fields, and the estimate of our total proved reserves through the current license expiration was revised from 1,499.1 mmbbl to

1,476.1 mmbbl, as presented in the Revised Reserves Report. This revision may affect our future net revenues subsequent to January 1, 2005. See “Exhibit 15.1—Report of Reserve Consultants, Miller and Lents, Ltd., dated March 20, 2006.”

## INTRODUCTION

This annual report on Form 20-F includes audited consolidated financial statements of OAO Tatneft (“Tatneft”) and its consolidated subsidiaries (together with Tatneft, the “Group”) as at December 31, 2004 and 2003, and for each of the years in the three-year period ended December 31, 2004. These financial statements have been prepared in accordance with U.S. GAAP. Information contained in such financial statements for periods prior to January 1, 2003 is expressed in constant rubles of December 31, 2002 purchasing power, except as otherwise indicated.

On December 31, 2004, the official ruble/U.S. dollar exchange rate reported by the Central Bank of the Russian Federation (the “Central Bank”) was U.S.\$1.00 = RR27.75. On June 23, 2006 the official ruble/U.S. dollar exchange rate reported by the Central Bank was U.S.\$1.00 = RR26.97. The Federal Reserve Bank of New York does not report a noon buying rate for rubles. In providing an exchange rate, we do not represent that ruble amounts have been, could have been or could be converted into U.S. dollars at that or any other exchange rate on that or any other date. See “Item 3—Key Information—Exchange Rates.”

1

---

## Table of Contents

Our records and financial statements for Russian purposes are prepared in accordance with the Regulations on Accounting and Reporting of the Russian Federation (“RAR”). RAR differ in significant respects from U.S. GAAP, and financial statements prepared in accordance with RAR are not included in this annual report.

Unless the context otherwise requires, in this annual report all references to the “Company” or “Tatneft” are to OAO Tatneft, and all references to “we,” “us” or “our” are to Tatneft and its consolidated subsidiaries and references to “you” or “your” are to holders of our ADSs.

Certain information presented in this annual report is presented on the basis of official public documents published by Russian federal, regional and local governments and federal agencies, and has been presented on the authority of such documents. In addition, certain information presented herein is based on other third-party published sources. We have not independently verified the accuracy of such information.

This annual report contains information concerning our oil reserves derived from the reports of Miller and Lents, oil and gas consultants based in Houston, Texas, dated May 28, 2004 and the Revised Reserves Report (collectively, the “Reserves Reports”), incorporated by reference from our reports on Form 6-K furnished to the SEC on July 23, 2004 and March 28, 2006, respectively. While the Reserves Reports have been prepared as set out in the definitions contained in SEC Regulation S-X, Rule 4-10(a), they are based on economic assumptions that may prove to be incorrect. For instance, as discussed above, estimates of our net oil reserves as of January 1, 2005 have been revised, as set out in the Revised Reserves Report. As a result, the estimate of our total proved reserves, previously 5,962.6 mmbbl, was revised to 5,801.1 mmbbl through the economic lives of our licensed fields, and the estimate of our total proved reserves through the current license expiration were revised from 1,499.1 mmbbl to 1,476.1 mmbbl. See “Exhibit 15.1—Report of Reserve Consultants, Miller and Lents, Ltd., dated March 20, 2006.” Our oil reserves could be further revised, as the economic assumptions on which the Reserves Reports are based may prove to be incorrect. In addition, the Russian economy is more unstable and subject to more significant and sudden changes than the

economies of many other countries and, therefore, economic assumptions in the Russian Federation are subject to a high degree of uncertainty. Readers should not place undue reliance on the forward-looking statements in the Reserves Reports, on the ability of the Reserves Reports to predict actual reserves or on comparisons of similar reports concerning companies established in countries with more mature economic systems. As indicated in the Reserves Reports, the reserves information is based on the reserves of 63 and 73 developed and producing and seven undeveloped oil fields covered by exploration, production or combined exploration and production licenses as of January 1, 2004 and 2005, respectively.

Like many other Russian and European oil companies, we use the metric ton as the standard unit of measurement for quantities of crude oil. For convenience, certain amounts of crude oil have been translated from tons to barrels. These translations were made at the rate of 7.123 barrels per ton of crude oil, reflecting the weighted average density of our crude oil reserves. However, the actual density of our crude oil reserves may vary by approximately 10% above and below this weighted average, such that actual barrel amounts may vary from this convenience translation. See “Item 4—Information on the Company—Exploration and Production.”

Columns in tables may not add to the stated totals due to rounding.

## FORWARD-LOOKING STATEMENTS

Certain statements in this annual report are not historical facts and are “forward-looking” (as such term is defined in the U.S. Private Securities Litigation Reform Act of 1995). We may from time to time make written or oral forward-looking statements in reports to shareholders and in other communications. This annual report contains forward-looking statements under the headings “Item 4—Information on the Company,” “Item 5—Operating and Financial Review and Prospects” and “Item 11—Quantitative and Qualitative Disclosures About Market Risk.” Examples of such forward-looking statements include, but are not limited to:

- projections of revenues, income (or loss), earnings (or loss) per share, dividends, capital structure or other financial items or ratios;

2

---

## Table of Contents

- statements of our plans, objectives or goals, including those related to products or services;
- statements of future economic performance; and
- statements of assumptions underlying such statements.

Words such as “believes,” “anticipates,” “expects,” “intends” and “plans” and similar expressions are intended to identify forward-looking statements but are not the exclusive means of identifying such statements.

By their very nature, forward-looking statements involve inherent risks and uncertainties, both general and specific, and risks exist that the predictions, forecasts, projections and other forward-looking statements will not be achieved. We caution readers that a number of important factors could cause actual results to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward-looking statements. These factors include:

- inflation, interest rate, and exchange rate fluctuations;
- the price of oil;
- the effect of, and changes in, Russian or Tatarstan government policy;

- the effect of terrorist attack or other geopolitical instability, either within Russia or elsewhere;
- the effects of competition in the geographic and business areas in which we conduct operations;
- the effects of changes in laws, regulations, taxation or accounting standards or practices;
- our ability to increase market share and control expenses;
- acquisitions or divestitures;
- technological changes; and
- our success at managing the risks of the aforementioned factors.

This list of important factors is not exhaustive; when relying on forward-looking statements to make decisions with respect to our ADSs, investors and others should carefully consider the foregoing factors and other uncertainties and events, especially in light of the difficult political, economic, social and legal environment in which we operate. Such forward-looking statements speak only at the date on which they are made, and we do not undertake any obligation to update or revise any of them, whether as a result of new information, future events or otherwise. We do not make any representation, warranty or prediction that the results anticipated by such forward-looking statements will be achieved, and such forward-looking statements represent, in each case, only one of many possible scenarios and should not be viewed as the most likely or standard scenario.

3

---

Table of Contents

PART I

ITEM 1—IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISORS

This Item is not applicable.

4

---

Table of Contents

ITEM 2—OFFER STATISTICS AND EXPECTED TIMETABLE

This Item is not applicable.

5

---

Table of Contents

ITEM 3—KEY INFORMATION

SELECTED FINANCIAL DATA



The selected financial data set forth below is derived from the consolidated financial statements of Tatneft for each of the years in the five-year period ended December 31, 2004. The financial statements for the years ended December 31, 2004 and 2003 have been audited by Ernst & Young, independent auditors. The financial statements for each of the years in the three-year period ended December 31, 2002 have been audited by PricewaterhouseCoopers, independent auditors. The selected financial data as at December 31, 2004 and 2003 and for each of the years in the three-year period ended December 31, 2004 should be read in conjunction with, and are qualified in their entirety by reference to, our consolidated financial statements and the notes thereto included elsewhere in this annual report. The information below should also be read in conjunction with “Item 5—Operating and Financial Review and Prospects.”

U.S. GAAP recognizes that the degree of inflation in a country’s economy may become so great that conventional financial statements prepared in historical local currency lose much of their significance and general price-level financial statements become more meaningful. General price-level financial statements are financial statements that have been restated to account for inflation, and such financial statements are required by U.S. GAAP when a country’s economy experiences “hyperinflation.”

As measured by Russia’s consumer price index, annual inflation in Russia was 10.9%, 11.7%, 12%, 15.1%, 18.8% and 20.1% in 2005, 2004, 2003, 2002, 2001 and 2000, respectively. Given Russia’s past inflation history, Russia’s economy was considered hyperinflationary for purposes of our consolidated financial statements for the year ended December 31, 2002 and prior periods, and such consolidated financial statements were prepared in accordance with Accounting Principles Board Statement No. 3, “Financial Statements Restated for General Price-Level Changes” (“APB 3”). These figures were thus expressed in millions of constant rubles as of December 31, 2002 purchasing power. At a meeting of the American Institute of Certified Public Accounts (“AICPA”) International Practices Task Force on November 25, 2002, the Task Force concluded that Russia would no longer be considered highly inflationary effective from January 1, 2003. See “Item 5—Operating and Financial Review and Prospects—Overview—Inflation and foreign currency exchange rate fluctuations.”

The monetary gain included in our consolidated statements of operations for periods prior to January 1, 2003 reflects gains attributable to the effect of Russian inflation on the monetary liabilities we owed during each period, net of the loss attributable to the effect of inflation on monetary assets held. Assets and liabilities are called “monetary” for purposes of general price level accounting if their amounts are fixed by contract or otherwise in terms of numbers of currency units regardless of changes in specific prices or in the general price level. Examples of monetary assets and liabilities include accounts receivable, accounts payable and cash.

6

---

## Table of Contents

	Year Ended December 31,				
	2004	2003	2002	2001	2000
	(in RR millions, except per share information)				
<b>CONSOLIDATED STATEMENT OF OPERATIONS DATA</b>					
Sales and other operating revenues, including excise tax and export duties <sup>(1)</sup>	206,782	155,818	146,328	156,861	199,503
Exploration and production <sup>(1)</sup>	124,076	93,155	84,394	91,528	108,615
Intersegment sales	124,076	93,155	84,394	91,528	108,615
Refining and marketing <sup>(1)</sup>	182,444	134,158	125,673	139,082	184,085
Domestic sales	47,790	34,891	36,279	51,342	56,056
Export sales (CIS)	20,436	9,806	11,540	7,702	1,757

Edgar Filing: O A O TATNEFT - Form 20-F

Export sales (Non-CIS)	114,218	89,461	77,854	80,038	126,272
Petrochemicals <sup>(1)</sup>	13,614	11,816	10,242	5,444	2,427
Intersegment sales	294	233	322	1,311	54
Tire sales (Domestic)	9,510	7,764	7,046	2,517	—
Tire sales (CIS)	1,875	1,799	908	38	—
Tire sales (Non-CIS)	977	739	814	163	—
Refined products	958	1,281	1,152	1,415	2,373
Banking <sup>(2)</sup>	1,851	1,531	1,180	1,615	—
Net interest income intersegment	241	530	335	265	—
Net interest income	1,610	1,001	845	1,350	—
Other sales	10,156	9,177	10,038	12,797	13,959
Elimination of income from equity investments reported separately in the consolidated statements of operations and comprehensive income	(748)	(101)	(148)	(501)	(914)
Elimination of intersegment sales	(124,611)	(93,918)	(85,051)	(93,104)	(108,669)
Total costs and other deductions	(169,818)	(141,474)	(128,549)	(132,830)	(148,934)
Operating	(34,227)	(31,799)	(36,389)	(31,297)	(24,836)
Purchased oil and refined products	(39,107)	(28,997)	(28,372)	(34,104)	(61,587)
Exploration	(861)	(812)	(463)	(839)	(740)
Transportation	(9,142)	(7,635)	(5,683)	(5,183)	(4,349)
Selling, general and administrative	(16,941)	(15,499)	(16,031)	(17,282)	(11,293)
Bad debt charges and credits, net	714	262	261	1,027	233
Depreciation, depletion and amortization	(9,237)	(8,850)	(7,541)	(6,139)	(5,963)
Loss on disposals of property, plant and equipment and impairment of investments	(726)	(2,325)	(851)	(2,502)	(2,604)
Taxes other than income taxes <sup>(3)</sup>	(59,587)	(43,378)	(31,988)	(33,373)	(37,415)
Maintenance of social infrastructure	(249)	(279)	(199)	(491)	(252)
Transfer of social assets	(455)	(2,162)	(1,293)	(593)	(128)
Other income (expenses)	(1,668)	313	1,525	567	1,406
Earnings from equity investments	748	101	148	501	914
Exchange gain (loss)	41	(225)	(1,042)	(851)	(591)
Monetary gain <sup>(3)</sup>	—	—	871	1,764	3,706
Interest income	746	303	804	1,517	—
Interest expense	(1,386)	(1,827)	(2,855)	(2,875)	(3,509)
Other income, net	(1,817)	1,961	3,599	511	886
Income (loss) before income taxes and minority interest	35,296	14,657	19,304	24,598	51,975

7

Table of Contents

	Year Ended December 31,				
	2004	2003	2002	2001	2000
	(in RR millions, except per share information)				
Total income tax (expense) benefit	(10,861)	(4,582)	(5,363)	(1,244)	(19,482)
Current <sup>(3)</sup>	(10,032)	(6,070)	(4,743)	7,072	(10,822)
Deferred	(829)	1,488	(620)	(8,316)	(8,660)
Income (loss) before minority interest	24,435	10,075	13,941	25,842	32,493

Edgar Filing: O A O TATNEFT - Form 20-F

Minority interest	(1,025)	63	(471)	(1,698)	(475)
Cumulative effect of change in accounting principle, net of RR1,498 million tax	—	4,742	—	—	—
Net income (loss)	23,410	14,880	13,470	24,144	32,018
Foreign currency translation adjustments	15	3	(20)	163	—
Unrealized holding gains on available-for-sale securities, net of RR nil tax	19	43	33	2,329	763
Less: reclassification adjustment for realized gains included in net income	(43)	(33)	(2,981)	(622)	—
Comprehensive income (loss)	23,401	14,893	10,502	26,014	32,781
Basic net income (loss) per Ordinary Share <sup>(4)</sup>	10.88	4.70	6.24	10.94	14.33
Diluted net income (loss) per Ordinary Share <sup>(4)</sup>	10.84	4.68	6.23	10.92	14.33
Net income (loss) per ADS <sup>(5)</sup>	217.6	139	125	219	287
Dividends declared per Ordinary Share <sup>(6)</sup>	0.90	0.30	0.10	0.10	0.30
Equivalent U.S.\$ per Ordinary Share <sup>(7)</sup>	0.0325	0.0102	0.0031	0.0031	0.0094
Dividends declared per Preferred Share <sup>(6)</sup>	1.00	1.00	1.00	1.00	0.60
Equivalent U.S.\$ per Preferred Share <sup>(7)</sup>	0.0360	0.0340	0.0315	0.0315	0.0189

Year Ended December 31,  
2004      2003      2002      2001      2000  
(in RR millions)

CONSOLIDATED STATEMENT OF CASH FLOWS DATA

Net cash provided by operating activities	27,791	20,000	8,683	15,259	21,466
Net cash used in investing activities	(22,105)	(19,150)	(11,770)	(17,512)	(17,907)
Net cash provided by financing activities	3,969	533	5,563	4,024	(2,579)
Effect of foreign exchange on cash and cash equivalents	(5)	(3)	10	(37)	96
Effect of inflation accounting	—	—	(288)	(393)	(611)
Net change in cash and cash equivalents	9,650	1,380	2,198	1,341	465

Year Ended December 31,  
2004      2003      2002      2001      2000  
(in RR millions)

CONSOLIDATED BALANCE SHEET DATA

Total assets	309,561	262,717	226,288	229,069	201,937
Total current assets	106,192	73,500	64,903	72,747	63,511
Property, plant and equipment, net	183,927	177,008	152,448	147,858	127,952
Other assets	19,442	12,209	8,937	8,464	10,474
Total liabilities	132,431	108,436	86,067	95,683	96,331
Total current liabilities <sup>(8)</sup>	71,713	54,233	48,140	66,789	51,310
Total long-term liabilities <sup>(9)</sup>	60,718	54,203	37,927	28,894	45,021
Minority interest	6,654	5,101	5,069	5,302	2,521
Total shareholders' equity	170,476	149,180	135,152	128,084	103,085

Table of Contents

	As of December 31,				
	2004	2003	2002	2001	2000
Capital Stock	2,327	2,327	2,327	2,327	2,327
Ordinary Shares	2,179	2,179	2,179	2,179	2,179
Preferred Shares	148	148	148	148	148

- 
- (1)For a discussion of certain important features of our crude oil and refined products sales reported under the exploration and production, refining and marketing and petrochemicals segments, see “Item 5—Operating and Financial Review and Prospects—Overview.”
- (2)For a discussion of certain features of our banking operations, see “Appendix A—Tatneft’s Banking Operations.”
- (3)See “Item 5—Operating and Financial Review and Prospects—Overview.”
- (4)Based on the number of Ordinary and Preferred Shares outstanding at December 31, 2004, 2003, 2002, 2001 and 2000 respectively. Per share data are calculated based on the two-class method. Under the two-class method of computing net income per share, net income is computed for common and preferred shares according to dividends declared and participation rights in undistributed earnings. Under this method, net income is reduced by the amount of dividends declared in the current period for each class of shares, and the remaining income is allocated to common and preferred shares to the extent that each class may share in income if all income for the period had been distributed.
- (5)Per ADS data reflects a ratio of 20 Ordinary Shares per ADS.
- (6)Dividends declared are stated in nominal rubles. Dividends are stated as approved for a specific year, at the shareholders' meeting held in the following year.
- (7)2004 dividends are presented at the exchange rate of U.S.\$1.00 = RR27.75 reported by the Central Bank on December 31, 2004. Dividends for 2000-2003 are presented at the exchange rate of U.S.\$1.00 = RR29.45 reported by the Central Bank on December 31, 2003.
- (8)Includes short-term debt, notes payable and banking customer deposits of RR45,268 million, RR36,826 million, RR31,508 million, RR44,327 million and RR25,914 million at December 31, 2004, 2003, 2002, 2001 and 2000, respectively.
- (9)Includes long-term debt, notes payable and banking customer deposits of RR13,645 million, RR15,618 million, RR16,640 million, RR8,632 million and RR21,739 million at December 31, 2004, 2003, 2002, 2001 and 2000, respectively.

9

Table of Contents

## EXCHANGE RATES

The following table shows, for the periods indicated, certain information regarding the exchange rate between the ruble and the U.S. dollar, based on the official exchange rate quoted by the Central Bank and rounded to the nearest 1/100<sup>th</sup> of a ruble. These rates may differ from the actual rates used in the preparation of our consolidated financial statements and other financial information appearing herein.

Year Ended December 31,	Period			
	end	Average <sup>(1)</sup>	High	Low
2000	28.16	28.13	28.87	26.90
2001	30.14	29.18	30.30	28.16
2002	31.78	31.35	31.86	30.14
2003	29.45	30.68	31.88	29.24
2004	27.75	28.81	29.45	27.75
2005	28.78	28.31	28.99	27.46
2006				
January	28.12	28.41	28.48	27.97
February	28.12	28.20	28.26	28.10
March	27.76	27.88	28.12	27.66
April	27.27	27.57	27.77	27.27
May	26.98	27.06	27.27	26.94

(1)The average of the exchange rates on the last business day of each month for the relevant annual period, and on each business day for which the Central Bank quotes the ruble to U.S. dollar exchange rate for the relevant monthly period.

On June 23, 2006, the exchange rate of ruble to U.S. dollar established by the Central Bank was U.S.\$1.00 = RR26.97. The Federal Reserve Bank of New York does not report a noon buying rate for rubles. No representation is made that ruble or U.S. dollar amounts stated herein could have been converted into U.S. dollars or rubles, as the case may be, at any particular rate or at all. The ruble is generally not convertible outside Russia. See ‘‘Item 10—Additional Information—Exchange Controls’’ for a description of Russian currency exchange controls.

#### CAPITALIZATION AND INDEBTEDNESS

This Item is not applicable.

#### REASONS FOR THE OFFER AND USE OF PROCEEDS

This Item is not applicable.

10

#### Table of Contents

#### RISK FACTORS

We have described below the risks and uncertainties that our management believes are material, but these risks and uncertainties may not be the only ones we face. Additional risks and uncertainties, including those we currently do not know or deem immaterial, may also result in decreased revenues, increased expenses, or other events that could result in a decline in the price of our ADSs.

#### Risks Relating to the Russian Federation

Political and social risks

Political and governmental instability could adversely affect the value of investments in Russia and the value of our ADSs

Since 1991, Russia has sought to transform itself from a one-party state with a centrally planned economy to a pluralist democracy with a market-oriented economy. As a result of the sweeping nature of the reforms, and the failure of some of them, the Russian political system remains vulnerable to popular dissatisfaction, as well as to unrest by particular social and ethnic groups. The composition of the Russian Government—the prime minister and the other heads of federal ministries—has at times been highly unstable. Six different prime ministers, for example, headed Governments between March 1998 and May 2000. On December 31, 1999, President Yeltsin unexpectedly resigned and Vladimir Putin was subsequently elected President on March 26, 2000. Mr. Putin was reelected for a second four-year term on March 14, 2004. While President Putin has maintained governmental stability and even accelerated the reform process in some areas, he may adopt a different approach over time. In late February 2004, President Putin dismissed Mr. Kasyanov's Government and appointed Mikhail Fradkov as Prime Minister. Shortly after the appointment of Mr. Fradkov as Prime Minister, a Presidential decree significantly reduced the number of federal ministries, redistributed certain functions amongst various government agencies and announced plans for a major overhaul of the federal administrative system. For example, the Ministry of Energy, which had been responsible for implementing fuel and energy policy, was abolished, and its functions were divided between the Ministry of Industry and Energy and the Federal Energy Agency. In addition, from December 31, 2004, federal law gives the President a significant role in choosing regional governors. See “—Risks Relating to Tatarstan—Relations between Tatarstan and Russia may deteriorate, adversely affecting our business” under this Item. Additionally, pursuant to legislation that was adopted in 2005 and took effect on December 7, 2005, single-member-district elections for the State Duma are to be eliminated, and all votes are instead to be cast on a party-list basis. Future changes in government, major policy shifts or lack of consensus among President Putin, the prime minister, Russia's parliament, regional governors and legislatures and powerful economic groups could also disrupt or reverse economic and regulatory reforms. Any disruption or reversal of the reform policies, recurrence of political or governmental instability or occurrence of conflicts with powerful economic groups could have a material adverse effect on our company and the value of investments in Russia, including our ADSs.

Conflicts between federal and regional authorities and other political conflicts could create an uncertain operating environment that could hinder our long-term planning ability and could adversely affect the value of investments in Russia

The Russian Federation is a federation of 88 sub-federal political units (reduced from 89 units on December 1, 2005, and to be further reduced to 86 on January 1, 2007), consisting of republics, territories, regions, cities of federal importance and autonomous areas. The delineation of authority and jurisdiction among the members of the Russian Federation and the federal governmental authorities is often unclear and contested. Some of these sub-federal political units, such as Tatarstan, exercise considerable power over their internal affairs pursuant to the Russian Constitution or, in certain cases, pursuant to agreements with the federal authorities. Such an agreement was signed in 1994 between Tatarstan and the federal authorities, which expired in July 2005. A new agreement is currently under negotiation. See “—Risks Relating to Tatarstan—Relations between Tatarstan and Russia may deteriorate, adversely affecting our business” under this Item. The Russian political system is therefore vulnerable to tension and conflict

---

## Table of Contents

between federal and regional authorities, and between different authorities within the federal government over various issues, including tax revenues, authority for regulatory matters and regional autonomy. Such tension and conflict have

in the past often resulted in the enactment of conflicting legislation at various levels. Although the balance of authority between the federal government and sub-federal units has, with some exceptions, stabilized in recent years, a return to lack of consensus could hinder our long-term planning efforts and create uncertainties in our operating environment, both of which may prevent us from effectively and efficiently carrying out our business strategy and adversely affect our operations. See “—Risks Relating to the Russian Legal System and Russian Legislation—Weaknesses relating to the Russian legal system and Russian legislation create an uncertain environment for investment and for business activity and thus could have a material adverse effect on the value of our ADSs” under this Item.

Additionally, ethnic, religious, historical and other divisions have, on occasion, given rise to tensions, and in certain cases, to military conflict, such as the continuing conflict in Chechnya, which has brought normal economic activity within Chechnya to a halt and disrupted the economies of neighboring regions. Various armed groups in Chechnya have regularly engaged in guerrilla attacks in that area. Violence and attacks relating to this conflict have also spread to other parts of Russia, and several terrorist attacks were carried out by Chechen terrorists in Moscow in recent years. For example, in October 2002, a large group of Chechen guerrillas seized a Moscow theatre and held 700 people hostage for three days until Russian special forces overpowered them, leading to the death of 129 hostages and 41 terrorists. Terrorists, allegedly linked to Chechen guerillas, also seized a school in Beslan, North Ossetia in September 2004, leading to the deaths of over 330 persons. The further intensification of violence, including terrorist attacks and suicide bombings, or its continued spread to other parts of Russia, could have significant political consequences, including the imposition of a state of emergency in some or all of Russia. Moreover, any terrorist attacks and the resulting heightened security measures may cause disruptions to domestic commerce and exports from Russia, and could materially adversely affect our business and the value of investments in Russia, including our ADSs.

Crime and corruption could disrupt our ability to conduct our business and could adversely affect our financial condition and results of operations

The political and economic changes in Russia since 1991 resulted in significant dislocations of authority, reduced policing and increased lawlessness. The local and international press has reported that significant organized criminal activity has arisen, particularly in large metropolitan centers. Property crimes in large cities have increased substantially. In addition, the local and international press has reported high levels of official corruption, including the bribing of officials for the purpose of initiating investigations by government agencies. Press reports have also described instances in which government officials engaged in selective investigations and prosecutions to further commercial interests of government officials or certain companies or individuals. Additionally, published reports have indicated that a significant number of Russian media outlets regularly publish disparaging articles in return for payment. The depredations of organized or other crime, demands of corrupt officials or claims that we have been involved in official corruption or illegal activities may in the future bring negative publicity, which could disrupt our ability to conduct our business effectively and could thus materially adversely affect our financial condition, results of operations or prospects and the value of our ADSs.

Social instability in Russia could lead to increased support for renewed centralized authority and a rise in nationalism or violence, which could adversely affect our ability to conduct our business effectively

The failure of the government and many private enterprises to pay full salaries on a regular basis and the failure of salaries and benefits generally to keep pace with the rapidly increasing cost of living in Russia have led in the past, and could lead in the future, to labor and social unrest and increased support for a renewal of centralized authority, increased nationalism, restrictions on foreign involvement in the Russian economy, and increased violence. For example, in 2005, Russian pensioners organized street protests against government proposals to monetize in-kind benefits. These protests periodically blocked highways and streets in major Russian cities. Such sentiments could lead to large-scale nationalization or expropriation of foreign-owned assets or businesses or to restrictions on foreign ownership of Russian companies in the oil and gas industry. Any of these or similar consequences of social instability could restrict our operations and lead to the loss of revenue, materially adversely affecting us.

Table of Contents

## Economic risks

## Economic instability in Russia could adversely affect our business

Since the dissolution of the Soviet Union, the Russian economy has experienced at various times:

- significant declines in gross domestic product;
- hyperinflation;
- an unstable currency;
- high government debt relative to gross domestic product;
- a weak banking system providing limited liquidity to Russian enterprises;
- a large number of loss-making enterprises that continued to operate due to the lack of effective bankruptcy proceedings;
- significant use of barter transactions and illiquid promissory notes to settle commercial transactions;
- widespread tax evasion;
- growth of black and grey market economies;
- pervasive capital flight;
- high levels of corruption and the penetration of organized crime into the economy;
- significant increases in unemployment and underemployment; and
- the impoverishment of a large portion of the Russian population.

The Russian economy has been subject to abrupt downturns. In particular, on August 17, 1998, in the face of a rapidly deteriorating economic situation, the Russian government defaulted on its ruble-denominated securities, the Central Bank stopped its support of the ruble, and a temporary moratorium was imposed on certain hard currency payments. These actions resulted in an immediate and severe devaluation of the ruble and a sharp increase in the rate of inflation; a dramatic decline in the prices of Russian debt and equity securities; and an inability of Russian issuers to raise funds in the international capital markets. These problems were aggravated by the near collapse of the Russian banking sector after the events of August 17, 1998, as evidenced by the revocation of the banking licenses of a number of major Russian banks. This further impaired the ability of the banking sector to act as a consistent source of liquidity to Russian companies, and resulted in the losses of bank deposits in some cases.

Russia's inexperience with a market economy compared to more developed economies also poses numerous risks. The failure to satisfy liabilities is widespread among Russian businesses and the government. Furthermore, it is difficult for us to gauge the creditworthiness of some of our customers, as there are no reliable mechanisms, such as reliable credit reports or credit databases, for evaluating their financial condition. Consequently, we face the risk that some of our customers or other debtors will fail to pay us or fail to comply with the terms of their agreements with us, which could adversely affect our results of operations.

We also cannot assure you that recent trends in the Russian economy—such as the increase in the gross domestic product, a relatively stable ruble and a reduced rate of inflation—will continue or will not be abruptly reversed. Additionally, because Russia produces and exports large quantities of oil and natural gas, the Russian economy is especially vulnerable to fluctuations in the price of such commodities on the world market and a decline in the price of oil or natural gas could significantly slow or disrupt the Russian economy. Recent military conflicts and international



terrorist activity have created significant uncertainty about the supply of oil and natural gas and such future events may continue to adversely affect the global economic environment, which could result in a decline in the demand for oil and natural gas. A strengthening of the ruble in real terms relative to the U.S. dollar, changes in monetary policy, inflation or other factors could adversely affect Russia's economy and our business in the future. Any such market

13

---

## Table of Contents

downturn or economic slowdown could also severely limit our and our customers' access to capital, also adversely affecting our and our customers' businesses in the future.

Russia's physical infrastructure is in poor condition, which could disrupt normal business activity

Russia's physical infrastructure largely dates back to Soviet times and has not been adequately funded and maintained over the past decade. Particularly affected are the rail and road networks; power generation and transmission; communication systems; and building stock. For example, a cold spell in Russia in January 2006 placed enormous pressure on Russia's power systems leading Moscow's authorities to force power cutbacks to nonessential companies in the region to prevent a massive power blackout. In May 2005, a fire and explosion in one of the Moscow power substations built in 1963 caused a major multi-hour outage in a large section of Moscow and some surrounding regions. During the winter of 2000-2001, electricity and heating shortages in Russia's far-eastern Primorye region seriously disrupted the local economy. In August 2000, a fire at the main communications tower in Moscow interrupted television and radio broadcasting and the operation of mobile telephones for several weeks. Road conditions throughout Russia are poor, with many roads not meeting minimum quality requirements. In addition, the Russian railway system is a state-owned railroad transportation services monopoly. Our use of the railways exposes us to risks such as potential delivery disruptions due to the deteriorating physical condition of the railway infrastructure. The federal government is actively considering plans to reorganize the nation's telephone system, and restructuring of the electricity and rail sectors is in progress. Any such reorganization or restructuring may result in increased charges and tariffs while failing to generate the anticipated capital investment needed to repair, maintain and improve these systems.

Russia's poor physical infrastructure harms the national economy, disrupts the transportation of goods and supplies, adds costs to doing business in Russia and can interrupt regular business operations. Further deterioration in the physical infrastructure could have a material adverse effect on our business and the value of our ADSs.

Fluctuations in the global economy may adversely affect Russia's economy and our business

Russia's economy is vulnerable to market downturns and economic slowdowns elsewhere in the world. As has happened in the past, financial problems or an increase in the perceived risks associated with investing in emerging economies could dampen foreign investment in Russia and adversely affect the Russian economy. Additionally, because Russia produces and exports large amounts of oil and natural gas, the Russian economy is especially vulnerable to changes in the prices of such commodities on world markets, and a decline in their prices could slow or disrupt the Russian economy. These developments could severely limit our access to capital and could adversely affect the purchasing power of our customers and thus our business.

We face inflation risks that could adversely affect our results of operations

The Russian economy has been characterized by high rates of inflation, including a rate of 84.4% in 1998, which subsided to 11.7% in 2004 and 10.9% in 2005. Certain of our costs, such as salaries, are sensitive to increases in the general price level in Russia. A significant portion of our revenues are either denominated in U.S. dollars or tightly linked to the U.S. dollar, and are affected primarily by international oil prices. Accordingly, our operating margins could be adversely affected if the inflation of our ruble costs in Russia is not balanced by a corresponding devaluation of the ruble against the U.S. dollar or an increase in oil prices.

#### Risks Relating to the Russian Legal System and Russian Legislation

Weaknesses relating to the Russian legal system and Russian legislation create an uncertain environment for investment and for business activity and thus could have a material adverse effect on the value of our ADSs

Russia is still developing the legal framework required to support a market economy. The following aspects of the Russian legal system create uncertainty with respect to many of the legal and business decisions that we make:

- conflicting local, regional and federal rules and regulations;

14

---

#### Table of Contents

- a lack of judicial and administrative guidance on interpreting Russian legislation;
- substantial gaps in the regulatory structure created by the delay or absence of implementing regulations for certain legislation;
- the relative inexperience of judges and courts in interpreting Russian legislation;
- corruption within the judiciary;
- lack of independence of the judiciary from other political branches;
- a high degree of discretion on the part of governmental authorities; and
- bankruptcy procedures that are not well developed and are subject to abuse.

All of these weaknesses could affect our ability to enforce our rights under our licenses and our contracts, or to defend ourselves against claims by others. Furthermore, due to these risks we cannot assure you that regulators, judicial authorities or third parties will not challenge our compliance with applicable laws, decrees and regulations.

Russian laws and regulations may change in ways that adversely affect our business

The Russian legal system and the body of laws on private enterprises continue to experience frequent changes. We cannot assure you that the legislature, federal or local regulators, or the President will not issue new edicts, decrees, laws or regulations adversely affecting our business, including:

- increasing state control over the activities of private companies;
- restricting exports of oil;
- increasing tariffs on oil exports;
- increasing governmental control over, or imposing limitations or restrictions, on foreign investment, imports and foreign personnel employed in business;
- increasing financial and currency controls relating to mandatory conversion of export proceeds and repatriation of profits;
- imposing limits on dividends and other payments;
- increasing protection of state-owned companies;
-

increasing anti-monopoly controls that may limit our ability to consummate certain acquisitions;  
and

- raising the standards of environmental regulations to conform to more stringent international standards that may subject us to increased costs and expenses.

Lack of independence and inexperience of some members of the Russian judiciary, the difficulty of enforcing court decisions and governmental discretion in instigating, joining and enforcing claims could prevent us or you from obtaining effective redress in a court proceeding, which could have a material adverse effect on our business or on the value of our ADSs

The independence of the judicial system and the prosecutor general's office, and their immunity from economic, political and nationalistic influences in Russia, remain largely unsatisfying. The court system is understaffed and underfunded. Judges and courts are generally inexperienced in the area of business and corporate law. As in other civil law countries, judicial precedents generally have no binding effect on subsequent decisions. Not all Russian legislation and court decisions are readily available to the public or organized in a manner that facilitates understanding. The Russian judicial system can be slow, and court orders are not always enforced or followed by law enforcement agencies. All of these factors make judicial decisions in Russia difficult to predict and effective redress uncertain. Additionally, court claims and governmental prosecutions are often used in furtherance of political aims. We may be subject to such claims or prosecutions and may not be able to receive a fair hearing.

15

---

## Table of Contents

These uncertainties also extend to property rights. During Russia's transformation from a centrally planned economy to a market economy, legislation was enacted to protect private property against expropriation and nationalization. However, it is possible that due to the lack of experience in enforcing these provisions and potential political factors, these protections would not be enforced in the event of an attempted expropriation or nationalization. Some government entities have tried to renationalize privatized businesses. Expropriation or nationalization of any of our entities, their assets or portions thereof, potentially without adequate compensation, could have a material adverse effect on us.

Unlawful, selective or arbitrary government action may have an adverse effect on our business and results of operations and the value of our ADSs

We operate in an uncertain regulatory environment. Governmental authorities have a high degree of discretion in Russia and at times exercise their discretion selectively or arbitrarily, without hearing or prior notice, and sometimes in a manner that is inconsistent with or contrary to law. Moreover, government authorities also have the power in certain circumstances to interfere with the performance of, nullify or terminate contracts. Standard & Poor's, a division of the McGraw-Hill Companies, Inc., has expressed concerns that "Russian companies and their investors can be subjected to government pressure through selective implementation of regulations and legislation that is either politically motivated or triggered by competing business groups." In this environment, our competitors may receive preferential treatment from the government, potentially giving them a competitive advantage over us.

Unlawful, selective or arbitrary governmental actions have reportedly included denial or withdrawal of licenses, sudden and unexpected tax audits, criminal prosecutions and civil actions. Federal and local government entities have also used common defects in matters surrounding share issuances and registration as pretexts for court claims and other demands to invalidate such issuances and registrations and/or to void transactions, often for political purposes. Unlawful, selective or arbitrary government action, if directed at us, could have a material adverse effect on our

business and on the value of our ADSs.

Shareholder liability under Russian legislation could cause us to become liable for the obligations of our subsidiaries

The Civil Code and the Russian Federal Law on Joint-Stock Companies of December 26, 1995 (the “Joint-Stock Companies Law”) generally provide that shareholders in a Russian joint stock company are not liable for the obligations of the joint stock company and bear only the risk of loss of their investment. This may not be the case, however, when one person is capable of determining decisions made by another person. The person capable of determining such decisions is called an “effective parent.” The person whose decisions are capable of being so determined is called an “effective subsidiary.” The effective parent bears joint and several responsibility for transactions concluded by the effective subsidiary in carrying out these decisions if:

- this decision-making capability is provided for in the charter of the effective subsidiary or in a contract between such entities; and
- the effective parent gives obligatory directions to the effective subsidiary.

In addition, an effective parent may be secondarily liable for an effective subsidiary’s debts if an effective subsidiary becomes insolvent or bankrupt as a result of the action or inaction of an effective parent. This is the case without regard to how the effective parent’s capability to determine decisions of the effective subsidiary arises. For example, this liability could arise through ownership of voting securities or by contract. In these instances, other shareholders of the effective subsidiary may claim compensation for the effective subsidiary’s losses from the effective parent that caused the effective subsidiary to take action or fail to take action knowing that such action or failure to take action would result in losses. Until very recently, there were no decisions of the Russian courts based on this provision of the law. However, on January 26, 2006, a commercial arbitration state court (“arbitrazh court”) of the Moscow region, reviewing a case on appeal, rendered a decision that imposed a liability on the shareholders of a bankrupt company. Accordingly, in our position as an effective parent company, we could be liable in some cases for the debts of our effective subsidiaries. This potential shareholder liability, which, where applicable, is joint and several with the liability of the subsidiary, could materially adversely

16

---

## Table of Contents

affect us. As of December 31, 2004, the total liabilities of our consolidated Russian subsidiaries were U.S.\$18.9 million, excluding intercompany indebtedness.

A shareholder of an effective parent should not itself be liable for the debts of the effective parent’s effective subsidiary, unless that shareholder is itself an effective parent of the effective parent. Accordingly, a shareholder of ours is not personally liable for our debts or those of our effective subsidiaries unless it controls our business.

Because of the weaknesses in Russian minority shareholder protection legislation, your ability to bring, or to recover in, an action against us will be limited

In general, minority shareholder protection under Russian law derives from supermajority shareholder approval requirements for certain corporate actions, as well as from the ability of a shareholder to demand that the company purchase the shares held by that shareholder if that shareholder voted against or did not participate in voting on certain types of action. Companies are also required by Russian law to obtain the approval of disinterested shareholders for certain transactions with interested parties. While these protections are similar to the types of protections available to

minority shareholders in U.S. corporations, in practice corporate governance standards for many Russian companies have proven to be poor, and minority shareholders in Russian companies have suffered losses due to abusive share dilutions, asset transfers and transfer pricing practices. Shareholders' meetings of certain Russian companies have been irregularly conducted, and shareholder resolutions have not always been respected by management. Shareholders of some companies have also suffered as a result of fraudulent bankruptcies initiated by hostile creditors.

In addition, the supermajority shareholder approval requirement is met by a vote of 75% of all voting shares that are present at a shareholders' meeting. Thus, controlling shareholders owning less than 75% of the outstanding shares of a company may have a 75% or more voting power if certain minority shareholders are not present at the meeting. In situations where controlling shareholders effectively have 75% or more of voting power at a shareholders' meeting, they are in a position to approve amendments to the charter of the company and other measures requiring supermajority shareholder approval, which could be prejudicial to the interests of minority shareholders.

Disclosure and reporting requirements and anti-fraud legislation have only recently been enacted in Russia. Most Russian companies and managers are not accustomed to restrictions on their activities arising from these requirements. The concept of fiduciary duties of management or directors to their companies and shareholders is also relatively new and is not well developed. Violations of disclosure and reporting requirements or breaches of fiduciary duties to us and our subsidiaries or to our shareholders could materially adversely affect the value of your investment in our ADSs.

While the Joint-Stock Companies Law provides that shareholders owning not less than one percent of the Company's stock may bring an action for damages on behalf of the company, Russian courts to date have very limited experience with respect to such lawsuits. Russian law does not contemplate class action litigation. Accordingly, your ability to pursue legal redress against us may be limited, reducing the protections available to you as a holder of ADSs.

You could be subject to a mandatory buy-out procedure initiated by any person acquiring more than 95% of our Ordinary Shares

The newly adopted Federal Law No. 7-FZ "On the Amendments to the Federal Law On Joint Stock Companies and other Legal Acts of the Russian Federation," dated December 27, 2005, which amends the Joint-Stock Companies Law, provides for the possibility of a squeeze-out of minority shareholders. Under this law, effective from July 1, 2006, a person acquiring, together with its affiliates, more than 95% of a company's shares is entitled to request, under certain conditions, a mandatory buy-out of the remaining shares purchased at market price from all the other shareholders. For a more detailed discussion on the provisions of this law, see "Item 10—Additional Information—Memorandum And Articles Of Association—Change of Control Provisions." Therefore, you could be subject to a mandatory buy-out procedure upon request of a person acquiring more than 95% of our Ordinary Shares.

17

---

## Table of Contents

Shareholder rights provisions under Russian law may impose additional costs on us, which could cause our financial results to suffer

Russian law provides that shareholders, including holders of our ADSs, that voted against or did not participate in voting on certain matters, have the right to sell their shares to the company at market value, as determined in accordance with Russian law. The decisions that trigger this right to sell shares include:

- reorganization;
- approval by shareholders of a “major transaction,” which, in general terms, is a transaction involving property worth more than 50% of the book value of our assets calculated according to RAR; and
- amendment of our charter that restricts the shareholder’s rights.

Our obligation to purchase the shares in these instances is limited to 10% of our net assets calculated according to RAR, at the time the matter at issue is voted upon. Our or our subsidiaries’ obligation to purchase shares in these circumstances could have an adverse effect on our cash flows and on our business.

Some transactions between us and interested parties require the approval of disinterested directors or shareholders and our failure to obtain approvals could cause our business to suffer

We are required by Russian law and our charter, as amended, most recently on June 30, 2005 (the “Charter”), and provisions on the Board of Directors to obtain the approval of disinterested directors or shareholders for certain transactions with “interested parties.”

Under Russian law, the definition of an “interested party” includes members of our Board of Directors, our General Director, members of any of our management bodies, any person that owns, together with that person’s close relatives and affiliates, at least 20% of our voting shares and any person who otherwise has the right to give mandatory instructions to the company if any of the above-listed persons, or a close relative or affiliate of such person, is:

- a party to a transaction with the company, whether directly or as a representative or intermediary, or a beneficiary of the transaction;
- the owner, together with any close relatives and affiliates, of at least 20% of the shares in the company that is a counterparty to a transaction, whether directly or as a representative or intermediary, or a beneficiary of the transaction; or
- a member of the board of directors or any management body of the company which is a counterparty to a transaction, whether directly or as a representative or intermediary, or a beneficiary of the transaction.

Due to the technical requirements of Russian law, entities within our consolidated group and other entities with which we deal on a regular basis may be deemed to be “interested parties” with respect to certain transactions between themselves. The failure to obtain approvals for interested party transactions when required to do so could adversely affect our business.

In addition, the concept of “interested parties” is defined with reference to the concepts of “affiliated persons” and “group of persons” under Russian law. These terms are subject to many different interpretations. Moreover, the provisions of Russian law that define which transactions must be approved as “interested party” transactions are subject to different interpretations, and we cannot be certain that our application of these concepts will not be subject to challenge. Any successful challenge could result in the invalidation of transactions that are important to our business.

Developing and uncoordinated regulation of Russian capital markets and corporate and securities laws could lead to insufficient protection of your rights as an investor in our ADSs

The regulation and supervision of the securities market, financial intermediaries and issuers are considerably less developed in Russia than in the United States and Western Europe. Securities laws, including those relating to corporate governance, disclosure and reporting requirements have only

## Table of Contents

recently been adopted and laws relating to anti-fraud safeguards, insider trading restrictions and fiduciary duties are rudimentary. In addition, the Russian securities market is regulated by several different authorities, which are often in competition with each other. These include:

- the Ministry of Finance;
- the Federal Antimonopoly Service;
- the Federal Service for Financial Markets (the ‘‘FSFM’’);
- the Central Bank; and
- various professional self-regulatory organizations.

The regulations of these various authorities are not always coordinated and may be contradictory. In addition, Russian corporate and securities rules and regulations can change rapidly, which may adversely affect our ability to conduct securities-related transactions. While some important areas are subject to virtually no oversight, the regulatory requirements imposed on Russian issuers in other areas result in delays in conducting securities offerings and in accessing the capital markets. It is often unclear whether, or how, regulations, decisions and letters issued by the various regulatory authorities apply to our company. As a result, we may be subject to fines or other enforcement measures despite our best efforts at compliance.

The lack of a central and rigorously regulated share registration system in Russia may result in improper record ownership of our shares, including the shares underlying your ADSs

Ownership of shares in Russian joint stock companies is determined by entries in a share register and is evidenced by extracts from that register. Currently, there is no central registration system in Russia. Share registration is carried out by the companies themselves or, as in our case, if a company has more than 50 shareholders or so elects, by licensed registrars located throughout Russia. In addition, shareholders may elect to hold their shares through a depository, which in turn is registered as the nominal holder of the shares in the registrar’s records. Regulations have been issued by the Federal Commission on the Securities Market, the predecessor of the FSFM, regarding the licensing conditions for such registrars and depositories and the procedures to be followed by them when performing the functions of a registrar or a depository. In practice, however, these regulations have not been strictly enforced, and registrars generally have relatively low levels of capitalization and inadequate insurance coverage. Moreover, registrars and depositories are not necessarily subject to effective governmental supervision. Due to the lack of a central and rigorously regulated share registration system in Russia, transactions in respect of a company’s shares could be improperly or inaccurately recorded, and share registration could be lost through fraud, negligence, official and unofficial governmental actions or oversight by registrars or depositories incapable of compensating shareholders for their misconduct. In addition, Russian courts have recently ruled that effectively no party shall be held liable in case of unlawful and fraudulent transfer of shares from owner’s depository account or account with the registrar.

You may be subject to Russian tax that might be withheld on trades of our Ordinary Shares, reducing their value

Russian withholding tax on capital gains may arise from the disposition of Russian shares and securities, such as Ordinary Shares, by non-resident holders. Russian tax authorities may attempt to apply withholding tax on capital gains derived from trading our shares (but not ADSs which are listed and traded on exchanges outside Russia). However, no procedural mechanism currently exists to collect any tax from capital gains with respect to sales of shares made between non-resident holders.

The Russian tax authorities currently require Russian residents to withhold 20% of the entire disposal proceeds or 24% of disposal proceeds less the original cost and certain expenses (in case of holders that are legal entities) or 30%

(in case of holders who are individuals) of the capital gain earned by a non-resident on any shares sold by such non-resident to a Russian resident if more than 50% of the assets in the Russian company whose securities are being sold consist of immovable property and such Russian company's shares are not listed and sold on exchanges outside Russia. A refund of all or a portion of the tax withheld may be available if an applicable tax treaty provides for an exemption or lower rate of

19

---

## Table of Contents

withholding tax. However, obtaining the refund under any relevant tax treaties can be difficult due to the documentary requirements imposed by the Russian tax authorities. If any such tax is assessed, the value of our shares could be materially adversely affected. See "Item 10—Additional Information—Taxation."

Restrictive currency regulations may adversely affect our business and financial condition

We have significant ruble-denominated revenues. Over the past decade, the ruble has at times fluctuated dramatically against the U.S. dollar. The Central Bank has from time to time imposed various currency control regulations in attempts to support the ruble, and may take further actions in the future. Although Russian companies are currently required only to repatriate their proceeds from export sales but not to convert them into rubles (mandatory conversion of 10% of such proceeds was abolished in May 2006), in the past Russian companies were required to convert as much as 75% of such repatriated proceeds, and under existing regulations the percentage of proceeds we are required to convert into rubles may be increased or decreased from time to time by the Russian authorities but may not exceed 30%. The restrictions on our ability to convert our ruble revenues into foreign currencies, or to reconvert to foreign currency the rubles we obtain pursuant to the mandatory repatriation and conversion requirements, may adversely affect our ability to pay overhead expenses outside Russia, meet debt obligations and efficiently carry on our business.

Federal Law No. 173-FZ "On Currency Regulation and Currency Control," dated December 10, 2003 (the "Currency Law"), introduced a new currency control regime, which broadly came into force in June 2004. The Currency Law empowered the Russian Government and the Central Bank to further regulate and restrict currency control matters, including operations involving foreign securities and foreign currency borrowings by Russian companies. It also abolished the need for Russian companies to obtain transaction-specific licenses from the Central Bank, envisaging instead the implementation of generally applicable restrictions on currency control operations, such as the deposit of mandatory reserves with authorized banks for certain currency operations, prior registration to open residents' foreign accounts, and the use of special accounts for certain currency operations. The Central Bank has issued some regulations that introduce currency controls, such as rules with respect to opening offshore bank accounts. Effective from July 2006, the Central Bank requirements to use special-purpose accounts and deposit mandatory reserves in connection with loans, operations with securities and residents' offshore bank accounts will be abolished. However, Central Bank practice has been subject to frequent changes and has not yet developed with respect to the application and enforcement of these new regulations.

The ruble is not convertible outside Russia and the Commonwealth of Independent States (the "CIS"), and the ability of companies operating in Russia to convert rubles into other currencies may be subject to a special account and/or mandatory reserve requirements from time to time. Because of the limited development of the foreign currency market in Russia, we may experience difficulty converting rubles into other currencies. Furthermore, the Central Bank and the Russian Government may impose from time to time additional requirements under the Currency Law, such as restricting any grant by Russian companies of payment deferrals of more than 180 days for commodities exports or requiring the deposit, interest free, of mandatory reserves where a Russian company receives a loan from a foreign



entity the maturity of which is less than three years.

Additionally, any delay or other difficulty in converting rubles into a foreign currency to make a payment or any practical difficulty in the transfer of foreign currency could limit our ability to meet our payment and debt obligations, which could result in the acceleration of debt obligations and cross-defaults.

Furthermore, there are only a limited number of available ruble-denominated instruments in which we may invest our excess cash. Any balances maintained in rubles will give rise to losses if the ruble devalues against major foreign currencies. Moreover, these restrictions may prevent or delay our efforts to pursue attractive acquisition opportunities outside of Russia.

20

---

## Table of Contents

Possible restrictions of foreign investments in strategic industries may limit your ability to hold or sell our ADSs

According to Russian and international press reports, the Russian Ministry of Industry and Energy has prepared a draft law restricting foreign investments in certain “strategic” Russian industries. This draft law has not been submitted to, or approved by, the State Duma and therefore has not become public. The draft law reportedly provides that foreign investors may not own, directly or through a chain of affiliated companies, 50% or more of the share capital of a company involved in a “strategic” industry. In addition, a governmental approval will reportedly be required for acquisition by a foreign investor of more than 25% of a company involved in a “strategic” industry. On March 2, 2006, the Kommersant daily newspaper published a list of 39 “strategic” industries that might be influenced by the proposed law, which included production of natural resources. It is not clear whether foreign investors holding shares in a company involved in a “strategic” industry at the time of the entry into force of any such law would be affected by the provisions of the law. The entry into force of the discussed law could limit your ability to hold, sell or otherwise dispose our ADSs, and, as a result, could adversely affect the value of your investment in our ADSs and your position as a holder of our ADSs.

## Risks Relating to Tatarstan

Relations between Tatarstan and Russia may deteriorate, adversely affecting our business

After the dissolution of the Soviet Union in 1991, certain politicians in Tatarstan, which has a significant non-Russian ethnic population that is predominantly Muslim, called for an independent Tatarstan state. In February 1994, Tatarstan and Russia signed a treaty under the terms of which Tatarstan enjoyed a high degree of autonomy. Since the treaty was signed, Tatarstan has existed peacefully within the Russian Federation. Russian authorities have repeatedly insisted on the revision of the treaty, claiming that it gives too much power to Tatarstan. This treaty expired in July 2005, as it has not been approved by the State Duma as required by Federal Law 95-FZ dated July 4, 2003 (as amended). A new agreement is currently under negotiation. See “—Risks relating to the Russian Federation—Political and social risks—Conflicts between federal and regional authorities and other political conflicts could create an uncertain operating environment that could hinder our long-term planning ability and could adversely affect the value of investments in Russia” under this Item. No assurance can be given that nationalism or other political, economic or religious tensions will not cause the relationship between Tatarstan and Russia to deteriorate, which would likely have a negative impact on us. For example, because Tatarstan is entirely surrounded by other regions of Russia and our principal markets are located outside of Tatarstan in Russia and in Europe, we ship substantially all of our crude oil to or through Russia and therefore rely on the cooperation of Russian authorities and the maintenance of good relations

between Tatarstan and Russia.

Until December 31, 2004, the heads of the 88 sub-federal political units were directly elected by the residents of the relevant region. However, pursuant to Federal Law No. 184-FZ “On General Principles of Organization of Legislative (Representative) and Executive Bodies of Sub-Federal Political Units of the Russian Federation,” the heads of the 88 sub-federal political units, including the President of Tatarstan, are nominated by the President of the Russian Federation and then confirmed by the region’s legislative body. In March 2005, President Putin first exercised this authority, dismissing Vladimir Loginov as the governor of Koryaksky autonomous district, after the region suffered a heating shortage. President Shaimiev was nominated by President Putin, and subsequently confirmed by the legislature of Tatarstan, in March 2005. Nonetheless, future appointments may cause a deterioration of the relationship between Tatarstan and Russia.

The Tatarstan government has the power to exercise significant influence over our operations

The Tatarstan government is able to exercise considerable influence over our operations through its indirect ownership interest in Tatneft, its legislative, taxation and regulatory powers, and significant informal pressures. As of May 15, 2006, OAO Svyazinvestneftekhim (“Svyazinvestneftekhim”), an entity wholly owned by the Tatarstan government, held, directly and through its subsidiary OOO Investneftekhim (“Investneftekhim”), approximately 33.59% of our capital stock and 35.87% of our Ordinary Shares. As of the date of this annual report, four members of our Board of Directors are members of the Tatarstan government.

21

---

## Table of Contents

Tatarstan also holds a “Golden Share”—a special governmental right—in Tatneft. The exercise of its powers under the Golden Share enables the Tatarstan government to appoint one representative to our Board of Directors and Revision Committee and to veto certain major decisions, including those relating to changes in our share capital, amendments to our Charter, our liquidation or reorganization and “major” as well as “interested party” transactions as defined under Russian law. See “Item 7—Major Shareholders and Related Party Transactions—Major Shareholders” for a description of the Golden Share rights of the Tatarstan government.

We may face pressures from the Tatarstan government to engage in certain business practices that we may not have independently chosen and that may not maximize shareholder value

The President of Tatarstan has publicly encouraged us to create a vertically integrated oil company in Tatarstan and also to construct an oil refinery in Tatarstan, and we have made significant investments in new refining facilities in Nizhnekamsk, Tatarstan. The Tatarstan government also controls a number of our suppliers and contractors, such as the electricity producer OAO Tatenergo (“Tatenergo”) and the petrochemicals company OAO Nizhnekamskneftekhim (“Nizhnekamskneftekhim”). Consequently, we may be subject to pressures to enter into transactions that we might not otherwise contemplate with such suppliers and contractors. Although we believe that our relations with the Tatarstan government are currently good, the Tatarstan government has in the past and may in the future cause us to take actions that may not maximize shareholder value, such as maintaining employment levels, increasing expenditure on social assets, selling oil to certain customers, transferring exploration or production licenses to small Tatarstan oil companies (including companies not affiliated with Tatneft), acquiring specified companies or taking actions to raise funds for the benefit of Tatarstan.

Tatarstan legislation may be inconsistent with Russian legislation, and resolution of these inconsistencies is uncertain

During the period from 1991 until February 1994, when the treaty between Russia and Tatarstan was signed, Tatarstan issued privatization and other legislation that was inconsistent with Russian legislation. The treaty gives Tatarstan law precedence over Russian legislation on certain matters. Recently, Tatarstan adopted a number of legislative acts intended to bring Tatarstan law generally into conformity with Russian legislation. However, there is continuing uncertainty about the application of Russian and Tatarstan law in Tatarstan in circumstances where there was in the past or currently remains a conflict between Russian and Tatarstan law. For example, our privatization was conducted primarily in accordance with Tatarstan law, even though there was conflicting Russian legislation under which we conceivably should have been privatized. We are not aware of any challenge to our privatization, but if challenged, our privatization might not be deemed valid under Russian law. Moreover, federal legislation on the Golden Share is in several respects inconsistent with pre-existing Tatarstan legislation. The Tatarstan legislation attaches broader powers to the Golden Share than the federal legislation. See “Item 7—Major Shareholders and Related Party Transactions—Major Shareholders.” It is not clear whether a court would adhere to the federal or Tatarstan legislation if in the future the Tatarstan government would attempt to exercise the broader powers attaching to the Golden Share pursuant to the Tatarstan legislation. In addition, we cannot be certain that we will not become subject to inconsistent regulatory demands in the future.

### Risks Relating to the Company

We have experienced liquidity problems in the past and could experience them in the future

As of December 31, 2004, our total indebtedness other than promissory notes, banking deposit certificates and banking customer deposits was RR27,619 million, of which approximately RR9,518 million was long-term indebtedness and RR18,101 million was short-term indebtedness. As of December 31, 2004, RR17,800 million of our indebtedness was denominated in U.S. dollars, incurred under loan facilities with various foreign banks and which includes the issuance of Eurobonds with a face value of U.S.\$125 million by OAO Bank Zenit (“Bank Zenit”), which were fully repaid in June 2006. Of this amount, approximately 50% was long-term indebtedness and approximately 50% was short-term indebtedness (including current portion of long-term indebtedness). At December 31, 2004, we had outstanding

22

---

### Table of Contents

RR2,998 million in promissory notes, RR6,444 million in bank promissory notes and RR24,597 million in banking customer deposits. A substantial portion of the revenues from our crude oil sales outside the CIS, our primary source of hard currency revenues, is pledged as collateral for our long-term hard currency indebtedness.

In mid-1998, we began to experience liquidity problems, which intensified in subsequent months, causing us to suspend certain payments of interest and principal to certain short-term hard currency creditors. This was primarily due to (i) the significant decrease in world crude oil prices which began in 1997 and continued throughout 1998 reducing our cash flow from exports; (ii) the turmoil in the Russian and international financial markets, most notably the financial crisis in Russia in 1998, which had a negative impact on the liquidity of our investments in Russian securities; and (iii) lending by us to Tatarstan, further reducing our available cash. Our suspension of payments to certain creditors resulted in export proceeds being temporarily retained by those creditors under security agreements in place, causing further cash flow difficulties.

In October 2000, we restructured RR13,635 million (U.S.\$484.7 million) of our hard currency indebtedness, including the principal and capitalized deferred interest. All amounts due under the restructuring agreement were repaid by

March 2002.

In 2001 and 2002, we entered into secured loans arranged by BNP Paribas and Credit Suisse First Boston for an aggregate amount of U.S.\$625 million. In April 2004, we repaid a syndicated loan of U.S.\$100 million and borrowed a further U.S.\$375 million in bridge loans from BNP Paribas and Credit Suisse First Boston, U.S.\$187.5 million from each, for a period of six months, in connection with the proposed acquisition of the shares of Turkey's oil refining monopoly Tupras. See "Item 7—Major Shareholders and Related Party Transactions—Related Party Transactions." We repaid both of these bridge loans in 2004. Our outstanding loans are currently collateralized by aggregate oil exports of 200,000 tons per month (subject to increases depending on crude oil prices). We have also entered into a number of short-term loans collateralized by crude oil export contracts.

Although we believe that the loan agreements were executed on terms beneficial to us, our level of hard currency indebtedness, combined with the uncertainty of world oil prices and instability in the Russian and international financial markets, could have material adverse consequences for us, including:

- limiting our access to additional financing;
- limiting our ability to invest in business development due to the obligation to divert a substantial portion of our hard currency revenues to debt service; and
- increasing our vulnerability to economic downturns and changing market conditions.

The terms of the loan agreements also impose certain financial ratios and constrain our ability to pledge our crude oil sales, which may limit our access to additional financing.

Future delays in the timely completion of our financial statements or filing of our annual reports could lead to negative consequences for us, including sanctions by the New York Stock Exchange or the London Stock Exchange, or cause us to be in default under our loan agreements

The delays in the completion of the audits of our 2003 and 2004 financial statements prepared under U.S. GAAP and the consequent delay in the filing of this annual report have caused us to be in breach of the listing requirements of the New York Stock Exchange, Inc. (the "NYSE"). Pending the filing of this annual report, the NYSE has permitted our ADSs to continue to be traded on the exchange. Nonetheless, should such delays occur again in the future we may be subject to a number of possible consequences, including the possible commencement of suspension or delisting procedures by the NYSE. In addition, the commencement of suspension or delisting procedures by the NYSE may also lead the United Kingdom Listing Authority to review our listing on the London Stock Exchange Limited (the "LSE") and to take possible action, which could, among other possible sanctions, include suspension or delisting. If a suspension or delisting were to occur, on either the NYSE or the LSE, there would be significantly less liquidity in our ADSs, which could result in a decline in the market price of our ADSs. See "—Our independent registered public accounting firm reported material weaknesses in our internal controls and we may not be able to remedy these material weaknesses or prevent future weaknesses" under this Item.

23

---

## Table of Contents

In addition, delays in the completion of our audited 2003 and 2004 financial statements prepared under U.S. GAAP, and our interim consolidated financial statements for the six months ended June 30, 2005, caused us not to comply with one of the covenants contained in our loan agreement with BNP Paribas for U.S.\$300 million and in our loan agreement with Credit Suisse First Boston for U.S.\$200 million. See "Item 5—Operating and Financial Review and

Prospects—Liquidity and Capital Resources—Debt—Long-term foreign currency denominated debt.” BNP Paribas notified us in April 2005 that it considered an event of default to have occurred under the loan agreement our failure to provide our audited 2003 U.S. GAAP financial statements and our interim U.S. GAAP consolidated financial statements for the six months ended June 30, 2004. However, we have provided BNP Paribas and Credit Suisse First Boston with our audited 2003 U.S. GAAP financial statements and we believe that by filing this annual report we have cured any event of default under our loan agreements. As such, we do not believe that BNP Paribas or Credit Suisse First Boston plan to attempt to accelerate payment of these loans or to enforce the related security. Nonetheless, should such delays occur again in the future we may be considered to be in default under certain of our loan agreements. Inability to obtain waivers for any such defaults could lead to acceleration of the payment of such loans, enforcement of the related security or, more generally, impairment of our ability to raise additional capital. See “—Our independent registered public accounting firm reported material weaknesses in our internal controls and we may not be able to remedy these material weaknesses or prevent future weaknesses” under this Item.

We sell a significant portion of our crude oil and refined products in the Russian market, where prices have historically been lower than in the international markets. These sales may adversely affect our revenues

In 2004, we sold approximately 25% of our crude oil volumes (including purchased crude oil) and 55% of our refined products volumes (including purchased refined products) within Russia, accounting for approximately 16% of our total revenues from sales of crude oil and 47% of our total revenues from sales of refined products, respectively. Russian crude oil prices remain below international spot market price levels due to, inter alia, significantly lower transport costs, large regional surpluses in Russia and increasing domestic supplies. Domestic Russian prices for refined products also remain below international spot market prices for refined products.

We are dependent on Transneft, a state-owned company that controls the monopoly pipeline system, for the transport of nearly all of our crude oil, and our ability to export crude oil is limited by the system for allocating access to Transneft’s pipelines

Over 90% of the crude oil produced in Russia, and most of our crude oil, is transported through the Transneft system of trunk pipelines. OAO Transneft (“Transneft”) is a state-owned oil pipeline monopoly. The Transneft pipeline system is subject to breakdowns and leakage. By using multiple pipelines, however, Transneft has generally avoided serious disruptions in the transport of crude oil, and to date, we have not suffered significant losses arising from the failure of the pipeline system. A significant disruption in the pipeline system would, however, have a material adverse effect on our results of operations and financial condition.

Russian government authorities regulate access to Transneft’s pipeline network. Pipeline capacity, including export pipeline capacity, is allocated quarterly to oil producers, generally in proportion to the amount of oil produced and delivered to Transneft’s pipeline network in the prior quarter, planned oil production in the forthcoming quarter, and total pipeline capacity. Generally, a Russian oil company is given an allocation for export to non-CIS countries equal to approximately one-third of its total crude oil so produced and delivered to Transneft. Limitations on access to the export pipelines constrain the ability of producers to export crude oil, and limited port, shipping and railway facilities represent further constraints on the export of crude oil. Though these constraints have subsided in recent years, they have in the past, and may continue in the future, to have a significant impact on our cash flows and results of operations, since export prices are generally higher than domestic prices. Furthermore, failure to pay expenses or taxes to the Russian government could result in the termination or temporary suspension of our access to the export pipelines, which would materially adversely affect our results of operations and financial condition.

In 2001, a Russian court ruled that Transneft stop accepting shipments of crude oil by one of our competitors in response to a lawsuit filed by one of that oil company’s shareholders. In 2002, Russian

---

Table of Contents

courts on several occasions granted similar requests in lawsuits against other Russian companies. Such rulings were overturned quickly. However, we cannot be certain that similar lawsuits will not be filed against us in the future or that any such lawsuits will be resolved in our favor. Any interruption in access to Transneft's pipeline network resulting from any such lawsuits could have a material adverse effect on our results of operations and financial condition.

A significant proportion of our crude oil production and reserves consists of high sulfur content oil, for which we receive a lower price and which has lower marketability than lower-sulfur content crude oil

As of January 1, 2005, most of our proved oil reserves had a high sulfur content, defined as greater than 1.8% sulfur content by mass.

A significant proportion of our crude oil production (approximately 42.8% in 2005, 43.1% in 2004, 42.5% in 2003 and 41.1% in 2002) consists of this high sulfur content oil, and we expect this proportion to continue to increase in the future. Our high sulfur content crude oil, which has an average sulfur content of approximately 3.5% by mass, typically commands a lower price than low sulfur content crude oil. Currently, however, virtually all of our high sulfur content crude oil is blended with low sulfur content crude oil produced by us and by other companies when it is transported through the Transneft pipeline system. The blended crude oil sells for a single uniform price. Although we pay Transneft a premium of U.S.\$2.5 per ton (exclusive of value added tax ("VAT")) of such blended and transported crude oil, we currently benefit overall from Transneft's practice of blending deliveries, as we generally receive a higher price for our blended crude oil than we would if either (i) the higher sulfur content crude oil were transported and sold separately or (ii) Transneft charged a premium for transporting high sulfur content crude that more closely matched the differential in world market price between high sulfur content crude oil and the blended crude oil that Transneft currently carries. There is currently no equalization scheme, often referred to as a "quality bank," for differences in crude oil quality supplied to the Transneft pipeline system. In the past, Transneft and members of the Russian Government have raised, inter alia, the possibility that the oil companies whose high sulfur content oil is blended with low sulfur content oil when transported in the Transneft pipelines should pay compensation to oil companies transporting low sulfur content oil through Transneft pipelines. If these proposals are adopted, the current system will be changed to our significant detriment and our business and results of operations would be adversely affected. See "Item 4—Information on the Company—Exploration and Production."

We do not have arrangements with any refineries with respect to our shipments of high sulfur content crude oil, and the refineries could cease accepting such crude oil from us at any time. Moreover, there are a limited number of refineries in Europe that have the technical capabilities necessary to refine high sulfur content crude oil. We have taken steps to diversify our outlets for high sulfur content crude oil and believe that sufficient refining facilities for this oil will be available to us on acceptable terms in the future. We have made and will continue to make significant investments in the construction of the new Nizhnekamsk refining and petrochemical complex in order to ensure our continued access to facilities for refining high sulfur content crude oil. No assurance can be given, however, that we will succeed in following this strategy or that adequate refining facilities will continue to be available to us.

We must pay transportation expenses and tariffs to Transneft in order to maintain pipeline access, and these expenses and tariffs may be raised in the future, which could increase our costs

We must pay transportation expenses to Transneft in order to maintain our access to export pipelines and seaports. Our failure to pay these expenses could result in the termination or temporary suspension of our access to these export pipelines and seaports, which would adversely affect our results of operations and financial condition. For example, in

October 1998, as a result of our significant liquidity problems, we interrupted payments of transportation expenses to Transneft. Consequently, our export capacity was suspended until we resumed such payments. Further, if the tariffs that we pay for the transportation by pipeline of our crude oil were raised, our costs would increase, which could adversely affect our revenues, cash flows and results of operations.

25

---

## Table of Contents

We have historically had commercial relations with certain countries, including Libya, Iraq, Syria, Iran and Sudan, that are currently or have been until recently the subject of economic sanctions imposed by the United States and international organizations. Violations of existing international or U.S. sanctions could subject us to penalties that would have a material adverse affect on our results of operations

International and U.S. sanctions have been imposed on companies engaging in certain types of transactions with specified countries or companies in those countries. The Tatarstan government and we have held discussions regarding possible transactions involving such countries, including Libya, Iraq, Syria, Iran and Sudan.

After the Libyan government opened its territory for international experts in September 2003, the U.N. lifted sanctions against Libya, and most U.S. trade sanctions were suspended in April 2004 and removed in September 2004. In October 2005, we, among nineteen other international oil companies, received a permit to explore and develop oil fields located in the central part of Libya.

U.N. and U.S. sanctions against Iraq have been lifted subsequent to the military action in Iraq in 2003. Prior to lifting of the sanctions we exported Iraqi oil under the U.N. oil-for-food program, participated in a consortium that includes Rosneft, a major Russian oil company indirectly owned by the Russian Federation (“Rosneft”), to develop Iraqi oil fields, drilled a number of oil wells in Iraq under U.N.-approved contracts and opened a representative office in Iraq. We believe that none of our activities in Iraq was prohibited by U.S. or international sanctions. We do not currently engage in any significant activities in Iraq.

We have opened a representative office in Iran and in February 2005 the government of Tatarstan and the government of Iran concluded an agreement pursuant to which we are expecting to register a joint venture with an Iranian entity in order to participate in various projects in Iran, including tenders for the development of oil fields. The terms of our participation in this venture have not yet been finalized. In 2002, we conducted work under a contract for demercaptanization (a process in which mercaptans—sulfur compounds—are removed from hydrocarbons) of refined products and oxidized gas in Iran and are currently performing contracts for testing microbiological bed stimulation technology in Iran. In addition, we have signed a contract to implement well casing technology in Iran and submitted proposals to participate in tenders to provide engineering services and to obtain production licenses for a group of Iranian oil fields. In March 2005, we concluded an agreement with the government of Syria and the Syrian Oil Company according to which we are to explore and to produce oil in eastern Syria. In the past, we and/or our affiliates discussed proposals for business projects in Sudan. We are currently not engaged, and are not contemplating to be engaged in the future, in any activities in Sudan.

In the future, we may enter into permitted transactions with other countries against which sanctions have been applied. If we violate existing U.S. or international sanctions, penalties could include a prohibition or limitation on our ability to obtain goods and services on the international market or to access the U.S. or international capital markets. However, we believe that we are not currently, and have not in the past been, involved in any transactions with Libya, Iraq, Syria, Iran and Sudan that could result in sanctions against us, and we intend to comply with international

sanctions law in the future.

The Russian and Tatarstan governments can mandate deliveries of crude oil and refined products at less than market prices, adversely affecting our revenue and relationships with other customers

The Russian and Tatarstan governments may direct us to deliver crude oil or refined products to certain government-designated customers, which generally take precedence over market sales. Government-directed deliveries may take several forms. We may be directed to make export sales, to make deliveries to government agencies, the military, agricultural producers or remote regions, or to specific consumers or refineries, such as Nizhnekamskneftekhim, or to domestic refineries in general. Government-directed deliveries may disrupt our relations with our customers, lead to delays in payments for crude oil and refined products or result in sales of our crude oil or refined products at below market prices.

Any failure to make government-directed deliveries may affect our ability to export our crude oil. For example, in November 1998 the Russian government threatened to revoke the export rights of four

26

---

## Table of Contents

Russian oil companies, including Tatneft, for failing to provide domestic refineries with steady supplies of oil. After receiving confirmation from us that we had been providing more than 50% of our crude oil to refineries located in the Russian Federation, the Russian government elected not to interrupt our exports. Any limitation of export rights could materially adversely affect our results of operations and financial condition.

We are dependent on oil refineries outside of Tatarstan

While we produce the majority of our oil in Tatarstan, we have limited ability to process crude oil in this area. Acting at the urging of Tatarstan President Shaimiev, in 1999 we formed a joint venture company, OAO Nizhnekamsk Oil Refinery, with Nizhnekamskneftekhim and OAO Tataro-American Investments and Finance (“TAIF”), which was at the time a related party of the Group, to expand, upgrade, and operate the refinery in Nizhnekamsk—the only oil refinery in Tatarstan. From December 2001, OAO Nizhnekamsk Oil Refinery leased a TAIF-owned crude distilling unit (the “CDU”). The CDU was installed at the Nizhnekamsk oil refinery in 2002 and is a vital asset for its operations. The upgrade included improvements to the CDU and construction of a base refining complex consisting of six additional refining units with a higher added value production. Following the completion of the upgrade, the partners were expected to contribute their assets, including the refining units, the construction of which they had financed, to the charter capital of OAO Nizhnekamsk Oil Refinery, receiving a stake in the company in proportion to the value of their contribution. Since 1999, our most significant capital expenditures were for the upgrade of the Nizhnekamsk oil refinery. Our total investment in the refinery through September 1, 2005 amounted to approximately RR8,450 million. In 2004, we delivered 5.84 million tons of crude oil to the Nizhnekamsk oil refinery, representing approximately 63% of all our domestic crude oil deliveries.

Following the completion of the Phase I base complex in December 2002, we were not able to agree with TAIF on the value of the CDU. In 2003, TAIF brought a case before the arbitrazh court of the Tatarstan Republic claiming the return of the CDU leased to OAO Nizhnekamsk Oil Refinery because of alleged breaches by OAO Nizhnekamsk Oil Refinery of several provisions of the lease agreement. On October 6, 2003 the arbitrazh court of the Tatarstan Republic ruled in favor of TAIF and this decision was upheld by the instance of appeals of the arbitrazh court of the Tatarstan Republic on January 13, 2004. As a consequence, OAO Nizhnekamsk Oil Refinery returned the CDU to



TAIF. In addition, in early September 2005, we sold to TAIF our share in the production assets of OAO Nizhnekamsk Oil Refinery, including the refining units, for approximately U.S.\$315 million. While these production assets have not been physically removed from the Nizhnekamsk oil refinery, TAIF established a new legal entity to which it transferred these assets. Following this sale, OAO Nizhnekamsk Oil Refinery was left without production assets, and is now in the process of liquidation. While we are now building a new oil refining and petrochemical complex in Nizhnekamsk, until its completion, we have limited ability to process crude oil in Tatarstan, and are thus dependent on oil refineries outside of Tatarstan. Should these oil refineries be unable to refine our crude oil, this would have a material effect on our operations.

The Russian tax system imposes substantial burdens on us and is subject to frequent change and significant uncertainty

We are subject to a broad range of taxes imposed at the federal, regional and local levels, including but not limited to excise taxes and export duties, income tax, value added tax, the unified natural resources production tax, property tax, social tax and pension contributions. We were subject to an effective income tax rate (current and deferred income tax expense/benefit as a percentage of income before income taxes and minority interest) of 30% and a total tax burden of 34% (income taxes and taxes other than income taxes as a percentage of sales and other operating revenue) in 2004.

Laws related to these taxes, such as the Russian Federation Tax Code (the “Tax Code”), have been in force for a short period relative to tax laws in more developed market economies, and the government’s implementation of these tax laws is often unclear or inconsistent. Accordingly, few precedents with regard to the interpretation of these laws have been established. Often, differing opinions regarding legal interpretation exist both between companies subject to such taxes and the government and within government ministries and organizations, such as the Federal Tax Service of the Russian Federation (the “Federal Tax Service”), and its various inspectorates, creating uncertainties and areas of conflict.

27

---

## Table of Contents

Generally, tax declarations remain open and subject to inspection by tax and/or customs authorities for a period of three years following the tax year. The fact that a year has been reviewed by tax authorities does not close that year, or any tax declaration applicable to that year, from further review by an upper level of the tax authorities during the three-year period. Several Russian companies have recently been subjected to additional claims for taxes in prior years, including YUKOS, Vimpelcom and TNK-BP. In addition, on July 14, 2005, the Russian constitutional court issued a decision that allows the statute of limitations for tax liabilities to be extended beyond the three-year statutory term if a court determines that a taxpayer has obstructed or hindered a tax inspection. Because none of the relevant terms is defined, tax authorities may have broad discretion to argue that a taxpayer has “obstructed” or “hindered” an inspection and, ultimately, seek penalties beyond the three-year term. These facts create tax risks in Russia substantially greater than typically found in countries with more developed tax systems. In April 2005, we received a claim for back taxes from the federal tax authorities, based on their review of our tax filings for the years 2001, 2002 and 2003, in the amount of RR1,380 million. This amount includes both alleged non-payment and under-payment of taxes as well as fines and penalties. The amount of the tax claim was accrued in our financial statements as of December 31, 2003. While we could have challenged this claim, the issue of any such claim would have been uncertain, given the results of recent Russian companies’ tax claims. In addition, the amounts claimed were significantly smaller than similar claims recently received by other Russian companies. Consequently, we paid in May 2005 the entire amounts claimed.

The taxation system in Russia is subject to inconsistent enforcement at the federal, regional and local levels, which complicates our tax planning and related business decisions. For example, tax laws are unclear with respect to the deductibility of certain expenses. This uncertainty exposes us to the possible imposition of significant fines and penalties and to enforcement measures despite our efforts at compliance, and could result in a greater than expected tax burden.

Financial statements of Russian companies are not consolidated for tax purposes. Therefore, each of our Russian entities pays its own Russian taxes and may not offset its profit or loss against the loss or profit, respectively, of another of our entities. Because Russian legislation contains no consolidation provisions, dividends within the entities comprising our group are subject to Russian taxes at each level (if dividends are paid by a Russian company to another Russian company, the tax base would be determined as the difference between dividends to be paid and dividends received). Currently, dividends payable to a Russian entity are taxed at 9%, and the payer is required to withhold the tax when paying the dividend.

The Russian government has recently revised the Russian tax system. The new tax system is intended to reduce the number of taxes and the overall tax burden on businesses and to simplify the tax laws. However, the revised tax system relies heavily on the judgments of local tax officials and fails to address many of the existing problems. Even in the event of further reforms to tax legislation, they may not result in a reduction of the tax burden on Russian companies and the establishment of a more efficient tax system. Conversely, they may introduce additional tax collection measures. For example, in May 2004, a law was approved that increased the base tax rate for the unified natural resources production tax from RR347 to RR419 per ton of crude oil starting from January 1, 2005. Effective June 1, 2006, crude oil export duty rates were adjusted upwards to U.S.\$199.8 per ton of crude oil from U.S.\$186.4 per ton of crude oil as of April 1, 2006. Accordingly, we may have to pay significantly higher taxes, which could have a material adverse effect on our business.

We maintain insurance against some, but not all, potential risks and losses affecting our operations. We cannot assure you that our insurance will be adequate to cover all of our losses or liabilities. Also, we cannot predict the continued availability of insurance at an acceptable cost

Oil drilling and production activities are subject to numerous risks, including the risk that no commercially productive oil reserves will be found. The cost of drilling and completing wells is often uncertain. Oil drilling and production activities may be shortened, delayed or canceled as a result of a variety of factors, many of which are beyond our control. These factors include:

- unexpected drilling conditions;
- pressure or irregularities in formations;

28

---

#### Table of Contents

- equipment failures or accidents;
- shortages in experienced labor or delays in the delivery of equipment;
- blowouts (i.e., uncontrolled releases of fluids, solids or gases) and surface cratering;
- pipe or cement failures;
- casing collapse; and
- embedded oil field drilling and service tools.

We only have a certain and potentially insufficient level of insurance coverage for expenses and losses that may arise in connection with property damage, work-related accidents and occupational disease, natural disasters and

environmental contamination. We have no insurance coverage for loss of profits or other losses caused by the death or incapacitation of our senior managers. Accordingly, losses or liabilities arising from such events could increase our costs and have an adverse effect on our operations and financial condition.

Our main oil fields are considered “mature” and require increased capital expenditures to maintain production levels. Inability to finance these and other expenditures could have a material adverse effect on our financial condition and the results of our operations

One of our key strategies has been to focus on rehabilitating existing wells to stabilize and optimize production. We anticipate that substantial expenditures will be required to maintain reservoir pressure in our key fields and otherwise to optimize production. Our business also requires other significant capital expenditures, including in exploration and development, production, transport, refining, and to meet our obligations under environmental laws and regulations. We expect to finance a substantial part of these capital expenditures out of cash flows from our operating activities. If international oil prices fall, however, we will have to finance our planned capital expenditures increasingly through bank borrowings and offerings of debt or equity securities in the international capital markets. If necessary, these financings may be secured by our exports of crude oil. During 2005 and 2004, up to 30% of our approximately 1.0 million tons per month and 1.1 million tons per month, respectively, of non-CIS crude oil exports, have been pledged as security for existing borrowings. No assurance can be given that we will be able to raise the financings required for our planned capital expenditures, on a secured basis or otherwise, on acceptable terms or at all. If we are unable to raise the necessary financing, we will have to reduce our planned capital expenditures. Any such reduction could adversely affect our ability to expand our business, and if the reductions are severe enough, could adversely affect our ability to maintain our operations at current levels.

Our exploration, development and production licenses may be suspended, amended or revoked prior to their scheduled expiration

The licensing regime in Russia for the exploration, development and production of oil and natural gas is governed primarily by the Federal Law on Use of Subsoil of February 21, 1992, as amended (the “Subsoil Law”) and regulations issued thereunder. Most of our licenses provide that fines may be imposed, or the licenses may be suspended, restricted or terminated if we fail to comply with license requirements, including the conditions that we make timely payments of levies and taxes for the use of the subsoil, if we systematically fail to provide information, if we go bankrupt or if we fail to fulfill any capital expenditure and/or production obligations or to meet certain environmental requirements.

Article 10 of the Subsoil Law also provides that a license to use a field must be extended by the relevant authorities at the initiative of the license holder if the extension is necessary to finish production in the field, provided that the licensee has not violated the terms of the license. We believe that our existing production licenses will be extended at or prior to their scheduled expiration and we will apply for extensions of our existing production licenses when appropriate.

We may not be able to, or may voluntarily decide not to, comply with the license conditions for some or all of our license areas. If the Russian government determines that we have failed to fulfill the specific terms of any of our licenses or if we operate in the license areas in a manner that violates Russian or local law, government regulators may impose fines on us or suspend or terminate our licenses, or we may not

be able to extend our licenses. Any of these events could have a material adverse effect on our operations and the value of our assets, or cause the price of our ADSs to decline. See “Item 4—Information on the Company—Exploration and Production.”

Our inability to replace current production with new reserves will result in reduced production and will have a material adverse impact on our financial condition and results of our operations

Since 1996, our oil production has generally remained stable. Increasing our crude oil production by developing our non-producing and undeveloped reserves will require significant capital expenditure. Though we believe that our current production levels are stable and sustainable as a result of our current development program, our exploration and production programs may not result in the replacement of current production with new reserves, such programs may not result in new, commercially viable operations and we may not be able to extend the life of our existing reserves. See “Item 4—Information on the Company—Exploration and Production.”

We depend on our senior managers and other key personnel, the loss of any of whom could have an adverse impact on our business

We depend on the continued services and performance of our senior management and other key personnel. If we lose the services of our senior managers or if any of our other executive officers or key employees should cease to take an active role in managing our affairs, we may not be able to operate our business as effectively as we anticipate and our operating results may suffer. In particular, we are heavily dependent upon our General Director, Shafagat F. Takhautdinov, and certain other key managers. We cannot assure you that their services, or those of other key managers, will continue to be available to us, and the loss of any one of these could materially adversely affect our business.

Failure to carry out our corporate reorganization program in its entirety or for it to have the desired effects may adversely affect our expected financial and operational results

We have adopted a corporate reorganization program as part of our strategy for reducing costs and improving production efficiency. This program faces numerous difficulties, including local opposition to the transfer of social assets, such as schools and medical facilities, from our ownership or management to local jurisdictions. These have prevented or delayed and may well continue to prevent or delay the implementation of certain aspects of the corporate reorganization program. See “Item 4—Information on the Company—Corporate Reorganization.”

Our independent registered public accounting firm reported material weaknesses in our internal controls and we may not be able to remedy these material weaknesses or prevent future weaknesses

In connection with their audits of our consolidated financial statements for the years ended December 31, 2003 and 2004, Ernst & Young, our independent auditor, reported weaknesses in our internal controls, as had PricewaterhouseCoopers, our independent auditor in respect of prior periods. Specifically, our independent auditor found that our system of internal control lacks adequate processes and controls relating to the timely and accurate capture and recording of transactions in accordance with U.S. GAAP that would reduce to a relatively low level the risk that errors in amounts that would be material in relation to those financial statements may occur and may not be detected within a timely period by management in the normal course of business. In particular, our independent auditor found that, with respect to the preparation of our U.S. GAAP consolidated financial statements for the year ended December 31, 2004:

- Our personnel directly involved in the financial reporting under U.S. GAAP consist of seven employees. Given our size, the complexity of our business transactions, the number of locations involved and the increasing requirements from the regulatory bodies (including those of Sarbanes-Oxley Act of 2002), our independent auditor believes that the size of our financial

reporting department is inadequate to meet the applicable U.S. GAAP and the SEC reporting requirements. There is a risk therefore that financial information may be materially misstated, since in the process of financial statement closing the results of various transactions may not be correctly summarized, reviewed, consolidated, edited and included into a variety of regulatory and financial reports.

30

---

### Table of Contents

- We do not have either integrated information systems or general ledgers which support dual Russian statutory and U.S. GAAP accounting. U.S. GAAP accounts are prepared with the use of spreadsheets, using Russian statutory accounting data as the initial inputs. Additionally, U.S. GAAP consolidation for the Group is performed using a complex spreadsheet. The lack of integrated information systems and the high volume of manual computations significantly increase the risk of unintentional material errors and create difficulties for us in preparing accurate and timely financial statements. Furthermore, our independent auditors note that we do not have computerized fixed assets registers for U.S. GAAP reporting purposes in respect of building and construction, and machinery and equipment. As a result, approximately RR27,229 million, or 15% of our consolidated fixed assets balance as at December 31, 2004, and approximately RR1,966 million, or 21% of our depreciation expense for 2004, were calculated with the use of spreadsheets, which, due to the human effort required, are prone to error.
- There is no process in place to ensure that the personnel charged with financial statement preparation are timely and fully informed by senior management about the substance of business transactions in order to determine their appropriate recognition in the consolidated financial statements prepared in accordance with U.S. GAAP.
- Our Executive Board controls the operations of OAO Tatneft, our parent company, only within the limits established by Russian legislation and our charter documents. We have a complex organization structure which includes more than one hundred subsidiaries and the structure changes from year to year. There is no written and clear policy establishing the role of senior executives of the Group in the internal control and oversight of the operations of the subsidiaries. Accordingly, there is a risk that certain significant business transactions that occur in the subsidiaries may not be properly authorized or approved by our senior executives, and these transactions may not be accurately disclosed or reported in the financial statements.
- There is no effective process in place to ensure that all entities (including those deemed immaterial) where we exercise control or significant influence are consolidated or equity accounted for in the U.S. GAAP financial statements, including consideration of variable interest entities, of which we may be the primary beneficiary or over which we may exert significant influence.
- There is no effective process in place to ensure that all related parties, as defined by U.S. GAAP and the SEC, are identified and the nature of relationships and respective transactions are reflected in the consolidated financial statements. In addition, the process that was in place during 2004 is not sufficient to allow us an opportunity to determine the identity of all counter-parties with which we enter into significant transactions.
- Given the seriousness of the material weaknesses discussed above, our independent auditor has recommended that the Audit Committee continues to be involved in the oversight of the financial reporting process, and in monitoring management's risk assessment processes (including the risks of fraud). Our independent auditor has also recommended that the Audit Committee provides guidance to our management in developing and implementing a plan to

overcome the above material weaknesses in an acceptable and timely manner. Our independent auditor has further recommended that the Audit Committee establishes a policy for reporting to our Board of Directors to allow important information to be brought to the attention of senior management on a regular basis.

In addition, an independent legal investigation into certain transactions, undertaken at the request of our Audit Committee in connection with the audit of our U.S. GAAP financial statements for the year ended December 31, 2003, indicated the following weaknesses in our internal controls: a lack of written policies and procedures at the group level; certain transactions not properly communicated to accounting and finance; incorrect recording of transactions, including failure to properly record substantial amounts of money being loaned; and procuring stock for a possible stock-based compensation plan without a complete formulation of the plan resulting in a failure to properly record treasury stock. The investigation found that our control environment (including our maintenance of books and records and internal controls) was inadequate under the applicable requirements of the Exchange Act.

31

---

## Table of Contents

One of the components of internal control is the control environment. The control environment reflects the tone of the organization, which influences the control consciousness of its personnel. The key factors affecting the control environment include among other things, participation of the Board of Directors, management's philosophy and clearly defined operating style, organizational structure, assignment of authority and responsibility and policies and procedures. Our independent auditor found that the lack of clearly defined and articulated policies and procedures, combined with a management tone, which does not stress the importance of controls within the organization, increases the risk of error or misstatement in reported financial results. In a weak control environment such as ours, there is usually a greater likelihood that the specific risks created by one identified deficiency will not be overcome by strengths in other areas or by the basic attitude of the organization toward controls.

For further discussion of the independent legal investigation, its conclusions and the steps that we are taking to remedy our control deficiencies, see "Item 15—Controls and Procedures." Notwithstanding the steps we are taking to address these issues, we may not be successful in remedying these material weaknesses or preventing future material weaknesses. If we are unable to remedy these material weaknesses, there is a risk that we may not be able to prevent or detect a material misstatement of our annual or interim U.S. GAAP consolidated financial statements. In addition, any failure to implement new or improved internal controls, or resolve difficulties encountered in their implementation, could harm our operating results or cause us to fail to meet our reporting obligations. Inferior internal controls could also cause investors to lose confidence in our reported financial information, which could have a negative effect on the trading price of our shares and ADSs.

We expect the oil industry in Russia to become increasingly competitive

We expect that the ongoing restructuring of the oil and natural gas industry in Russia will lead to increased competition for new exploration and production licenses, access to capital resources, transportation infrastructure, sales and other aspects of the production and transportation process. Recently, the Russian oil industry has experienced significant consolidation, including the privatization sale of Slavneft, a large Russian oil company, to a consortium of shareholders who also control Tyumen Oil Company ("TNK") and Sibneft, Russia's third and fifth largest oil companies, respectively; establishment of a strategic joint venture between BP and TNK on the basis of their respective Russian assets; the sale of Yuganskneftegaz, the most significant subsidiary of YUKOS, to Rosneft; and the acquisition of Sibneft, the fifth largest oil producer in Russia, by the state-owned Gazprom. These and other companies may have better access to financial and other resources than we do, and this may give them a competitive

advantage. In addition, our domestic competitors may be strengthened through strategic acquisitions of additional assets, including in Tatarstan. Russneft, the tenth largest oil producer in Russia, has recently acquired significant production and refinery facilities in Russia and announced its plans to acquire additional facilities in the near future. See “Item 4—Information on the Company—Competition.”

Excessive appreciation of the ruble against the U.S. dollar would adversely affect our margins and cash flows

After a protracted period of weakness, the ruble has appreciated against the U.S. dollar in recent years, including by 13.6% in 2004 and 3.9% in 2005 in real terms. Because our revenues are substantially linked to the U.S. dollar and our costs (other than a large portion of debt-service costs) are denominated primarily in rubles, the real appreciation of the ruble has already had and may continue to have an adverse effect on our business, results of operations, financial condition and cash flows by causing our costs to increase relative to our revenue.

### Risks Relating to the Oil Industry

A substantial or extended decline in prices for crude oil and refined products could adversely affect our business, results of operations, financial condition, liquidity and our ability to finance planned capital expenditures

Our revenues, profitability and future rate of growth depend substantially upon prevailing prices of crude oil and refined products. Historically, prices for oil have fluctuated widely in respect to changes in many factors. Factors that can cause this fluctuation include:

32

---

### Table of Contents

- global and regional supply and demand, and expectations regarding future supply and demand, for crude oil and refined products;
- market uncertainty;
- weather conditions;
- domestic and foreign governmental regulations;
- prices and availability of alternative fuels;
- prices and availability of new technologies;
- the ability of the members of the Organization of Petroleum Exporting Countries (the “OPEC”), and other crude oil producing nations, to set and maintain specified levels of production and prices;
- political and economic developments in oil producing regions, particularly the Middle East;
- Russian and foreign governmental regulations and actions, including export restrictions and taxes; and
- global and regional economic conditions.

The decline in world oil prices from October 1997 to December 1998 by more than 54% to less than U.S.\$10 per barrel was one of the primary reasons for our significant liquidity problems in the second half of 1998. See “—Risks Relating to the Company—We have experienced liquidity problems in the past and could experience them in the future” under this Item. While oil prices remain volatile, average price levels since 1998 have been consistently above the low levels reached in 1998. According to the International Energy Agency, the average prices of Brent crude, an international benchmark oil price, for the three years ended December 31, 2004, 2003 and 2002, were approximately U.S.\$38.22, U.S.\$28.83, and U.S.\$25.02 per barrel, respectively. The average price of Brent crude increased to U.S.\$54.38 per barrel in 2005 and the price of Brent crude was U.S.\$69.39 per barrel at June 1, 2006. Crude oil prices

increased in 2005, 2004 and 2003, following a slight increase in 2002 and after declining significantly in 2001, as a result of export restrictions imposed by OPEC and certain other crude oil producing nations, including Russia, in 2003, improving global economic conditions and heightened tensions in the Middle East and war in Iraq. However, there can be no assurance that oil prices will not decline again. Because our crude oil export sales are the primary source of our hard currency revenues, including revenues needed to repay lines of credit from foreign lenders, and an important source of our earnings and cash flows, any decline in international crude oil or refined product prices is likely to have a material adverse effect on our financial position and results of operations.

Lower prices may also reduce the amount of oil that we can produce economically or reduce the economic viability of projects planned or in development. We may reduce our planned capital expenditures if international crude oil or refined product prices fall below the price assumptions used in our internal estimates.

We do not currently engage in any hedging transactions or other derivatives trading to reduce the impact of fluctuations of crude oil prices on our company.

The crude oil and natural gas reserves data in the Reserves Reports are only estimates and are inherently uncertain, and our actual production, revenues and expenditures with respect to our reserves may differ materially from these estimates

The crude oil reserves data set forth in this annual report and the crude oil and natural gas reserves data set forth in the Reserves Reports, incorporated by reference into this annual report from our reports on Forms 6-K furnished to the SEC on July 23, 2004 and March 20, 2006, respectively, are estimates based primarily on internal engineering analyses that were audited by Miller and Lents, independent petroleum engineering consultants as of January 1, 2005 and 2004, respectively. The most recent reserves estimates were calculated using oil and natural gas prices for us in effect on January 1, 2005. Any significant price changes could have a material effect on the quantity and present values of our proved reserves.

Petroleum engineering is a subjective process of estimating underground accumulations of oil and natural gas that cannot be measured in an exact manner. Estimates of the value and quantity of

33

---

## Table of Contents

economically recoverable oil and natural gas reserves, rates of production, future net revenues and cash flows and the timing of development expenditures necessarily depend upon a number of variable factors and assumptions, including the following:

- historical production from the area compared with production from other comparable producing areas;
- interpretation of geological and geophysical data;
- the assumed effects of regulations adopted by governmental agencies;
- assumptions concerning future percentages of international sales;
- assumptions concerning future oil and natural gas prices;
- capital expenditures; and
- assumptions concerning future operating costs, tax on the extraction of commercial minerals and excise taxes, development costs and workover and remedial costs.



Because all reserves estimates are subjective, each of the following items may differ materially from those assumed in estimating reserves as set forth in the Reserves Reports:

- the quantities and qualities of oil and natural gas that are ultimately recovered;
- the production and operating costs incurred;
- the amount and timing of future development expenditures; and
- future oil and natural gas sales prices.

Many of the factors, assumptions and variables involved in estimating reserves are beyond our control and assumptions and variables on which the Reserves Reports are based may prove to be incorrect over time. This is especially true in Russia, where there has been political and economic uncertainty in the recent past. Results of drilling, testing and production after the date of the estimates may require substantial upward or downward revisions in our reserves data. Furthermore, different reservoir engineers may make different estimates of reserves and cash flows based on the same available data. Actual production, revenues and expenditures with respect to reserves will vary from estimates and the variances may be material. Any downward adjustment could lead to lower future production and thus adversely affect our financial condition, future prospects and market value. See “Item 4—Information on the Company—Exploration and Production.”

We may incur material costs to comply with, or as a result of, health, safety and environmental laws and regulations

We incur, and expect to continue to incur, substantial capital and operating costs in order to comply with increasingly complex laws and regulations covering the protection of the environment and human health and safety.

The level of pollution and potential clean-up is impossible to assess without an environmental audit (which we have not undertaken) and consistent interpretation and enforcement of environmental laws by the federal, regional and local authorities (which has not occurred). In connection with our applications for licenses to explore and develop oil resources, we are generally required to make significant commitments concerning levels of pollutants that we release and remediation in the event of environmental contamination.

New laws and regulations, the imposition of tougher requirements in licenses, increasingly strict enforcement of, or new interpretations of, existing laws, regulations and licenses, or the discovery of previously unknown contamination may require further expenditures to:

- modify operations;
- install pollution control equipment;
- perform site clean-ups;

34

---

#### Table of Contents

- curtail or cease certain operations; or
- pay fees or fines or make other payments for pollution, discharges or other breaches of environmental requirements.

Furthermore, the implementation of the Kyoto Protocol to the United Nations Framework Convention on Climate Change from February 2005 (the “Kyoto Protocol”) may impose new and/or additional rules or more stringent environmental norms. Such requirements may require additional capital expenditures or modifications in our operating practices.

Under existing legislation, we believe that there are no significant environmental liabilities, beyond the amounts that we have already incurred in order to comply with the environmental requirements, that will have a material adverse effect on our operating results or our financial position.

Although the costs of the measures taken to comply with the environmental regulations have not had a material adverse effect on our financial condition or results of operations to date, in the future the costs of such measures and liabilities related to environmental damage caused by us may increase. Furthermore, we do not have any insurance for environmental damage caused by our activities.

#### Risks Relating to Investment in our ADSs

You may be unable to repatriate your earnings from our ADSs

Russian currency control legislation pertaining to payment of dividends currently requires dividends on ordinary shares to be paid in rubles. Under this legislation, ruble dividends may be converted into U.S. dollars by the depository for distribution to owners of ADSs without restriction. In addition, ADSs may be sold by non-residents of Russia for U.S. dollars outside Russia without regard to Russian currency control laws as long as the buyer is not a Russian resident for currency control purposes.

The ability of the depository and other persons to convert rubles into U.S. dollars (or another hard currency) is also subject to the availability of U.S. dollars (or another hard currency) in Russia's currency markets. Although there is an existing market within Russia for the conversion of rubles into U.S. dollars, including the interbank currency exchange and over-the-counter and currency futures markets, the further development of this market is uncertain. At present, there is no market for the conversion of rubles into foreign currencies outside of Russia and no viable market in which to hedge ruble and ruble-denominated investments. See "Item 10—Additional Information—Exchange Controls."

Our ability to pay dividends is constrained by Russian accounting practices and our loan agreements with creditors

We are permitted to pay dividends on our Ordinary Shares out of net profits, and dividends on Preferred Shares out of net profits and special funds designated for such purposes, in each case calculated in accordance with RAR, which differ in significant respects from U.S. GAAP. Any amounts available for distribution as dividends on our shares as determined under RAR may be significantly lower than the amounts that would have been determined under U.S. GAAP. In addition, our loan agreements with some of our hard currency lenders contain restrictions on the payment of dividends. See "Item 8—Financial Information—Dividends and Dividend Policy."

The market price of our shares and ADSs could be adversely affected by potential future sales

The trading price of our shares and ADSs could be adversely affected as a result of sales of substantial numbers of our shares in the public market, or by the perception that this could occur. These factors could also make it more difficult to raise capital through equity or equity-linked offerings.

As of May 15, 2006, the Tatarstan government, through its wholly-owned entity Svyazinvestneftekhim and its subsidiary Investneftekhim, held approximately 33.59% of our capital stock and 35.87% of our Ordinary Shares. Svyazinvestneftekhim is free to dispose the Ordinary Shares it holds at any time. Significant dispositions of these shares could adversely affect the price of our ADSs.

Table of Contents

The rights of non-Russian residents to own or vote our shares or ADSs may be subject to restrictions

According to the Law on the Securities Market and the regulations of the Russian Federal Commission on the Securities Market, the predecessor of the FSFM, the deposit of shares of a Russian company into an American Depositary Receipt (“ADR”) program requires the permission of the FSFM. Such permission may be denied, among other reasons, if more than 35% of the class of shares eligible for deposit into the ADR program will circulate outside Russia, including in the form of ADSs, or if the ADR program contemplates the voting of the shares underlying the ADSs other than in accordance with the instructions of the ADS holders. Our ADR program has no express limitations on the deposit of our Ordinary Shares into the program, and it contemplates that, in the absence of instructions from ADS holders, the depository will give a proxy to vote the shares underlying such ADRs to our representative. There is uncertainty as to whether the FSFM regulation applies to ADR programs into which additional shares have been deposited and/or continue to be deposited in excess of 35% of the Ordinary Shares at the time of enactment of the regulation, or only to ADR programs established after the time of its enactment. Articles appearing in the press have noted that in January 2003, The Bank of New York ceased deposits of shares of another Russian company into its ADR program after the aggregate number of shares deposited into the program exceeded the amount permitted by the FSFM for this company. We have never applied to the FSFM or its predecessor entities for permission for our ADR program. The number of the Ordinary Shares deposited in our ADR program constitutes approximately 24.5% of our Ordinary Shares, and we may be required to limit the amount of the Ordinary Shares deposited in our ADR program to 35% of our Ordinary Shares. Accordingly, we can give no assurance that The Bank of New York, acting as one of the depositories for our ADR program, will allow additional deposits of the Ordinary Shares if they exceed the 35% limitation. Furthermore, the FSFM regulation does not specify the consequences of violating the regulation. An assertion that the FSFM regulation and/or the limitation on shares deposited in the program apply to our ADR program could have a material adverse effect on the market price of our Ordinary Shares or ADSs.

Voting rights with respect to the shares represented by our ADSs are limited by the terms of the deposit agreement for our ADSs and relevant requirements of Russian law, which may prevent or delay the ability of ADS holders to exercise their rights

ADS holders may exercise voting rights with respect to the Ordinary Shares represented by ADSs only in accordance with the provisions of the deposit agreement relating to the ADSs and relevant requirements of Russian law. However, there are practical limitations with respect to their ability to exercise their voting rights due to the additional procedural steps involved in communicating with them. For example, the Joint-Stock Companies Law and the Charter require us to notify shareholders at least 20 days in advance of any general meeting, 30 days in advance if the agenda of such meeting includes an item on the Company’s reorganization and at least 50 days in advance of an extraordinary meeting relating to election of directors. Holders of our Ordinary Shares receive notice directly from us and are able to exercise their voting rights by either attending the meeting in person or voting by proxy.

By comparison, an ADS holder will not receive notice directly from us. Rather, in accordance with the deposit agreement, we will provide the notice to the depository. The depository has undertaken in turn, as soon as practicable thereafter, to mail to ADS holders the notice of such meeting, voting instruction forms and a statement as to the manner in which instructions may be given by holders. To exercise his or her voting right, the ADS holder must then instruct the depository how to vote its shares. Because of this extra procedural step involving the depository, the process for exercising voting rights may take longer for ADS holders than for holders of Ordinary Shares. ADSs for which the depository does not receive timely voting instructions will not be voted. In addition, although securities regulations expressly permit the depository to split the votes with respect to the shares underlying the ADSs in accordance with instructions from ADS holders, this regulation remains untested, and the depository may choose to refrain from voting at all unless it receives instructions from all ADS holders to vote the shares in the same manner. ADS holders may thus have significant difficulty in exercising voting rights with respect to the shares underlying the

ADSs.

36

---

Table of Contents

Because the depositary may be considered the beneficial holder of the shares underlying the ADSs, these shares may be arrested or seized in legal proceedings in Russia against the depositary, adversely affecting the holders of our ADSs

Russian regulations governing nominee holders, including global custodians and ADS depositaries in their custodial capacity, are underdeveloped and subject to varying interpretations. For example, it is unclear whether global custodians and ADS depositaries that are acting outside of Russia for non-Russian clients and investors but who are, on behalf of their clients and investors, holding in Russia through a Russian licensed custodian, securities issued by Russian companies, including our Ordinary Shares underlying our ADSs, are required to obtain a license from the FSFM to hold Russian securities on behalf of these clients and investors. If they do not obtain this license, their “nominee holder” status in Russia might not be recognized and therefore they may be viewed under Russian law as the beneficial owner. Because Russian law may not recognize ADS holders as beneficial owners of the underlying shares, it is possible that an ADS holder could lose all its rights to those shares if the depositary’s assets in Russia are seized or arrested. In that case, an ADS holder would lose all the money invested in our ADSs.

Russian law may treat the depositary as the beneficial owner of the shares underlying the ADSs. This is different from the way other jurisdictions treat ADSs. In most states of the United States, for example, although shares may be held in the depositary’s name or to its order, making it a “legal” owner of the shares, the ADS holders are the “beneficial,” or real owners. In those jurisdictions, an action against the depositary, the legal owner, would not result in the beneficial owners losing their shares. Russian law may not make the same distinction between legal and beneficial ownership, and a court may only recognize the rights of the depositary in whose name the shares are held, not the rights of ADS holders, to the underlying shares. Thus, in proceedings brought against a depositary, whether or not related to shares underlying ADSs, Russian courts may treat those underlying shares as the assets of the depositary, subject to seizure or arrest. We do not know yet whether the shares underlying the ADSs may be seized or arrested in Russian legal proceedings against a depositary. In the past, a lawsuit was filed against a depositary bank seeking the seizure of various Russian companies’ shares represented by ADSs issued by that depositary. In the event that this type of suit were to be successful in the future, and if the shares underlying our ADSs were to be seized or arrested, the ADS holders involved would lose their rights to such underlying shares.

Given that under Russian law the depositary may also be viewed as the owner of the shares underlying the ADSs, the depositary may need to comply with various Russian legal requirements regarding aggregate share ownership in a Russian company. For example, under Russian law, a person must receive the prior approval of the Federal Antimonopoly Service, a successor to the Russian Ministry for Antimonopoly Policy and Support of Entrepreneurship, before holding more than 20% of a company the size of Tatneft. As of March 31, 2006, Bank of New York held approximately 24.5% of our Ordinary Shares.

You may have limited recourse against us and our officers and directors because we conduct our operations outside the United States and all of our officers and directors reside outside the United States

Our presence outside the United States may limit your legal recourse against us. We do not have any presence in the United States and are incorporated under the laws of the Russian Federation. All of our directors and executive officers reside outside the United States. All or a substantial portion of our assets and the assets of our officers and directors are located outside the United States. As a result, you may not be able to effect service of process within the

United States upon us or on our officers and directors. Similarly, you may not be able to obtain or enforce U.S. court judgments against us, our officers or directors, including actions based on the civil liability provisions of the federal securities laws of the United States. In addition, it may be difficult for you to enforce liabilities predicated upon U.S. securities laws in original actions brought in courts in jurisdictions outside the United States.

There is no treaty between the United States and the Russian Federation providing for reciprocal recognition and enforcement of foreign court judgments in civil and commercial matters. Similarly, you may not be able to obtain or enforce foreign judgments against us on the same basis. These limitations may deprive you of effective legal recourse for claims related to your investment in our ADSs.

37

---

## Table of Contents

The deposit agreement provides for controversies, claims and causes of action brought thereunder by any party thereto against us to be settled by arbitration in accordance with the Commercial Arbitration Rules of the American Arbitration Association, provided that any controversy, claim or cause of action relating to or based upon the provisions of the federal securities laws of the United States or the rules or regulations promulgated thereunder may, but need not, be submitted to arbitration. The Russian Federation is a party to the United Nations (New York) Convention on the Recognition and Enforcement of Foreign Arbitral Awards. However, it may be difficult to enforce arbitral awards in the Russian Federation due to a number of factors, including the inexperience of Russian courts in international commercial transactions, official and unofficial political resistance to enforcement of awards against Russian companies in favor of foreign investors, Russian courts' inability to enforce such orders, and corruption.

You may not be able to benefit from the United States-Russia double tax treaty

The Russian tax rules applicable to U.S. holders of our ADSs are characterized by significant uncertainties and by an absence of interpretive guidance. Russian tax authorities have not provided any guidance regarding the treatment of ADS arrangements, and there can be no certainty as to how the Russian tax authorities will ultimately treat those arrangements. In particular, it is unclear whether Russian tax authorities will treat U.S. holders as the beneficial owners of the underlying shares and dividends and other proceeds relating to the underlying shares and, therefore, persons entitled to the underlying shares, for the purposes of the United States-Russia double tax treaty. If the Russian tax authorities do not treat U.S. holders as the beneficial owners of such dividends and proceeds, then the U.S. holders would not be able to benefit from the provisions of the United States-Russia double tax treaty. In this event, dividends paid to U.S. holders generally will be subject to Russian withholding tax at a rate of 15% for holders that are legal entities and 30% for individual holders rather than the reduced rate of 5% for corporate legal entities owning at least 10% or more of our outstanding voting shares and the rate of 10% in other cases under the United States-Russia double tax treaty. See "Item 10—Additional Information—Taxation."

## Other Risks

Terrorist activity and global instability could have an adverse effect on our business and share price

On September 11, 2001, terrorist attacks were carried out against multiple targets in the United States causing the loss of many lives and extensive property damage. These events and their aftermath have had a significant effect on international financial and commodities markets. Any future acts of terrorism of such magnitude could have an adverse effect on the international financial and commodities markets and the global economy.

Table of Contents

## ITEM 4—INFORMATION ON THE COMPANY

## BUSINESS OVERVIEW

Tatneft is one of the largest producers of crude oil in Russia. Substantially all of our production and other operations are located in Tatarstan, a republic of Russia situated between the Volga River and the Ural Mountains and located approximately 750 kilometers southeast of Moscow. We currently hold most of the exploration and production licenses and produce over 80% of the crude oil produced in Tatarstan. As of January 1, 2004, our total proved reserves of crude oil were approximately 836.6 million tons (5,959 mmbbl) and as of January 1, 2005, our total proved reserves of crude oil were approximately 814.4 million tons (5,801.1 mmbbl). We revised our estimate of the net oil reserves as of January 1, 2005, as set out in the Revised Reserves Report. See “Exhibit 15.1—Report of Reserve Consultants, Miller and Lents, Ltd., dated March 20, 2006” and “—Exploration and Production.” In addition to crude oil production, in recent years we have diversified our operations by building up our refining capabilities, developing a network of retail service stations, creating a petrochemicals holding division centered around one of Russia’s largest tire producers Nizhnekamskshina and providing banking services through Bank Zenit and AB Bank Devon-Credit (“Bank Devon-Credit”). In April 2005, our wholly-owned subsidiary, Tatneft Oil AG, sold its 26.75% stake in Bank Zenit to three companies acting for the benefit of certain beneficiaries of Urals Energy NV (“Urals Energy”). This transaction had the effect of reducing our ownership interest in Bank Zenit from 52.70% to 25.95%. In May 2006 we acquired 48.92% of newly issued shares in Bank Zenit, thus increasing our stake to 39.73%. In December 2005, we sold all of our shares, 92%, in Bank Devon-Credit to Bank Zenit. See Appendix A to this report. Our sales and other operating revenues were RR206,782 million, RR155,818 million and RR146,328 million for the years ended December 31, 2004, 2003 and 2002, respectively. We employed approximately 80,560 persons as of December 31, 2005.

## HISTORY AND DEVELOPMENT

Tatneft is an open joint-stock company organized under the laws of Russia and Tatarstan. Our principal business is to explore for, develop, produce and market crude oil. Our registered office is located at 75 Lenin Street, Almetyevsk, Tatarstan 423450, Russian Federation (telephone: 7-8553-250-700). Our main offices and virtually all of our administrative staff are located in Almetyevsk, a city located approximately 950 kilometers southeast of Moscow and 250 kilometers southeast of Kazan, the capital of Tatarstan. Our agent for service of process in the United States in connection with any suit or proceeding arising out of, or relating to, our Ordinary Shares, ADSs or the deposit agreement pursuant to which they were issued is Puglisi & Associates, located at 850 Library Avenue, Suite 204, P.O. Box 885, Newark, Delaware 19715, United States of America.

Tatneft is the legal successor to the Soviet-era production association “PA Tatneft,” which was formed in 1950, along with several other oil production-related state enterprises in Tatarstan. As part of the process of privatization of state-owned enterprises following the dissolution of the Soviet Union, substantially all of the assets of these enterprises were transferred to us, and we became an open joint-stock company in January 1994. For the history of our privatization, see “Item 7—Major Shareholders and Related Party Transactions—Major Shareholders—Shareholding Structure.”

The first oil was discovered in Tatarstan in 1943, and Romashkinskoye oil field, the largest oil field in Tatarstan, was discovered in 1948. PA Tatneft received the right to develop the Romashkinskoye field in 1950 when PA Tatneft was formed. It was soon thereafter given the right to develop what is now Tatneft’s second largest oil field, the

Novo-Yelkhovskoye field. Tatneft still produces most of its crude oil from these two fields. PA Tatneft subsequently also acquired licenses to numerous smaller fields in Tatarstan. See “—Exploration and Production” under this Item.

Tatneft’s core exploration and production activities are currently organized along geographic lines, although a number of exploration and production support functions have been centralized. Our core exploration and production activities are carried out by 11 units known as the Oil and Gas Production Departments, or by their Russian acronym “NGDUs.” Two of these units are expected to be merged into two other existing units in 2006. Each NGDU is responsible for the exploration and production of crude

39

---

## Table of Contents

oil on specified sections of oil fields. Each NGDU historically combined exploration and production activities (production wells, oil preparation and storage units, maintenance units, automation shops and research units) with exploration and production support capabilities (transport and construction) and certain “social” activities (housing and agriculture). As part of a reorganization program, our exploration and production support capabilities and certain social assets have been transferred into separate service companies (in the areas of drilling, well rehabilitation, production services, construction and assembly) and other companies (e.g., road construction and maintenance companies and collective farms). Certain other social assets are being transferred to local authorities (e.g., housing) in order to allow Tatneft to focus on its core exploration and production functions. We intend to retain control over the new exploration and production service companies but may not retain control over the other companies. See “—Corporate Reorganization” under this Item for more information.

Our other business segments are refining and marketing (including our interests in the Nizhnekamsk oil refinery (until September 2005) and the Kichuyi oil refinery, our gas production, transportation and refining division Tatneftegaspererabotka, interests in oil trading companies and gas stations), petrochemicals (including our interests in one of the largest Russian tire producers, Nizhnekamskshina, and its technologically-integrated enterprises and management company OOO Tatneft-Neftekhim (“Tatneft-Neftekhim”)) and banking operations (including, until December 2005, majority stakes in Bank Devon-Credit, an Almeteyevsk-based retail and commercial bank that serves southeastern Tatarstan, and, until April 2005, Bank Zenit, the sixteenth largest Russian bank by net profit, the twentieth by net assets and the twenty-fourth by capital as of April 1, 2006, as calculated under RAR, according to Kommersant: Money magazine, a leading Russian business weekly). For a further discussion of our banking operations see Appendix A to this annual report.

We have a number of oil production joint ventures. These include ZAO TATEX (“TATEX”), which installs Tatneft’s unique vapor recovery system in its holding tanks and produces small amounts of crude oil from one field using horizontal drilling techniques; ZAO Tatoiigas (“Tatoiigas”), which specializes in the recovery of oil from sludge and operates several small oil fields in Tatarstan; and ZAO Kalmtatneft (“Kalmtatneft”), a small oil company engaged in crude oil exploration and production activities in the Republic of Kalmykia, Russia, which we and the regional oil company Kalmneft established in May 2000, and in which we own 50%. In addition, we have entered into a joint operations agreement with ZAO Ritek-Vnedreniye (“Ritek-Vnedreniye”), pursuant to which Ritek-Vnedreniye operates the third block of the Pavlovskoye area of the Romashkinskoye oil field. We are entitled to 60% of the economic benefit from Ritek-Vnedreniye’s production from this area.

In 2001, we increased our shareholdings in Nizhnekamskshina from 34.6% to 51.7%, in Bank Devon-Credit from approximately 27% to approximately 51%, in ZAO IFK Solid (“IFK Solid”), a Russian broker-dealer, from approximately 55% to approximately 59.7% and in OAO Bank Ak Bars (“Bank Ak Bars”), the largest private bank

registered in the Russian Federation and located in the Republic of Tatarstan in terms of assets and number of retail customers, from approximately 10% to approximately 13%. In the second quarter of 2001, we acquired approximately 40% of the shares of the Minnibaevsk Gas Refinery, which we had held as collateral for a loan to the government of Tatarstan. We also acquired an approximately 27% interest in OAO Health Recovery Complex Zelenaya Rostsha, a company operating a resort and recovery center on the shores of the Black Sea, and established ZAO Yarpolymermash-Tatneft (“Yarpolymermash-Tatneft”), formed on the basis of the assets of the Yaroslavl Polymer Machine Plant, to produce equipment for processing materials for tire production. In the course of 2001, our major divestitures included the sale of our 5.5% stake in OAO Norski Oil, the operator of the Norski oil refinery in Nizhny Novgorod. In December 2001, our joint venture OAO Nizhnekamsk Oil Refinery entered into an agreement with TAIF for the lease of the CDU, a vital asset for the Nizhnekamsk oil refinery operations.

In 2002, a reverse stock split carried out by the Minnibaevsk Gas Refinery resulted in our ownership of 100% of its outstanding shares, the minority shareholders having been cashed out. Subsequently, we transferred the assets of Minnibaevsk Gas Refinery into our newly-formed unincorporated gas production, transportation and refining division Tatneftegaspererabotka. We also increased our stake in Bank Devon-Credit to approximately 92.2% and in Bank Ak Bars to approximately 17.9% and divested our approximately 12.8% interest in OAO Tatfondbank.

40

---

## Table of Contents

In 2003, we increased our stake in Nizhnekamskshina from 51.7% to 76.01% following a new share issuance by Nizhnekamskshina. We also raised our ownership interest in Bank Ak Bars from approximately 17.9% to approximately 21.77% and in ZAO Chulpan (“Chulpan”), an insurance company, from 79.6% to 95.8%, divested our interests in 21 agricultural companies and sold our 75.01% stake in OAO Tatincom-T (“Tatincom-T”), a regional cellular telecommunications company. In the same period we allowed our stake in Tatnefteotdacha, a joint venture that specializes in recovering hard-to-extract oil and increasing oil production efficiency, to decline from 14.5% to 3.5% following an additional share issuance in which we did not participate. In the beginning of 2003, we also increased our ownership in OAO Finansovaya Lizingovaya Kompania, a leasing company, from 12% to 21%. In October of 2003, we sold our interest in this company for RR676 million, resulting in a loss of RR99 million. In 2003, TAIF brought a case before the arbitrazh court of the Tatarstan Republic claiming the return of the CDU leased to OAO Nizhnekamsk Oil Refinery because of alleged breaches by OAO Nizhnekamsk Oil Refinery of several provisions of the lease agreement. On October 6, 2003 the arbitrazh court of the Tatarstan Republic ruled in favor of TAIF. In December 2003, together with the government of Tatarstan, OAO Tatneftekhinvest-Holding, a holding company of the government of Tatarstan, Nizhnekamskneftekhim, LG International Corp. and LG Engineering and Construction Corp., we signed a letter of intent contemplating future joint work on the construction of an oil refining and petrochemical complex in Tatarstan. We subsequently formed OAO TKNK (“TKNK”) in order to carry out feasibility studies and arrange for financing of the construction of the oil refining and petrochemical complex. We held a 45.5% interest in TKNK, Nizhnekamskneftekhim held a 36.4% interest, Svyazinvestneftekhim held a 9.1% interest and LG International Corp. held a 9.1% interest.

In 2004, we acquired 33.3% of OAO Kalmneftegaz (“Kalmneftegaz”), which holds four licenses to explore and develop four oil fields in Kalmykia and two licenses for geological survey in Kalmykia. We also acquired 51% of ZAO Abdulinskneftegaz, which holds one geological survey license for oil fields in the Orenburg region. Over the course of 2004, we have acquired and established a number of oil production subsidiaries, such as OOO Tatneft-Abdulino (“Tatneft-Abdulino”), OOO Tatneft Severny (“Tatneft Severny”) and ZAO Tatneft-Samara (“Tatneft-Samara”). We own 75.1% in each of Tatneft-Abdulino and Tatneft Severny, which hold one and two subsoil licenses, respectively, for the exploration of hydrocarbon materials in deposits in the Orenburg region. Tatneft-Abdulino and Tatneft Severny each



also received an additional license for the exploration of hydrocarbon materials in deposits in the Orenburg region in a license tender held on March 29, 2005. We also hold a 74.9% interest in Tatneft-Samara, which holds three subsoil licenses for the exploration of hydrocarbon deposits in the Samara region and recently received an additional two licenses for the exploration and production of hydrocarbon materials in deposits in the Samara region in a license tender held on February 22, 2005.

In January 2004, the instance of appeals of the arbitrazh court of the Tatarstan Republic upheld the decision of the arbitrazh court of the Tatarstan Republic to return to TAIF the CDU leased by OAO Nizhnekamsk Oil Refinery. As a consequence, OAO Nizhnekamsk Oil Refinery returned the CDU to TAIF. In September 2004, TKNK entered into a non-binding engineering, procurement and construction works arrangement with LG International Corp. and LG Engineering and Construction Corp. that sets forth the basic terms by which the LG entities are to carry out engineering, procurement and construction work on an oil refinery and petrochemical complex in Nizhnekamsk. TKNK and the LG entities entered into a further non-binding engineering, procurement and construction work arrangement in December 2004 that provided for the construction of certain refining equipment in Nizhnekamsk. In May 2004, Tatneft provided TKNK with a U.S.\$4.3 million loan for financing feasibility studies and services as part of developing the oil refining and petrochemical complex. In addition, Tatneft has invested RR40 million in the first phase of the construction of the oil refining plant.

During 2004, we raised our ownership interest in Bank Zenit from 50% plus one share to 52.7%. We also raised our ownership interest in Bank Ak Bars from 21.77% to 29.46%. Our participation in Chulpan decreased in 2004 from 95.8% to 45.5%, as a result of two share issuances undertaken by Chulpan, in which we did not participate. In accordance with our expansion strategy, we concluded in 2004 an agency agreement with Integrated Petroleum Services Co. to market Tatneft's technologies and services in Oman.

41

---

## Table of Contents

We also continued our program of transferring our social assets to public ownership. We transferred to public ownership assets with a net book value of RR455 million, RR2,162 million and RR1,293 million in the years ended December 31, 2004, 2003 and 2002, respectively.

We have not been the subject of any public takeover offers by third parties in the past three years.

## Developments in 2005 and 2006

Our capital expenditures for 2005 (exclusive of acquisitions) were approximately RR18,000 million, which were financed through operating cash flows and debt. Our most significant current capital commitment for 2005 was made on production development, drilling development and other equipment to maintain current crude oil production. We have also made significant investments in the Nizhnekamsk oil refinery.

## Production

Over the course of 2005 we have acquired and established a number of oil production subsidiaries and joint-ventures, including ZAO Severgeologia ("Severgeologia") and ZAO Severgazneftprom ("Severgazneftprom"), with a share ownership of 50% of each of these two entities. Severgeologia and Severgazneftprom each hold two geological survey licenses for oil fields in Nenetsk Autonomous District. We, along with Rosneft, which owns the remaining portion in these entities, have developed a geological exploration program for 2005 to 2007. While at this stage we

cannot predict the level of capital investment that may be required of us in connection with Severgeologia and Severgazneftprom, preliminary studies suggest that the total necessary investment for the exploration and production will amount to RR1.4 billion. In 2005, we also acquired 70% of OAO Ilekneft (“Ilekneft”), which holds one production license and two combined exploration and production licenses in the Orenburg region.

#### Oil Refining and Petrochemical Plants

In early September 2005, we sold to TAIF our share in the production assets of OAO Nizhnekamsk Oil Refinery, including the refining units, for approximately U.S.\$315 million. While these production assets have not been physically removed from the Nizhnekamsk oil refinery, TAIF established a new legal entity to which it transferred these assets. Following this sale, OAO Nizhnekamsk Oil Refinery was left without production assets, and is now in the process of liquidation. See “Item 3—Key Information—Risk Factors—Risks Relating to the Company—We are dependent on oil refineries outside of Tatarstan.” In October 2005, we entered into a long-term supply contract with TAIF in order to supply up to 650,000 tons per month of crude oil to TAIF at market price to be refined by the Nizhnekamsk oil refinery.

In accordance with the decision of the Security Counsel of the Republic of Tatarstan and subsequent decisions of our Board of Directors, in September 2005, together with Svyazinvestneftekhim, we founded ZAO Nizhnekamsk Oil Refinery to build an oil refining and petrochemical complex in Nizhnekamsk. We directly own 40% of the new company and Svyazinvestneftekhim owns 9%. The remaining 51% is indirectly held by International Petro-Chemical Growth Fund Limited (“IPCG Fund”), an open-ended investment company incorporated in Jersey, Channel Islands. The new complex will comprise an oil refinery with a refining capacity of 7 million tons of oil per year, construction of which is expected to be completed in 2008, a deep refining unit with a fuel oil capacity of 3.5 million of tons, construction of which is expected to be completed in 2009, and a petrochemical plant producing products based on aromatics that is projected to be opened in 2010. The initial construction works (including the preparation of the site, etc.) commenced in September 2005. The total projected cost of this new refinery and petrochemical complex is approximately U.S.\$3.2 billion. As of December 31, 2005, our investments in ZAO Nizhnekamsk Oil Refinery amounted to approximately RR240 million, and our projected investments for 2006 are approximately RR6.5 billion. These funds have been and will continue to be lent to ZAO Nizhnekamsk Oil Refinery and used by the latter to finance initial construction phase as well as to cover certain administrative and operational expenses. We expect ZAO Nizhnekamsk Oil Refinery to repay these loans to us once the project finance funding for the project has been obtained by ZAO Nizhnekamsk Oil Refinery from outside financiers. The project financing is expected to be opened in 2007. In May 2006, we retained BNP Paribas to advise us on the possible structure of the financing of the new refinery

42

---

#### Table of Contents

complex. In connection with this project, we applied for financial support for the construction and upgrade of existing infrastructure relating to the new Nizhnekamsk refinery (such as pipelines and railways) to the Ministry of Economic Development and Trade of the Russian Federation, which oversees the Investment Fund of The Russian Federation. On June 14, 2006 the State Investment Commission made a preliminary recommendation to the Government of the Russian Federation to approve financial support in the amount of RR16.5 billion. The final decision is expected to be made by the Government of the Russian Federation in July 2006.

In June 2005, all work on the TKNK project was suspended as the joint venture parties could not reach an agreement with respect to its financing and as we designed the project to build a new refinery complex in Nizhnekamsk.

## Operations Outside Tatarstan

In May 2005, we registered a joint venture with Omani company Hamed International Marketing and Services Co. LLC to promote our products and services in Oman and other countries in the region. In 2005, we held discussions with the state-owned Petroleum Development Company of Oman regarding local well-casing technology for problem wells. In 2005, we also signed an agreement with an Omani firm for the development of special-sized well casings.

In October 2005, we, among nineteen other international oil companies, received a permit to explore and develop petroleum in the Gedames basin located in the central part of Libya, which is the site where Africa's largest known crude-oil reserves are located. In December 2005, we entered into an exploration and production sharing agreement with the National Oil Corporation of Libya ("NOCL") to that effect. We currently expect that exploration works at this project will take three to four years, and we anticipate that our initial exploration and development expenses in this project will be approximately U.S.\$23 million through 2008. At this stage we cannot predict the level of reserves on these fields and the level of capital investment that may be required from us in connection with the development of any reserves that may be discovered. In accordance with the applicable Libyan laws and regulations, development and production activities will be carried out through a joint venture. Although the joint venture agreement has not been signed yet, the form of such agreement was approved in a schedule to the exploration and production sharing agreement signed with NOCL in 2005 as described above.

In March 2005, we concluded an agreement with the government of Syria and the Syrian Oil Company according to which we are to explore for oil in eastern Syria and to develop a field on the basis of a 25-year production sharing agreement. We are required to spend at least U.S.\$7 million on exploration activities over three years, but we may extend this for two additional two-year periods, provided that we make additional minimum expenditures of U.S.\$6.3 million and U.S.\$12.8 million, respectively. We currently conduct no exploration or production activities in Syria as no agreement has been reached on the financing of the joint venture for the development of the field.

We have opened a representative office in Iran, and in February 2005 the government of Tatarstan and the government of Iran concluded an agreement pursuant to which we are expecting to register a joint venture with an Iranian entity in order to participate in various projects in Iran, including tenders for the development of oil fields. Our participation in this venture and the terms of any such participation have not yet been finalized. Our final decision as to our participation in Iranian projects will take into account the possible international sanctions imposed on Iran.

## Banking Operations

In April 2005, our wholly-owned subsidiary Tatneft Oil AG sold its 26.75% stake in Bank Zenit to three companies acting for the benefit of certain beneficiaries of Urals Energy. This transaction had the effect of reducing our ownership interest in Bank Zenit to 25.95%. In May 2006, we acquired 48.92% of newly issued shares in Bank Zenit, as a result of which our total shareholding in Bank Zenit currently is 39.73%.

In 2005, we increased our shareholding in Bank Ak Bars to 29.98% and in 2006 we further increased it to 32.27%.

43

---

## Table of Contents

In December 2005, we sold all of our shares in Bank Devon-Credit, representing 92% of the total outstanding shares of Bank Devon-Credit, to Bank Zenit. Prior to this sale, Bank Zenit owned 3.2% of the shares of Bank Devon-Credit.

As a result of the sale of a significant part of our participation in Bank Zenit and of all our participation in Bank Devon-Credit, we no longer consider our banking activities to be significant to our operations. For more comprehensive information about our sale of the shares of Bank Zenit and Bank Devon-Credit, see Note 22 to our audited consolidated financial statements included in this annual report.

#### Other Developments

On December 23, 2005, our subsidiary Tatneft Oil AG acquired participation shares with the total value of U.S.\$394.4 million in an open-ended investment company IPCG Fund, incorporated in Jersey, Channel Islands, by contributing 116 million ordinary shares of Tatneft, treasury shares of the Group, and U.S.\$1 million in cash into the fund. IPCG Fund invests its assets primarily in equity and debt of companies operating in, or whose activities are connected to, the Russian Federation in general, and in or to the Republic of Tatarstan, in particular, with a priority for entities operating in the oil and chemicals industry and, to a lesser extent, the banking sector. IPCG Fund's investment objective is to achieve medium and long-term capital appreciation of its investments. IPCG Fund is managed by MARS Capital Management Limited, a company regulated by Jersey Financial Services Commission. IPCG Fund is an indirect shareholder of ZAO Nizhnekamsk Oil Refinery and is expected to participate in the financing of the new refinery and petrochemical complex, including through participation of additional investors in the fund.

In late December 2005, we sold all of our shares in IFK Solid, representing 59.7% of the total outstanding shares of IFK Solid. This company was not considered as material to our financial condition or results of operations.

In August 2005, our wholly-owned subsidiary Tatneft Oil AG acquired from a third party two land plots in the city of Kazan, Tatarstan, of a total size of approximately 2 million square meters for U.S.\$46.6 million. The acquisition was made on market terms for investment purposes.

In March-April 2006, we acquired 100% of the shares of OAO LDS-1000, the owner of the ice hockey arena in the city of Kazan, for RR2.1 billion.

In March 2006, we entered into a general cooperation agreement with OAO Avtovaz (“Avtovaz”), a large Russian car manufacturer. Pursuant to this agreement, we will supply Avtovaz with petrochemical complex products, including synthetic motor oils and high quality gasoline and tires manufactured by Nizhnekamskshina. This agreement will remain in force for three years and it will be automatically extended for each subsequent year, unless the parties agree to its termination.

In July 2005, we entered into a six-month crude oil sales contract with Ukratoil Limited to supply 3.5 million tons in total at market price.

#### ORGANIZATIONAL STRUCTURE

##### General

Our operations are currently divided into the following main segments:

- exploration and production;
- refining and marketing;
- petrochemicals; and
- banking.

Our exploration and production segment is the largest segment, and comprises the majority of our structural subdivisions. It consists of 11 NGDUs (two of these units are expected to be merged into two

---

## Table of Contents

other existing units in 2006); a natural gas production, transportation and refining subdivision; three well repair and reservoir oil yield improvement subdivisions; a chemical production subdivision (Neftekhimservis); two pumping equipment repair centers; a research and development institute; and subdivisions responsible for geological exploration, communications and information support, drilling fluid delivery, security and logistics, operations outside Tatarstan and other matters. This segment also includes service subsidiaries over which we continue to retain control.

Our refining and marketing segment consisted of our interests in OAO Nizhnekamsk Oil Refinery (until September 2005) and the Kichuyi oil refinery and a minority stake in ZAO Ukrtatnafta (“Ukrtatnafta”); OOO Tatneft-Centernefteproduct and OOO Tatneft - Moskvanefteproduct, management companies for Tatneft-branded gas station network; and certain other oil trading and ancillary companies.

Our petrochemicals segment has been consolidated into a management company, Tatneft-Neftekhim, which manages Nizhnekamskshina and the companies technologically integrated with it, including OAO Nizhnekamsk Industrial Carbon Plant (“Nizhnekamsk Industrial Carbon Plant”), Yarpolymermash-Tatneft and Nizhnekamsk Mechanical Plant. OOO Tatneft-Neftekhimsnab and OOO Trading House Kama are responsible, respectively, for procuring supplies and marketing products produced by the companies of this segment.

Bank Zenit (until April 2005) and Bank Devon-Credit (until December 2005) constituted our banking segment. We also hold stakes in a number of other financial services companies.

We have non-core assets, such as social and cultural facilities, road construction companies, transportation companies, telecommunications companies and other ancillary enterprises, most of which we plan to sell in the course of our continuing reorganization.

### Joint Ventures, Subsidiaries and Associated Companies

We have a number of oil production joint ventures. These include TATEX, in which we own 50% and which is accounted for under the equity method in our consolidated financial statements, Kalmtatneft, in which we own 50% and which is accounted for under the equity method in our consolidated financial statements, and Tatoilgas, in which we currently own 50% but maintain management control and which is fully consolidated. We are also party to a joint operations agreement with Ritek-Vnedreniye pursuant to which Ritek-Vnedreniye operates an oil field that is licensed to us, and we provide various services to Ritek-Vnedreniye in connection with its operations. We are entitled to 60% of the economic benefit from Ritek-Vnedreniye’s operations of this field.

Currently, oil production by the joint ventures is limited. We believe that the primary benefits of the joint ventures are their contribution to us of new technologies and techniques that increase productivity and well recoverability and the introduction of new approaches to improve our organization and efficiency.

With the exception of Tatneft Oil AG and its subsidiaries, including our Western European marketing agent Tatneft Europe AG (“Tatneft Europe”), which are incorporated in Switzerland, all of our significant joint ventures, subsidiaries and associates are incorporated in the Russian Federation.

The joint ventures are:

- TATEX. TATEX is a joint venture with the U.S. company Texneft (a subsidiary of Devon Energy Corp.) in which we each held a 50% interest as of December 31, 2004. TATEX has installed oil vapor recovery systems on all of Tatneft's oil holding tanks to capture natural gas; TATEX subsequently sells this natural gas. TATEX has also obtained rights to the Onbiyskoye oil field, previously developed by Tatneft, where TATEX produces oil. In 2005, TATEX produced approximately 492,100 tons (3.50 mmbbl) of oil, 492,633 tons (3.50 mmbbl) of oil in 2004 and 486,141 tons (3.46 mmbbl) of oil in 2003.
- Tatoiigas. At December 31, 2004, we owned 50% of the voting shares of Tatoiigas, a joint venture with the German firm Mineralol-Rohstoff-Handel, GmbH. Tatoiigas recovers oil from sludge and holds production licenses for two small oil fields in Tatarstan. In 2005, Tatoiigas produced approximately 267,691 tons (1.91 mmbbl) of oil, and 257,198 tons (1.83 mmbbl) of oil in 2004. Tatoiigas is consolidated in our consolidated financial statements.

45

---

### Table of Contents

- Kalmtatneft. We own 50% of Kalmtatneft, which holds four licenses to explore and develop four oil fields in Kalmykia.

We control a number of subsidiary companies and have minority stakes in a number of other companies, including those described below. Except for Nizhnekamskshina and Bank Zenit (until April 2005), we do not believe that any of these companies is material to our financial condition or results of operations.

- Nizhnekamskshina. We purchased approximately 34.6% of Nizhnekamskshina in 2000 from the Tatarstan government as part of our strategy to become a vertically integrated oil company. In 2001, we increased our stake to 51.7% and Nizhnekamskshina was consolidated in our consolidated financial statements from September 30, 2001. In 2003 we increased our stake to 76.01% following an additional share issuance by Nizhnekamskshina. Nizhnekamskshina is one of the largest tire manufacturing plants in Russia, and supplies products to both domestic and foreign markets. The Tatarstan government holds a Golden Share in Nizhnekamskshina that permits it to veto certain board and shareholder decisions and to appoint representatives to Nizhnekamskshina's management bodies.
- Bank Zenit. Until April 2005, we owned 52.7% of Bank Zenit, a Russian commercial bank founded in December 1994 and based in Moscow, having increased our holdings from 50% plus one share in 2004. Bank Zenit has branches in Rostov-on-Don, Nizhny Novgorod, Almetyevsk, Gorno-Altaysk, St. Petersburg, Kemerovo and Kursk, a representative office in Kazan and additional offices in Kazan and Nizhnekamsk. In April 2005, our wholly-owned subsidiary Tatneft Oil AG sold its 26.75% stake in Bank Zenit to three companies acting for the benefit of certain beneficiaries of Urals Energy. This transaction had the effect of reducing our ownership interest in Bank Zenit to 25.95%. In May 2006, we acquired 48.92% of newly-issued shares in Bank Zenit, increasing our current shareholding to 39.73%. See "Appendix A—Tatneft's Banking Operations."
- IFK Solid. As of December 31, 2004, we owned approximately 59.7% of IFK Solid. IFK Solid is a market maker in our shares in the Russian equity markets and also acted as a financial advisor and agent to us for transactions in the Russian equity markets and in connection with our stock option plan. See "Item 9—The Offer and Listing—Markets—Activities of the Company and its Affiliates in the Market" and "Item 6—Directors, Senior Management and Employees—Compensation." In late December 2005, we sold the totality of our stake in IFK Solid.
- Bank Ak Bars. We currently own approximately 32.27% of Bank Ak Bars.

- Bank Devon-Credit. As of December 31, 2004, we owned approximately 92% of Bank Devon-Credit, a Russian commercial and retail bank. Bank Devon-Credit serves Tatneft and much of the local population in Almetyevsk and the southeast of Tatarstan through a network of 13 branch offices. We sold the totality of our stake in Bank Devon-Credit in December 2005 to Bank Zenit.
- Tatneft, Solid & Co. Tatneft is both a general partner and a limited partner in Tatneft, Solid & Co., a limited partnership set up to purchase our Ordinary Shares. See “Item 9—The Offer and Listing—Markets—The Ordinary Share Market.”
- Chulpan. As of December 31, 2004, we owned approximately 45.5% of Chulpan, an Almetyevsk-based company that provides voluntary medical and property insurance services. Our participation in this company was diluted in 2005 as a result of two share issuances undertaken by Chulpan, in which we did not participate.
- Marketing Agents. We have formed a number of subsidiaries that act as sales agents dedicated to working with specific refineries and markets. One of these agents, Tatneft Europe, registered in Switzerland, is one of the major offtakers of our oil. Each of the sales agents is consolidated in our consolidated financial statements.
- OAO Tatneftegeofizika. We own 88.1% of a geophysical services company, OAO Tatneftegeofizika (“Tatneftegeofizika”), which provides services in the discovery and exploration

46

---

## Table of Contents

of oil and natural gas reserves in Tatarstan, Siberia and outside of Russia (including Egypt, India, Kazakhstan, Libya and Turkey). The Tatarstan government holds a Golden Share in Tatneftegeofizika that permits it to veto certain board and shareholder decisions and appoint representatives to the company’s management bodies.

- Nizhnekamsk Industrial Carbon Plant. We own 77.1% of Nizhnekamsk Industrial Carbon Plant. Nizhnekamskshina uses the carbon plant products as raw materials, and this acquisition is part of our efforts to create a vertically integrated group.
- OAO Nizhnekamsk Oil Refinery. We hold 63% of OAO Nizhnekamsk Oil Refinery, which operated the production facilities at the Nizhnekamsk oil refinery, previously owned by us and other shareholders. In early September 2005, we sold our share in the production assets of OAO Nizhnekamsk oil refinery. Following this sale, OAO Nizhnekamsk Oil Refinery was left without production capacity, and is now in process of liquidation. See “—Refining and Marketing—Refined Products” under this Item and “Item 3—Key Information—Risk Factors—Risks Relating to the Company—We are dependent on oil refineries outside of Tatarstan.”
- Yarpolymermash-Tatneft. In 2001, we formed Yarpolymermash-Tatneft, of which we currently own 51%, based on the assets of the Yaroslavl Polymer Machine Plant, to manufacture equipment for processing materials for tire production.
- Ukratnafta. We own 8.6% of Ukratnafta. Ukratnafta holds a 100% interest in the Kremenchug refinery in Ukraine, one of the largest refineries for high sulfur content crude oil in the CIS. The Tatarstan government holds 28.8% of Ukratnafta. The Ukrainian government currently owns approximately 46% of Ukratnafta’s shares. There is currently a dispute between the Ukrainian government and certain holding companies of Ukratnafta over 18% of Ukratnafta’s shares.

## STRATEGY

Our strategic objectives are to enhance our position as a leading crude oil producer in Russia and to become an internationally recognized oil company. We seek to fulfill these objectives by (i) creating a vertically integrated oil

company, (ii) maintaining production from our existing crude oil reserves base in Tatarstan, (iii) expanding and diversifying our reserves base outside Tatarstan and (iv) improving our corporate governance, through the following strategic initiatives:

Shaping and improving our structure as a vertically integrated oil company. We intend to increase our refining capacity and to expand our petrochemicals activities and retail gasoline operations in order to become a vertically integrated oil company. The government of Tatarstan, our major shareholder, is actively encouraging this approach. We believe that increasing our presence in these market sectors is the most effective strategy for mitigating the potential risks presented by possible fluctuations in global crude oil prices and demand.

We intend to continue to develop our relationships with refineries that have installed, or plan to install, the equipment necessary to convert heavy fraction high sulfur content crude oil, which constitutes a large proportion of our production, into higher-value products such as gasoline, jet fuel and diesel. As part of this strategy, in September 2005, together with Svyazinvestneftekhim, we founded ZAO Nizhnekamsk Oil Refinery to build an oil refining and petrochemical complex in Nizhnekamsk. We directly own 40% of the new company and Svyazinvestneftekhim owns 9%. The remaining 51% is indirectly held by IPCG Fund. The new complex will comprise an oil refinery with a refining capacity of 7 million tons of oil per year, construction of which is expected to be completed in 2008, a deep refining unit with a fuel oil capacity of 3.5 million of tons, construction of which is expected to be completed in 2009, and a petrochemical plant producing products based on aromatics that is projected to be opened in 2010. The initial construction works (including the preparation of the site, etc.) commenced in September 2005. The total projected cost of this new refinery and petrochemical complex is approximately U.S.\$3.2 billion. As of December 31, 2005, our investments in ZAO Nizhnekamsk Oil Refinery amounted to approximately RR240 million, and our projected investments for 2006 are approximately RR6.5 billion. These funds have been and will continue to be lent to ZAO Nizhnekamsk Oil Refinery and used by the latter to finance initial construction phase as well as to cover certain administrative and operational expenses. We

47

---

## Table of Contents

expect ZAO Nizhnekamsk Oil Refinery to repay these loans to us once the project finance funding for the project has been obtained by ZAO Nizhnekamsk Oil Refinery from outside financiers. The project financing is expected to be opened in 2007. In May 2006, we retained BNP Paribas to advise us on the possible structure of the financing of the new refinery complex. In connection with this project, we applied for financial support for the construction and upgrade of existing infrastructure relating to the new Nizhnekamsk refinery (such as pipelines and railways) to the Ministry of Economic Development and Trade of the Russian Federation, which, oversees the Investment Fund of The Russian Federation. On June 14, 2006 the State Investment Commission made a preliminary recommendation to the Government of the Russian Federation to approve financial support in the amount of RR16.5 billion. The final decision is expected to be made by the Government of the Russian Federation in July 2006.

In addition to investing in our refining activities, we own a 76.01% stake in Nizhnekamskshina, one of the largest tire-producing factories in the Russian Federation, located in the city of Nizhnekamsk. We also own a 77.1% share of Nizhnekamsk Industrial Carbon Plant, a major supplier of technical carbon to tire manufacturers in Russia, including Nizhnekamskshina. We also formed Yarpolymermash-Tatneft, of which we own 51%, in 2001 based on the assets of Yaroslavl Polymer Machine Plant to construct equipment for processing materials for tire production. In 2000, we established control over a large producer of chemical reagents, OAO Tatneftekhimservice. We also constructed a plant in Nizhnekamsk for the production of synthetic lubricants for engines and machinery. To increase the efficiency of our petrochemicals operations, in 2002 we created the management company Tatneft-Neftekhim and transferred control



over our shares in Nizhnekamskshina, Nizhnekamsk Industrial Carbon Plant, Yarpolymermash-Tatneft and other petrochemicals companies to it.

We are also currently expanding the Tatneft-controlled network of retail gasoline sales outlets both inside and outside Tatarstan, particularly in Moscow, St. Petersburg and the Moscow, Chuvashiya, Ulyanovsk, Arkhangelsk, Vladimir and Leningrad regions in Russia, as well as in Ukraine. We are conducting this expansion both directly and through our subsidiaries and affiliates. As of January 1, 2006, there were 553 Tatneft-controlled service stations throughout Russia and Ukraine, including 408 in Russia and 145 in Ukraine. Tatneft-controlled service stations sold 1 million tons of refined products in 2005. We are currently implementing a program to increase the number of our controlled service stations.

Maintain crude oil production from existing fields. In the mid-term, we plan to maintain production from our existing fields at approximately the current level, subject to the absence of significant adverse changes in taxation. We believe that this level of production will optimize the long-term value of the reserves base while generating cash flows to support our current operations. In addition, by maintaining production from our existing fields we may benefit from the introduction of a differentiated unified natural resources production tax that would apply a lower tax rate to oil companies with mature fields. See “—Overview of the Russian Oil industry—Current System of Oil-Related Taxes and Payments—The Unified Natural Resources Production Tax” under this Item. We expect to continue to implement our well rehabilitation program to increase the use of secondary and tertiary recovery methods in order to maintain production levels. Our ability to carry out these programs will be limited by the extent to which we are able to provide the necessary financing. We also are actively pursuing opportunities to use new technologies in order to maximize the recovery from our existing reserves base. See “Item 4—Information on the Company—Exploration and Production.”

We are currently exploring bitumen reserves in Tatarstan, with a view to begin in 2007 the production of bitumen from these reserves. In order to drill these reserves, we are using Steam Assisted Gravity Drainage Solutions-based technology. We will proceed to the development of the bitumen production only if this production proves economically viable. In particular, the production of bitumen is currently subject to a significant tax burden. Taxation of bitumen production may be revised by the new tax law introducing a differentiated rate for the unified natural resources production tax and designed to stimulate development of new oil fields in certain regions. See “Item 4—Information on the Company—Exploration and Production.”

Expansion of reserves base outside Tatarstan. We intend to expand and diversify our reserves base by gaining access to reserves outside Tatarstan, particularly in Kalmykia, the Ulyanovsk, Samara, Orenburg, Saratov and Murmansk regions, Astrakhan, and the Chuvash Republic. We intend selectively

48

---

## Table of Contents

to establish strategic alliances to develop and operate oil fields in order to facilitate this process. Outside the Russian Federation, we participate or intend to participate in projects in Oman, Libya, Iraq, Syria and Iran, subject to compliance with applicable international sanctions regimes.

Improving our corporate governance. We are seeking to improve our corporate governance in accordance with Russian and international standards, such as the Principles of Corporate Governance of the Organization for European Cooperation and Development and the model Code of Corporate Conduct approved by the Russian Government. Among the areas we are trying to improve are the transparency of financial activity, informational transparency, responsibility to shareholders and corporate social responsibility. Steps taken in recent years towards improving our

corporate governance have included establishing the Audit Committee, Disclosure Committee and Corporate Governance Committee, progressive implementation of non-financial modules of the SAP R/3 corporate management system and divestiture of non-core assets.

However, Ernst & Young, our independent auditor, and PricewaterhouseCoopers, our independent auditor until 2003, have identified weaknesses in our control environment. For further information regarding weaknesses in our control environment, see “Item 3—Key Information—Risk Factors—Risks Relating to the Company—Our independent registered public accounting firm reported material weaknesses in our internal controls and we may not be able to remedy these material weaknesses or prevent future weaknesses” and “Item 15—Controls and Procedures.”

## OVERVIEW OF THE RUSSIAN OIL INDUSTRY

The information presented herein is presented on the basis of official public documents, including, without limitation, the laws, regulations and rules cited therein, and has been presented on the authority of such documents unless otherwise indicated.

### Background

Since the dissolution of the Soviet Union, the oil industry in Russia has undergone a major restructuring. Under the Soviet regime, the incentive system focused on the quantity of crude oil produced without regard to the quality of the oil. Furthermore, the domestic prices for oil and refined products were maintained by the state at artificially low levels, and the maximization of economic value played little or no part in the production decisions. As a result, producers had little incentive to produce crude oil from which a relatively high percentage of premium products could be refined, and over-production and under-maintenance of equipment were widely prevalent in the system.

The privatization of the Russian oil industry was launched by Presidential Decree No. 1403, issued on November 17, 1992, which established the federal framework for privatizing Russian oil companies and the basis for the transformation of state-owned exploration, production, refining and distribution enterprises into several major vertically integrated companies. Initially the major Russian oil companies essentially functioned as holding companies with shares in separate production, refining and distribution subsidiaries. The process of vertical integration of such companies was facilitated by a further Russian Presidential decree No. 327, issued on April 1, 1995, allowing the integration of subsidiaries into vertically integrated companies through share exchanges.

Other major Russian oil companies, such as Tatneft, also possess significant crude oil reserves and exploration and production capabilities, but do not currently possess significant independent refining capabilities. These entities were also formed through the transformation of separate state-owned exploration and production enterprises into new companies during the privatization process.

The Russian government’s shares in several vertically-integrated oil companies were placed under fiduciary management with banks and other institutions in the “loan-for-shares” program held in late 1995 under which the institutions extended loans to the government in return for the right to manage the shares. When these loans were not repaid at maturity, the lending institutions generally acquired the right to sell the stakes they had managed to settle the loans, which has resulted in the sale of the managed shares of Surgutneftegaz, Sidanco, Sibneft and YUKOS.

The Russian government continued to privatize Russian oil companies that remained under its control. Privatization of an 85% government stake in ONAKO was completed in 2000. In May 2002, the government sold 36.82% of Eastern Oil Company through an auction to YUKOS and sold approximately 6% in LUKOIL in December 2002. In November 2002, the government of Belarus sold its 10.83% stake in Slavneft to a consortium of shareholders of TNK and Sibneft, and the Russian government sold its 74.95% in Slavneft at an auction held in December 2002 to the same consortium. The Russian government sold its remaining 7.6% stake in LUKOIL in a privatization auction to ConocoPhillips in September 2004.

The Russian oil industry has also recently undergone a wave of consolidation. In February 2003, Alfa Group and Access-Renova (together, TNK's, ONAKO's and Sidanko's majority shareholders) and BP announced plans to combine their oil and natural gas operations in Russia and Ukraine, and this transaction was completed in August 2003. The new holding company, TNK-BP, created on the basis of the combined assets of TNK, ONAKO, Sidanco and BP's Russian assets (excluding BP's assets in the Sakhalin Islands), is owned 50% each by BP and the combined Alfa-Access-Renova and is the third-largest oil company in Russia by reserves and production. Alfa-Access-Renova and BP subsequently reached an agreement to contribute TNK's 50% stake in Slavneft to TNK-BP, and announced the completion of this transaction in January 2004. In April 2003, YUKOS and Sibneft announced that their respective shareholders had reached an agreement in principle on effecting a merger and this transaction was completed with effect in October 2003. However, pursuant to claims for back taxes against YUKOS by the Russian government, the merger has since been reversed. In December 2004, the Russian government auctioned a 76.8% stake in Yuganskneftegaz, YUKOS' largest production subsidiary, in partial settlement of back tax claims against YUKOS, to Rosneft. In October 2005, Gazprom Finance B.V., a subsidiary of Gazprom, acquired approximately 76% of the shares of Sibneft, in line with Gazprom's new long-term strategy to become a diversified energy group represented in all energy sectors. Gazprom has publicly announced plans to proceed to further acquisitions of oil assets in Russia and abroad.

The various oil companies differ as to their size of operations, geographic focus and management philosophy. Moreover, the Russian government has applied different policies with respect to such companies at various times during the privatization process. Some companies seek foreign ventures beyond neighboring countries, while others concentrate primarily on opportunities in their historical region of operations or within the former Soviet Union. In addition, Russian oil companies may acquire additional assets through mergers or other forms of combination.

## Production

Oil production in Russia declined between the late 1980s and 1997. The decrease in production was attributable to many factors, including overproduction of wells during the Soviet period, lack of funds for capital expenditures to maintain operations, inefficient secondary recovery methods, insufficient transportation capacity in the pipeline system, losses during transit and reduced demand attributable to the Russian economic recession. In 1997, production increased by approximately 1.3% to approximately 305 million tons (2,172.5 mmbbl) as compared to 1996. After a slight decrease by approximately 0.8% to 303.2 million tons (2,159.7 mmbbl) in 1998, Russian crude oil production began to increase starting 1999. This rise has resulted from several factors, including relatively high world and domestic oil prices, increased rehabilitation of non-operational wells and increased export opportunities.

50

---

## Table of Contents

The table below sets forth data on Russian oil production for the years indicated:

Year	Russian production of crude oil		Change from prior year
	(millions of tons)	(mmbbl)	
1999	305.0	2,172.5	0.6%
2000	312.7	2,227.4	2.5%
2001	336.9	2,399.7	7.7%
2002	379.6	2,703.9	12.7%
2003	421.4	3,001.6	11.0%
2004	458.8	3,268.1	8.9%
2005	470.0	3,349.2	2.5%

Source: BP Statistical Review of World Energy.

In general, reforms in regulation are now prompting the Russian oil industry to adopt commercially-oriented production practices. These reforms included the liberalization of crude oil and refined product prices and the elimination of export quotas and licensing requirements in early 1995. However, domestic pricing remained until recently significantly below world levels, hampering the ability of companies to reinvest or modernize production practices, equipment and facilities. The following table shows approximate crude oil production levels of the largest Russian oil companies in 2005, 2004, 2003 and 2002:

Company	2005 <sup>(2)</sup>	2004 <sup>(2)</sup>	2003 <sup>(2)</sup>	2002 <sup>(2)</sup>
	(millions of tons)			
YUKOS <sup>(1)</sup>	24.4	85.7	80.7	69.9
LUKOIL	87.3	84.1	78.9	75.5
TNK-BP <sup>(4)(5)</sup>	74.9	70.3	43.0	37.5 <sup>(3)</sup>
Surgutneftegaz	63.5	59.6	54.0	49.2
Sibneft <sup>(5)</sup>	32.8	34.0	31.4	26.3
Tatneft	25.6 <sup>(6)</sup>	25.4 <sup>(6)</sup>	24.9 <sup>(6)</sup>	24.9 <sup>(6)</sup>
Sidanco	17	17	18.6	16.3
Slavneft	24.0	22.0	18.1	16.2
Rosneft <sup>(8)</sup>	73.9	21.6		