

# ALROSA FINANCE S.A.

U.S.\$500,000,000

8.125 per cent. Notes due 2008

Guaranteed by ALROSA Company Limited

## The Notes

- The U.S.\$500,000,000 8.125 per cent. Notes due 2008 (the “Notes”) will be issued by ALROSA Finance S.A. (the “Issuer”), a private company incorporated with limited liability under the laws of The Grand Duchy of Luxembourg (“Luxembourg”) and a wholly owned subsidiary of ALROSA Finance B.V., a private company incorporated with limited liability under the laws of The Netherlands which is wholly owned by ALROSA Company Limited (“ALROSA Ltd.”), a closed joint stock company organised under the laws of the Russian Federation (“Russia”), with the alternate legal name AK “ALROSA” (ZAO). References to “we” and “us” in this Offering Circular refer collectively to ALROSA Ltd. and its consolidated subsidiaries, including the Issuer.
- The Issuer will lend all of the proceeds of this offering of Notes (the “Offering”) to ALROSA Ltd. This loan (the “Intercompany Loan”) and payments by ALROSA Ltd. thereunder will comprise the only significant assets which the Issuer will have in order to make payments on the Notes.

## Issue Price

- The issue price of the Notes is 98.996 per cent. of the principal amount.

## Maturity

- The Notes will mature on 6 May 2008 (the “Maturity Date”).

## Interest

- Interest payments on the Notes will be payable semi-annually in arrear on 6 May and 6 November of each year, commencing on 6 November 2003, at the rate of 8.125 per cent. per annum.
- Payments on the Notes will be made free and clear of, and without withholding or deduction for or on account of, any taxes imposed by Luxembourg, The Netherlands or Russia, to the extent described under Condition 9–“Taxation”–in “Terms and Conditions of the Notes”.

## Ranking and Guarantee

- The Notes will be general unsecured and unsubordinated obligations of the Issuer, and will rank senior to all future subordinated obligations and equal to all future unsecured obligations of the Issuer.
- The Notes will be guaranteed by ALROSA Ltd. (the “Guarantee”). This Guarantee will be unsecured indebtedness of ALROSA Ltd. and will rank senior to all future subordinated obligations and equal to all future unsecured obligations of ALROSA Ltd.

## Redemption and Repurchase

- Except in certain limited circumstances, the Notes are not redeemable prior to the Maturity Date.

## Notice to Potential Investors

- **You should carefully consider the risk factors beginning on page 11 of this Offering Circular before investing in the Notes.**
- The Notes have not been and will not be registered under the United States Securities Act of 1933, as amended (the “U.S. Securities Act”), or the securities laws of any other jurisdiction. Accordingly, the Notes are only being offered outside the United States in reliance on Regulation S (“Regulation S”) under the U.S. Securities Act to non-U.S. Persons (as defined in Regulation S). You should read the section entitled “Plan of Distribution” for information on restrictions that apply to the purchase and resale of the Notes.

## Settlement and Closing

- It is expected that the Notes will be issued in the form of a global certificate in registered form (the “Global Note”). On the closing date of this offering, the Global Note will be deposited with, and registered in the name of a nominee of, a common depositary for Euroclear Bank S.A./N.V., as operator of the Euroclear System (“Euroclear”), and Clearstream Banking, société anonyme (“Clearstream, Luxembourg”).
- The closing date of this Offering is expected to be 6 May 2003.

## Listing

- Application has been made to list the Notes on the Luxembourg Stock Exchange.

## Rating

- The Notes have been assigned a preliminary rating of B by Standard & Poor’s Ratings Services (“S&P”) and B3 by Moody’s Investor Service, Inc. (“Moody’s”). These ratings address the Issuer’s ability to make interest and principal payments in accordance with the terms and conditions of the Notes (the “Terms and Conditions”). The Guarantor has been assigned a senior implied rating of B1 by Moody’s. A rating is not a recommendation to buy, sell or hold the Notes and may be subject to suspension, reduction or withdrawal at any time by S&P or Moody’s, as applicable. A suspension, reduction or withdrawal of the rating assigned to the Notes may adversely affect the market price of the Notes.

**Price: 98.996 per cent.**

**Lead Manager**

**ING**

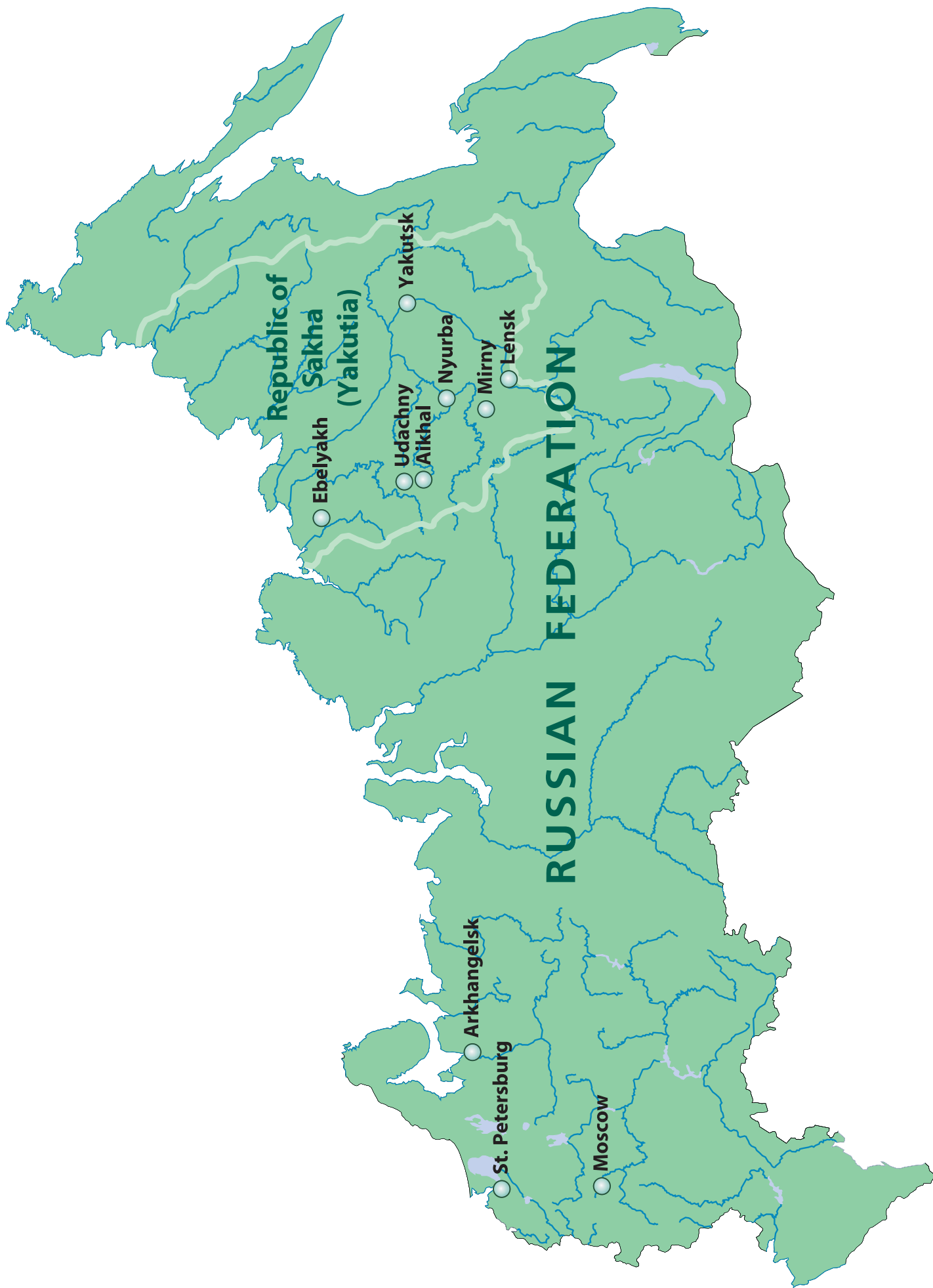
**Co-Managers**

**Commerzbank Securities**

**Deutsche Bank**

**JPMorgan**

**UBS Warburg**



**Republic of  
Sakha  
(Yakutia)**

**RUSSIAN FEDERATION**

**Arkhangelsk**

**St. Petersburg**

**Moscow**

**Yakutsk**

**Udachny**

**Aikhal**

**Nyurba**

**Mirny**

**Lensk**

**Ebelyakh**

In making an investment decision, you should rely only on the information contained in this Offering Circular. We have not, and ING Bank N.V., London Branch (“ING”) has not, authorised any other person to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it.

We are offering to sell the Notes only in places where such offers and sales are permitted.

Unless otherwise stated to the contrary, you should not assume that the information contained in this Offering Circular is accurate as of any date other than the date on the front cover of this Offering Circular.

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“ALROSA”, “Brilliantly ALROSA”, “ALROSA-Nyurba” and “Almazny Dvor” are our most important trademarks and trade names. All other trademarks and tradenames referred to in this Offering Circular are the property of their respective owners.

**In connection with this offering, ING may over-allot or effect transactions with a view to supporting the market price of the Notes at a level higher than that which might otherwise prevail for a limited period after the issue date. However, there may be no obligation on ING to do this. Such stabilising, if commenced, may be discontinued at any time and must be brought to an end after a limited period.**

Having made all reasonable enquiries, we confirm that (i) this Offering Circular contains all information with respect to our business, the Guarantee and the Notes that is material in the context of the Offering; (ii) the statements contained in this Offering Circular relating to us are in every material particular true and accurate and not misleading; (iii) the opinions, expectations and intentions expressed in this Offering Circular with regard to us are honestly held, have been reached after considering all relevant circumstances and are based on reasonable assumptions; (iv) there are no other facts in relation to us, the Guarantee or the Notes, the omission of which would, in the context of the Offering, make any statement in this Offering Circular misleading in any material respect; and (v) we have made all reasonable enquires to ascertain such facts and to verify the accuracy of all such information and statements. We accept responsibility accordingly. Neither ING nor any of its affiliates nor any person acting on its behalf makes any representation or warranty, express or implied, as to the accuracy or completeness of the information contained in this document, and none of such persons has attempted to verify such information.

We are providing this Offering Circular only to prospective purchasers of the Notes. You should read this Offering Circular before making a decision whether to purchase the Notes. You must not:

- use this Offering Circular for any other purpose; or
- make copies of any part of this Offering Circular.

In addition, the distribution of this Offering Circular may be restricted by law in certain jurisdictions, about which restrictions you agree to inform yourself. By accepting delivery of this Offering Circular you agree to the foregoing restrictions.

We have prepared this Offering Circular and are solely responsible for its contents. You are responsible for making your own examination of our business and your own assessment of the merits and risks of investing in the Notes. By purchasing the Notes, you will be deemed to have acknowledged that:

- you have reviewed this Offering Circular;
- you have had an opportunity, in connection with making an informed investment decision with respect to the Notes, to request additional information that you need from us; and
- ING is not responsible for, and is not making any representation to you concerning, our future performance or the accuracy or completeness of this Offering Circular or otherwise in connection with this Offering.

We are not providing you with any legal, business, tax or other advice in this Offering Circular. You should consult with your own advisors, as needed, to assist you in making your investment decision and to advise you whether you are legally permitted to purchase the Notes.

You must comply with all laws that apply to you in any place in which you buy, offer or sell any Notes or possess this Offering Circular. You must also obtain any consents and approvals that you need in order to purchase any Notes. Neither we nor ING are responsible for your compliance with these legal requirements.

You should contact us or ING with any questions about this Offering or if you require additional information to verify the information contained in this Offering Circular.

We reserve the right to withdraw this Offering at any time. We and ING also reserve the right to reject any offer to purchase the Notes, in whole or in part, for any reason and to allot to any prospective investor less than the full amount of Notes sought by that investor.

### **Industry Information**

In this Offering Circular, we rely on and refer to information regarding the world diamond industry, its segments and its participants from market research reports, analyst reports and other publicly available information released by official and unofficial sources. These sources include the U.S. Geological Survey Minerals Handbook and the World Diamond Industry Directory and Yearbook, as well as publications prepared by the De Beers Group (“De Beers”); Terraconsult, a geological consulting group; and Yorkton Securities. See “Industry Overview”. Although we believe that this information is reliable, we have not independently verified this information and cannot guarantee its accuracy and completeness. Accordingly, we accept responsibility for the information contained in this Offering Circular other than the country and industry information described under “Industry Overview” and “The Russian Federation” (except where it relates specifically to us), in respect of which we only take responsibility for the correct extraction of that industry and country information from the relevant sources.

### **Regulatory Issues Related to the Offering**

This Offering Circular does not constitute an offer of, or an invitation by or on behalf of us or ING to subscribe or purchase, any Notes in any jurisdiction where such offer or invitation would be unlawful if made. The distribution of this Offering Circular and the Offering of the Notes in certain jurisdictions may be restricted by law. We and ING require persons into whose possession this Offering Circular comes to inform themselves about and to observe any such restrictions. In particular, the Notes have not been approved or disapproved by the U.S. Securities and Exchange Commission (the “SEC”), any state securities commission in the United States or any other U.S. regulatory authority, nor have any of the foregoing authorities passed upon or endorsed the merits of the Offering or the accuracy or adequacy of this Offering Circular. Any representation to the contrary is a criminal offence in the United States. Neither we nor ING have authorised any offer of Notes to the public in the United Kingdom within the meaning of the Public Offers of Securities Regulations 1995 (the “Regulations”). Notes may not lawfully be offered or sold to persons in the United Kingdom except in circumstances which do not result in an offer to the public in the United Kingdom within the meaning of the Regulations or otherwise in compliance with all applicable provisions of the Regulations. For a description of certain further restrictions on offers and sales of Notes and distribution of this Offering Circular, see “Plan of Distribution”.

No person is authorised to provide any information or to make any representation not contained in this Offering Circular and any information or representation not so contained must not be relied upon as having been authorised by or on behalf of us, the Trustee for the Notes or ING. The delivery of this document at any time does not imply that the information contained in it is correct as at any time subsequent to its date.

*United Kingdom.* The Notes are not offered, prior to the expiry of a period of six months from the issue date of such Notes, to persons in the United Kingdom except to persons whose ordinary activities involve them in acquiring, holding, managing or disposing of investments (as principal or agent) for the purposes of their businesses or otherwise in circumstances which have not resulted and will not result in an offer to the public in the United Kingdom within the meaning of the Regulations.

A person may only communicate or cause to be communicated an invitation or inducement to engage in investment activity (within the meaning of Section 21 of the Financial Services and Markets Act 2000 (the “FSMA”)) received by it in connection with the issue or sale of any Notes in circumstances in which Section 21(1) of the FSMA does not apply to the Issuer or ALROSA Ltd.

This communication is directed only at persons who (1) are outside the United Kingdom, (2) have professional experience in matters relating to investments or (3) are persons falling within Article 49(2) (a) to (d) (“high net worth companies, unincorporated associations, etc.”) of the FSMA (Financial Promotion) Order 2001 (all such persons together being referred to as “relevant persons”). This communication must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this communication relates is available only to relevant persons and will be engaged in only with relevant persons.

*United States.* The Notes have not been and will not be registered under the U.S. Securities Act, and may not be offered or sold within the United States or to, or for the account or benefit of, U.S. Persons (as defined in Regulation S) except pursuant to an exemption from the registration requirements of the U.S. Securities Act. Prospective purchasers are hereby notified that sellers of the Notes may be relying on the exemption from the provisions of Section 5 of the U.S. Securities Act provided by Regulation S.

Neither the SEC, nor any state securities commission has approved or disapproved of the Notes or determined if this Offering Circular is truthful or complete. Any representation to the contrary is a criminal offence.

*Russia.* Each Manager has agreed that the Notes will not be offered, sold or transferred as part of their initial distribution or at any time thereafter to or for the benefit of any persons (including legal entities) resident, incorporated, established or having their usual residence in Russia or to any person located within the territory of Russia unless and to the extent otherwise permitted under Russian law.

#### **LIMITATION ON ENFORCEMENT OF CIVIL LIABILITIES**

Substantially all of our directors and executive officers and the experts named in this Offering Circular reside in Russia. All or a substantial portion of their and our assets are located in Russia. As a result, it may not be possible for you to:

- effect service of process outside Russia upon substantially all of our directors and executive officers and the experts named in this Offering Circular; or
- enforce outside Russia court judgments obtained against us or substantially all of our directors and executive officers and the experts named in this Offering Circular in non-Russian courts in any action, including actions under the civil liability provisions of U.S. securities laws.

In addition, it may be difficult for you to enforce, in original actions brought in courts in jurisdictions located outside the United States, liabilities predicated upon the United States securities laws.

Judgments rendered by a court in any jurisdiction outside Russia will be recognised by courts in Russia only if an international treaty providing for the recognition and enforcement of judgments in civil cases exists between Russia and the country where the judgment is rendered. If there is such a treaty, Russian courts may nonetheless refuse to recognise and enforce a foreign court judgment on the grounds provided in such treaty and in Russian legislation in effect on the date on which such recognition and enforcement are sought. Furthermore, it is expected that Russian legislation may be changed, *inter alia*, by way of inserting further grounds preventing foreign court judgments from being recognised and enforced in Russia. No such treaty exists between the United States and Russia for the reciprocal enforcement of foreign court judgments.

#### **CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS**

This Offering Circular includes forward-looking statements within the meaning of the U.S. securities laws. All statements other than statements of historical fact contained in this Offering Circular, including, without limitation, those regarding our future financial position and results of operations, strategy, plans, objectives, goals and targets, future developments in the markets in which we participate or seek to



participate, and any statements preceded by, followed by or that include the words “believes”, “expects”, “aims”, “intends”, “will”, “may”, “anticipates” or similar expressions or the negative thereof, are forward-looking statements. These forward-looking statements include, amongst other things, statements concerning:

- estimates of future production for specific operations;
- estimates of future production costs and other expenses for specific operations;
- estimates of future capital expenditures and other cash needs for specific operations and expectations as to the funding thereof;
- statements as to the projected development of certain diamond deposits, including estimates of development and other capital costs, financing plans for these deposits and expected production commencement dates;
- estimates of future costs and other liabilities for certain environmental matters;
- estimates of diamond reserves; and
- estimates of certain tax liabilities.

The forward-looking statements included in this Offering Circular involve known and unknown risks, uncertainties and other factors which may cause our actual results, performance, achievements or industry results to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. These forward-looking statements are based on numerous assumptions regarding present and future business strategies and the environment in which we will operate in the future. Important factors that could cause the industry’s or our own actual results or performance to differ materially from those in the forward-looking statements include, amongst others:

- our ability to continue to export diamonds through De Beers or to find alternative purchasers for the rough diamonds that we currently sell through De Beers;
- our ability to obtain additional financing in the future;
- our ability to adapt our business to Russia’s changing regulatory environment and to implement and successfully execute our strategy;
- our ability to complete existing and future projects on schedule and on budget;
- losses from operational hazards and uninsured risks;
- risks related to our business development, operations and financial condition;
- our ability to obtain, maintain and renew the permits, licenses and other governmental authorisations required to conduct our operations; and
- legal, political and regulatory compliance risks relating to our operations.

Additional factors that could cause actual results, performance or achievements to differ materially include those discussed under “Risk Factors”. These forward-looking statements speak only as of the date of this Offering Circular.

This Offering Circular includes market data and industry forecasts and projections which have been obtained from internal surveys, market research, publicly available information and industry publications. Industry publications generally state that the information they provide has been obtained from sources believed to be reliable, but that the accuracy and completeness of such information are not guaranteed. The forecasts and projections are based on industry surveys and the preparers’ experience in the industry, and there is no assurance that any of the forecasts or projections will be achieved. Similarly, we believe that

the surveys and market research others have performed are reliable, but we have not independently verified this information.

In addition, this Offering Circular describes our diamond reserves and expected ability to continue mining at current production levels. See “Our Business–Diamond Reserves” and “Appendix A–Certification of Diamond Deposits”. Although this information has been certified by the Ministry of Natural Resources of Russia and the Ministry of Finance of Russia (collectively, the “Ministries”), the Notes have not been guaranteed by the Ministries or by any other agency or political subdivision of Russia, and do not represent obligations of any such body.

## **PRESENTATION OF FINANCIAL INFORMATION**

This Offering Circular includes audited consolidated financial statements of ALROSA Ltd. and its subsidiaries as at and for the years ended 31 December 1999, 2000 and 2001 and unaudited consolidated financial statements of ALROSA Ltd. and its subsidiaries as at and for the nine months ended 30 September 2001 and 2002. The consolidated financial statements contained in this Offering Circular have been prepared in accordance with International Accounting Standards (“IAS”).

Our reporting currency is the Rouble. Until 1 January 2003, the Rouble was considered a hyperinflationary currency under IAS and we have accordingly prepared our financial statements in accordance with International Accounting Statement 29, “Financial Reporting in Hyperinflationary Economies” (“IAS 29”). As a result, the financial information contained in this Offering Circular, unless otherwise stated, is presented in terms of the general purchasing power of the Rouble at 30 September 2002. Effective 1 January 2003, the Rouble is no longer considered a hyperinflationary currency under IAS, and our financial statements will not be subject to inflationary adjustment for periods after 31 December 2002.

We do not prepare interim consolidated financial statements. However, we do prepare non-consolidated quarterly financial statements in accordance with Russian Accounting and Reporting Rules.

## **CURRENCIES AND EXCHANGE RATES**

All references in this Offering Circular to:

- “RUB” and “Rouble” are to the currency of Russia;
- “\$”, “U.S.\$”, “Dollars” and “U.S. Dollars” are to the currency of the United States of America; and
- “€” and “euro” are to the currency introduced at the start of the third stage of European Economic and Monetary Union pursuant to the treaty establishing the European Community, as amended by the Treaty on European Union.

Our principal exchange rate risk involves fluctuations in the value of the Rouble relative to the U.S. Dollar. In previous periods, the Russian economy has been characterised by high levels of inflation and an unstable currency. The value of the Rouble depreciated significantly against the U.S. Dollar from 1991 through the first half of 1995, but stabilised, in part due to new policies adopted by the Russian Central Bank (the “Central Bank”), until August 1998 when the Rouble again depreciated significantly against the U.S. Dollar following the decision by the Russian federal government (the “Government of Russia”) to temporarily stop supporting the Rouble. See “Risk Factors–Risks Relating to Our Business–We may be negatively affected by currency fluctuations and Russian law is uncertain with respect to our ability to use hedging instruments”.

The table below sets forth, for the periods and dates indicated, certain information regarding the exchange rate between the Rouble and the U.S. Dollar, based on the official exchange rate quoted by the



Central Bank. Fluctuations in the exchange rates between the Rouble and the U.S. Dollar in the past are not necessarily indicative of fluctuations that may occur in the future.

	Roubles per U.S. Dollar			
	High	Low	Average <sup>(1)</sup>	Period End
<b>Year ended 31 December</b>				
1997 .....	5.96	5.57	5.80	5.96
1998 .....	20.99	5.96	10.12	20.65
1999 .....	27.00	20.65	24.67	27.00
2000 .....	28.87	26.90	28.13	28.16
2001 .....	30.30	28.16	29.22	30.14
2002 .....	31.86	30.13	31.39	31.78

(1) The average of the exchange rates on the last business day of each full month during the relevant period.

<b>Month</b>	Roubles per U.S. Dollar	
	High	Low
October 2002 .....	31.74	31.67
November 2002 .....	31.84	31.76
December 2002 .....	31.86	31.78
January 2003 .....	31.88	31.78
February 2003 .....	31.85	31.55
March 2003 .....	31.60	31.38
April 2003 (through 29 April) .....	31.38	31.10

Solely for the convenience of the reader, and except as otherwise specified, this Offering Circular contains translations of some Rouble amounts into U.S. Dollars at a conversion rate of RUB 31.64 to U.S.\$1.00, which was the official exchange rate quoted by the Central Bank on 30 September 2002. We make no representation that the Rouble amounts referred to in this Offering Circular could have been or could be converted into U.S. Dollars at the above exchange rate or at any other rate.

Certain monetary amounts and other figures included in this Offering Circular have been subject to rounding adjustments. Accordingly, figures shown as totals in certain tables may not be the arithmetical aggregation of the figures which precede them, and figures expressed as percentages in the text may not total 100 per cent. when aggregated.

### Exchange Controls

Exchange control regulations in Russia and in Luxembourg currently do not limit the amount of payments that we may remit to non-residents of those countries. However, the license ALROSA Ltd. received from the Central Bank sets a limit on the rate of interest applicable to the Intercompany Loan.

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## SUMMARY

*This summary highlights information contained elsewhere in this Offering Circular. This summary does not contain all of the information that you should consider before investing in the Notes. Data on diamond reserves and production output of rough diamonds expressed in carats or value in Russia are classified as official state secrets. Further, certain information which investors in securities of a natural resources company might expect in order to evaluate such an investment is not publicly available in relation to our business. The Ministries have, however, provided certain assurances in respect of proven diamond reserves. See "Appendix A—Certification of Diamond Deposits". Prospective investors should read the entire Offering Circular carefully, especially the risks of investing in the Notes discussed in the "Risk Factors" section beginning on page 11.*

### Overview

We are the second largest diamond mining company in the world by diamond production, measured as a multiple of average market prices. In 2001 we produced approximately 20.9 per cent. of the world's rough diamond output, measured as a multiple of average market prices, and approximately 17.3 per cent. by carat volume. Our principal mining operations are located in the Republic of Sakha (Yakutia) ("Yakutia"), in north-eastern Siberia. In addition, we hold a 32.8 per cent. interest in Catoca Mining Ltd., a diamond mining joint venture in Angola, and a 71.9 per cent. interest in Severalmaz, a diamond mining company that holds the license to mine the Lomonosov diamond field in the Arkhangelsk region of north-western Russia. We are also engaged in diamond exploration throughout north-eastern Russia. We produce rough gem diamonds and near-gem diamonds, which are cut and used primarily in jewellery, and non-gem diamonds which are used primarily as industrial abrasives. We are one of Russia's largest industrial enterprises by revenue, with 2001 total revenues of RUB 64.3 billion (U.S.\$2.0 billion), and total revenues for the nine months ending 30 September 2002 of RUB 42.0 billion (U.S.\$1.3 billion).

We operate open-pit, underground and alluvial mines, which are located near the cities of Aikhal, Anabar, Mirny, Nyurba and Udachny within Yakutia, and our seven primary ore treatment production plants have an aggregate design capacity to process approximately 30 million tonnes of ore annually. In 2001, our Russian mines processed approximately 24.7 million tonnes of ore to produce rough diamonds valued at U.S.\$1.7 billion, based on average market prices, and for the first nine months of 2002 these mines processed 23.6 million tonnes of ore to produce rough diamonds valued at U.S.\$1.1 billion. As of 30 September 2002 we employed 46,527 people, including approximately 14,700 people in connection with our primary Russian mining operations.

We had total sales of diamonds for 2001 and the nine-month period ended 30 September 2002 of RUB 58.5 billion (U.S.\$1.8 billion) and RUB 37.8 billion (U.S.\$1.2 billion), respectively. Exports accounted for approximately 60 per cent., of our 2001 diamond sales, and approximately 50 per cent. of our sales of these diamonds for the nine-month period ended 30 September 2002. Our exports are established pursuant to periodic export quotas imposed by Russia. In each case, almost all of our exports have been through sales to De Beers pursuant to trade agreements.

Approximately 40 per cent. of total diamond sales in 2001, and approximately 50 per cent. of our total diamond sales for the nine-month period ended 30 September 2002, were made to domestic purchasers, primarily Russian cutting and polishing companies that process the diamonds for use in jewellery. We also cut and polish some of our rough diamond production primarily through our Brillianty ALROSA division. Our sales of polished diamonds were approximately U.S.\$133.8 million and U.S.\$84.8 million for the year ended 31 December 2001 and the nine-month period ended 30 September 2002, respectively. Our sales of industrial diamonds are conducted almost exclusively through Almaziuvelirexport, a Government of Russia-owned jewellery exporter. In 2001, we sold U.S.\$8.0 million of industrial diamonds, and our sales of such diamonds in the first nine months of 2002 were U.S.\$5.0 million. The sales figures provided in this paragraph are presented on an historical rather than on an inflation-adjusted basis.

As certified by the Ministry of Natural Resources of Russia, our proven diamond reserves of categories B and C<sub>1</sub> (see “Industry Overview–Calculation of Diamond Reserves”) are sufficient to permit mining of diamonds until 31 December 2026 in an annual average volume that is not less than the volume of diamonds produced during 2001. The Ministry of Finance of Russia has certified that our proven reserves of natural diamonds (categories A, B and C<sub>1</sub>) are sufficient to permit mining of diamonds until 31 December 2027 in an annual average volume that is not less than the volume of diamonds produced during 2002. The Ministry of Natural Resources of Russia also confirmed that the average value per carat of diamonds to be mined in each of the next 25 years will not be materially less than the average value per carat of the diamonds that we mined during the year ended 31 December 2002. See “Our Business–Diamond Reserves” and “Appendix A–Certification of Diamond Deposits”. To increase our reserves, we engage in a variety of exploratory activities. These include geological surveying, detailed prospecting and developmental analysis of current mines.

To reduce our costs and ensure operational support, we are engaged in a number of businesses that provide materials and services to our mining operations, including construction and freight transportation services, timber and logging production, agriculture and food supplies and passenger air transport. We have also developed oil and natural gas extraction and hydroelectric plants to supply a portion of our energy needs. In addition, we continue to maintain for the benefit of our Russian employees certain non-productive, “social” assets, which we inherited from our predecessor entities. We are continuing to transfer to the government of Yakutia the obligation to maintain these assets.

We have established representative offices in London, England; Luanda, Angola; Ramat-Gan, Israel; and Antwerp, Belgium.

### **Our Formation and Development**

The diamond industry in Russia dates back to the mid-1950s, with the discovery of significant diamond deposits in regions comprising the former Soviet Union, including the Mir and Zarnitsa diamond pipes.

We were registered as a closed joint stock company in Yakutia on 13 August 1992 under the name “Almazy Rossii-Sakha”, which was changed in 1998 to ALROSA Company Limited. We commenced operations as an independent entity on 1 January 1993. Pursuant to a decree of the President of Russia, we took direct control over the exploration, production, marketing and domestic and foreign sales of diamonds. Various assets previously operated by the former State enterprise, Yakutalmaz, and a State-owned enterprise, Almaziuvirexport, were transferred to our newly established company, largely by means of a lease. In connection with our formation, we also entered into a lease agreement with Yakutia in January 1993 (the “Lease Agreement”) pursuant to which we operate the main part of our mining assets.

Our largest shareholders are Russia, which holds 37 per cent. of our shares through its State Property Ministry, and Yakutia, which holds 32 per cent. of our shares through its State Property Ministry.

### **Strengths**

We believe that we benefit from the following strengths:

- *We have a leading market position in a large and relatively stable market.* We are the second largest producer of rough diamonds in the world, accounting for approximately 20.9 per cent. of world production output in 2001, measured as a multiple of average market prices. We believe that the stability of the diamond market, relative to commodities markets in general, is primarily attributable to the role of the Diamond Trading Company (the “DTC”), a wholly owned subsidiary of De Beers, which purchases and sells rough diamonds and seeks to reduce market price volatility by aggregating supply and demand.
- *We have significant diamond reserves.* We have increased the reserves of our predecessor entities through a combination of successful exploration and investment. We estimate that our total

reserves, including the reserves at the Severalmaz sites, represented approximately 20 per cent. of total global reserves as of 30 September 2002, calculated by value.

- *Our mines have consistently produced high-quality, high-margin gems.* Other than our smaller alluvial operations, our mines have consistently produced gem and near-gem diamonds with per-carat values ranging from U.S.\$15 to U.S.\$10,000. We believe that the quality of our diamonds is relatively high as compared to the quality of diamonds of other producers, and we expect to continue to benefit from the production of high quality diamonds in the future.
- *We have a limited number of competitors.* In general, the global diamond mining industry is characterised by a limited number of competitors, which we believe results primarily from a combination of the limited number of diamond deposits suitable for commercial mining and the large capital requirements for exploration and excavation. Within Russia, we hold exclusive prospecting licenses in numerous locations. We believe that structural and legal barriers to entry will continue to exist which will assist us in maintaining our market position in the future.
- *We benefit from our export arrangements with De Beers.* De Beers purchases a substantial amount of rough diamonds from us each year. We believe that the distribution of our diamonds through De Beers allows us to reduce our distribution costs and to obtain steady inflows of hard currency, as we receive all payments under our agreements with De Beers in U.S. Dollars.
- *We have strong technical mining expertise.* Our predecessor entities have been engaged in diamond mining since 1957. In particular, we have developed unique mining expertise related to the permafrost environment of north-eastern Russia. We believe that our experience helps us to increase efficiency and output and makes us an attractive partner for the joint development of mines outside of Russia.

## Strategy

We generally formulate our long-term strategy pursuant to the adoption of five-year strategic plans. Under our current five-year plan we intend to:

- *Complete construction of new mines to enhance production.* We are currently constructing a number of new mines to replace mines which have recently closed and to enhance our long-term production capacity. In addition to constructing new open-pit mines relating to the Komsomolskaya and Nyurba diamond pipes and a new underground mine at the Mir diamond pipe, we are increasing the capacity of our Zarnitsa open-pit mine and our International and Aikhal underground mines. We estimate that these projects will increase our overall ore processing by 300,000 tonnes in 2003, and by approximately one million tonnes per year by 2008.
- *Lower costs and seek production efficiencies.* We are engaged in a number of cost-reduction projects. In particular, we intend to continue to focus on reducing our energy costs through developing hydroelectric power stations and gas and oil refinery projects and the introduction of energy-saving equipment. We also intend to continue to modernise and automate our ore treatment plants.
- *Divest social assets to improve focus on core business.* To reduce our long-term expenses, we are continuing to transfer to local governments responsibility for the various social assets which we inherited from our predecessor entities, including residential houses, schools and hospitals. We also plan to increase our focus on core operations by divesting or reducing our participation in business ventures which are ancillary to our diamond production operations.
- *Capitalise on anticipated diamond market liberalisation in Russia.* In February 2003 a Presidential decree became effective which we believe reflects the first step in a programme of liberalisation of the Russian diamond market. We believe that this liberalisation trend will generally create

opportunities for our business. For instance, as a result of our new five-year export quota granted pursuant to the decree, we may be able to obtain long-term financing secured by exports, which we believe will reduce our borrowing costs.

- *Continue our relationship with De Beers.* Pending resolution of the Statement of Objections issued by the European Commission with respect to our most recent trade agreement with De Beers (see “Risk Factors–Risks Relating to Our Business–The De Beers Trade Agreement is subject to European Commission approval”), we have continued our monthly sales to De Beers under individual sale agreements. To the extent that we explore opportunities to export our rough diamonds through sales channels other than De Beers in the future, we anticipate that, at least initially, any such sales would be limited to diamonds that are not to be supplied to De Beers.
- *Further diversify geographically.* In addition to exploring regions of Russia outside Yakutia, we intend to seek geographic diversification by participating in additional joint ventures in key diamond mining regions in other countries. We are currently focused on Angola, where the Catoca mine is increasing its production capacity, and we have entered into an agreement with the Angolan government with respect to the development of the Angolan Lour diamond deposit and other joint ventures.
- *Enhance financial planning and improve the efficiency of our corporate governance.* We have been working to improve our financial planning to strengthen our financial stability. As part of our strategy we intend to continue to restructure our borrowings toward longer-term debt, which we believe will enable us to better manage our cash and enhance our liquidity. We are also introducing a new integrated accounting software system.

In addition, while our primary focus continues to be on the production of rough diamonds, we have from time to time considered increasing our cutting and polishing operations, either through the expansion of our own facilities or the acquisition of other established polishing businesses.

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The registered office of the Issuer is 8-10, rue Mathias Hardt, L-1717, The Grand Duchy of Luxembourg. The registered office of ALROSA Ltd. is 6, Lenina Street, Mirny, Republic of Sakha (Yakutia), 678170, Russia, and the address and telephone number of its representative office in Moscow are 10/12 1<sup>st</sup> Kazachy per., Moscow 109017, Russia, telephone: +7 095 230 66 93.



## **SUMMARY CONSOLIDATED FINANCIAL AND OPERATING INFORMATION**

The following table contains historical financial and operating information derived from the audited consolidated financial statements of ALROSA Ltd. as at and for the three years ended 31 December 1999, 2000 and 2001, which were prepared in accordance with IAS. The interim consolidated financial statements of ALROSA Ltd. as at and for the nine-month periods ended 30 September 2001 and 2002 were prepared in accordance with IAS, but are unaudited. The unaudited interim results for the nine-month period ended 30 September 2002 are not necessarily indicative of the results that may be expected for the year ended 31 December 2002. The unaudited interim consolidated financial statements include all adjustments which our management considers necessary for a fair presentation of our consolidated financial position and results of operations for these periods.

You should read the following summary consolidated financial and operating information in conjunction with the information contained in “Selected Financial and Operating Information”, “Capitalisation”, “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and our consolidated financial statements and the related notes thereto appearing elsewhere in this Offering Circular.

Our reporting currency is the Rouble. Until 1 January 2003, the Rouble was considered a hyperinflationary currency under IAS and we have, accordingly, prepared our financial statements in accordance with IAS 29. As a result, the financial information contained in this Offering Circular, unless otherwise stated, is presented in terms of the general purchasing power of the Rouble at 30 September 2002. Effective 1 January 2003, the Rouble is no longer deemed to be a hyperinflationary currency under IAS, and our financial statements will not be subject to inflationary adjustment for periods after 31 December 2002.

Solely for the convenience of the reader, certain information derived from the consolidated financial statements included herein has been translated into U.S. Dollars using the exchange rate of RUB 31.64 to U.S.\$1.00, which was the exchange rate quoted by the Central Bank on 30 September 2002. The U.S. Dollar amounts set forth below were not included in our annual consolidated financial statements or our unaudited interim consolidated financial statements. No representation is made that such Rouble or U.S. Dollar amounts could have been or could be converted into U.S. Dollars or Roubles, respectively, at this exchange rate or at any other rate. See “Currencies and Exchange Rates” for further information regarding rates of exchange between the Rouble and the U.S. Dollar. For a discussion of the effects of fluctuating exchange rates on our results of operations, see “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Certain Factors Affecting Our Results of Operations—Inflationary accounting and exchange rates”.

	For the nine months ended 30 September				For the year ended 31 December					
	2002		2001		2001		2000		1999	
					(amounts in millions)					
	(RUB)	(U.S.\$)	(RUB)	(U.S.\$)	(RUB)	(U.S.\$)	(RUB)	(U.S.\$)	(RUB)	(U.S.\$)
<b>Statement of Income:</b>										
Sales <sup>(1)</sup>	42,045	1,329	47,694	1,507	64,309	2,033	68,729	2,172	67,318	2,128
Cost of sales	(19,059)	(602)	(18,307)	(579)	(24,647)	(779)	(23,471)	(742)	(17,205)	(544)
General and administrative expenses	(1,817)	(57)	(1,778)	(56)	(2,416)	(76)	(1,071)	(34)	(510)	(16)
Other operating expenses	(16,027)	(507)	(19,175)	(606)	(25,144)	(795)	(26,711)	(844)	(27,663)	(874)
of which:										
Royalty <sup>(2)</sup>	(6,173)	(195)	(7,648)	(242)	(10,075)	(318)	(11,531)	(364)	(11,518)	(364)
Taxes other than profit tax <sup>(3)</sup>	(6,350)	(201)	(6,783)	(214)	(8,688)	(275)	(10,245)	(324)	(10,907)	(345)
Social costs <sup>(4)</sup>	(988)	(31)	(1,091)	(34)	(1,927)	(61)	(1,230)	(39)	(2,418)	(76)
Other operating income	1,068	34	1,105	35	1,415	45	1,867	59	2,066	65
<b>Other non-operating gains and losses:</b>										
Monetary gain	2,829	89	3,143	99	3,637	115	1,880	59	5,741	181
Foreign currency losses	(739)	(23)	(461)	(15)	(822)	(26)	(117)	(4)	(3,137)	(99)
Finance costs, net	(2,935)	(93)	(3,370)	(107)	(4,090)	(129)	(2,270)	(72)	(1,720)	(54)
Income from associates	269	9	238	8	277	9	257	8	235	7
Profit tax <sup>(5)</sup>	(3,044)	(96)	(973)	(31)	(1,732)	(55)	(7,757)	(245)	(6,715)	(212)
Minority interest	(81)	(3)	(253)	(8)	(280)	(9)	627	20	–	–
Net profit <sup>(6)</sup>	2,509	79	7,863	249	10,507	332	11,963	378	18,410	582
	As of 30 September				As of 31 December					
	2002		2001		2001		2000		1999	
					(amounts in millions)					
	(RUB)	(U.S.\$)	(RUB)	(U.S.\$)	(RUB)	(U.S.\$)	(RUB)	(U.S.\$)	(RUB)	(U.S.\$)
<b>Balance Sheet Data:</b>										
Property, plant and equipment	88,868	2,809	80,636	2,549	67,712	2,140	58,126	1,837		
Investments <sup>(7)</sup>	2,815	89	2,770	88	3,895	123	3,895	123		
Other non-current assets	2,588	82	2,175	69	883	28	705	22		
Total current assets	27,331	864	23,948	757	26,762	846	17,512	553		
Total shareholders' equity <sup>(6)</sup>										
of which:										
Share capital	53,479	1,690	51,599	1,631	41,184	1,302	29,218	923		
Retained earnings	11,022	348	11,022	348	11,022	348	10,933	346		
Grant <sup>(8)</sup>	42,457	1,342	40,577	1,282	30,162	953	18,285	578		
Minority interest	11,467	362	12,275	388	13,371	423	15,045	476		
	2,631	83	2,458	78	2,542	80	–	–		
<b>Liabilities:</b>										
Long-term debt, excluding current portion	10,384	328	7,338	232	3,628	115	2,576	81		
Provision for restoration liability <sup>(9)</sup>	2,614	83	2,923	92	3,397	107	6,854	217		
Other long-term liabilities	3,614	114	2,457	78	4,554	144	5,139	162		
Total current liabilities	37,413	1,182	30,479	963	30,576	966	21,406	677		
Total debt <sup>(10)</sup>	35,967	1,137	25,844	817	21,460	678	12,486	395		
Net debt <sup>(11)</sup>	33,348	1,054	23,814	753	19,865	628	11,420	361		

	As of and for the nine months ended 30 September				As of and for the year ended 31 December					
	2002		2001		2001		2000		1999	
	(RUB)	(U.S.\$)	(RUB)	(U.S.\$)	(unaudited) (amounts in millions, except certain ratios) (RUB)	(U.S.\$)	(RUB)	(U.S.\$)	(RUB)	(U.S.\$)
<b>Other Financial Data:</b>										
Adjusted EBITDA <sup>(12)</sup> . . . . .	10,513	332	12,806	405	17,597	556	24,220	765	27,451	868
Gross interest expense <sup>(13)</sup> . . . .	3,246	103	3,835	121	5,017	159	2,040	64	1,987	63
Net interest expense <sup>(14)</sup> . . . . .	3,014	95	3,671	116	4,801	152	1,933	61	1,817	57
Adjusted EBITDA/gross interest expense <sup>(12)/(13)</sup> . . . . .	3.24		3.34		3.51		11.87		13.82	
Adjusted EBITDA/net interest expense <sup>(12)/(14)</sup> . . . . .	3.49		3.49		3.67		12.53		15.11	
Net debt/Adjusted EBITDA <sup>(11)/(12)</sup> . . . . .	3.17		1.98		1.35		0.82		0.42	
Net cash provided by operating activities . . . . .	5,969	189	2,315	73	10,090	319	9,855	311	9,409	297
Net cash used for investing activities . . . . .	(10,536)	(333)	(7,282)	(230)	(10,906)	(345)	(9,807)	(310)	(4,364)	(138)
Net cash (used for) provided by financing activities . . . . .	5,329	168	6,790	215	1,475	47	586	19	(6,238)	(197)

- (1) Sales includes revenue from diamond sales and ancillary services, including transport, trading, construction, social infrastructure and exploration activities.
- (2) Royalty expense represents payments made to Yakutia pursuant to the Lease Agreement.
- (3) Taxes other than profit tax include non-recoverable resource tax and resource recovery tax (these two taxes were replaced by the extraction tax starting from 1 January 2002), tax penalties, property tax, ecology fund expense and other taxes.
- (4) Social costs represent expenses related to maintenance of social infrastructure and charity.
- (5) Profit tax includes current profit tax and deferred profit tax.
- (6) Totals may not add due to rounding.
- (7) Investments is defined as equity accounted investments and available for sale investments classified as non-current assets in the balance sheet as at 30 September 2002 and at 31 December 2001, 2000 and 1999.
- (8) Grant is recorded at the carrying values of assets granted to ALROSA Ltd. pursuant to the Lease Agreement, which are reflected in property, plant and equipment. See "Our Business—Regulatory and Environmental Matters—Lease Agreement".
- (9) Provision for restoration liability is defined as the estimated net present value of the production assets that are to be returned to Yakutia at the expiration of the Lease Agreement in January 2018.
- (10) Total debt is defined as short-term debt and the current portion of long-term borrowings, short-term commercial paper, short-term non-convertible bonds, long-term debt, long-term commercial paper and long-term non-convertible bonds.
- (11) Net debt is defined as total debt less cash, cash equivalents and cash equivalents restricted as to withdrawal under the terms of certain borrowings and other contractual obligations.
- (12) Adjusted EBITDA is defined as operating profit plus depreciation expense reduced for amortisation of grant plus the impairment provisions for bad debts, inventory obsolescence and loss on disposal of property, plant and equipment. Adjusted EBITDA is included because management believes it is a useful indicator of its ability to incur and service its indebtedness. Adjusted EBITDA should not be considered as a substitute for operating earnings, net income, cash flow or other statements of operations or cash flow data computed in accordance with IAS or as a measure of our results of operations or liquidity. Funds depicted by this measure may not be available for management's discretionary use (due to covenant restrictions, debt service payments and other commitments). Because all companies do not calculate adjusted EBITDA identically, this presentation of adjusted EBITDA may not be comparable to similarly titled measures of other companies.

The following table sets forth our calculation of adjusted EBITDA:

	For the nine months ended 30 September		For the year ended 31 December		
	2002	2001	2001	2000	1999
	(unaudited) (RUB millions)				
Operating profit . . . . .	6,210	9,539	13,517	19,343	24,006
Depreciation . . . . .	3,719	3,721	4,751	5,269	3,592
Amortisation of grant . . . . .	(808)	(809)	(1,096)	(1,674)	(1,790)
Bad debt expense . . . . .	591	656	735	13	52
Write-down (reversal) of inventory . . . . .	388	(301)	(312)	(331)	375
Loss on disposal of property, plant and equipment . . . . .	413	–	2	1,600	1,216
Adjusted EBITDA . . . . .	10,513	12,806	17,597	24,220	27,451

(13) Gross interest expense is defined as interest expense on bank loans, commercial paper, bonds and other interest.

(14) Net interest expense is defined as gross interest expense less interest income.

## THE OFFERING

*The following summary contains basic information about the Notes and the Guarantee and is not intended to be complete. For a more complete understanding of the Notes and the Guarantee, please refer to the section of this document entitled "Terms and Conditions of the Notes".*

Issuer:	ALROSA Finance S.A.
Guarantor:	ALROSA Company Limited
Issue:	Guaranteed Notes due 2008
Amount:	U.S.\$500,000,000
Issue Price:	98.996 per cent.
Closing Date:	6 May 2003
Maturity Date:	Unless previously redeemed, or purchased and cancelled, the Notes will be redeemed at their principal amount on 6 May 2008.
Interest:	8.125 per cent. per annum payable in equal instalments semi-annually in arrear on 6 May and 6 November in each year, commencing on 6 November 2003.
Form:	<p>The Notes will be in registered form, without interest coupons attached. Notes will be offered and sold outside the United States in reliance upon Regulation S.</p> <p>The Notes will be represented by interests in the Global Note which will be in definitive, fully registered form, without interest coupons attached, and which will be registered in the name of a nominee for, and shall be deposited on or about the Closing Date with a common depositary for, Euroclear and Clearstream, Luxembourg.</p> <p>Beneficial interests in the Global Note will be shown on, and transfers thereof will be effected only through, records maintained by Euroclear, and Clearstream, Luxembourg.</p> <p>Beneficial interests in the Global Note may at all times be held only through Euroclear and Clearstream, Luxembourg.</p>
Status of the Notes:	The Notes constitute (subject to Condition 4 of the Terms and Conditions) unsecured and unsubordinated obligations of the Issuer which rank <i>pari passu</i> and without any preference among themselves. The payment obligations of the Issuer under the Notes and of the Guarantor under the Guarantee shall, save for such exceptions as may arise by mandatory operation of law and subject to Condition 4 of the Terms and Conditions, at all times rank at least equally with all other present and future unsecured and unsubordinated obligations of the Issuer and the Guarantor, respectively.
Guarantee:	The payment, when due, of all sums expressed to be payable by the Issuer under the Trust Deed and the Notes has the benefit of an unconditional and irrevocable guarantee of the Guarantor (see Condition 2(a) of "Terms and Conditions of the Notes").

Cross Default:	There will be a cross default in respect of certain Indebtedness (as defined in the Terms and Conditions) of the Issuer, the Guarantor or any Material Subsidiary (as defined in the Terms and Conditions) equal to or greater than U.S.\$10,000,000 (or its equivalent in another currency) (see Condition 10(c) of “Terms and Conditions of the Notes”).
Negative Pledge:	There will be a negative pledge in respect of certain Indebtedness of the Issuer, the Guarantor and its Material Subsidiaries (see Condition 4 of the Terms and Conditions).
Covenants:	The Terms and Conditions contain restrictions on certain activities of the Issuer, the Guarantor and certain subsidiaries of the Guarantor, including their ability, amongst other things, to borrow money, pay distributions or dividends on equity, make certain investments, enter into sale and leaseback transactions, sell assets or merge with or into other companies, engage in transactions with affiliates and engage in unrelated businesses. For more information, see “Terms and Conditions of the Notes”.
Tax Redemption:	The Issuer may redeem the Notes, in whole but not in part, at their principal amount, plus accrued interest, in the event of certain changes in taxation by Luxembourg or Russia.
Listing of Notes:	Application has been made to list the Notes on the Luxembourg Stock Exchange.
Governing Law and Arbitration:	The Notes and the Trust Deed (including the Guarantee) will be governed by and construed in accordance with English law and contain provisions for arbitration in London, England.
Use of Proceeds:	The net proceeds of the Issue, which will be approximately U.S.\$491,480,000, will be on-lent by the Issuer to the Guarantor and will be used by the Guarantor to repay short- and medium-term financing. See “Use of Proceeds”.



## RISK FACTORS

*An investment in the Notes involves a high degree of risk. Accordingly, you should carefully consider the risks described below, as well as the other information in this Offering Circular, before making an investment decision. The risks and uncertainties below are not the only ones we face. Additional risks and uncertainties not presently known to us, or that we currently believe are immaterial, could also impair our business operations. If any of the following risks actually materialises, our business, results of operations and financial condition could be materially and adversely affected. If that were to happen, the trading price of the Notes could decline and ALROSA Ltd. may be unable to meet its financial obligations to the Issuer or to fully perform its obligations under the Intercompany Loan and the Guarantee, in which case the Issuer would be unable to pay interest or principal on the Notes, and you may lose all or part of your investment.*

### **Risks Relating to Our Business**

#### ***Our business is particularly susceptible to fluctuations in diamond prices***

Our primary revenues are derived from the mining and sale of diamonds and, as a result, our financial results are affected by the marketability and price of diamonds. Unlike commodities, the price of rough diamonds has remained relatively stable in recent years, which we believe is primarily attributable to the role of the DTC. See “Industry Overview–Marketing and Role of the DTC”. The DTC purchases and sells rough diamonds and seeks to reduce market price volatility by aggregating supply and demand. However, a number of factors could result in fluctuations in rough diamond prices, including, amongst other things, the following:

- international or regional political and economic events or trends;
- structural changes in the world diamond market, such as a change in the system of marketing through the DTC, the DTC’s reduced participation, altered role or withdrawal from this market, whether as a result of changing market conditions, legal requirements, regulatory intervention or otherwise;
- speculative trading in diamonds;
- decreased demand for diamonds used in connection with the manufacture of jewellery, as well as for industrial and investment purposes;
- overproduction of diamonds; and
- drawdowns of existing diamond stocks held by private entities, governments, industrial organisations and individuals.

The prices we receive for our diamonds are based on the clarity, colour and quality of individual diamonds sold, as well as general trends in market supply and demand for diamonds. See “Our Business–Sales of Rough and Polished Diamonds”. To the extent that we sell diamonds to De Beers pursuant to contractual arrangements, we have an assured distribution outlet but eventually any sustained increase or decrease in prices will be passed through to us. Accordingly, any sustained drop in the market price of diamonds is likely to have an adverse impact on our business, results of operations and financial condition.

#### ***We are dependent on De Beers for the distribution of our diamonds outside of the Commonwealth of Independent States***

Until 6 February 2003, the effective date of the Presidential Decree No. 1373 dated 30 November 2002 (the “2002 Decree”) which introduced certain market liberalisation measures, we exported our rough diamonds pursuant to an export license that required all export sales to be made through De Beers, subject to certain limited exceptions and except for exports to countries within the Commonwealth of Independent

States (“CIS”) to meet those countries’ internal requirements for rough diamonds. See “Our Business–Sales of Rough and Polished Diamonds”. We have, therefore, traditionally exported our rough diamonds outside of the CIS pursuant to trade agreements with De Beers, which obligate De Beers to make minimum annual purchases of rough diamonds in amounts specified in those agreements. For 2001 exports through De Beers accounted for 50 per cent of our diamond sales.

We and our predecessor entity, Yakutalmaz, have contracted exclusively with De Beers for the distribution of our exported diamonds on the international market since 1959. We executed our most recent trade agreement with De Beers, which we refer to herein as the “De Beers Trade Agreement”, on 17 December 2001. The Directorate-General for Competition (the “Directorate-General”) of the Commission for the European Communities (the “European Commission”) is currently conducting an investigation of our relationship with De Beers, and the De Beers Trade Agreement remains subject to approval by the European Commission. Pending such approval, we have made sales to De Beers under *ad hoc* written agreements for each shipment. However, as part of its investigation, the European Commission could require the termination of the De Beers Trade Agreement and the suspension of the practice of making sales to De Beers pursuant to the *ad hoc* written agreements, or the modification of the terms of the De Beers Trade Agreement or such *ad hoc* agreements. See “–The De Beers Trade Agreement is subject to European Commission approval” below.

Although we believe that we have strong arguments in support of the De Beers Trade Agreement, we cannot offer any assurance as to the European Commission’s ultimate decision. If our ability to sell diamonds through De Beers were to be limited because of a modification of the De Beers Trade Agreement (or a modification or suspension of the current arrangements with respect to *ad hoc* agreements) or a prohibition on our performance thereunder, or for any other reason, we believe this would adversely affect our ability to market and distribute rough diamonds efficiently in the international market, the volume of rough diamonds we are able to sell and the revenue stream from such sales. If these events occur, we could, as a consequence, experience difficulty in future periods in attracting longer-term financing on acceptable terms, as well as a negative effect on our credit ratings.

***The De Beers Trade Agreement is subject to European Commission approval***

The Directorate-General has reviewed the terms of the De Beers Trade Agreement, and has considered our initial legal arguments in support of the De Beers relationship and the De Beers Trade Agreement. As a result of this review, on 17 January 2003, the European Commission issued a Statement of Objections (the “Statement of Objections”), expressing its view that:

- the De Beers Trade Agreement breaches the European Commission prohibition on restrictive agreements by preventing us from competing with De Beers in the European market, and does not qualify for an exemption from such prohibition;
- De Beers’ performance under the De Beers Trade Agreement constitutes abuse by De Beers of its dominant position in the diamond market, and no exemption can be granted for activities which constitute such abuse; and
- our *ad hoc* sales to De Beers pursuant to per-shipment, willing-buyer/willing-seller arrangements, as described above, which have, to date, approximated the sales levels of the De Beers Trade Agreement, amount to a constructive implementation of the De Beers Trade Agreement by the parties and should, therefore, be prohibited.

We have submitted a written response to the Statement of Objections.

If the European Commission were to limit our ability to sell diamonds through De Beers by terminating or restricting the terms of the De Beers Trade Agreement or the current arrangements with respect to *ad hoc* written agreements, we would have to seek alternative purchasers for the rough diamonds that we are unable to sell to De Beers. We are considering a number of strategies for the export

of our rough diamonds in the event of any mandatory reduction in our sales to De Beers, including the establishment of a direct selling organisation outside Russia to market our rough diamonds to smaller purchasers. However, substantial time may be required to fully implement these new arrangements, and we can offer no assurance that we will be able to fully implement any of these arrangements in a reasonable period of time or at a reasonable cost, or that the implementation of these arrangements would result in the maintenance of our current export levels.

If we are unsuccessful in procuring purchasers for the rough diamonds that we currently sell to De Beers at prices comparable to those we receive through our arrangements with De Beers, this may have an adverse effect on our business, results of operations and financial condition. Any delays in connection with the establishment of a direct selling organisation outside Russia may compel us to create and maintain our own stockpiles of unsold rough diamonds, which could negatively affect our business. In addition, we cannot predict the impact of an adverse decision by the European Commission on world prices of diamonds, the impact that potential price fluctuations may have on our business and results of operations or the duration and magnitude of such price fluctuations.

Although we believe that we have strong arguments that neither the De Beers Trade Agreement nor our current arrangements with De Beers contravene applicable law or regulations, we cannot offer any assurance as to the European Commission's ultimate decision. If we are unsuccessful in persuading the European Commission to change its findings with respect to our relationship with De Beers, the European Commission, in addition to its actions with respect to the De Beers Trade Agreement, could seek to prohibit or restrict our *ad hoc* sales of rough diamonds to De Beers to the extent that such sales would be deemed to constitute implementation of the De Beers Trade Agreement. We cannot be fined for violation of EC law with respect to the De Beers Trade Agreement because it has been notified to the European Commission. However, the European Commission could seek to impose fines in respect of our previous De Beers trade agreements, which were not notified to the European Commission. Because of our dependence on De Beers for the export of rough diamonds, any restriction imposed by the European Commission on our ability to sell rough diamonds through De Beers could have an adverse effect on our business, results of operations or financial condition. See “–We are dependent on De Beers for the distribution of our diamonds outside of the Commonwealth of Independent States”.

***We are prohibited from disclosing our Russian diamond reserves and other information which may be considered material by investors***

The Law on State Secrecy No. 5485-I (the “Secrecy Law”) was enacted in 1993 to prohibit the disclosure of certain data considered to be state secrets. Moreover, the Decree of the President No. 1203, dated 30 November 1995 (the “1995 Presidential Decree”) more specifically provides for secrecy as to deposits of precious stones (including diamonds) in Russia, certain production data relating to the Russian state diamond reserves and data in relation to deposits of diamonds containing reserves in excess of 25 million carats. As a result, we are prohibited from disclosing to you certain information, including information concerning:

- diamond deposits in carats;
- diamond extraction volumes in carats;
- diamond recovery rates;
- export quotas in carats;
- dispositions of our diamond production in carats;
- consumption of diamonds within Russia in carats;
- diamond reserves located within Russia in carats; and
- diamond stockpiles in carats.

Accordingly, you will need to make your investment decision regarding the Notes without the benefit of this information, which may be material to that decision.

The Ministries have made certain confirmations regarding our proven reserves of diamonds and, with respect to future years, the expected average grade, production volumes and average value per carat to be realised by us. See “Appendix A–Certification of Diamond Deposits”. However, the Notes have not been guaranteed by the Ministries or any other agency or political subdivision of Russia, and do not represent obligations of any such body.

***Estimates of our reserves are subject to uncertainties***

To the extent that this Offering Circular contains estimates concerning our reserves, these estimates are subject to considerable uncertainty. Such estimates may be based on interpretations of geological data obtained from sampling techniques. In addition, these estimates may rely on feasibility studies to predict grades of ore, configuration of the ore body, expected recovery rates of diamonds from the ore and other factors. See “Industry Overview–Calculation of Diamond Reserves”. Actual production results may differ significantly from original estimates. In addition, it may take many years from the initial phase of drilling before production is possible. During that time, the economic feasibility of exploiting a discovery may change as a result of changes in the market price of rough diamonds which would determine the projected realisable value of diamonds from the deposit.

***We are dependent on licenses and quotas issued by the Government of Russia and the government of Yakutia to conduct our business***

Russian legislation provides that “all underground resources within the territory of Russia are state property and cannot be sold, purchased or pledged”. Once extracted, mined resources may, however, become the property of the producer unless otherwise specified in a license granted by the federal or regional authorities. Pursuant to the federal law on Subsoil enacted on 21 February 1992 (the “Federal Law”), the Government of Russia and its respective regional administrations, including the government of Yakutia, granted us licenses to conduct our mining operations on the basis of their joint decisions in accordance with the Federal Law. Moreover, our ability to export rough diamonds from Russia is based on licenses issued annually after the general quota for export of rough diamonds outside of Russia has been approved by the Government of Russia. See “Our Business–Regulatory and Environmental Matters–Licenses”. The mineral licenses and the export licenses can be suspended and/or terminated by the licensing authorities if we are deemed to have violated their terms, or repeatedly violated the applicable requirements of Russian law.

The termination, modification or failure, for any reason, to renew these licenses or any export quota in a timely manner could have a material adverse effect on our business, results of operations and financial condition as we will not be able to carry on some or all of our current activities, including our diamond mining activities.

***We lease mining assets from Yakutia and a modification to, or termination of, this lease could negatively affect our business***

Pursuant to the Lease Agreement entered into in January 1993, we lease from Yakutia production and non-production facilities that were constructed by our predecessor entities in connection with the mines that we operate. The net book value of the assets covered by the Lease Agreement was approximately RUB 15.1 billion (U.S.\$477.2 million) as of 30 September 2002. The Lease Agreement expires in January 2018, and contains an option to purchase the assets based on an agreed valuation prior to the expiration date. See “Our Business–Regulatory and Environmental Matters–Lease Agreement”. However, the Lease Agreement could be terminated earlier if we are deemed to be in breach of the Lease Agreement terms and on a number of other grounds. Such early termination of the Lease Agreement

could have a material adverse effect on our business, results of operations and financial condition as we would have to replace, or negotiate the purchase of, some or all of the assets covered by the Lease Agreement which would increase our capital costs and might interrupt our mining and other operations.

A number of terms and provisions of the Lease Agreement are susceptible to more than one interpretation or leave important matters to be agreed between the parties on an *ad hoc* basis. Future interpretations or agreements relating to the Lease Agreement may be contrary to our interests. In addition, as a general rule, the principal economic terms of the Lease Agreement are subject to renegotiation every five years, with the next renegotiation expected to occur in 2006. However, the terms of this Lease Agreement may be amended at any time by the parties. The terms of our Lease Agreement have been amended four times in the ten years since the Lease Agreement became effective. Any future amendments to the Lease Agreement may result in increased lease payments, and Yakutia is likely to seek an increase in such payments if it expects that we will experience a shortfall in revenues which would materially decrease tax revenues paid by us to Yakutia. Any significant increase in the payments we are required to make under the Lease Agreement could have a negative effect on our business, results of operations and financial condition.

***Under Russian law we are currently subject to restrictions on our ability to sell large and rare diamonds***

Under the Decree of the President No. 1524 dated 15 November 1999 (the “1999 Decree”) and Resolution No. 233 of the Government of Russia dated 26 March 2001 (“Resolution No. 233”), we may only sell diamonds which weigh 10.8 carats or more within Russia pursuant to an auction authorised by the Government of Russia, except for those stones sold by Gokhran and polished by Brillianty ALROSA. In addition, diamonds with “special gemological qualities”, as determined by the Ministry of Finance of Russia, may only be sold to the Government of Russia. These special diamonds include diamonds with characteristics which make them rare, such as their colour, as well as all diamonds weighing more than 50.0 carats. Although sales of these diamonds to the Government of Russia are at agreed market prices, the valuation of large and unique diamonds is generally difficult due to their relative scarcity. Because the auctions of diamonds of 10.8 or more carats must take place within Russia, and the process is subject to strict controls by the Government of Russia which could deter potential purchasers from participating, we cannot give any assurance that the prices we receive in these auctions are indicative of the prices that could be achieved if the sale of these gems were to be conducted without such restrictions. As the Government of Russia is the only permitted purchaser of diamonds with special gemological qualities, consensus as to the valuation of these stones is even more difficult to achieve and we may, as a result, be unable to sell certain high-value diamonds for extended periods of time. To the extent that the sale restrictions set forth in Resolution No. 233 prevent us from receiving the highest prices for our largest and most unique diamonds in the future, our revenue will continue to be negatively affected.

***ALROSA Ltd.’s status as a closed joint stock company may violate Russian law***

ALROSA Ltd. was established in 1992 in an uncertain and internally contradictory legal environment. A number of Presidential decrees and resolutions of the Government of Russia pursuant to which ALROSA Ltd. was set up were inconsistent and, to a certain extent, contradicted each other and other applicable laws. For example, the Law “On Joint Stock Companies” of 26 December 1995 (the “JSC Law”) provides that a joint stock company whose founders include Russia, a subject of Russia or a municipality may only be an open joint stock company, unless such company was established in the course of the privatisation of state and municipal enterprises. ALROSA Ltd. was initially organised as a private company rather than a company established in the course of privatisation. However, notwithstanding the provisions of the JSC Law, ALROSA Ltd. was established and continues to exist as a closed joint stock company. If ALROSA Ltd. were found not to be in strict technical compliance with the JSC Law, it could be subject to mandatory conversion into an open joint stock company or to liquidation. We believe that it is unlikely that a challenge of the current legal status of ALROSA Ltd. would be successful. However, we can offer no



assurance that any of our shareholders, or any regulatory authorities, such as the State Property Ministry, will not challenge the status of ALROSA Ltd. as a closed joint stock company and attempt to force it either to liquidate or to convert into an open joint stock company. See “–The Audit Chamber has issued a series of recommendations which, if implemented by the Government of Russia, would change our relationship with Yakutia, the ownership of our shares, the membership of our Supervisory Council and our ability to export diamonds”.

In view of the uncertainty associated with the legality of our closed joint stock company status, our Supervisory Council is contemplating the conversion of ALROSA Ltd., subject to shareholder approval, into an open joint stock company in due course. However, we cannot predict with any degree of certainty the impact that a change in our legal-organisational structure from a closed joint stock company to an open joint stock company may have on our shareholding structure, our management structure or the composition of our Supervisory Council, nor can we predict the impact of such a change upon our business, our financial condition or our results of operations. In addition, a conversion of ALROSA Ltd. to an open joint stock company could result in technical breaches by ALROSA Ltd. of certain covenants and event of default provisions contained in certain agreements to which ALROSA Ltd. is a party, to the extent that it is unsuccessful in obtaining waivers of such covenants and event of default provisions.

The issues referred to above as well as certain other possible violations and contradictions, including, *inter alia*, the claim that Russian laws on privatisation did not provide for the privatisation of Russian diamond industry enterprises and the claim that certain provisions of the applicable regulations regarding the allocation of shares in ALROSA Ltd. among its founders and regarding contribution of certain assets to ALROSA Ltd. may not have been observed, are set out in the report of the Russian Audit Chamber (the “Audit Chamber”) dated 15 December 2002 (the “Audit Chamber Report”). See “Our Business–Legal Matters–The Audit Chamber”. If the Government of Russia or any other party pursues the measures proposed by the Audit Chamber Report or takes any other enforcement action in connection with the possible violations, we can provide no assurance that any such action, whether or not resolved in our favour, will not have an adverse impact on our business and operations.

***From time to time, we could be subject to technical defaults under our credit agreements, loan facilities and other debt instruments***

Although we intend to repay existing credit facilities and loans with the proceeds from the Offering, we anticipate that following the Offering we will retain a significant number of our existing credit agreements, loan facilities and other debt instruments. Many of these agreements, facilities and instruments have broad and far-reaching event of default provisions. Because of the breadth of these provisions and the ambiguities and imprecisions currently found in Russian laws to which such provisions may pertain (see “–Risks Related to the Legal and Regulatory Environment in Russia–Russia’s developing legal system creates a number of uncertainties for our business”), from time to time we may be deemed to be in technical default under such agreements, facilities and instruments. Although we believe that it would be impracticable to seek waivers under these agreements, facilities and instruments where an event of default may have occurred, we have never been in a payment default under, and no lender has ever accelerated any of our indebtedness under, any such agreements, facilities or instruments, nor threatened any such acceleration. Future events which significantly impact our business or involve a change in our legal-organisational form could also be deemed to constitute defaults under one or more of our credit agreements, loan facilities and other debt instruments. Accordingly, we can give no assurance that upon the occurrence of any such default our lenders would not claim an event of default and seek acceleration of the relevant outstanding amounts, which could trigger additional defaults under applicable cross-default provisions in other credit agreements, loan facilities and debt instruments.



***We are substantially exposed to the maintenance of social infrastructure in Yakutia***

Our predecessor entities established most of the physical infrastructure in the areas within Yakutia in which we operate, as these areas were largely uninhabited prior to the discovery of diamond deposits in the 1950s. Although in recent years the economy of Yakutia has become more diversified with the development of oil and gas and other industries, the region remains economically dependent on our business to a significant degree. We are by far the largest employer in our areas of operation within Yakutia, and we estimate that our payments to Yakutia account for a majority of Yakutia's total budget. Yakutia and its local municipalities have historically appealed to us for additional assistance, beyond our required Lease Agreement and tax payments, when local budgets have been insufficient to provide necessary public services. For instance, we have from time to time undertaken to complete necessary road repairs and maintenance to the extent that local budgets could not provide for these activities. We have also been called upon to assist in remedying natural disasters, such as the flooding in Lensk in 2001 in relation to which we incurred costs in 2001 of approximately RUB 4.0 billion (U.S.\$126.4 million), which included reconstruction of housing and payments to flood victims but excluded costs associated with the construction of a flood-control dam as these are to be reimbursed by Yakutia. We expect that Yakutia and its municipalities will continue to rely on us for a substantial portion of their budgets and for additional assistance, where necessary. To date, extraordinary payments made by us have generally either been set off against our required tax and lease payments or have been reimbursed by the relevant governmental entity, except with respect to the assistance we provided to victims of the flooding in Lensk. However, if we were to be required to make such payments to Yakutia and these local entities and these payments were not set off or reimbursed, then such payments would increase our expenses and, consequently, reduce the amounts available for repayment of the Notes.

***We are subject to an arbitration claim which could prevent or delay the completion of our Nyurba ore treatment facilities***

In addition to litigation arising in the ordinary course of business, we are involved in a civil claim relating to the technologies used at our Nyurba mines. Bateman Projects Limited, a South African company, and its Dutch subsidiary, Bateman International B.V. (collectively, "Bateman"), the outside construction firms involved in the development of our Nyurba processing plant, have filed an arbitration claim against us which alleges that technology used in our Nyurba plant infringes Bateman's intellectual property rights. The claim seeks damages of approximately U.S.\$43 million and requests that a Stockholm-based arbitration panel issue an order to prevent us from performing further work on the construction of the Nyurba diamond processing plant. See "Our Business—Legal Matters—Litigation".

If the claim proceeds to arbitration, the arbitration panel could, in addition to granting damages, issue an injunction prohibiting further work on the Nyurba processing facilities, and grant other equitable remedies. We intend to vigorously defend this claim. We believe that our legal defences are strong, and that, in any event, it is unlikely that we would be prevented from continuing our Nyurba processing operations. However, we can offer no assurance in this regard. These actions could increase the cost of, or delay the development of, our Nyurba mining operations, and could have an adverse affect on our business, results of operations and financial condition.

***The Audit Chamber has issued a series of recommendations which, if implemented by the Government of Russia, would change our relationship with Yakutia, the ownership of our shares, the membership of our Supervisory Council and our ability to export diamonds***

The Audit Chamber is an independent auditing body which is authorised to investigate Russian agencies and other entities associated with the Government of Russia. The Audit Chamber may report its findings and make recommendations to such entities; however, these recommendations do not carry the force of law and are, therefore, not mandatory.

In December 2002, the Audit Chamber issued a report to the Government of Russia and to us in which it made certain recommendations. See “Our Business—Legal Matters—The Audit Chamber”. These included recommendations that the Government of Russia, amongst other things:

- transfer ownership of certain of the assets underlying our Lease Agreement from Yakutia to the Government of Russia, and amend the Lease Agreement so that the Government of Russia would lease these assets to us;
- acquire our shares from certain current shareholders to increase the Government of Russia’s ownership in our shares to 51 per cent.;
- set up a new state-owned company which will effect sales of all of our production (rough and polished diamonds) to both internal and external markets; and
- replace certain members of our Supervisory Council.

We believe that it is highly unlikely that the Government of Russia will seek to implement the recommendations of the Audit Chamber. In addition, we believe that there is some uncertainty as to whether Russian law would permit the full implementation of these recommendations, as proposed by the Audit Chamber. Moreover, we believe that the proposed changes to our Supervisory Council would require the consent of all of our major shareholders. However, we cannot offer any assurance that the Government of Russia will not seek to implement some or all of the recommendations made by the Audit Chamber. The full implementation of these recommendations may require substantive changes to our Lease Agreement and the other documents under which we operate. It would also result in majority control of our business by the Government of Russia, changes to the composition of the Supervisory Council, our governing body and may have an adverse effect on our ability to export diamonds. We are unable to predict what effects, if any, these changes could have on our business, results of operations and financial condition.

In addition to the issue of the Audit Chamber Report in December 2002, the Audit Chamber has examined the 1993 contract under which we were required to sell approximately U.S.\$1.2 billion of diamonds on behalf of Almaziuvelirexport. In connection with the Audit Chamber’s review we were not able to supply records confirming all of these sales because, under our record retention policy, we do not maintain records dating back to the time of these sales. Based on the absence of records, the Audit Chamber issued a report which concluded that we may have breached certain contractual obligations in connection with our sale of diamonds of behalf of Almaziuvelirexport. Although the Audit Chamber has submitted this claim to the General Prosecutor’s Office, we do not expect that the General Prosecutor’s Office will institute any claim against us with respect to these sales. However, we can provide no assurance in this regard, and any such claim could adversely affect our business.

***We are subject to general mining risks***

Our business operations, like those of other mining companies, are subject to all of the hazards and risks normally associated with the exploration, development and production of natural resources, any of which could result in work stoppages or damage to persons or property. In particular, hazards associated with our open-pit mining operations include:

- flooding of the open pit;
- collapses of the open-pit wall;
- accidents associated with the operation of large open-pit mining and rock transportation equipment;
- accidents associated with the preparation and ignition of large-scale open-pit blasting operations;
- production disruptions due to weather; and
- hazards associated with the disposal of mineralised waste water, such as groundwater and waterway contamination.

Hazards associated with our underground mining operations include:

- underground fires and explosions, including those caused by flammable gas;
- cave-ins or ground falls;
- discharges of gases and toxic chemicals;
- flooding;
- sinkhole formation and ground subsidence; and
- other accidents and conditions resulting from drilling, blasting and removing and processing material from an underground mine.

Hazards associated with our rock dump and production stockpile mining and tailings disposal include:

- accidents associated with operating a rock dump and production stockpile and with rock transportation;
- production disruptions due to weather;
- collapses of tailings dams; and
- ground and surface water pollution.

We are at risk of experiencing any and all of these environmental or other industrial hazards. The occurrence of any of these hazards could delay production, increase production costs and result in injury to persons and damage to property, as well as liability for us.

To the extent that liabilities resulting from any of these risks are not adequately covered by insurance, we may incur significant costs that could have a material adverse effect upon our business, results of operations and financial condition.

***As our open-pit mines mature, increasingly we must rely on underground mining, which is more expensive and subjects us to additional risks***

We have historically operated open-pit mines. However, as some of our open-pit mines have matured and reached their target depths, we have shifted to underground mining in order to continue extracting diamonds from the deposits related to these open-pit mines. We now conduct underground mining at our Aikhal and International mines and are constructing underground mines to continue the work of our Mir and Udachny open-pit mines. Underground mines typically result in lower ore production volumes than open-pit mines because the volumes of underground mines are limited to the capacity of such mines to transport ore to the surface through access shafts. In addition, underground mining is generally more expensive than open-pit mining. Accordingly, where we replace open-pit mining with underground mining, the historical operating and financial results of the replaced open-pit mines will not necessarily be indicative of the operating and financial results we can expect to achieve with underground mining. Any reductions in volumes and/or increases in operating expenses relating to our increasing use of underground mining could have an adverse effect on our business, result of operations and financial condition.

Underground mining is also considered to be more dangerous than open-pit mining. Underground mines present an increased risk of cave-ins and are dependent on artificial ventilation systems. Although we believe that the safety record of our underground mines has been consistent with that of our open-pit mining operations, we can offer no assurance that we will not experience material losses due to accidents in the future. For a description of the risks relating to underground mining, see “–We are subject to general mining risks”. Any such losses may have a material adverse effect on our business, results of operations and financial condition.

***Our operations may be adversely affected by difficult geological conditions***

The success of our operations depends, in part, upon the success of our engineering solutions to difficult hydrological and geothermal conditions. Significant removal of groundwater inflow and geothermal control is required during mining. While we have achieved considerable success to date in addressing these conditions, no assurance can be given that future efforts will be adequate or will meet future operational demands or expectations. A failure to resolve any unexpected problems relating to these conditions at a commercially reasonable cost could adversely affect the economics and/or feasibility of our operations.

***We could be subject to liabilities which are not covered by insurance***

The insurance industry is not yet well developed in Russia, and many forms of insurance protection common in more economically developed countries are not yet available in Russia on comparable terms, including coverage for business interruption. We insure the transport of all our diamonds from our production sites in Yakutia to our sorting facility in Moscow. We also maintain general liability insurance in an amount that we believe is sufficient for our mining operations. However, few of our operating assets are insured, and, in the case of assets which are insured, the insurance is generally insufficient to cover replacement costs. With respect to our passenger airline services we have carrier's liability insurance, and we also insure our airplanes. However, in the course of our business, certain claims may be brought against us relating to, amongst other things, personal injury, death or property damage caused by our operations. Accordingly, we may incur uninsured losses of assets and may be subject to a claim which is not covered, or not sufficiently covered, by insurance. Any such loss or claim may have a material adverse effect on our business, results of operations and financial condition.

***We depend on our port facilities in Lensk and other self-maintained transportation infrastructure within Yakutia***

For all of our mines, the vast majority of materials and supplies are shipped by rail to the river port at Osetrovo, then transported by the river Lena to our port at Lensk and delivered to the mines by truck, in part over gravel roads that we have constructed and maintain. In addition, we have built and maintain airports located in Mirny, Vitim, Lensk, Aikhal, Polyarny and Saskylakh for transportation of passengers, including our employees, and cargo used in our operations. In the future we may experience interruptions to this transportation network, including as a result of natural causes such as the severe flooding that in 2001 destroyed the city of Lensk along with our port facilities. In 2001 we incurred costs in connection with the flood of approximately RUB 4.0 billion (U.S.\$126.4 million), which included payments to flood victims and construction of replacement housing but excluded the costs of building a flood-control dam as these costs will be reimbursed by Yakutia. We cannot assure you that similar interruptions in the transportation of our materials, supplies and employees will not occur in the future. Any such interruption may adversely affect our ability to operate our business, and may result in material additional costs associated with repairs and the implementation of alternative modes of transportation.

***Our activities with respect to diamond cutting and polishing subject us to additional risks which may increase in the future***

Through our Brillianty ALROSA division we cut and polish a limited amount of our production of rough diamonds. The business of diamond cutting and polishing entails difficulties and risks which are different from those we face as a producer of rough diamonds. As compared with mining, which is capital intensive, cutting and polishing operations entail high variable costs, as the cost of rough diamonds generally comprises approximately 90 per cent. of the total production costs. Because our polishing operations are supplied with rough diamonds from our own mines, we do not need to purchase rough diamonds on the international market. However, the further processing and sale of diamonds as polished gems rather than rough diamonds affects our cash flows by delaying receipt of the sale proceeds for those diamonds. In addition, the demand for polished diamonds is seasonal, and may be more sensitive to

fluctuations in the world economy than the rough diamond market. The market for polished diamonds has in the past also been more prone to overproduction than the rough diamond market. As a result of these factors we can give no assurance that our cutting and polishing operations will continue to be profitable in the future. Any losses resulting from our polishing operations could have a material adverse affect on our business, results of operations and financial condition. To the extent that we expand our polishing activities in the future, our risks relating to these activities will also increase.

***We may be subject to environmental liabilities***

As part of our mining operations, we use various chemicals and produce overburden and wastewater, which could have a negative impact on wildlife and vegetation of adjacent areas if improperly discharged. In addition, we use hazardous materials, such as explosives used in mining operations and solvents used to clean, refurbish and maintain mining, processing and other equipment. Through our Irilyakhneft subsidiary, we are also currently engaged in the extraction, transport and storage of oil principally for use in our mining operations, and we dispense petroleum products from underground and above-ground storage tanks on our mining sites. These activities are subject to a number of federal laws and regulations relating to environmental protection, including a “pay-to-pollute” regime administered by the Russian Ministry of Ecology and local authorities. Fees are assessed for exceeding agreed limits on emissions and effluents. Currently these fees are generally small in relation to the cost of environmental protection equipment and it is generally less expensive to pay the fees than to install anti-pollution devices. Further, the applicable laws do not generally require clean-up of environmental pollutants, and when clean-up is required, the applicable laws provide no guidance as to the extent to which the clean-up must be carried out. However, enforcement of existing legislation, regulations and licenses may become more stringent, and more comprehensive legislation could be adopted, particularly in connection with Russia’s application to join the World Trade Organisation. Accordingly, future changes in environmental laws or in the enforcement of such laws may require us to make significant capital expenditures or otherwise alter aspects of our operations and this may have an adverse effect on our operations and financial condition.

***We will require substantial additional capital to finance our current business plan***

We currently estimate that through the end of 2005 we expect to make capital expenditures of approximately U.S.\$1.1 billion to U.S.\$1.3 billion, as follows:

- U.S.\$10 million to U.S.\$15 million for the maintenance of our existing operations;
- U.S.\$790 million to U.S.\$945 million for maintaining production levels and production expansion;
- U.S.\$140 million to U.S.\$160 million for new construction and social capital expenditures; and
- U.S.\$160 million to U.S.\$180 million for cost-reduction projects.

The cash that we generate from our business may not be sufficient to meet our capital requirements in accordance with our current business plan. Accordingly, we may require additional debt and/or equity financing. We cannot be certain that any additional financing will be available or available on terms that are satisfactory to us. In addition, the Terms and Conditions will restrict our ability to obtain additional financing. Because our projected capital expenditures are primarily related to longer-term production-expansion and cost-reduction projects, we believe that a reduction in capital spending would not significantly affect our revenues through 2005. However, a reduction in capital expenditures resulting from an inability to obtain additional financing may limit the implementation of our business plan, which may have an adverse effect on our operations and financial condition over the long term.

***We may be negatively affected by currency fluctuations and Russian law is uncertain with respect to our ability to use hedging instruments***

Our business is affected by currency fluctuations between the U.S. Dollar and the Rouble. Our revenues are denominated in both currencies. However, our Rouble revenues are generally linked to the U.S. Dollar in so far as our domestic sales are generally based on prices established in the world rough diamond market, which are quoted in U.S. Dollars. The vast majority of our production costs are incurred in Roubles, but we have a significant amount of debt denominated in both currencies, and the Notes will be repayable in U.S. Dollars. Because our revenues as well as our costs involve both U.S. Dollars and Russian Roubles, the appreciation of one of these currencies against the other will have both positive and negative effects on our finances. Thus, it is difficult to predict how currency fluctuations will impact us in the future. In addition, we are currently unable to manage the risk associated with currency fluctuations through the use of hedging instruments, as hedging instruments may be deemed to be illegal under Russian law. As a result, any sustained change in currency rates may have a material adverse effect on our financial condition.

***Catoca Mining Ltd., our minority-owned Angolan subsidiary, is subject to the risks of doing business in Angola***

We currently have a 32.8 per cent. interest in Catoca Mining Ltd., a joint venture which, pursuant to a concession from the Angolan government, mines the Catoca diamond pipe located in the Luande Norte Province in eastern Angola, approximately 1,000 kilometres north of that nation's capital. In addition to our investment, we provide advisory services to Catoca Mining Ltd. and as of 30 September 2002 we had approximately 117 employees seconded to that joint venture. We intend to increase our activities in Angola and we recently entered into an agreement with the Angolan government to jointly develop a hydroelectric station to supply electricity to Catoca. We have also agreed to participate in the development of a new mine in Angola to extract diamonds from the Lour deposit in Angola; however, there is currently no agreement as to the structure or capital allocation for these projects. See "Our Business—Mining Joint Ventures—The Catoca mine in Angola".

There are substantial risks associated with investments in less developed countries and countries with emerging economies, such as Angola, where civil unrest, nationalist movements, political violence and economic crises are possible. These countries may also pose heightened risks of expropriation of assets, increased taxation and a unilateral modification of concessions and contracts. Exploration, development and production activities in these countries are potentially subject to political and economic risks, including:

- cancellation or renegotiation of contracts;
- changes in domestic laws or regulations, including tax laws;
- royalty and tax increases or claims by governmental entities, including retroactive claims;
- expropriation or nationalisation of property;
- currency fluctuations and foreign exchange controls;
- import and export regulations, including restrictions on the export of diamonds; and
- risks of loss due to civil strife, acts of war, guerrilla activities, insurrection and terrorism.

Angola recently ended three decades of civil war, with a ceasefire in February 2002. However, the Angolan economy is still recovering from the effects of the civil war, which has displaced millions of people. In addition, the war destroyed much of the country's industrial infrastructure, and it is estimated that four million landmines have been laid in Angola's countryside. Catoca Mining Ltd. may be materially affected by these factors. These risks will increase to the extent that we increase our investment in Angola in the future as we intend to do. Furthermore, as a result of our investment in Catoca Mining Ltd., we



could be subject to the jurisdiction of Angolan courts in disputes relating to such investment, which could result in unpredictable or adverse outcomes.

***We rely on the continued services of key managerial and technical personnel and, because of our remote operations, we may have difficulty retaining and attracting new employees***

Our continued success will depend in part on our ability to retain our managers and skilled employees and to attract additional managers and employees who are skilled in our business. Currently, there is a high level of competition for highly trained managers, qualified geologists and other technical personnel. We may also have difficulties attracting and retaining skilled workers at our Yakutian facilities due to their remote location and the local climate. We believe that we will continue to hire the majority of our Yakutia-based employees from the cities surrounding our mining operations, and that we have been successful in attracting other skilled employees, in part through scholarship programmes with Russian universities and technical colleges. However, we may not be able to continue to attract and retain skilled employees in the future. Any failure in this regard could have a material adverse effect on our business, results of operations and financial condition.

***To the extent that full liberalisation of the Russian diamond market is not implemented, our operational flexibility will continue to be subject to limitations***

Although the President signed the 2002 Decree implementing certain liberalisations of the Russian diamond market effective from February 2003, we remain subject to various governmental controls, including, amongst other things, export quotas, secrecy laws, mandatory price lists and restrictions on the sale of large and rare diamonds. See “Industry Overview—Liberalisation of the Russian Diamond Market”. Based on discussions with officials of the Government of Russia, we expect additional liberalisation initiatives to occur in the future, which may be implemented as part of reforms relating to Russia’s application for membership in the World Trade Organisation. Our strategy considers ways in which we might capitalise on the additional flexibility that liberalisation would create. See “Our Business—Strategy”. However, we can offer no assurance as to when or if further liberalisation will be adopted. To the extent that liberalisation of the Russian diamond market is delayed or abandoned, we will remain subject to the existing rules which materially limit our operational flexibility and our ability to implement a portion of our strategy.

***We are subject to the control of our existing shareholders, whose interests may differ from the interests of Noteholders***

Russia and Yakutia own 37 per cent. and 32 per cent. of our share capital, respectively. In addition, 8 per cent. of our share capital is held by districts within Yakutia. Collectively, these governmental entities are entitled to appoint a majority of the 15 members of our Supervisory Council, although none of these entities individually exercises control of the Supervisory Council. See “Principal Shareholders”. As a result, Russia, Yakutia and the districts within Yakutia will continue to be able to exercise effective control over us, including the disposition of virtually all matters submitted to a vote of shareholders. As sovereign entities, their interests may not be aligned with the interests of private investors who have principally an economic interest in our company. Specifically, these entities may support policies which contribute to national and regional interests, such as policies intended to increase employment, which may conflict with our interests and the interests of Noteholders. In addition, Russia, Yakutia and the districts within Yakutia may have divergent interests with respect to our management and operations, and any resulting disagreements could adversely affect the Supervisory Council’s ability to effectively manage our affairs.

***Terrorist activity and global instability could have an adverse impact on the diamond market***

On 11 September 2001, terrorist attacks were conducted 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, as well as the market for diamonds. Following 11 September, the average prices for rough diamonds fell by more than 14 per cent. However, diamond prices have partially recovered since that time. Any future acts of terrorism and, in particular, another terrorist attack in the United States, could have an adverse effect on the global economy and world diamond prices. A significant reduction in demand for diamonds, particularly in the United States, which consumes the majority by value of the world's supply of polished diamonds, could materially adversely affect our business, results of operations and financial condition.

***Adverse publicity regarding “conflict diamonds” could have an adverse impact on the diamond industry and our business***

Increasing attention has been focused within the last few years on the issue of “conflict diamonds”, the name ascribed to diamonds which are extracted in war-torn regions and sold by rebel forces to fund insurrection. Allegations have been made in the press that such diamonds are used in connection with the financing of terrorist activities. Concerned participants in the diamond trade, including De Beers as well as certain other non-governmental organisations, seek to exclude such diamonds, which represent a small fraction of the world's supply, from legitimate trade through an international system of certification and legislative initiatives. We and other diamond producers have worked with The World Diamond Council and the United Nations to establish the “Kimberley Process”. The Kimberley Process consists of a system of self-regulation in which a seller of diamonds must certify that it either has personal knowledge or has received a written warranty that the diamonds have been purchased from a legitimate source. It is expected that such efforts, if successful, will not substantially affect the supply of diamonds. However, in the near term, efforts by these non-governmental organisations to increase consumer awareness of the issue and encourage governmental initiatives to curb the proliferation of “conflict diamonds” could affect consumer demand for polished diamonds, and decrease demand for rough diamonds, which could have an adverse impact on our business, results of operations and financial condition.

***The diamond industry may be adversely affected by the discovery of an economically feasible method of producing artificial gem-quality diamonds***

Since the creation of the first artificial industrial diamonds, there have been several attempts to develop an inexpensive process for the creation of gem-quality artificial diamonds. From time to time, third parties have made public claims of having successfully manufactured gem-quality diamonds by artificial means; however, to our knowledge there have been no claims regarding the successful commercialisation of such a process. To the extent that the synthetic manufacture of gem-quality diamonds is successfully commercialised in the future and the resulting artificial diamonds receive consumer acceptance as a substitute for naturally occurring gem-quality diamonds, these developments could have an adverse effect on the prices of diamonds generally as well as on our business, results of operations and financial condition.

***Information we have obtained from third parties may be unreliable***

For certain information included in this Offering Circular we have relied, without independent verification, on publicly available information. Such third party information was derived from press releases and information from various private and governmental publications, some or all of which could be based on estimates or unreliable sources. When reading this Offering Circular, you should keep in mind that the information, data and statistics attributed to third parties could be incomplete or erroneous.

## **Risks Related to the Political and Social Environment in Russia**

### ***The volatile political situation in Russia could restrict our ability to obtain financing and our business could be harmed if governmental instability recurs***

Since 1991, Russia has been evolving from a communist state with a centrally planned economy to a pluralist democracy with a market economy. The process of political and economic reform has not been uninterrupted nor has it been completed, and no assurance can be given that the reform process will continue. The Russian political system remains vulnerable to social and ethnic unrest and any significant political instability could adversely affect the value of foreign investments in Russia and our ability to mine and export diamonds. Until 2000, the Government of Russia was characterised by frequent change, having, in addition to the resignation of President Yeltsin on 31 December 1999 and the election of President Putin on 26 March 2000, experienced five changes in prime minister since March 1998. The value of investments in Russia, including investments in our company, could be reduced if such frequent change resumes or if political liberties or market-oriented reforms were to be curtailed.

### ***Conflicts between Russian federal and regional authorities could create an uncertain operating environment for us***

Russia is a federation of 89 sub-federal units comprising republics, territories, regions, districts, cities of federal importance and autonomous areas. The delineation of authority among Russia's constituent entities as well as among the branches of government is often uncertain and at times contested. The Russian political system is therefore vulnerable to tension and conflict between federal, regional and local authorities over various issues, including tax revenues, authority for regulatory matters and regional autonomy, and such conflicts may exist between Russia and Yakutia with respect to their ownership and control of our business. In addition, lack of consensus often results in the enactment of conflicting legislation at various levels, and may result in political instability. This lack of consensus, as well as resultant conflicts among the regions or between the regions and the Government of Russia, may have negative economic effects on us.

In addition, ethnic, religious, historical and other divisions have, on occasion, given rise to tensions and, in certain cases, military conflict. Russian military and paramilitary forces have been engaged in Chechnya in the recent past and continue to maintain a presence there. Chechen rebels continue to present a threat, and in late October 2002 they coordinated a terrorist attack in Moscow in which over 700 people were taken hostage. The spread of violence, or its intensification, could have significant political consequences, which could have a material adverse effect on the investment environment in Russia.

### ***Labour and social unrest may adversely affect our operations***

The failure of some Russian companies to pay full salaries on a regular and timely basis, and the failure of salaries and benefits to keep pace with the increasing cost of living, could lead to future labour and social unrest in Russia. This may have political, social and economic consequences, such as increased support for a renewal of centralised authority, increased nationalism with restrictions on foreign involvement in the Russian economy and increased violence, any of which could have a material adverse effect on our operations.

### ***Organised crime and corruption may adversely affect our operations***

Political and economic changes in Russia since the break-up of the Soviet Union have resulted in a significant redistribution of power and authority. In particular, Russia continues to experience widespread organised criminal activity and corruption, which adds to the uncertainties we face, may increase our costs and may, in the future, subject us to threats of violence and extortion. In addition, growing political pressure on the Government of Russia to deal with corruption and organised crime could precipitate extraordinary government measures that could increase our costs, increase governmental oversight and regulation of our business and otherwise adversely affect our operations.

## **Risks Related to the Economic Situation in Russia**

### ***Economic instability in Russia could adversely affect our operations***

Since the late 1980s the Government of the former Soviet Union and, since late 1991, the Government of Russia have been attempting to implement policies of economic reform and stabilisation. These policies have involved liberalising prices, reducing defence expenditures and subsidies, privatising state-owned enterprises, reforming the tax and bankruptcy systems, and introducing legal structures designed to facilitate private, market-based activities, foreign trade and investment. Despite the implemented reform policies, the Russian economy has at times continued to experience declining industrial production, rising unemployment and underemployment, high levels of debt maintained by the Government of Russia relative to gross domestic product, high levels of *de jure* and *de facto* corporate insolvency and widespread tax evasion. The Russian economy has been subject to abrupt downturns. In particular, on 17 August 1998, in the face of a rapidly deteriorating economic situation, the Government of Russia defaulted on its Rouble-denominated securities, and the Central Bank stopped its support of the Rouble and imposed a temporary moratorium on certain hard currency payments. These actions resulted in an immediate and severe devaluation of the Rouble 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 17 August 1998, which further impaired the ability of the banking sector to act as a consistent source of liquidity.

Although economic conditions in Russia have recently improved, there is a lack of consensus as to the scope, content and pace of economic and political reform. No assurance can be given that reform policies will continue to be implemented and, if implemented, will be successful, that Russia will remain receptive to foreign trade and investment or that the economy in Russia will continue to improve. Any failure of the current policies of economic reform and stabilisation could have a material adverse effect on our operations.

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

Russia's economy is vulnerable to market downturns and economic slowdown 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. In addition, a steep decline in the world price of oil could slow or disrupt the Russian economy because Russia produces and exports large amounts of oil. These developments could severely limit our access to capital and could adversely affect the purchasing power of our Russian customers and, consequently, our business.

### ***We are only able to conduct banking transactions with a limited number of creditworthy Russian banks as the Russian banking system remains underdeveloped***

Russia's banking and other financial systems are not well developed or regulated and Russian legislation relating to banks and bank accounts is subject to varying interpretations and inconsistent application. There are currently a limited number of creditworthy Russian banks with which we can conduct banking transactions, as the August 1998 financial crisis resulted in the bankruptcy and liquidation of many Russian banks and almost entirely eliminated the developing market for commercial bank loans. Most creditworthy Russian banks are located in Moscow and there are fewer creditworthy Russian banks in the regions outside of Moscow. We have endeavoured to reduce our risk by receiving and holding funds in a number of Russian banks, including subsidiaries of foreign banks. However, another prolonged or more serious banking crisis or the bankruptcy of a number of banks in which we receive or hold our funds could adversely affect our business and our ability to complete banking transactions in Russia. Russian companies face significant liquidity problems due to the limited supply of domestic savings, the scarcity of

foreign sources of funds, high taxes, limited lending by the banking sector to the industrial sector and other factors. An intensification of liquidity problems or a further deterioration in the Russian banking system could have a material adverse effect on our business, financial condition and results of operations.

***Sustained periods of high inflation may adversely affect our business***

The Russian economy has been characterised by high rates of inflation. The annualised inflation rate in 1998 was 84.4 per cent., although it subsided to 36.6 per cent. in 1999, 20.1 per cent. in 2000, 18.8 per cent. in 2001 and 15.1 per cent. in 2002. Certain of our costs, such as salaries, are sensitive to increases in the general price level in Russia. Most of our revenues are either denominated in U.S. Dollars or are linked to the U.S. Dollar, and are affected primarily by the international price of diamonds. Accordingly, our operating margins could be adversely affected if the inflation of our Rouble costs in Russia is not balanced by a corresponding devaluation of the Rouble against the U.S. Dollar or an increase in diamond prices.

***Restrictions on investments outside Russia or in hard-currency-denominated instruments in Russia expose our cash holdings to devaluation***

Currency regulations established by Russian legislation restrict investments by Russian companies outside Russia and in most hard-currency-denominated instruments in Russia, and there are only a limited number of available Rouble-denominated instruments in which we may invest our excess cash. Any balances maintained in Roubles will give rise to losses if the Rouble devalues against the U.S. Dollar. Moreover, the obligors of our Rouble-denominated investments may default, resulting in substantial losses.

***International sources of funding may not be available to Russia***

Russia in the past has received substantial funding from several foreign governments and international organisations and through international capital markets transactions. After the events of August 1998, none of the above sources of financing were immediately available to Russia. While we are not aware of any effort by the Government of Russia to secure new funding, the value of investments in Russia could be adversely affected if the Government of Russia were to fail in an attempt to regain access to international sources of funding or the international capital markets. In addition, any failure by the Government of Russia in an attempt to obtain new financing could limit its ability to repay its existing debt obligations as they become due and could lead to direct or indirect monetary financing of future budget deficits, putting pressure on inflation and the value of the Rouble. The occurrence of one or more of these factors could have a material adverse effect on our ability to raise additional sources of external funding.

***We could experience disruptions in our normal business activities as a result of problems associated with Russia's physical infrastructure***

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. Breakdowns and failures of any part of Russia's physical infrastructure may disrupt normal business activity. The Government of Russia is actively considering plans to reorganise the nation's rail, electricity and telephone systems. Any such reorganisation may result in increased charges and tariffs while failing to generate the anticipated capital investment needed to repair, maintain and improve these systems. Continued deterioration of Russia's physical infrastructure would harm the national economy, disrupt the transportation of goods and supplies and add to the cost of doing business in Russia and may interrupt business operations, all of which could have a material adverse effect on our business.



## **Risks Related to the Legal and Regulatory Environment in Russia**

### ***Russia's developing legal system creates a number of uncertainties for our business***

Russia is still developing the legal framework required by a market economy, and several fundamental Russian laws have only recently become effective. The recent nature of much Russian legislation and the rapid evolution of the Russian legal system place the enforceability and constitutionality of Russian laws in doubt and result in ambiguities, inconsistencies and anomalies in their application. In addition, Russian legislation often leaves substantial gaps in the regulatory infrastructure. Among the risks of the current Russian legal system are the following:

- since 1991, Soviet law has been largely, but not entirely, replaced by a new legal regime as established by the 1993 federal Constitution, the Civil Code and by other federal laws, and by decrees, orders and regulations issued by the President, the Government of Russia and federal ministries, which are, in turn, complemented by regional and local rules and regulations. These legal norms, at times, overlap or contradict one another;
- there exists limited judicial and administrative guidance on interpreting Russian legislation;
- judges are relatively inexperienced in interpreting Russian legislation;
- governmental authorities retain a high degree of discretion; and
- bankruptcy procedures are not well developed and are subject to abuse.

In addition, the independence of the judicial system and its immunity from economic, political and nationalistic influences in Russia remain largely untested. Court claims are often used in furtherance of political aims in Russia, and we may be subject to such claims and may not be able to receive a fair hearing. All of these weaknesses could affect (i) our ability to enforce our rights under contracts or to defend ourselves against claims by others and (ii) the Trustee's ability to enforce its rights under the Guarantee, which may have an impact on payments to the Noteholders.

### ***Russia's unpredictable acknowledgement and enforcement of foreign court judgment or arbitral awards give rise to significant uncertainties***

Russia is not a party to any multilateral or bilateral treaties with most Western jurisdictions for the mutual enforcement of court judgments. Consequently, should a judgment be obtained from a court in any of such jurisdictions, it is unlikely to be given direct effect in Russian courts. However, Russia (as successor to the Soviet Union) is a party to the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the "New York Convention") and the Trust Deed (containing the Terms and Conditions) and the Intercompany Loan each contains a provision allowing for arbitration of disputes in a country that is also a party to the New York Convention. A foreign arbitral award obtained in a state which is a party to the New York Convention should be recognised and enforced by a Russian court (subject to the qualifications provided for in the New York Convention and compliance with Russian rules of civil procedure and applicable Russian law). There is also a risk that Russian rules of civil procedure will be amended to introduce further grounds preventing foreign court judgments and arbitral awards from being recognised and enforced in Russia. In practice, reliance upon international treaties may meet with resistance or a lack of understanding on the part of Russian courts or other officials, thereby introducing delays and unpredictability into the process of enforcing any foreign judgment or any foreign arbitral award in Russia.

### ***Unlawful or arbitrary government action may have an adverse effect on our business and the value of an investment in the Notes***

Authorities of the Government of Russia exercise a high degree of discretion in Russia and may at times act without hearing or prior notice, or in a manner that is contrary to, or not directly within the scope

of, Russian law. Moreover, the Government of Russia also has the power in certain circumstances, by regulation or government decree, to interfere with the performance of, nullify or terminate contracts. Unlawful or arbitrary governmental actions have included withdrawal of licenses, sudden and unexpected tax audits, criminal prosecutions and civil actions. Federal and regional government entities have also used common defects in matters surrounding share issuances and registration as pretexts for court actions, claims and other demands to invalidate such issuances and registrations and/or to void transactions, possibly for political purposes. Unlawful or arbitrary government action, if directed at us, could have a material adverse effect on our business, results of operations and financial condition.

***Russia's developing securities laws and regulations may limit our ability to attract future investment***

The regulation and supervision of the securities market, financial intermediaries and issuers are considerably less developed in Russia than in the United States or Western Europe. Disclosure and reporting requirements, anti-fraud safeguards, insider trading restrictions and fiduciary duties are relatively new to Russia and are unfamiliar to most Russian companies and managers. On the other hand, certain regulatory requirements imposed on Russian issuers in other areas are not common in other markets and result in delays in conducting securities offerings and in accessing the capital markets. In addition, Russian securities rules and regulations can change rapidly, and it is often unclear whether certain regulations, decisions and letters issued by the various regulatory authorities are applicable. The developing nature of Russian securities laws and regulations may adversely affect our ability to conduct securities-related transactions in the future, including sales of additional debt securities, to the extent permitted under the Terms and Conditions.

***Russian law may expose us to liability for actions taken by our subsidiaries or joint venture entities***

We have a number of Russian subsidiaries. Under Russian law, we may be jointly and severally liable for any obligations of a subsidiary or joint venture entity under a transaction if we are able to give compulsory instructions to a subsidiary or joint venture entity and the liability arises pursuant to actions taken in accordance with our mandatory instructions. We may also have secondary liability for any obligations of a subsidiary or joint venture entity which becomes insolvent or bankrupt due to our actions or our failure to act. In either of these circumstances, the shareholders of the subsidiary or joint venture entity may seek compensation from us for the losses sustained by the subsidiary or a joint venture entity if we knew that the action taken pursuant to our instructions or the failure to act would result in losses. This type of liability could result in significant liabilities for us and could adversely affect our business.

***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 VAT, import customs duties, profits tax, mineral resources extraction tax, property tax, the unified social tax and, until 31 December 2002, road use tax. In the nine month period ended 30 September 2002, we were subject to a current profit tax rate of 33.5 per cent. (calculated as a percentage of current profit tax, totalling RUB 1,887 million, to profit before profit tax) and a total current tax burden of 25.5 per cent. (calculated as tax expense to total sales; tax expense, totaling RUB 10,701 million, includes current profit tax, export duties, unified social tax and taxes other than profit tax and excludes import duties, non-recoverable VAT and royalty payments).

Laws related to these taxes, such as the Russian Tax Code, have been in force for a relatively short period of time as compared to tax laws in more developed market economies; as a result, implementation of Russian tax laws is often unclear or inconsistent. It is not uncommon for differing opinions regarding legal interpretation to exist both between companies subject to such taxes and the ministries and organisations of the Government of Russia and within the Government of Russia such as the Ministry of Taxes and Duties and its various local tax inspectorates, resulting in uncertainties and areas of conflict. The



fact that a tax declaration has been audited by tax authorities does not bar that declaration, or any other tax declaration applicable to that year, from a further tax review by a superior tax authority during a three-year period. Consequently, the Russian tax system presents risks substantially more significant than those typically found in countries with more developed tax systems.

The taxation system in Russia is subject to frequent change and inconsistent enforcement at the federal, regional and local levels. In addition to our substantial tax burden, these conditions complicate our tax planning and related business decisions. This uncertainty exposes us to significant fines and penalties and to enforcement measures despite our efforts at compliance, and could result in greater than expected tax expenses. For a description of the status of recent tax claims against us, see “Our Business–Legal Matters–Tax claims”.

***Restrictive currency regulations may interfere with our ability to conduct routine business transactions***

A substantial portion of our revenues are received in Roubles. The Rouble is generally not convertible outside Russia. Although a market exists within Russia for the conversion of Roubles into other currencies, it is limited in size and is subject to rules limiting such conversion. Our limited ability to convert our Rouble earnings into foreign currency may adversely affect our ability to conduct routine transactions in foreign currencies, which may have a negative affect on our business. In addition, Russian law currently requires that 50 per cent. of our foreign currency revenues from export sales be converted into Roubles, and the conversion of Roubles into foreign currency on the domestic market is subject to Russian currency regulations. The relative stability of the exchange rate of the Rouble against the U.S. Dollar since 1999 has mitigated risks associated with this forced conversion; however, this situation may change in the future. To the extent that we have difficulty converting the required percentage of our Rouble revenue, we may not be able to comply with applicable currency regulations, which may subject us to fines and penalties.

***If we forfeit any of our Central Bank licenses, breach any of the terms of such licenses or fail to receive such licenses, we could suffer cash flow difficulties***

Many transactions involving foreign currencies require transaction-specific licenses from the Central Bank of Russia. The application process for a Central Bank license is potentially burdensome and time-consuming. The Central Bank may impose additional requirements or deny our application for such licenses, which could harm our business. A Central Bank license may be required for certain financing activities, such as for the issuance of a guarantee in favour of a foreign third party or to create a foreign subsidiary, including finance subsidiaries. Such Central Bank licenses were obtained in connection with the Offering (except as further described below). The loss of a Central Bank license, the breach of the terms of a Central Bank license or our failure to obtain Central Bank licenses in the future could result in significant delays in purchasing equipment, cash flow difficulties and fines and penalties, and could result in a default by the Issuer on the Notes and a default by ALROSA Ltd. under the Intercompany Loan. The loss of Central Bank licenses relating to this Offering would affect, amongst other things, ALROSA Ltd.’s ability to meet its obligations under the Intercompany Loan and the Guarantee.

A Central Bank license is required for the payment by ALROSA Ltd. of amounts in Dollars in respect of the Guarantee. This license was issued to ALROSA Ltd. on 16 April 2003. However, its effectiveness is subject to a written confirmation from the Central Bank. Although ALROSA Ltd. expects to receive this confirmation within a relatively short period of time following the closing of the Offering of the Notes, no assurance can be given in this regard, and, as at the date of this Offering Circular, the Central Bank license has not become effective. If and for so long as ALROSA Ltd. does not receive the written confirmation of license effectiveness from the Central Bank, the license will not be valid and effective so as to permit ALROSA Ltd. to make payments under the Guarantee in Dollars, and any payments under the Guarantee would be permitted to be made only in Roubles.

Central Bank regulations also restrict investments in most foreign currency-denominated instruments. Consequently, there are a limited number of low-risk instruments in which we can invest our excess cash. Putting our excess cash at risk could interfere with our ability to conduct operations and could adversely affect our business.

### **Risk Factors Relating to an Investment in the Notes**

#### ***Our substantial indebtedness could adversely affect our financial condition***

We have incurred a substantial amount of debt. As of 30 September 2002 we had total net debt of RUB 33,348 million (U.S.\$1,054 million), primarily consisting of bank debt and Rouble-denominated bonds. We anticipate that we will continue to incur additional debt and maintain a considerable amount of debt for the foreseeable future. For the holders of Notes this has important consequences. Our substantial leverage poses the risk that:

- a significant portion of our cash flow from operations will have to be dedicated to servicing our debt obligations;
- our ability to obtain additional financing for working capital, capital expenditures or business opportunities may be limited by certain covenants associated with our debt obligations;
- our debt may put us at a competitive disadvantage and may make it difficult for us to pursue our business strategy and make us more vulnerable to general economic and industry conditions than competitors who have less debt;
- our debt level may make it more difficult to adequately plan for or react to changing market conditions and changes in the diamond mining industry; and
- we may have difficulty meeting our obligations under the Intercompany Loan.

Our ability to make payments on and to refinance our debt, including the Intercompany Loan, will depend on our ability to generate cash in the future. The ability to generate cash is, to a certain extent, beyond our control. Accordingly, we cannot provide any assurance that we will generate sufficient cash from operations or additional financing activities to meet debt service obligations and liquidity needs in the future or that subsidiaries of ALROSA Ltd. will be able to transfer assets to ALROSA Ltd. for such debt obligations and liquidity needs. In addition, future borrowings may not be available to us in an amount sufficient to enable us to fund our liquidity needs or to make required payments on our debt in the future.

We may need to refinance all or a portion of our existing indebtedness, as well as the Notes, on or before maturity. We may not be able to refinance existing indebtedness and, even if we can, the terms of such refinancing might be less favourable than the terms of existing indebtedness, which could have a material adverse effect on our business, results of operations or financial condition.

#### ***Both ALROSA Ltd. and the Issuer are dependent on intercompany cash flow***

The Issuer is a special purpose financing entity with no business operations other than the issuance of debt securities, including the Notes, and the lending of the proceeds of such offerings to us under the Intercompany Loan (or similar agreements to be concluded in the future). The Intercompany Loan (and similar agreements to be concluded in the future) and payments by ALROSA Ltd. thereunder comprise the only significant assets of the Issuer. Accordingly, the Issuer will rely on payments ALROSA Ltd. must make under the Intercompany Loan to provide the necessary funds for it to pay principal and interest on the Notes and to pay its other expenses. Therefore, the Issuer is subject to all risks to which ALROSA Ltd. is subject, to the extent such risks could limit the ability of ALROSA Ltd. to satisfy its obligations under the Intercompany Loan and perform its obligations under the Guarantee.

In addition, although ALROSA Ltd. is an operating company, it derives a portion of its operating income from its subsidiaries. ALROSA Ltd.'s subsidiaries have no obligation, contingent or otherwise, to pay any amount owed under the Notes, the Intercompany Loan or the Guarantee or to make any funds available for such payment. Therefore, ALROSA Ltd.'s operating cash flow and ability to meet its debt obligations, including under the Intercompany Loan and the Guarantee, will depend in part on the cash flow provided by its subsidiaries in the form of loans, dividends or other payments to ALROSA Ltd. as a shareholder. The ability of ALROSA Ltd.'s subsidiaries to make such payments will depend on their earnings, as well as applicable tax considerations and legal restrictions. In the event of insolvency, liquidation, dissolution or reorganisation of any of ALROSA Ltd.'s subsidiaries, the creditors of each subsidiary would be entitled to payment in full from such subsidiary's assets. After paying their own creditors, these subsidiaries may not have any remaining assets for distribution to ALROSA Ltd. as a shareholder and, consequently, none of these assets may be available for payment to the Issuer pursuant to the Intercompany Loan. In that event, the Issuer may be unable to meet its obligations to Noteholders. The Notes, therefore, are effectively subordinated to the obligations of such subsidiaries of ALROSA Ltd. As of 30 September 2002, subsidiaries of ALROSA Ltd. had RUB 7,690 million (U.S.\$243 million) of external liabilities, all of which would have ranked structurally senior to ALROSA Ltd.'s obligations with respect to the Intercompany Loan, the Guarantee and the Notes.

***The Guarantee and the Intercompany Loan are effectively subordinated to secured obligations of ALROSA Ltd.***

The Guarantee and the Intercompany Loan are effectively subordinated in right of payment to the existing and/or future secured indebtedness of ALROSA Ltd. As of 30 September 2002, we had indebtedness totalling RUB 17,761 million (U.S.\$561 million) secured with the assets of the Company, primarily related to loans secured by diamond production and receivables, as well as financing under which we have pledged aircraft, ships and real property. The foregoing amount of secured indebtedness does not include certain items of our indebtedness that are subject to guarantees and general security interests over our assets that, by their terms, do not identify any specific assets pledged, because we believe that, under applicable Russian law, it is likely that such indebtedness would be deemed to rank *pari passu* with our unsecured indebtedness, including the Notes. In addition, the Terms and Conditions will permit us to incur substantial additional secured indebtedness under some circumstances. See "Terms and Conditions of the Notes". If an event of default occurs under a secured credit facility, the lenders may foreclose upon the respective collateral. Additionally, in the event of a bankruptcy, liquidation, dissolution, reorganisation or similar proceeding, the holders of any secured indebtedness of ALROSA Ltd. will be entitled to proceed against the collateral that secures such indebtedness and such collateral will not be available for satisfaction of any amounts owed to the Issuer under the Intercompany Loan or payable pursuant to the Guarantee.

***We will have the ability to incur substantially more debt, and this could increase the risks described above***

We may decide to incur substantial additional debt in the future. While the Terms and Conditions contain certain restrictions on our ability to incur additional debt, they nonetheless permit us to incur substantial amounts of additional debt. In addition, debt permitted to be incurred by ALROSA Ltd.'s subsidiaries, other than the Issuer, will be structurally senior to the Notes. If new debt is added to our current debt levels, the magnitude of the related risks described above could increase, and the foregoing factors could have a material adverse effect on our ability to pay amounts due in respect of the Notes.

***Limitations on our ability to borrow and invest and to engage in certain transactions could impair our ability to expand or finance our future operations***

The agreements that govern our debt instruments, including the Terms and Conditions, contain certain restrictions limiting our flexibility in operating our business. Such restrictions limit or may limit our ability to:

- borrow money;
- sell assets;
- make investments;
- engage in mergers or consolidations;
- enter into new lines of business;
- enter into transactions with affiliates other than on arm's-length terms; and
- pay dividends or make other distributions.

These restrictions could hinder our ability to carry out our business strategy, ALROSA Ltd.'s ability to make payments on the Intercompany Loan or the Guarantee and the Issuer's ability to make payments of principal or interest on the Notes.

In addition, a breach of the Terms and Conditions or the terms of other debt instruments could cause a default under the terms of our other financing arrangements, causing all debt under those financing arrangements to become due. We can offer no assurance that if the indebtedness under the Notes were to be accelerated, the assets of ALROSA Ltd. would be sufficient to generate the funds necessary to repay the Notes in full in satisfaction of its obligations under the Intercompany Loan or the Guarantee.

***Insolvency and administrative laws in Russia, The Netherlands and Luxembourg could negatively affect the ability of Noteholders to enforce their rights***

Russian bankruptcy law may prohibit ALROSA Ltd. from making payments pursuant to the Guarantee or the Intercompany Loan under certain circumstances. Specifically, Russian bankruptcy law provides that transactions or payments entered into or made at or after the time when a company becomes unable to pay its debts may be declared void by a Russian bankruptcy court. After such time, the subject company is prohibited from paying any debts outstanding prior to the bankruptcy proceedings, subject to specified exceptions. After the company becomes insolvent, creditors of that company may not pursue any legal action to obtain an order for payment of indebtedness, to set aside a contract for non-payment or to enforce the creditor's rights against any asset of the debtor. Contractual provisions, such as those contained in the Terms and Conditions and the Intercompany Loan, which would accelerate the payment of the debtor's obligations upon the occurrence of certain bankruptcy events, are not enforceable under Russian law. In addition, an administrator may renounce or set aside executory contracts, including the Terms and Conditions.

Additionally, if a bankruptcy court orders a judicial reorganisation, it can prohibit the sale of an asset that it deems to be essential to the continued business of the debtor and can postpone the payment of debts owed by the debtor. Russian bankruptcy law assigns priority to the payment of certain creditors, including employees, secured creditors and post-petition creditors. If any of these laws are applied to ALROSA Ltd., holders of the Notes may not be able to enforce their rights under the Guarantee.

The Issuer is incorporated under the laws of Luxembourg, and ALROSA Finance B.V. is incorporated under the laws of The Netherlands. Generally, insolvency and administrative laws in Luxembourg and The Netherlands could negatively affect the ability of Noteholders to enforce their rights under the Notes and the Guarantee in a manner similar to the Russian laws described above.

***A court could invalidate or subordinate the Notes, the Guarantee or the Intercompany Loan pursuant to fraudulent conveyance laws***

The Offering and sale of the Notes and the implementation of the Intercompany Loan may be subject to review under Russian law if a bankruptcy or reorganisation case or a lawsuit is commenced by or on behalf of unpaid creditors of ALROSA Ltd. If a court were to find that ALROSA Ltd. incurred indebtedness pursuant to this Offering with the intent to hinder, delay or defraud such creditors, then the issuance of the Notes, the Intercompany Loan and the Guarantee could be declared void, but only with respect to the creditors involved in such action. Similarly, if a court were to find, in connection with a bankruptcy, reorganisation or similar proceeding, that ALROSA Ltd.:

- received less than reasonably equivalent value for incurring indebtedness in connection with the Offering;
- was rendered insolvent at the time of or pursuant to the Offering;
- was engaged or was about to engage in a business or transaction for which the assets remaining constituted unreasonably small capital to carry on its business; or
- intended to incur, or believed that it would incur, debts beyond its ability to pay such debts as they mature;

then, in each such case, a Russian court could declare void, in whole or in part, the Notes, the Intercompany Loan or the Guarantee and take other action detrimental to the holders of these instruments, including, under certain circumstances, ordering the return of payments previously made thereunder. For purposes of the foregoing, ALROSA Ltd. would be considered insolvent if it is unable to settle its current liabilities from available assets.

***Tax gross-up provisions under the Intercompany Loan may be unenforceable against ALROSA Ltd. under Russian law***

If payments from ALROSA Ltd. under the Intercompany Loan are subject to any withholding of Russian tax (as a result of which the amounts received by the Issuer would be reduced by the amount of such withholding), ALROSA Ltd. is obliged, subject to certain conditions, to increase payments under the Intercompany Loan as may be necessary so that the net payments received by the Issuer, and consequently, the Noteholders, will be equal to the amounts they would have received in the absence of such withholding. However, there is some uncertainty under Russian law as to the enforceability of such gross-up provisions. To the extent that the tax gross-up provisions under the Intercompany Loan are deemed to be unenforceable, the net amount of the payments made by ALROSA Ltd. to the Issuer may be insufficient to permit the Issuer to make payment in full under the Notes.

***No prior market for the Notes***

Prior to the Offering, there was no public market for the Notes. Although application has been made to list the Notes on the Luxembourg Stock Exchange, an active trading market in the Notes may not develop or be maintained after listing. If an active trading market does not develop or cannot be maintained, this could have a material adverse effect on the liquidity and the trading price of the Notes. In addition, the stock markets, in recent years and, in particular, in recent months, have experienced significant price fluctuations. These fluctuations often were unrelated to the operating performance of the companies whose securities are traded on such stock markets. Market fluctuations as well as adverse economic conditions have negatively affected the market price of many securities and may affect the market price of the Notes.

## **Risks Relating to the Taxation of the Notes**

### ***Payments under the Guarantee may be subject to Russian withholding tax***

Payments under the Guarantee to a Noteholder who is not a tax resident of Russia might, due to the lack of clarity in the law, be characterised as Russian source income that would be subject to a 30 per cent. withholding tax (if a holder is an individual) or 20 per cent. withholding tax (if a holder is not an individual) at source of payment in Russia. It is not expected that the Trustee will, or will be able to, claim a withholding tax exemption under any double tax treaty. In addition, while it may be possible for some Noteholders who are eligible for withholding tax relief under Russian double tax treaties to claim a refund of tax withheld, there would be considerable practical difficulties in obtaining any such refund.

The Issuer may, at its option, redeem the Notes if: (i) the Issuer (or, if the Guarantee was called, ALROSA Ltd.) has or will become obliged to pay additional amounts, as provided or referred to in the Terms and Conditions, as a result of any change in, or amendment to, the laws or regulations of Luxembourg or Russia or any political subdivision or any authority thereof or therein having power to tax, or any change in the application or official interpretation of such laws or regulations, which change or amendment becomes effective on or after the issue date of the Notes and (ii) such obligation cannot be avoided by the Issuer (or ALROSA Ltd., as the case may be) taking reasonable measures available to it. If the Issuer redeems the Notes under such circumstances, the redemption price will be equal to 100 per cent. of the principal amount of the Notes plus any interest and additional amounts due. See Condition 7–“Redemption and Purchase”–in “Terms and Conditions of the Notes” and “Taxation”.

### ***Tax might be withheld on dispositions of our Notes, reducing their value***

If an individual tax non-resident Noteholder sells Notes to a resident of Russia, there is a risk that the proceeds from such disposal may be subject to a withholding tax on any gain realised, subject to any available treaty relief. There is no assurance that advance double tax treaty relief would be granted, and obtaining a refund can involve considerable practicable difficulties. The withholding tax rate applicable to proceeds from the sale of Notes to a purchaser within Russia by an individual tax non-resident holder is 30 per cent. The imposition or possibility of imposition of this withholding tax could adversely affect the value of the Notes. See “Taxation”.

## **USE OF PROCEEDS**

The net proceeds from this Offering, after payment of commissions related to the Offering, will be approximately U.S.\$491,480,000 million. This figure does not include expenses related to the Offering, estimated to be approximately U.S.\$2 million, which will be paid directly by the Issuer. We expect to use substantially all of the net proceeds of this Offering to repay short- and medium-term indebtedness.



## ISSUER OF THE NOTES

### General

The Issuer was incorporated on 17 April 2003 as a *société anonyme* with limited liability under the laws of Luxembourg. The principal purpose of the Issuer is to finance the business operations of ALROSA Ltd. and its subsidiaries, as described in this Offering Circular.

The Issuer has conducted no operations since it was established. It has no subsidiaries or significant business other than the issuance of the Notes and, potentially, other debt securities in the future and is not expected to produce any income except payments received from ALROSA Ltd. under the Intercompany Loan (and under any similar agreements which may be entered into upon any future debt issuances by the Issuer). The only assets of the Issuer available to meet the claims of the Noteholders will be the obligations owed to the Issuer under the Intercompany Loan and any amounts representing its issued and paid-up capital. Pursuant to the Intercompany Loan, operating and other expenses of the Issuer are payable by ALROSA Ltd.

The Issuer has its registered office at 8-10, rue Mathias Hardt, L-1717, The Grand Duchy of Luxembourg. The authorised share capital of the Issuer is €31,000 divided into 310 ordinary shares with a par value of €100 each. The Issuer has issued a total of 310 shares, all of which have been one-quarter paid. The Issuer has no other authorised or issued securities.

### Shareholders

ALROSA Finance B.V., a Dutch company wholly owned by ALROSA Ltd., owns 309 of the Issuer's shares and Shapburg Limited, a nominee company established under the laws of the British Virgin Islands, owns one share.

### Statuts

Pursuant to article three of the Issuer's articles of incorporation, the Issuer's purpose is the holding of participations, in any form whatsoever, in Luxembourg and foreign companies and any other form of investment, the acquisition by purchase, subscription or in any other manner as well as the transfer by sale, exchange or otherwise of securities of any kind and the administration, control and development of its portfolio; the Issuer may further guarantee, grant loans or otherwise assist the companies in which it holds a direct or indirect participation or which form part of the same group of companies as the Issuer; and the Issuer may carry out commercial, industrial or financial activities which it may deem useful in accomplishment of this purpose. The by-laws of the Issuer will be published in the Memorial, *Journal Officiel du Grand-Duché de Luxembourg, Recueil des Sociétés en Associations*. Any person interested in inspecting them may do so at the Register of Commerce and Companies of Luxembourg City. In connection with the listing of the Notes on the Luxembourg Stock Exchange, the constitutional documents of the Issuer and a legal notice relating to the issue of the Notes have been deposited prior to the listing with the Chief Registrar of the District Court of Luxembourg, where such documents may be examined and copies obtained free of charge.

### Management

The board of directors of the Issuer consists of Shapburg Limited and Quenon Investments Limited and Liftwood Investments Limited, nominee companies established under the laws of the British Virgin Islands, each of whom was appointed by ALROSA Finance B.V. The address of the directors is c/o AM MERCURIA, 8-10, rue Mathias Hardt, L-1717, The Grand Duchy of Luxembourg.

### Auditors

The auditors of the Issuer are PricewaterhouseCoopers.

### Financial Year

The Issuer's financial year begins on 1 January and ends on 31 December.

## CAPITALISATION

### Capitalisation of ALROSA Ltd.

The following table shows the capitalisation of ALROSA Ltd. as of 30 September 2002, on an actual basis and as adjusted to reflect (i) the issuance of the Notes and (ii) application of the net proceeds of this Offering as described under “Use of Proceeds”. You should read this table in conjunction with the consolidated financial information included elsewhere in this Offering Circular.

	As at 30 September 2002		As Adjusted <sup>(1)</sup>
	(unaudited) (RUB millions)	(unaudited) (U.S.\$ millions) <sup>(2)</sup>	(unaudited) (U.S.\$ millions) <sup>(2)</sup>
Short-term loans and current portion of long-term debt <sup>(3)</sup> . . . .	25,583	809	318
Grant <sup>(4)</sup> . . . . .	11,467	362	362
Long-term debt <sup>(5)</sup> . . . . .	10,384	328	819
<b>Shareholders' equity:</b>			
Share capital <sup>(6)</sup> . . . . .	11,022	348	348
Retained earnings . . . . .	42,457	1,342	1,342
Total shareholders' equity . . . . .	53,479	1,690	1,690
Total capitalisation . . . . .	100,913	3,189	3,189

(1) Adjusted to give effect to receipt of the Intercompany Loan, but not adjusted to give effect to any other change subsequent to 30 September 2002. The adjustment assumes the use of proceeds from the Intercompany Loan to retire short-term debt only; however, some of the loans ultimately selected for repayment may be classified as long-term debt rather than short-term debt in our consolidated financial statements.

(2) Solely for the convenience of the reader, the U.S. Dollar amounts shown above have been translated from the Rouble amounts at the rate of RUB 31.64 to U.S.\$1.00, which was the official exchange rate at 30 September 2002.

(3) Short-term loans and current portion of long-term debt includes RUB 16,122 million (U.S.\$510 million) of bank debt, RUB 2,652 million (U.S.\$84 million) of commercial paper, RUB 5,414 million (U.S.\$171 million) representing the current portion of long-term debt and RUB 1,395 million (U.S.\$44 million) of other debt. See “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources”.

(4) Grant is recorded at the carrying values of assets granted to ALROSA Ltd. pursuant to the Lease Agreement, which are reflected in property, plant and equipment. See “Our Business—Regulatory and Environmental Matters—Lease Agreement”.

(5) Long-term debt as adjusted as at 30 September 2002 includes the Intercompany Loan, bank debt, non-convertible bonds and other long-term indebtedness. See “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources”.

(6) Authorised share capital consisted of 200,000 ordinary shares of RUB 55,110 (U.S.\$1,742) par value each, all of which have been issued and fully paid.

Except as indicated above and elsewhere in this Offering Circular, there has been no material change in the capitalisation of ALROSA Ltd. since 30 September 2002, other than, as at 31 December 2002, a RUB 5,202 million net increase in our long-term debt and a RUB 6,797 million net decrease in our short-term debt, in each case in terms of the purchasing power of the Rouble at 31 December 2002.

## Capitalisation of the Issuer

The Issuer was incorporated on 17 April 2003. The following table shows the Issuer's capitalisation as of that date, on an actual basis and as adjusted to reflect (i) the issuance of the Notes and (ii) the loan of the proceeds of this Offering under the Intercompany Loan.

	As at Historical	2003 As Adjusted
		(unaudited) (€'000)
Total debt . . . . .	—	445,038
Shareholders' equity <sup>(1)</sup> . . . . .	8	8
Total capitalisation . . . . .	8	445,046

(1) Authorised share capital consisted of 310 ordinary shares of €100 par value each. All of the shares have been issued and one-quarter paid.

In the above table Dollar amounts have been translated into euros at a conversion rate of U.S.\$1.00 to €0.89, which was the exchange rate quoted by the Federal Reserve Bank of New York on 30 April 2003. No representation is made that such Dollar amounts could be converted into euros at this rate.

Except as indicated above and elsewhere in this Offering Circular, there has been no material change in the capitalisation of the Issuer since 17 April 2003.

## SELECTED FINANCIAL AND OPERATING INFORMATION

The following table contains historical financial and operating information derived from the audited consolidated financial statements of ALROSA Ltd. as at and for the three years ended 31 December 2001, 2000 and 1999, which were prepared in accordance with IAS. The interim consolidated financial statements of ALROSA Ltd. as at and for the nine-month periods ended 30 September 2002 and 2001 were prepared in accordance with IAS, but are unaudited. The unaudited interim results for the nine-month period ended 30 September 2002 are not necessarily indicative of the results that may be expected for the year ended 31 December 2002. The unaudited interim consolidated financial statements include all adjustments which our management considers necessary for a fair presentation of our consolidated financial position and results of operations for these periods.

You should read the following selected consolidated financial and operating information in conjunction with the information contained in “Capitalisation”, “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and the consolidated financial statements and the related notes thereto appearing elsewhere in this Offering Circular.

Our reporting currency is the Rouble. Until 1 January 2003, the Rouble was considered a hyperinflationary currency under IAS and we have, accordingly, prepared our financial statements in accordance with IAS 29. As a result, the financial information contained in this Offering Circular, unless otherwise stated, is presented in terms of the general purchasing power of the Rouble at 30 September 2002. Effective 1 January 2003, the Rouble is no longer deemed to be a hyperinflationary currency under IAS, and our financial statements will not be subject to inflationary adjustment for periods after 31 December 2002.

Solely for the convenience of the reader, certain information derived from the consolidated financial statements included herein has been translated into U.S. Dollars using the exchange rate of RUB 31.64 to U.S.\$1.00, which was the exchange rate quoted by the Central Bank on 30 September 2002. No representation is made that such Rouble or U.S. Dollar amounts could have been or could be converted into U.S. Dollars or Roubles, respectively, at this exchange rate or at any other rate. See “Currencies and Exchange Rates” for further information regarding rates of exchange between the Rouble and the U.S. Dollar. For a discussion of the effects of fluctuating exchange rates on our results of operations, see “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Certain Factors Affecting Our Results of Operations—Inflationary accounting and exchange rates”.

	For the nine months ended 30 September				For the year ended 31 December					
	2002		2001		2001		2000		1999	
	(RUB)	(U.S.\$)	(RUB)	(U.S.\$)	(amounts in millions)		(RUB)	(U.S.\$)	(RUB)	(U.S.\$)
					(RUB)	(U.S.\$)				
<b>Statement of income:</b>										
Sales <sup>(1)</sup>	42,045	1,329	47,694	1,507	64,309	2,033	68,729	2,172	67,318	2,128
Cost of sales	(19,059)	(602)	(18,307)	(579)	(24,647)	(779)	(23,471)	(742)	(17,205)	(544)
General and administrative expenses	(1,817)	(57)	(1,778)	(56)	(2,416)	(76)	(1,071)	(34)	(510)	(16)
Other operating expenses	(16,027)	(507)	(19,175)	(606)	(25,144)	(795)	(26,711)	(844)	(27,663)	(874)
of which:										
Royalty <sup>(2)</sup>	(6,173)	(195)	(7,648)	(242)	(10,075)	(318)	(11,531)	(364)	(11,518)	(364)
Taxes other than profit tax <sup>(3)</sup>	(6,350)	(201)	(6,783)	(214)	(8,688)	(275)	(10,245)	(324)	(10,907)	(345)
Social costs <sup>(4)</sup>	(988)	(31)	(1,091)	(34)	(1,927)	(61)	(1,230)	(39)	(2,418)	(76)
Other operating income	1,068	34	1,105	35	1,415	45	1,867	59	2,066	65
<b>Other non-operating gains and losses:</b>										
Monetary gain	2,829	89	3,143	99	3,637	115	1,880	59	5,741	181
Foreign currency losses	(739)	(23)	(461)	(15)	(822)	(26)	(117)	(4)	(3,137)	(99)
Finance costs, net	(2,935)	(93)	(3,370)	(107)	(4,090)	(129)	(2,270)	(72)	(1,720)	(54)
Income from associates	269	9	238	8	277	9	257	8	235	7
Profit tax <sup>(5)</sup>	(3,044)	(96)	(973)	(31)	(1,732)	(55)	(7,757)	(245)	(6,715)	(212)
Minority interest	(81)	(3)	(253)	(8)	(280)	(9)	627	20	–	–
Net profit <sup>(6)</sup>	2,509	79	7,863	249	10,507	332	11,963	378	18,410	582
	As of 30 September				As of 31 December					
	2002		2001		2000		1999			
	(RUB)	(U.S.\$)	(RUB)	(U.S.\$)	(amounts in millions)		(RUB)	(U.S.\$)	(RUB)	(U.S.\$)
					(RUB)	(U.S.\$)				
<b>Balance sheet data:</b>										
Property, plant and equipment	88,868	2,809	80,636	2,549	67,712	2,140	58,126	1,837		
Investments <sup>(7)</sup>	2,815	89	2,770	88	3,895	123	3,895	123		
Other non-current assets	2,588	82	2,175	69	883	28	705	22		
Total current assets	27,331	864	23,948	757	26,762	846	17,512	553		
Total shareholders' equity <sup>(6)</sup>										
of which:										
Share capital	11,022	348	11,022	348	11,022	348	10,933	346		
Retained earnings	42,457	1,342	40,577	1,282	30,162	953	18,285	578		
Grant <sup>(8)</sup>	11,467	362	12,275	388	13,371	423	15,045	476		
Minority interest	2,631	83	2,458	78	2,542	80	–	–		
<b>Liabilities:</b>										
Long-term debt, excluding current portion	10,384	328	7,338	232	3,628	115	2,576	81		
Provision for restoration liability <sup>(9)</sup>	2,614	83	2,923	92	3,397	107	6,854	217		
Other long-term liabilities	3,614	114	2,457	78	4,554	144	5,139	162		
Total current liabilities	37,413	1,182	30,479	963	30,576	966	21,406	677		
Total debt <sup>(10)</sup>	35,967	1,137	25,844	817	21,460	678	12,486	395		
Net debt <sup>(11)</sup>	33,348	1,054	23,814	753	19,865	628	11,420	361		

	As of and for the nine months ended 30 September				As of and for the year ended 31 December					
	2002		2001		2001		2000		1999	
	(RUB)	(U.S.\$)	(RUB)	(U.S.\$)	(RUB)	(U.S.\$)	(RUB)	(U.S.\$)	(RUB)	(U.S.\$)
<b>Other financial data:</b>										
Adjusted EBITDA <sup>(12)</sup> . . . . .	10,513	332	12,806	405	17,597	556	24,220	765	27,451	868
Gross interest expense <sup>(13)</sup> . . . .	3,246	103	3,835	121	5,017	159	2,040	64	1,987	63
Net interest expense <sup>(14)</sup> . . . . .	3,014	95	3,671	116	4,801	152	1,933	61	1,817	57
Adjusted EBITDA/gross interest expense <sup>(12)/(13)</sup> . . . . .	3.24		3.34		3.51		11.87		13.82	
Adjusted EBITDA/net interest expense <sup>(12)/(14)</sup> . . . . .	3.49		3.49		3.67		12.53		15.11	
Net debt/Adjusted EBITDA <sup>(11)/(12)</sup> . . . . .	3.17		1.98		1.35		0.82		0.42	
Net cash provided by operating activities . . . . .	5,969	189	2,315	73	10,090	319	9,855	311	9,409	297
Net cash used for investing activities . . . . .	(10,536)	(333)	(7,282)	(230)	(10,906)	(345)	(9,807)	(310)	(4,364)	(138)
Net cash (used for) provided by financing activities . . . . .	5,329	168	6,790	215	1,475	47	586	19	(6,238)	(197)

- (1) Sales includes revenue from diamond sales and ancillary services, including transport, trading, construction, social infrastructure and exploration activities.
- (2) Royalty expense represents payments made to Yakutia pursuant to the Lease Agreement.
- (3) Taxes other than profit tax include non-recoverable resource tax and resource recovery tax (these two taxes were replaced by the extraction tax starting from 1 January 2002), tax penalties, property tax, ecology fund expense and other taxes.
- (4) Social costs represent expenses related to maintenance of social infrastructure and charity.
- (5) Profit tax includes current profit tax and deferred profit tax.
- (6) Totals may not add due to rounding.
- (7) Investments is defined as equity accounted investments and available for sale investments classified as non-current assets in the balance sheet as at 30 September 2002 and at 31 December 2001, 2000 and 1999.
- (8) Grant is recorded at the carrying values of assets granted to ALROSA Ltd. pursuant to the Lease Agreement, which are reflected in property, plant and equipment. See "Our Business—Regulatory and Environmental Matters—Lease Agreement".
- (9) Provision for restoration liability is defined as the estimated net present value of the production assets that are to be returned to Yakutia at the expiration of the Lease Agreement in January 2018.
- (10) Total debt is defined as short-term debt and the current portion of long-term borrowings, short-term commercial paper, short-term non-convertible bonds, long-term debt, long-term commercial paper and long-term non-convertible bonds.
- (11) Net debt is defined as total debt less cash, cash equivalents and cash equivalents restricted as to withdrawal under the terms of certain borrowings and other contractual obligations.
- (12) Adjusted EBITDA is defined as operating profit plus depreciation expense reduced for amortisation of grant plus the impairment provisions for bad debts, inventory obsolescence and loss on disposal of property, plant and equipment. Adjusted EBITDA is included because management believes it is a useful indicator of its ability to incur and service its indebtedness. Adjusted EBITDA should not be considered as a substitute for operating earnings, net income, cash flow or other statements of operations or cash flow data computed in accordance with IAS or as a measure of our results of operations or liquidity. Funds depicted by this measure may not be available for management's discretionary use (due to covenant restrictions, debt service payments and other commitments). Because all companies do not calculate adjusted EBITDA identically, this presentation of adjusted EBITDA may not be comparable to similarly titled measures of other companies.

The following table sets forth our calculation of adjusted EBITDA:

	<b>For the nine months ended 30 September</b>		<b>For the year ended 31 December</b>		
	<b>2002</b>	<b>2001</b>	<b>2001</b>	<b>2000</b>	<b>1999</b>
	<b>(unaudited)</b>				
	<b>(RUB millions)</b>				
Operating profit . . . . .	6,210	9,539	13,517	19,343	24,006
Depreciation . . . . .	3,719	3,721	4,751	5,269	3,592
Amortisation of grant . . . . .	(808)	(809)	(1,096)	(1,674)	(1,790)
Bad debt expense . . . . .	591	656	735	13	52
Write-down (reversal) of inventory . . . . .	388	(301)	(312)	(331)	375
Loss on disposal of property, plant and equipment . . . . .	413	–	2	1,600	1,216
Adjusted EBITDA . . . . .	10,513	12,806	17,597	24,220	27,451

(13) Gross interest expense is defined as interest expense on bank loans, commercial paper, bonds and other interest.

(14) Net interest expense is defined as gross interest expense less interest income.



## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

*The following discussion and analysis of our financial condition and results of operations covers the years ended 31 December 1999, 2000 and 2001 and the nine months ended 30 September 2001 and 2002. The financial information presented in this discussion has been extracted or derived from ALROSA Ltd.'s audited consolidated IAS financial statements for the years ended 31 December 1999, 2000 and 2001 and unaudited consolidated IAS financial statements for the nine months ended 30 September 2001 and 2002. You should read this section together with the IAS financial statements and the notes thereto and the other financial information included elsewhere in this Offering Circular. All Rouble amounts are expressed in constant Roubles based on the purchasing power of the Rouble as at 30 September 2002, except as otherwise noted.*

*Certain information contained in the discussion and analysis set forth below and elsewhere in this Offering Circular includes "forward-looking statements" within the meaning of the U.S. Private Securities Litigation Reform Act of 1995. Such forward-looking statements are subject to risks, uncertainties and other factors which could cause our actual results to differ materially from those expressed or implied by such forward-looking statements. See "Cautionary Statement Regarding Forward-Looking Statements".*

### Overview

We are the second largest diamond mining company in the world by diamond production, measured as a multiple of average market prices. In 2001 we produced approximately 20.9 per cent. of the world's rough diamond output, measured as a multiple of average market prices, and approximately 17.3 per cent. by carat volume. Our principal mining operations are located in Yakutia, in north-eastern Siberia. We also hold a 32.8 per cent. interest in Catoca Mining Ltd., a diamond mining joint venture in Angola, and a 71.9 per cent. interest in Severalmaz, a diamond mining company that holds the license to mine the Lomonosov diamond field in the Arkhangelsk region of north-western Russia. We are one of Russia's largest industrial enterprises by revenue, with 2001 total revenues of RUB 64.3 billion, and total revenues for the first nine months of 2002 of RUB 42.0 billion.

We produce rough gem diamonds and near-gem diamonds, which are cut and used primarily in jewellery, and non-gem diamonds used primarily as industrial abrasives. In 2001, sales of gem and near-gem diamonds, including polished diamonds, accounted for approximately 99.5 per cent. of our total diamond sales.

Our business activities are conducted primarily through one business segment, which is engaged in diamond production and sales. We are also involved in exploration activities, research and development, diamond polishing, construction and trading activities and a number of supporting operations, such as transportation and the supply of fuel, electricity and water. These ancillary activities are not considered as reportable segments under IAS 14 "Segment Reporting".

### Acquisitions

As discussed in more detail below, we were engaged in the acquisition of significant controlling or strategic interests in several companies in 2000 and 2001. We accounted for each of our acquisitions in accordance with IAS 22 (revised) "Business Combinations" using the benchmark treatment. Under this treatment, the identifiable assets and liabilities of acquired subsidiaries were recognised at the aggregate of the fair market value of these identifiable assets and liabilities, as of the date of acquisition, taking into account the acquirer's ownership interest and the minority's portion of the pre-acquisition carrying amounts of the assets and liabilities.

We were involved in the following significant acquisitions during 2000 and 2001:

- *OA O Vilyuiskaya GES-3.* OA O Vilyuiskaya GES-3 is engaged in the construction of a hydroelectric station on the Vilyui River near the village of Svetly. The station is expected to supply

up to 270 million kilowatt hours of electricity in 2003 and will increase its capacity to up to 1.2 billion kilowatt hours of electricity by 2012 within the western power distribution province of Yakutia. On 11 May 2000, we entered into an agreement to purchase from Yakutskenergo their 66 per cent. voting share in this entity for a total consideration of RUB 940 million, which included commercial paper of ALROSA Ltd. and settlements of accounts receivable. This transaction was completed in July 2000. At the date of the acquisition, we recognised in our balance sheet the identifiable assets of OAO Vilyuiskaya GES-3 totalling RUB 1,755 million, assumed liabilities totalling RUB 345 million and recorded minority interest totalling RUB 470 million. We expect the completion of the hydroelectric power station to decrease our electricity expenses and to provide an uninterrupted electricity supply. The construction is expected to be completed in four stages starting in 2003. See “Our Business—Supporting Operations—Supply of energy and water”.

- *OAO Severalmaz.* In 2000, we increased our shareholding from 12 per cent. to 39 per cent. in OAO Severalmaz, a diamond mining company located in the Arkhangelsk region in Russia. We recorded this investment using the equity method. In December 2001, we increased our shareholding in Severalmaz from 39 per cent. to 71.9 per cent., and Severalmaz is now our consolidated subsidiary. The remaining 28.1 per cent. is owned as to 25.6 per cent. by the administration of the Arkhangelsk region and as to 2.5 per cent. by individuals. Our total investment in Severalmaz was RUB 2,173 million, and was represented at the date of the acquisition by identifiable assets totalling RUB 2,468 million and assumed liabilities totalling RUB 295 million.

Severalmaz began construction of an open-pit mine in July 2002, and it is expected that construction will be completed by the end of 2004. In this initial stage, commercial extraction of ore has commenced at low levels. In the next stage of Severalmaz’s business, a larger processing plant will be built with a design capacity to process approximately one million tonnes of ore per year.

### **Certain Factors Affecting Our Results of Operations**

Our final results have been affected by various external factors which exist in our industry and operating environment. Because our primary exploration and production activities are conducted within Russia, certain of these factors are attributable to the special characteristics of the Russian economy and legal environment. These include the fluctuation of exchange and interest rates, inflation, a relatively high tax burden and current government regulations.

#### ***Government regulations and the Secrecy Law***

We are subject to laws which significantly influence our core operating activities. These laws include the following:

- *The Secrecy Law.* Our diamond reserves and related production information are subject to the Secrecy Law, which was enacted in 1993 to prohibit the disclosure of certain data considered to constitute State secrets. In addition, the 1995 Presidential Decree more specifically provides for secrecy as to deposits of precious stones (including diamonds) in Russia, certain production data relating to the Russian state diamond reserves and data in relation to deposits of diamonds containing reserves in excess of 25 million carats. See “Industry Overview—Russian Diamond Industry and Regulation—The Secrecy Law”.

Our management considers our reserve and production information when assessing the recoverability and amortisation of production asset costs and in planning our investment programme. In conducting this assessment, reserve estimates are verified by representatives of the State Reserves Committee of the Ministry of Natural Resources of Russia. However, due to existing laws, we are not able to obtain an independent valuation of our reserves.

- *Annual quotas for the export of diamonds.* The maximum quantity of diamonds that we can export each year, by value, is determined pursuant to a periodic export quota set by the Government of Russia. Historically, we have been granted annual export quotas. However, the 2002 Decree authorised the Government of Russia to grant multi-year export quotas, and in February 2003 we were granted a five-year export quota to export annually up to U.S.\$800 million of diamonds, based on current market value. The quota amounts, as expressed in carats, are protected as State secrets, and are therefore not disclosed in this Offering Circular.

### ***Inflationary accounting and exchange rates***

*Impact of inflationary accounting and presentation in constant Roubles.* Our financial results, including comparatives, include a restatement for changes in the general purchasing power of the Rouble in accordance with IAS 29, “Financial Reporting in Hyperinflationary Economies”. IAS 29 requires that financial statements prepared in the currency of a hyperinflationary economy be stated in terms of the measuring unit current at the balance sheet date. Consequently, except as otherwise indicated, our financial statements, as presented herein, have been calculated on the basis of the conversion factors derived from the Russian Consumer Price Index (the “CPI”) published by the Russian State Committee on Statistics (“Goskomstat”), and on the basis of indices obtained from other published sources for years prior to 1992. The Russian economy is no longer deemed to be hyperinflationary, and we will not be required to apply IAS 29 to periods beginning in January 2003.

The impact of restating our financial information in terms of the purchasing power of the Rouble at the most recent balance sheet date is to:

- inflate the value of current-period transactions recorded in our statement of operations by the average rate of inflation for the period in order to state them in terms of the purchasing power of the Rouble as of the balance sheet date (30 September 2002);
- restate our period-end non-monetary assets and liabilities and shareholders’ equity, including share capital, in terms of the purchasing power of the Rouble as of the period-end (30 September 2002); and
- restate all comparatives and monetary and non-monetary items in terms of the purchasing power of the Rouble as of the most recent balance sheet date (30 September 2002).

The restatement of all comparatives, in particular, can have a significant impact on our reported sales and operating profit. For example, sales expressed in constant Roubles will decrease if increases in nominal prices are lower than inflation, and will increase less than might otherwise be expected, even when increases in nominal prices are higher than inflation. As discussed more fully below, the impact of U.S. Dollar price increases on the results of our export sales has been offset in recent periods by the real appreciation of the Rouble (i.e., by a rate of inflation that is higher than the rate at which the Rouble is depreciating against the U.S. Dollar). As a result, our comparative reported sales have been higher than they would have been if calculated on the basis of the average of the prices we actually received, expressed in nominal terms. By comparison, our costs, which are mainly in Roubles, have tended to increase in line with or at a rate higher than the rate of inflation in recent periods.

The restatement of comparatives can have a significant impact on our debt balances, primarily those denominated in U.S. Dollars. For example, even though our net borrowing position increased during the nine-month period ended 30 September 2002 and during the years ended 31 December 1999, 2000 and 2001, the restatement of our comparatives based upon the purchasing power of the Rouble as at 30 September 2002 reduced the increase in debt at each period end due to the fact that the exchange rate increase was lower than the rate of inflation. However, if the exchange rate increase was to be higher than the rate of inflation, then it would result in a greater increase in our debt balances at each period end. For

a discussion of our debt obligations, see “–Liquidity and Capital Resources–Debt obligations and other commitments”.

*Impact of inflation and changes in exchange rates on export sales and operating margins.* More than 90 per cent. of our sales (net of VAT and export duties) for the nine months ended 30 September 2002 and 91 per cent., 93 per cent. and 96 per cent. of such sales for the years ended 31 December 2001, 2000 and 1999, respectively, were denominated in U.S. Dollars, while most of our costs were denominated in Roubles. As a result, the relative movements of inflation and exchange rates significantly affect our results of operations.

The following table sets forth the rates of inflation in Russia, the rates of nominal depreciation of the Rouble against the U.S. Dollar and the rates of real change in the value of the Rouble against the U.S. Dollar for the periods shown:

	For the nine months ended 30 September		For the year ended 31 December		
	2002	2001	2001	2000	1999
	(in per cent.)				
Inflation (based on the CPI) . . . . .	10.4	14.1	18.8	20.1	36.6
Nominal devaluation (RUB v. U.S.\$) . .	5.0	4.4	7.0	4.3	30.8
Real appreciation (RUB v. U.S.\$) . . . .	5.2	9.3	11.0	15.2	4.5

Period-to-period comparisons of our export sales revenues, as restated in constant Roubles, have been significantly affected by the real change in the value of the Rouble against the U.S. Dollar. If the U.S. Dollar sales revenues we actually realise are the same as the related sales revenues for any periods being compared, but between the periods the Rouble has appreciated in real terms against the U.S. Dollar, then the related sales revenues restated in constant Roubles will decline from one period to the next. If the real appreciation rate of the Rouble is sufficiently high, our export prices and sales, restated in constant Roubles, will decline from one period to the next even in circumstances where both the U.S. Dollar revenues we actually realised and the related sales have increased. Conversely, if the Rouble depreciates in real terms against the U.S. Dollar, our prices and the related sales, restated in constant Roubles, will increase from one period to the next even if the U.S. Dollar revenues we actually receive remain unchanged from period to period, and may increase even if our realised U.S. Dollar revenues decline from period to period.

*Impact of monetary effects.* Our results of operations have also been substantially affected by the impact of nominal devaluation and inflation on the value of our monetary assets and liabilities. Nominal devaluation of the Rouble has generally resulted in foreign exchange gains on monetary assets denominated in foreign currencies and foreign exchange losses on monetary liabilities denominated in foreign currencies. These gains and losses are recorded on a net basis in our statements of operations under the caption “foreign currency losses”. Inflation has resulted in purchasing-power gains on monetary liabilities and purchasing-power losses on monetary assets. Because our financial statements are restated by reference to the purchasing power of the Rouble as at 30 September 2002, these gains and losses are recorded on a net basis in our statements of income under the caption “monetary gain”.

The following table sets forth our net foreign currency loss and net monetary gain realised for the periods shown:

	For the nine months ended 30 September		For the year ended 31 December		
	2002	2001	2001	2000	1999
	(unaudited)		(RUB millions)		
Net foreign currency loss . . . . .	(739)	(461)	(822)	(117)	(3,137)
Net monetary gain . . . . .	2,829	3,143	3,637	1,880	5,741

### ***Taxation and lease payments***

We are subject to numerous taxes at the federal, regional and local levels and are one of the largest sources of tax revenue to the federal authorities in Russia, as well as to the regional and local authorities within the areas of our operations. We contribute a majority of Yakutia's total annual revenues. Russian tax laws are and have been subject to varying interpretations and frequent changes. Given the relative size of our activities in Russia, our tax burden is largely determined by the taxes payable in Russia.

In addition to profit tax, we have also been subject to VAT, mineral extraction taxes, unified social taxes, road use and property taxes. The high tax rates to which we are subject and the often-changing tax regime constitute a particularly difficult operating environment. See "Risk Factors—Risks Related to the Legal and Regulatory Environment in Russia".

As a result of the changes in Russian tax legislation, a profit tax rate of 30 per cent. had been imposed effective from 1 April 1999 as compared to a profit tax rate of 35 per cent. in prior years. The net effect on deferred tax recognised as at 31 December 1998 as a result of the change in the profit tax rate amounted to RUB 415 million and has been credited to our tax expense for the year ended 31 December 1999.

Until 31 December 2000, we were subject to profit tax at a maximum statutory rate of 30 per cent. In August 2000, the federal Law on the Profits Tax on Enterprises and Organisations was amended to increase the maximum statutory profit tax rate to 35 per cent., effective 1 January 2001.

In August 2001, the Russian Tax Code was amended to include a new chapter relating to profits tax. This amendment became effective on 1 January 2002 and is expected to affect our results of operations significantly. As a result of this amendment, the maximum profit tax rate for income received from ordinary activities was reduced from 35 per cent. to 24 per cent. However, investment tax concessions, which were previously used to offset profit tax liabilities by up to 50 per cent., have been abolished.

### ***Seasonality of our business***

We have seasonal working capital requirements as a result of the remote location of our mining operations and the climatic conditions in our principal operating regions. There is a relatively short navigation period (May to September) during which time we can amass stocks of consumables and production materials, both for production and consumption by the local communities, to last until the next summer. Thus, we experience seasonal working capital requirements as most of the year's supplies must be purchased in the second quarter of the year and transported to their destination prior to September. Further, most employees in Yakutia are entitled to 57 vacation days per year, for which they are entitled to be paid in advance. Also, once every two years we are required to reimburse employees for vacation air travel. Because most of our employees accumulate such benefits and take vacations in the summer, we experience increased cash requirements during this period for the payment of salary advances and travel expenses. Additional factors contributing to the seasonality of our operations include a decrease in ore-processing capacity as a result of routine maintenance of certain ore treatment plants, offset by an increase in the volume of ore processed at our Nyurba and Anabar plants during the same period.

### ***Interest rates***

We have significant short-term and long-term debt obligations with both fixed and variable interest rates. See "—Liquidity and Capital Resources—Debt obligations and other commitments". Fluctuations in interest rates can have an impact on our operating results. We currently do not engage in any hedging activities related to interest rate exposure.

## *Sales and prices*

Our gem and near-gem rough diamonds are primarily sold in one of the following ways:

- *Exports through De Beers.* In 2001 and for the first nine months of 2002, exports accounted for approximately 60 per cent. and 50 per cent., respectively, of our diamond sales, and these exports were primarily made through sales to De Beers. The prices paid by De Beers for our rough diamonds are based on a schedule of prices agreed by us and De Beers and amended from time to time. This schedule is set forth in the De Beers Trade Agreement. Pending resolution of the Statement of Objections with respect to the De Beers Trade Agreement, we have made *ad hoc* sales to De Beers at prices agreed between the parties on the basis of our past commercial relationship and with respect to current market prices.
- *Domestic sales.* We sell a significant portion of our diamond production to domestic purchasers, primarily Russian cutting and polishing companies that finish the diamonds for use in jewellery. The prices at which we sell diamonds on the domestic market are set with reference to the Price List maintained by the Ministry of Finance of Russia, although we are not required to strictly follow the prices contained in the Price List. We attempt to manage domestic demand to achieve prices for our diamonds that are comparable to, or higher than, the prices established according to the De Beers Trade Agreement. See “Our Business–Sales of Rough and Polished Diamonds–Domestic sales of gem and near-gem rough diamonds”. In addition, we are required to sell diamonds having a weight of 10.8 or more carats only through Government-authorised auctions within Russia, except for those diamonds we purchase from Gokhran and that are polished by Brillianty ALROSA.
- *Sales to the Government of Russia and Yakutia.* Pursuant to the licenses and the Lease Agreement under which we operate, the Government of Russia and the government of Yakutia have the right to acquire diamonds from us. In addition, the Government of Russia has an exclusive right to purchase from us all rare diamonds having “special gemological qualities”, such as their colour, and diamonds weighing more than 50 carats at agreed market prices.
- *Sales of polished diamonds through Brillianty ALROSA.* We cut and polish some of our rough diamond production through our Brillianty ALROSA division and sell these stones as finished diamonds. In addition, we sell diamonds to Orel-ALROSA and ALROSA-Neva, which are polishing companies under our control. Sales by these subsidiaries are included in our consolidated sales.

In addition, we sell industrial diamonds. Exports of industrial diamonds have until recently been conducted almost exclusively through Almaziuvelirexport, a Government-owned jewellery exporter. Under the 2002 Decree, which liberalised the Russian diamond market, we are authorised to directly sell our industrial diamonds to third party purchasers outside Russia.

For a detailed description of our diamond sales, see “Our Business–Sales of Rough and Polished Diamonds”.



The following table sets forth our historical diamond sales, including export duties, through each of these channels without the application of inflationary accounting. Sales include export duties:

	For the nine months ended 30 September		For the year ended 31 December		
	2002	2001	2001	2000	1999
	(unaudited)		(in U.S.\$ millions)		
<b>Gem and near-gem rough diamonds:</b>					
Exports through De Beers . . . . .	501	602	869	392	312
Sales within Russia and CIS countries . . . . .	499	473	594	601	532
Sales to the government of Yakutia . . . . .	6	32	37	389	370
Repayment of the diamond loan <sup>(1)</sup> . . . . .	—	—	—	44	97
Sales to the Government of Russia . . . . .	—	—	—	1	93
Other domestic sales <sup>(2)</sup> . . . . .	53	36	43	45	32
Sales through Almaziuvelirexport <sup>(3)</sup> . . . . .	29	30	52	22	22
Sales through consolidated subsidiaries <sup>(4)</sup> . . . . .	29	7	10	9	—
<b>Sales of polished diamonds:<sup>(5)</sup></b>					
Sales by Brillianty ALROSA . . . . .	82	100	131	89	42
Sales through consolidated subsidiaries . . . . .	3	1	3	—	—
Sales of industrial diamonds . . . . .	5	6	8	9	9
<b>Total . . . . .</b>	<b>1,207</b>	<b>1,287</b>	<b>1,747</b>	<b>1,601</b>	<b>1,509</b>

- (1) Represents delivery of diamonds received from Russia pursuant to a diamond loan. The diamond loan is an agreement between us and Russia to exchange gem diamonds. For a description of the diamond loan agreement, see note 11 to the audited financial statements, appearing at page F-65.
- (2) Includes sales of diamonds weighing at least 10.8 carats, which must be sold by auction. These stones account for approximately 3 per cent. of our total production, by value, and less than 1 per cent. of our production in carats.
- (3) Represents the sale on the international market of “control parcels” of diamonds extracted from the diamonds we set aside for purchase by De Beers. These control parcels are sold in order for the Government of Russia to be able to determine whether the prices we receive from De Beers are consistent with international diamond prices.
- (4) Represents sales by “ALROSA-Nyurba” and “Almazy Anabara”.
- (5) Prior to 2000, sales of polished diamonds were performed through our other divisions as Brillianty ALROSA was established in 2000.

#### *Sales on behalf of Russia and Yakutia*

In addition to selling the rough and polished diamonds we produce, we are responsible for diamond sales on behalf of Russia and Yakutia. We receive a commission of 1.5 per cent., including VAT, on sales for Russia and 2.6 per cent., including VAT, on sales for Yakutia, which commission also includes our fees for sorting the diamonds being sold. Our recent sales on behalf of Russia and Yakutia, presented in historical terms without the application of inflationary accounting, were as follows:

	For the nine months ended 30 September		For the year ended 31 December		
	2002	2001	2001	2000	1999
	(unaudited)		(in U.S.\$ millions)		
Sales on behalf of Russia . . . . .	—	29	29	—	38
Sales on behalf of Yakutia . . . . .	27	154	158	458	408
<b>Total . . . . .</b>	<b>27</b>	<b>183</b>	<b>187</b>	<b>458</b>	<b>446</b>



## Recent Developments

- *Angola.* We have recently begun to implement plans to increase our activities and investments in Angola through our participation in new projects and the ongoing development of Catoca Mining Ltd., a joint venture in which we participate with Endiama E.P. (“Endiama”), Odebrecht Mining Services, Inc. and Daumonti Financing Company B.V. Catoca Mining Ltd. is engaged in mining the Catoca diamond pipe in Angola. Catoca Mining Ltd. has recently begun construction of a new processing facility, which will significantly increase its production capacity. This project will be financed by the revenues generated by Catoca Mining Ltd. In addition, we are negotiating for the purchase of a 51 per cent. interest in Hydroshikupa Ltd., a company formed to construct a hydroelectric power station to supply electricity to the operations of Catoca Mining Ltd. We estimate that our total investment in Hydroshikupa Ltd. will be approximately U.S.\$45 million, although the economic terms have not been fully agreed. We intend to obtain, indirectly through an intermediate entity, a 25 per cent. interest in Kamachia-Kamagiku Ltd., a joint venture with the Angolan government that will mine the Lour diamond deposit in Angola. We estimate that the total capital expenditures for this project will be approximately U.S.\$100 million. Currently, there is no agreement as to the structure or capital allocation of this project.
- *Sale of ALROSA-Gas.* In late 2002, we signed a non-binding memorandum of intention to sell our stake in ALROSA-Gas to Gazprom. ALROSA-Gas is engaged in the extraction of natural gas to supply our operations in Aikhal and Udachny. We currently hold a 53 per cent. interest in ALROSA-Gas and the remaining 47 per cent. is owned by Yakutia. We have not yet begun negotiations with respect to the final terms of this sale and we can give no assurance as to when the sale will be completed, if at all.
- *Tax audit.* In 2002, ALROSA Ltd. was subject to a comprehensive tax audit by federal tax authorities in Yakutia covering taxable years 1999 to 2001. As a result of this audit, the tax authorities issued a claim for underpaid taxes and penalties, which we appealed. Certain tax claims were withdrawn and the total amount of claimed taxes, excluding penalties, was reduced by the set-off of existing tax credits in 2003. We are currently appealing the tax claim. See “Our Business—Legal Matters—Tax claims”.

## Basis of Presentation and Critical Accounting Policies

Our consolidated financial statements were prepared in accordance with IAS. These statements reflect the selection and application of accounting policies which require management to make significant estimates and assumptions. We believe that the following are some of the most critical accounting policies that currently affect our financial condition and results of operations.

### *Principles of consolidation*

We include in our consolidated financial statements the financial position and results of operations of subsidiaries. A subsidiary is an entity in which we have an interest equal to more than one-half of the voting rights or we otherwise have the power to exercise control over such entity. All intercompany transactions are eliminated.

Other investments in companies in which we directly or indirectly hold voting interests of between 20 per cent. and 50 per cent., or otherwise have significant influence but not control, are accounted for by the equity method of accounting.

For subsidiaries that are not wholly owned, the minority interest is measured at the pre-acquisition carrying amount of the assets and liabilities of the minority's share in the subsidiary at the acquisition date, as adjusted for the minority's share of post-acquisition dividends, profits and losses.

### ***Deferred tax***

Tax laws in Russia are subject to varying interpretations and frequent changes. We calculate deferred taxes at rates enacted or substantively enacted at the relevant balance sheet date, using the liability method, for all temporary differences between the tax bases of assets and liabilities and their carrying values for financial reporting purposes. Deferred tax assets attributable to temporary differences, unused tax losses and credits are recognised only to the extent that it is probable that future taxable profit or temporary differences will be available against which they can be utilised.

### ***Property, plant and equipment***

Property, plant and equipment consists of costs incurred in developing our business operations, as well as the costs related to the construction and acquisition of mining assets. Expenditure related to geophysical analysis is deferred on a project-by-project basis until the viability of the project is determined. If a project is not determined to be economically viable, the accumulated project costs are charged to operations in the year in which the determination is made. Costs associated with economically viable projects are depreciated over the useful economic life of those projects as set out below.

### ***Impairment of assets***

At each reporting date, management assesses whether there is any indication of impairment of property, plant and equipment and other assets. If any such indication exists, management estimates the recoverable amount which is determined as the higher of an asset's net selling price and its value in use. The carrying amount is reduced to the recoverable amount and the difference is recognised as an expense (impairment loss) in the statement of income. An impairment loss recognised for an asset in prior years will be reversed if there has been a change in the estimates used to determine the asset's recoverable amount.

### ***Leased assets***

We record the assets leased from Yakutia in 1993 under the Lease Agreement at historical cost, as adjusted for the effects of inflation, with a corresponding credit reflected as a grant in our financial statements. The grant is amortised in line with the reduction in the carrying value of the assets. The amortised portion is recorded as an increase in income.

Social assets received under the Lease Agreement are not reflected in our financial statements because the majority of these assets have been transferred, without consideration, to the government of Yakutia as part of our continuing divestiture of these assets.

### ***Revenue recognition***

Sales are recognised for financial reporting purposes when goods are shipped to customers and title and risk pass. Sales are stated net of VAT and export duties and after eliminating intercompany sales.

### ***Provisions***

We reassess provisions annually in our consolidated financial statements. We recognise provisions in our financial statements when we have a present legal or constructive obligation, as a result of past events, when it is probable that an outflow of resources embodying economic benefits will be required to settle such obligation and a reliable estimate of the amount of the obligation can be made. Provisions are included in our consolidated financial statements at their expected net present values using discount rates appropriate to us in the economic environment in Russia at each balance sheet date.

Changes in provisions resulting from the passage of time are reflected in the consolidated statement of income under “financial items”. Other changes in provisions, relating to a change in the discount rate applied, in the expected timing of cash outflows with respect to our obligations and in the estimated amount of such obligations, are treated as a change in the accounting estimate in the period of the change. The effects of such changes are added to, or deducted from, the amount recognised as the related asset to the extent the change relates to future periods. The amount that relates to current and past periods is recorded in the statement of income in the year of the change.

The provision for restoration liability, determined based on the terms of the Lease Agreement (see note 10 to the consolidated financial statements), is recorded on the balance sheet, with a corresponding amount being recorded as part of property, plant and equipment in accordance with IAS 16, “Property, Plant and Equipment” (revised 1998) and amortised over the life of the property.

### ***Inventories***

Inventories of diamonds, extracted ore and concentrates, mining and construction stores and consumable supplies are valued at the lower of their weighted average cost or net realisable value. Cost of extracted ore and concentrates is calculated using the quantities determined based on surveyors’ measurements of the volumes of ore and concentrates remaining at the period end. The costs included in inventories are those directly attributable to mining diamonds, extracting ore and producing concentrates, as well as those directly attributable to bringing mining and construction stores and consumable supplies to their present location and condition.

### ***Reserves***

We do not regard reserves as a critical accounting matter because we are prohibited by law from disclosing and recognising reserve amounts in our financial statements. For a discussion of our reserves, see “Our Business–Diamond Reserves” and “Appendix A–Certification of Diamond Deposits”.

## **Nine Months Ended 30 September 2002 Compared to the Nine Months Ended 30 September 2001**

### ***Revenues***

The following table sets forth our inflation-adjusted revenues, based on the purchasing power of the Rouble as at 30 September 2002, for the periods indicated and the proportion of such revenues represented by the items indicated:

	For the nine months ended 30 September			
	2002		2001	
	(RUB millions)	(per cent. of revenues)	(RUB millions)	(per cent. of revenues)
<b>Revenue from diamond sales:</b>				
Export . . . . .	18,840	45	24,355	51
Sales to the government of Yakutia . . . . .	202	— <sup>(1)</sup>	1,096	2
Repayment of the diamond loan <sup>(2)</sup> . . . . .	—	—	—	—
Other domestic sales <sup>(3)</sup> . . . . .	18,734	45	18,146	38
Total revenue from diamond sales . . . . .	37,776	90	43,597	91
Other <sup>(4)</sup> . . . . .	4,269	10	4,097	9
Total revenues . . . . .	42,045	100	47,694	100
Net income . . . . .	2,509		7,863	

(1) Less than 1 per cent.

(2) Represents delivery of diamonds received from Russia pursuant to a diamond loan. The diamond loan is an agreement between us and Russia to exchange gem diamonds. For a description of the diamond loan agreement, see note 11 to the audited financial statements, appearing at page F-65.

(3) Includes sales within Russia and Yakutia.

(4) Includes revenues generated from transportation services, trading, construction, social infrastructure and exploration activities.

The following table sets forth our historical revenues from diamond sales without the application of inflationary accounting. Sales are represented net of VAT and export duties.

	For the nine months ended 30 September			
	2002		2001	
	(RUB millions)	U.S.\$ millions)	(unaudited) (RUB millions)	U.S.\$ millions)
Export .....	18,229	582	20,216	696
Sales to the government of Yakutia .....	195	6	910	32
Repayment of the diamond loan <sup>(1)</sup> .....	—	—	—	—
Other domestic sales <sup>(2)</sup> .....	18,127	585	15,063	518
Total .....	36,551	1,173	36,189	1,246

(1) Represents delivery of diamonds received from Russia pursuant to a diamond loan. The diamond loan is an agreement between us and Russia to exchange gem diamonds. For a description of the diamond loan agreement, see note 11 to the audited financial statements, appearing at page F-65.

(2) Includes sales within Russia and Yakutia.

Sales of diamonds represented 90 per cent. of total sales in the nine months ended 30 September 2002 compared to 91 per cent. in the nine months ended 30 September 2001. All diamond sales are U.S. Dollar-denominated. Total diamond sales revenues decreased by 13 per cent., or RUB 5,821 million, in the nine months ended 30 September 2002 compared to the nine months ended 30 September 2001. This decrease was primarily due to the impact of inflationary accounting, which was responsible for a 14 per cent. decrease in sales revenues. It was also attributable to an 8 per cent. decrease resulting from reductions in average U.S. Dollar sales prices, which was offset by a 7 per cent. increase resulting from changes in the applicable exchange rate and a 2 per cent. increase relating to an increase in sales volume in carats. The decrease in prices was primarily due to a decrease in world diamond market prices following the terrorist attacks in the United States on 11 September 2001.

Export sales decreased by 23 per cent., or RUB 5,515 million, in the nine months ended 30 September 2002 as compared to the nine months ended 30 September 2001, primarily reflecting a 12 per cent. decrease resulting from lower export sales volume in carats and a 4 per cent. net decrease resulting from lower average U.S. Dollar export prices offset by an increase in the overall quality of diamonds sold. The decrease also reflects, in part, a 14 per cent. decrease relating to the negative impact of inflationary accounting and a 7 per cent. increase resulting from changes in the applicable exchange rate. Export sales for the nine-month period ended 30 September 2002 represented a smaller portion of total sales than for the comparable period in 2001. This is also reflected in the fact that our export quota, which represented 59 per cent. of our total sales in carats for the nine-month period ended 30 September 2001, represented only 56 per cent. of total sales in carats for the nine-month period ended 30 September 2002.

Sales to the government of Yakutia decreased by 82 per cent., or RUB 894 million, in the nine months ended 30 September 2002 compared to the nine months ended 30 September 2001. This decrease was mainly attributable to a decrease in the volume of sales in carats.

Other domestic diamond sales increased by 3 per cent., or RUB 588 million, in the nine months ended 30 September 2002 compared to the nine months ended 30 September 2001. This change was mainly attributable to a 14 per cent. decrease relating to the impact of inflationary accounting, a 7 per cent. increase from changes in the applicable exchange rate and an increase due to increased sales volumes in carats, partially offset by a decrease in average U.S. Dollar prices and in the overall quality of diamonds sold, having a net positive effect of 13 per cent.

Other sales increased by 4 per cent., or RUB 172 million, in the nine months ended 30 September 2002 compared to the nine months ended 30 September 2001. This increase was primarily due to the

increase in construction sales to the government of Yakutia. In addition, in 2002 the government of Yakutia abolished the partial reimbursement of exploration costs, which we had been recording as exploration sales.

### *Cost of sales*

Our cost of sales increased by 4 per cent., or RUB 752 million in the nine months ended 30 September 2002, to RUB 19,059 million from RUB 18,307 million in the nine months ended 30 September 2001. As a percentage of revenues, our cost of sales also increased from 38 per cent. in the nine months ended 30 September 2001 to 45 per cent. in the nine months ended 30 September 2002, primarily as a result of the decrease in sales.

The following table sets forth our cost of sales, based on the purchasing power of the Rouble as at 30 September 2002:

	For the nine months ended 30 September	
	2002	2001
	(unaudited) (RUB millions)	
Wages, salaries and other staff costs . . . . .	6,497	7,064
Depreciation . . . . .	3,719	3,721
Transport . . . . .	845	883
Fuel and energy . . . . .	2,946	3,228
Services . . . . .	529	350
Materials . . . . .	3,530	3,719
Other . . . . .	550	330
Write down (reversal) of inventory . . . . .	388	(301)
Movement in inventories . . . . .	55	(687)
Total . . . . .	<u>19,059</u>	<u>18,307</u>

*Wages, salaries and other staff costs.* Wages and salaries decreased by 8 per cent., or RUB 567 million, to RUB 6,497 million in the nine months ended 30 September 2002 from RUB 7,064 million in the nine months ended 30 September 2001. The decrease was primarily due to a period-to-period decrease in bonus payments, as well as a 2 per cent. decrease in the average number of employees. From period to period, there was a 19 per cent. increase in average salary payments. This was offset by the application of inflationary accounting for salary expenses incurred in the nine months ended 30 September 2001.

*Depreciation.* There were no significant changes in the depreciation charge in the nine months ended 30 September 2002 compared to the nine months ended 30 September 2001, as increases in depreciation for new assets were balanced by the decrease in the charge for fully depreciated assets.

*Fuel and energy.* Fuel and energy costs decreased by 9 per cent., or RUB 282 million, from RUB 3,228 million in the nine months ended 30 September 2001 to RUB 2,946 million in the nine months ended 30 September 2002. This decrease was primarily due to increases in the inflation rate in excess of price increases.

*Services.* Costs related to services increased by 51 per cent., or RUB 179 million, from RUB 350 million in the nine months ended 30 September 2001 to RUB 529 million in the nine months ended 30 September 2002. The increase in costs related to services was primarily due to an increase in services provided to us by contractors in connection with the construction of a flood-control dam in Lensk following the 2001 flooding in that city. This dam was subsequently sold to Yakutia.

*Materials.* The cost of materials decreased by 5 per cent., or RUB 189 million, from RUB 3,719 million in the nine months ended 30 September 2001 to RUB 3,530 million in the nine months ended 30 September 2002. The decrease in material costs reflects inflation in excess of price increases.

*Write down (reversal) of inventory.* In accordance with our accounting policy, a provision for impairment is created for inventory that is older than two years. The increase in provision for impairment to RUB 388 million in the nine months ended 30 September 2002 was due to the high level of stock that was more than two years old, mainly as a result of advance stock purchases made in 2000 in connection with capital construction.

*Movement in inventories.* Movement in inventories changed by RUB 742 million to RUB 55 million in the nine months ended 30 September 2002 from RUB (687) million in the nine months ended 30 September 2001. The change was primarily the result of the periodic imbalances between our sales and production. In the nine months ended 30 September 2002 our sales exceeded our production, while in the nine months ended 30 September 2001 our sales were less than our production.

### ***Other operating expenses***

*Taxes other than profit tax.* The following table sets forth our inflation-adjusted tax expense, other than profit tax expense, for the periods indicated:

	For the nine months ended 30 September	
	2002	2001
	(unaudited) (RUB millions)	
Royalty payments . . . . .	6,173	7,648
Resource recovery tax . . . . .	–	1,494
Non-recoverable resource tax . . . . .	–	3,131
Extraction tax . . . . .	3,402	–
Road use tax . . . . .	428	473
Ecology fund . . . . .	535	773
Property tax . . . . .	658	643
Tax penalties . . . . .	1,259	190
Other taxes . . . . .	68	79
Total . . . . .	12,523	14,431

Taxes other than profit tax decreased by 13 per cent., or RUB 1,908 million in the nine months ended 30 September 2002, to RUB 12,523 million, from RUB 14,431 million in the nine months ended 30 September 2001. During the same periods, royalty payments decreased from RUB 7,648 million to RUB 6,173 million and the ecology fund tax decreased from RUB 773 million to RUB 535 million due to the fact that, starting from 2002, royalty payments and ecology fund tax are fixed in the Lease Agreement, while such payments were revenue-based in 2001. Effective 1 January 2002, the resource recovery tax and non-recoverable resource tax were replaced by an extraction tax, which is calculated as 8 per cent. of the value of extracted diamonds. The increase in tax penalties, from RUB 190 million to RUB 1,259 million, was mainly due to the recognition of the aggregate liability for tax penalties relating to 1999, 2000 and 2001. Other taxes remained relatively constant.

*Social costs.* Social costs primarily consist of maintenance of hospitals, educational institutions and the provision of housing and public utilities. In the nine months ended 30 September 2002 social costs decreased by 9 per cent., or RUB 103 million, to RUB 988 million from RUB 1,091 million in the nine months ended 30 September 2001. This decrease mainly resulted from the implementation of our social



costs reduction policy. For a discussion of our social services and our social cost reduction policy, see “Our Business–Non-Mining Activities–Social services”.

The following table sets forth our other expenses included in the caption “other operating expenses”, for the periods indicated:

	For the nine months ended 30 September	
	2002	2001
	(unaudited) (RUB millions)	
Selling and marketing expenses . . . . .	860	836
Research and development expenses . . . . .	844	536
Loss on disposal of fixed assets . . . . .	413	–
Loss from flooding in Lensk . . . . .	–	2,105
Other expenses, net . . . . .	399	176
Total . . . . .	<u>2,516</u>	<u>3,653</u>

Other expenses decreased in the nine months ended 30 September 2002 by 31 per cent., or RUB 1,137 million, to RUB 2,516 million from RUB 3,653 million in the nine months ended 30 September 2001. The decrease primarily resulted from expenses incurred as a result of the flooding in Lensk in 2001. The increase in the loss on disposal of fixed assets in the nine months ended 30 September 2002 was primarily attributable to the write-off of certain construction in progress, consisting of individually insignificant items such as pipelines constructed for utilities servicing municipalities in which we operate, including for residential usage. The increase in research and development costs was in line with our budget, and this increase was intended to ensure the maintenance of our diamond reserves. Other expenses included in operating expenses remained relatively constant period to period.

*General and administrative expenses.* General and administrative expenses primarily consist of bad debt expense, salaries paid to administrative employees and head-office expenses. General and administrative expenses increased by 2 per cent., or RUB 39 million, to RUB 1,817 million in the nine months ended 30 September 2002 from RUB 1,778 million in the nine months ended 30 September 2001, mainly reflecting salary increases for administrative employees.

*Gain on net monetary position.* Monetary gain decreased by 10 per cent., or RUB 314 million, from RUB 3,143 million in the nine months ended 30 September 2001 to RUB 2,829 million in the nine months ended 30 September 2002. The decrease was primarily attributable to the decrease in the rate of inflation, offset by the increase in our net monetary liabilities position, primarily resulting from an increase in borrowings.

*Interest expense.* The following table sets forth our interest expense for the periods indicated:

	For the nine months ended 30 September	
	2002	2001
	(unaudited) (RUB millions)	
Interest on bank loans . . . . .	1,322	1,318
Interest on commercial paper . . . . .	916	1,874
Interest on bonds . . . . .	496	253
Provision for restoration liability . . . . .	267	98
Interest on other borrowings . . . . .	245	292
Total . . . . .	<u>3,246</u>	<u>3,835</u>



Our interest expense decreased by 15 per cent., or RUB 589 million, from RUB 3,835 million in the nine months ended 30 September 2001 to RUB 3,246 million in the nine months ended 30 September 2002. The decrease was primarily attributable to a decrease in interest paid on outstanding commercial paper from RUB 1,874 million in the nine months ended 30 September 2001 to RUB 916 million in the nine months ended 30 September 2002, resulting from a reduction in outstanding commercial paper and a decrease in the applicable interest rate. Interest paid on bonds increased from RUB 253 million to RUB 496 million due to the issuance of new bonds in 2002. Interest paid on bank loans was relatively constant, reflecting the incurrence of additional short-term and long-term loans to repay loans coming due, offset by the overall decrease in interest rates.

*Profit tax.* Our profit tax expense increased from RUB 973 million in the nine months ended 30 September 2001 to RUB 3,044 million in the nine months ended 30 September 2002. Total profit tax reflects current profit tax of RUB 1,887 million in the nine months ended 30 September 2002 and RUB 3,396 million in the nine months ended 30 September 2001, as well as a deferred tax charge of RUB 1,157 million in the nine months ended 30 September 2002 and deferred tax gain of RUB 2,423 million in the nine months ended 30 September 2001. The net decrease in current profit tax resulted from the reduction in our profit tax rate from 35 per cent. in 2001 to 24 per cent. in 2002. This was also attributable to the reduction in profit before profit tax primarily due to reductions in diamond prices. Deferred profit tax significantly changed as a result of the revaluation of fixed assets performed for statutory accounts in 2001, which resulted in a significant decrease in taxable temporary differences related to property, plant and equipment (see “–Basis of Presentation and Critical Accounting Policies–Property, plant and equipment”) and a decrease in the profit tax rate applicable to our calculation of deferred tax at 31 December 2001 from 35 per cent. to 24 per cent.

## Year Ended 31 December 2001 Compared to the Year ended 31 December 2000

### Revenues

The following table sets forth our inflation-adjusted revenues, based upon the purchasing power of the Rouble as at 30 September 2002, for the periods indicated and the proportion of such revenues represented by the items indicated:

	For the year ended 31 December			
	2001		2000	
	(RUB millions)	(per cent. of revenues)	(RUB millions)	(per cent. of revenues)
<b>Revenue from diamond sales:</b>				
Export . . . . .	34,945	54	19,577	28
Sales to the government of Yakutia . . . . .	1,275	2	15,770	23
Repayment of the diamond loan <sup>(1)</sup> . . . . .	–	–	1,773	3
Other domestic sales <sup>(2)</sup> . . . . .	22,272	35	26,622	39
Total revenue from diamond sales . . . . .	58,492	91	63,742	93
Other <sup>(3)</sup> . . . . .	5,817	9	4,987	7
Total revenues . . . . .	64,309	100	68,729	100
Net income . . . . .	10,507		11,963	

(1) Represents delivery of diamonds received from Russia pursuant to a diamond loan. The diamond loan is an agreement between us and Russia to exchange gem diamonds. For a description of the diamond loan agreement, see note 11 to the audited financial statements, appearing at page F-65.

(2) Includes sales within Russia and Yakutia.

(3) Includes revenues generated from transportation services, trading, construction, social infrastructure and exploration activities.

The following table sets forth our historical revenues from diamond sales, without the application of inflationary accounting. Sales are represented net of VAT and export duties.

	For the year ended 31 December			
	2001		2000	
	(RUB millions)	(U.S.\$ millions)	(RUB millions)	(U.S.\$ millions)
Export . . . . .	29,373	1,008	13,609	485
Sales to the government of Yakutia . . . . .	1,075	37	10,927	389
Repayment of the diamond loan <sup>(1)</sup> . . . . .	—	—	1,229	44
Other domestic sales <sup>(2)</sup> . . . . .	18,881	643	18,565	658
Total . . . . .	<u>49,329</u>	<u>1,688</u>	<u>44,330</u>	<u>1,576</u>

(1) Represents delivery of diamonds received from Russia pursuant to a diamond loan. The diamond loan is an agreement between us and Russia to exchange gem diamonds. For a description of the diamond loan agreement, see note 11 to the audited financial statements, appearing at page F-65.

(2) Includes sales within Russia and Yakutia.

Sales of diamonds represented 91 per cent. of total sales in 2001 compared to 93 per cent. in 2000. Total diamond sales revenues decreased by 8 per cent., or RUB 5,250 million, in 2001 compared to 2000. This decrease was primarily due to the impact of inflationary accounting, which was responsible for an 18 per cent. decrease in sales from 2000 to 2001, as well as a 4 per cent. decrease in sales volume in carats. The decrease was partially offset by a 4 per cent. increase related to changes in the applicable exchange rate and an 11 per cent. increase in average U.S. Dollar sales prices.

Export diamond sales increased by 79 per cent., or RUB 15,368 million, in 2001 compared to 2000. The increase was primarily due to an 85 per cent. increase in sales volume in carats as a result of a significant decrease in sales to the government of Yakutia, a cumulative 23 per cent. increase associated with an increase in average U.S. Dollar prices and an increase in the overall quality of diamonds sold and a 4 per cent. increase in the applicable exchange rate. These factors were partially offset by a 19 per cent. decrease resulting from the application of inflationary accounting. Export sales for 2001 represented a significantly larger portion of total sales than in 2000. This is also reflected in the fact that our export quota, which represented 33 per cent. of our total sales in carats for 2000, represented 59 per cent. of total sales in carats for 2001.

Sales to the government of Yakutia decreased by 92 per cent., or RUB 14,495 million, in 2001 compared to 2000. This decrease was mainly due to the elimination in 2001 of our prior obligation to sell up to 25 per cent. of our diamond production to the government of Yakutia pursuant to the terms of the Lease Agreement.

Repayment of the diamond loan relates to the repayment of our April 1993 diamond loan from Russia in an aggregate amount of 7,857 million carats of gem diamonds. The loan was repaid in 2000.

Other domestic diamond sales decreased by 16 per cent., or RUB 4,350 million, in 2001 compared to 2000. This decrease was primarily due to an 18 per cent. decrease related to the impact of inflationary accounting, which was offset by a 4 per cent. increase attributable to a change in the applicable exchange rate. In addition, there was an increase in average U.S. Dollar prices and the overall quality of diamonds sold, offset by a decrease in sales volume in carats, with a net negative effect of 1 per cent.

Other sales increased by 17 per cent., or RUB 830 million, in 2001 compared to 2000. This increase mainly resulted from an increase in the volume of transportation services provided.

### *Cost of sales*

Overall, our cost of sales increased by 5 per cent., or RUB 1,176 million, in 2001 to RUB 24,647 million from RUB 23,471 million in 2000. As a percentage of revenues, cost of sales also increased from 34 per cent. in 2000 to 38 per cent. in 2001. This increase reflects the decrease in sales, based on the purchasing power of the Rouble as at 30 September 2002.

The following table sets forth our cost of sales, based on the purchasing power of the Rouble as at 30 September 2002:

	For the year ended 31 December	
	2001	2000
	(RUB millions)	
Wages, salaries and other staff costs . . . . .	9,133	9,716
Depreciation . . . . .	4,751	5,269
Transport . . . . .	937	765
Fuel and energy . . . . .	4,347	3,811
Services . . . . .	410	374
Materials . . . . .	5,211	4,314
Other . . . . .	278	285
Reversal of inventory . . . . .	(312)	(331)
Movement in inventories . . . . .	(108)	(732)
Total . . . . .	<u>24,647</u>	<u>23,471</u>

*Wages, salaries and other staff costs.* Wages and salaries decreased by 6 per cent., or RUB 583 million, to RUB 9,133 million in 2001 from RUB 9,716 million in 2000. The change in salary costs is primarily due to an increase in average salary payments in excess of the inflation rate, offset by a reduction in payroll taxes. Beginning in 2001, payroll taxes ranged from 5 per cent. to 35.6 per cent., as compared with a payroll tax of 39.9 per cent. in 2000.

*Depreciation.* Depreciation charge decreased by 10 per cent., or RUB 518 million, to RUB 4,751 million in 2001 from RUB 5,269 million in 2000. Our overall depreciation charge decreased primarily as a result of the closure of the Mir open-pit mine in the beginning of 2001 and the depreciation of the related fixed assets in 2000 due to a significant increase in diamond extraction activity in that mine prior to its closure and the overall excess of the Mir mine's assets above the comparable assets in other mines.

*Fuel and energy.* Fuel and energy costs increased by 14 per cent., or RUB 536 million, from RUB 3,811 million in 2000 to RUB 4,347 million in 2001. The increase was primarily attributable to a more than 50 per cent. increase in energy tariffs set by the local energy provider, which was offset by a decrease in our usage of more expensive heating energy and the impact of inflation. In addition, there was an increase in fuel prices and an increase in fuel consumption due to an increase in the volume of ore stripping works.

*Materials.* The cost of materials increased by 21 per cent., or RUB 897 million, from RUB 4,314 million in 2000 to RUB 5,211 million in 2001. This increase primarily reflects the increase in material consumption due to a year-on-year increase in the volume of stripping works.

*Reversal of inventory.* In accordance with our accounting policy, a provision for impairment is created for inventory which is older than two years. Reversals of provision for impairment of RUB 312 million made in 2001 and RUB 331 million in 2000 reflect our use of inventories which were previously subject to provision.

### *Other operating expenses*

*Taxes other than profit tax.* The following table sets forth our inflation-adjusted tax expenses, other than in respect of profit tax, for the periods indicated:

	For the year ended 31 December	
	2001	2000
	(RUB millions)	
Royalty payments . . . . .	10,075	11,531
Resource recovery tax . . . . .	2,012	2,187
Non-recoverable resource tax . . . . .	4,041	4,500
Road use tax . . . . .	628	1,565
Ecology fund . . . . .	943	1,187
Property tax . . . . .	845	540
Tax penalties . . . . .	179	(88)
Other taxes . . . . .	40	354
Total . . . . .	18,763	21,776

Taxes other than profit tax decreased by 14 per cent., or RUB 3,013 million, from RUB 21,776 million in 2000 to RUB 18,763 million in 2001. These taxes are primarily based on diamond sales revenues, and represented 34 per cent. and 32 per cent. of diamond sales revenue in 2000 and 2001, respectively. The decrease in taxes other than profit tax was primarily attributable to a decrease in revenues, in Rouble terms, and a year-to-year reduction in the road use tax, from 2.5 per cent. in 2000 to 1 per cent. in 2001. Property taxes increased by 56 per cent. from 2000 to 2001. This was primarily attributable to the growth of our tax base due to a revaluation of fixed assets performed for purposes of our Russian statutory accounts at 1 January 2001.

Royalty payments are due to Yakutia pursuant to the terms of the Lease Agreement. In accordance with the Lease Agreement, royalty payments for 2001 comprised 19.8 per cent. of our revenues from the sale of rough diamonds, as compared with 19.5 per cent. of such revenues in 2000. Royalty payments became subject to recoverable VAT effective from 1 January 2001. This change in Russian tax law decreased our effective royalty payments in 2001. The resource recovery tax represents 3.5 per cent. of our diamond sales revenues, while non-recoverable resource tax represents 7 per cent. of the value of the diamonds we extract. During 2001 and 2000 we were required to contribute 2 per cent. of our diamond sales revenues to the ecological fund.

*Social costs.* Social costs primarily consist of maintenance of hospitals, educational institutions, provision of housing and public utilities and charitable costs. Social costs increased by 57 per cent., or RUB 697 million, to RUB 1,927 million in 2001 from RUB 1,230 million in 2000, mainly as a result of unreimbursed construction costs associated with a school that was transferred to the local administration for consideration which was less than its nominal cost. In addition, in 2001 the government of Yakutia stopped financing local infrastructure expenses.

The following table sets forth our other expenses, included in the caption “other operating expenses” for the periods indicated:

	For the year ended 31 December	
	2001	2000
	(RUB millions)	
Loss from flooding in Lensk . . . . .	2,105	–
Selling and marketing expenses . . . . .	1,218	1,124
Research and development expenses . . . . .	926	828
Loss on disposal of fixed assets . . . . .	2	1,600
Other expenses, net . . . . .	203	153
Total . . . . .	4,454	3,705

Other expenses increased by 20 per cent., or RUB 749 million, to RUB 4,454 million in 2001 from RUB 3,705 million in 2000 primarily due to losses incurred in connection with the flooding in Lensk. The decrease primarily resulted from a reduction in the loss on the disposal of fixed assets due to the significant write-off of assets under construction in 2000, including but not limited to several warehouses and roads. Other expenses included in operating expenses remained relatively constant from period to period.

*General and administrative expenses.* General and administrative expenses primarily consist of bad debt expense, salaries to administrative employees and head-office expenses. General and administrative expenses increased by 126 per cent., or RUB 1,345 million, to RUB 2,416 million in 2001 from RUB 1,071 million in 2000. The increase was mainly due to the write-off of bad debts in the amount of RUB 735 million in 2001, as compared to a write-off in 2000 of bad debts in the amount of RUB 13 million. This increase was also attributable to an increase in information and consulting services fees in 2001 related to the negotiation of new loan facilities.

Bad debt expense increased primarily as a result of additional provisions of note receivables made as a result of the insolvency of the note issuers. In addition, the increase was due to impairment of that portion of VAT paid on construction materials which is generally recoverable when the completed asset is put into use. This impairment was recorded as a result of the excess of the nominal amount of recoverable VAT over the net present value of future cash flow.

*Gain on net monetary position.* The gain on net monetary position increased by 93 per cent., or RUB 1,757 million, to RUB 3,637 million in 2001 from RUB 1,880 million in 2000 due to an increase in our net monetary liabilities position. This increase was primarily a result of an increase in borrowings and a decrease in accounts receivable.

*Interest expense.* The following table sets forth our interest expenses for the periods indicated:

	For the year ended 31 December	
	2001	2000
	(RUB millions)	
Interest on bank loans . . . . .	1,898	1,237
Interest on commercial paper . . . . .	2,211	370
Interest on bonds . . . . .	438	235
Provision for restoration liability . . . . .	133	151
Interest on other borrowings . . . . .	337	47
Total . . . . .	5,017	2,040

Our interest expense increased by 146 per cent., or RUB 2,977 million, from RUB 2,040 million in 2000 to RUB 5,017 million in 2001. The increase was primarily due to the inclusion in this item of interest on commercial paper as a result of the adoption of IAS 39 in 2001. In accordance with the requirements of IAS 39, commercial paper balances have been stated at amortised cost using the effective interest rate method, with resulting accounting of interest; before 2001, short-term commercial paper balances were stated at their nominal amounts, without interest recognition. Interest paid on bonds increased from RUB 235 million in 2000 to RUB 438 million in 2001, reflecting interest relating to additional short- and long-term bonds issued in 2001. Interest paid on bank loans increased primarily due to an increase in short-term loans.

*Profit tax.* Our profit tax expense decreased from RUB 7,757 million in 2000 to RUB 1,732 million in 2001. The total profit tax expense reflects current profit tax of RUB 5,970 million in 2000 and RUB 3,903 million in 2001, as well as deferred profit tax charges of RUB 1,787 million in 2000 and deferred income gains of RUB 2,171 million in 2001. The decrease in current profit tax expense was primarily due to the reduction in profit before profit tax and increased statutory depreciation due to a statutory revaluation of assets in 2001. The decrease was partially offset by an increase in profit tax concessions for capital expenditures. Deferred profit tax significantly changed from 2000 to 2001 as a result of a reduction in corporate profit tax from 35 per cent. to 24 per cent. effective January 2002.

### Year Ended 31 December 2000 Compared to the Year ended 31 December 1999

#### Revenues

The following table sets forth our inflation-adjusted revenues, based upon the purchasing power of the Rouble as at 30 September 2002 for the periods indicated and the proportion of such revenues represented by the items indicated:

	For the year ended 31 December			
	2000		1999	
	(RUB millions)	(per cent. of revenues)	(RUB millions)	(per cent. of revenues)
<b>Revenue from diamond sales:</b>				
Export . . . . .	19,577	28	15,971	24
Sales to the government of Yakutia . . . . .	15,770	23	16,126	24
Repayment of the diamond loan <sup>(1)</sup> . . . . .	1,773	3	4,172	6
Other domestic sales <sup>(2)</sup> . . . . .	26,622	39	28,294	42
Total revenue from diamond sales . . . . .	63,742	93	64,563	96
Other <sup>(3)</sup> . . . . .	4,987	7	2,755	4
Total revenues . . . . .	68,729	100	67,318	100
Net income . . . . .	11,963		18,410	

(1) Represents delivery of diamonds received from Russia pursuant to a diamond loan. The diamond loan is an agreement between us and Russia to exchange gem diamonds. For a description of the diamond loan agreement, see note 11 to the audited financial statements, appearing at page F-65.

(2) Includes sales within Russia and Yakutia.

(3) Includes revenues generated from transportation services, trading, construction, social infrastructure and exploration activities.

The following table sets forth our historical revenues from diamond sales, without the application of inflationary accounting. Sales are represented net of VAT and export duties.

	For the year ended 31 December			
	2000		1999	
	(RUB millions)	(U.S.\$ millions)	(RUB millions)	(U.S.\$ millions)
Export . . . . .	13,609	485	9,099	367
Sales to the government of Yakutia . . . . .	10,927	389	9,166	370
Repayment of the diamond loan <sup>(1)</sup> . . . . .	1,229	44	2,383	97
Other domestic sales <sup>(2)</sup> . . . . .	18,565	658	16,183	658
Total . . . . .	<u>44,330</u>	<u>1,576</u>	<u>36,831</u>	<u>1,492</u>

(1) Represents delivery of diamonds received from Russia pursuant to a diamond loan. The diamond loan is an agreement between us and Russia to exchange gem diamonds. For a description of the diamond loan agreement, see note 11 to the audited financial statements, appearing at page F-65.

(2) Includes sales within Russia and Yakutia.

In 2000, 93 per cent. of total sales were derived from the sale of diamonds, as compared with 96 per cent. in 1999. Our total diamond sales revenues decreased by 1 per cent., or RUB 821 million, in 2000 compared to 1999. This change was mainly due to the 18 per cent. decrease relating to inflationary accounting and a 1 per cent. decrease in average U.S. Dollar prices, partially offset by a 14 per cent. increase due to changes in the applicable exchange rate and a 7 per cent. increase in the volume of diamond sales in carats.

Export diamond sales increased by 23 per cent., or RUB 3,606 million, in 2000 compared to 1999. The increase was primarily due to a 45 per cent. increase in sales volume in carats and a 13 per cent. increase in the applicable exchange rate, partially offset by a 13 per cent. decrease in average prices, mainly due to a decrease in the quality of diamonds sold, as well as an 18 per cent. reduction relating to the effect of inflationary accounting.

Sales to the government of Yakutia decreased by 2 per cent., or RUB 356 million, in 2000 compared to 1999. This change was primarily the result of a 13 per cent. increase in the applicable exchange rate and a 19 per cent. increase in average U.S. Dollar prices and sales volume in carats. These factors were partially offset by an 18 per cent. decrease resulting from the application of inflationary accounting.

Repayment of the diamond loan relates to the repayment of the April 1993 diamond loan received from Russia in the amount of 7.857 million carats of gem diamonds. Amounts repaid under the diamond loan decreased by 58 per cent., or RUB 2,399 million, in 2000 compared to 1999 in accordance with the schedule of loan repayment.

Other domestic diamond sales decreased by 6 per cent., or RUB 1,672 million, in 2000 compared to 1999. This change was due to an 18 per cent. decrease relating to the impact of inflationary accounting and a 17 per cent. decrease in sales volumes in carats. These decreases were partially offset by a 12 per cent. increase in average U.S. Dollar prices, mainly due to an increase in the overall quality of diamonds sold, and a 15 per cent. increase from changes in the applicable exchange rate.

Other revenues increased by 81 per cent. to RUB 4,987 million in 2000 from RUB 2,755 million in 1999. The increase was primarily attributable to an increase in the volume of transportation, construction and social infrastructure services provided.

### *Cost of sales*

Cost of sales increased by 36 per cent., or RUB 6,266 million, to RUB 23,471 million in 2000 from RUB 17,205 million in 1999. As a percentage of revenues, cost of sales also increased from 26 per cent. in



1999 to 34 per cent. in 2000, primarily due to an increase in fuel and energy costs, staff costs and depreciation charges and a decrease in revenues from diamond sales. The following table sets forth our cost of sales, based on the purchasing power of the Rouble as at 30 September 2002:

	For the year ended 31 December	
	2000	1999
	(RUB millions)	
Wages, salaries and other staff costs . . . . .	9,716	5,992
Depreciation . . . . .	5,269	3,592
Transport . . . . .	765	791
Fuel and energy . . . . .	3,811	2,242
Services . . . . .	374	564
Materials . . . . .	4,314	4,356
Other . . . . .	285	123
Write down (reversal) of inventory . . . . .	(331)	375
Movement in inventories . . . . .	(732)	(830)
Total . . . . .	23,471	17,205

*Wages, salaries and other staff costs.* Wages and salaries increased by 62 per cent., or RUB 3,724 million, to RUB 9,716 million in 2000 from RUB 5,992 million in 1999. This increase was due to an average salary increase of 35 per cent. at the end of 1999 and average salary increases totalling 25 per cent. in 2000, as well as an increase in the number of employees and an increase in the cost of employees' travel reimbursements. In addition, we made no bonus payments in 1999. These increases were offset by the effect of inflationary accounting.

*Depreciation.* Depreciation charge increased by 47 per cent., or RUB 1,677 million, to RUB 5,269 million in 2000 from RUB 3,592 million in 1999. This increase was attributable to an increase in depreciation charges relating to an increase in ore extraction from 1999 to 2000, depreciation of assets relating to the Mir mine due to increased extraction at that mine and the excess of the Mir mine's assets above the comparable value of the assets in our other mines, as well as significant additions of fixed assets, including the purchase of equipment for Ore Treatment Plant No. 14.

*Fuel and energy.* Fuel and energy costs increased by 70 per cent., or RUB 1,569 million, to RUB 3,811 million in 2000 from RUB 2,242 million in 1999. The increase was mainly due to increased electricity consumption as a result of higher ore extraction activities, as well as a significant increase in electricity rates set by the electricity provider, in excess of the inflation rate, in the middle of 2000. In addition, from 1999 to 2000, fuel prices increased at a rate in excess of the inflation rate and consumption increased as a result of increases in our transportation services.

*Materials.* Material expenses remained relatively constant in 2000 at RUB 4,314 million, as compared to RUB 4,356 million in 1999. This stability reflects the increase in material consumption due to increased ore extraction activities, offset by cost increases below the rate of inflation.

*Write down (reversal) of inventory.* In accordance with our accounting policy, we make a provision for impairment of inventory that is older than two years. The decrease in the provision for impairment of inventory to RUB (331) million in 2000 from RUB 375 million in 1999 was primarily due to the utilisation of inventory in 2000 that had been written off in 1999.

### ***Other operating expenses***

*Taxes other than profit tax.* The following table sets forth our inflation-adjusted tax expenses, other than in respect of profit tax, for the periods indicated:

	For the year ended 31 December	
	2000	1999
	(RUB millions)	
Royalty payments . . . . .	11,531	11,518
Resource recovery tax . . . . .	2,187	2,162
Non-recoverable resource tax . . . . .	4,500	4,748
Road use tax . . . . .	1,565	1,542
Ecology fund . . . . .	1,187	1,185
Property tax . . . . .	540	450
Tax penalties . . . . .	(88)	784
Other taxes . . . . .	354	36
Total . . . . .	<u>21,776</u>	<u>22,425</u>

Taxes other than profit tax decreased by 3 per cent., or RUB 649 million, to RUB 21,776 million in 2000 from RUB 22,425 million in 1999. The decrease was primarily due to the nature of these taxes, which are primarily based on diamond sales. Taxes other than profit tax remained constant as a percentage of diamond sales at 34 per cent. and 35 per cent. in 2000 and 1999, respectively, as our diamond sales did not significantly change from 1999 to 2000.

Our royalty payment was 19.5 per cent. of rough diamond sales in both 2000 and 1999. Resource recovery tax was 3.5 per cent. of diamond sales, while the non-recoverable resource tax was 7 per cent. of the value of extracted diamonds. For both 1999 and 2000, we contributed 2 per cent. of revenues from diamond sales to the ecological fund in Yakutia.

*Social costs.* Social costs decreased by 49 per cent., or RUB 1,188 million, to RUB 1,230 million in 2000 from RUB 2,418 million in 1999. The decrease was primarily the result of the introduction of a new policy relating to the reduction of social costs. In addition, in 2000 social costs were offset by a tax concession for community tax paid.

The following table sets forth our expenses included in the caption “other operating expenses” for the periods indicated:

	For the year ended 31 December	
	2000	1999
	(RUB millions)	
Selling and marketing expenses . . . . .	1,124	714
Research and development expenses . . . . .	828	708
Loss on disposal of fixed assets . . . . .	1,600	1,216
Other expenses, net . . . . .	153	182
Total . . . . .	<u>3,705</u>	<u>2,820</u>

Other operating expenses increased by 31 per cent., or RUB 885 million, to RUB 3,705 million in 2000 from RUB 2,820 million in 1999. The increase was primarily due to an increase in the loss on disposal of fixed assets as a result of the write-off of Ore Treatment Plant No. 11, as well as the write-off of certain assets under construction which we considered unnecessary for further construction, including construction of warehouses and roads. Sales and marketing expenses increased from RUB 714 million in 1999 to

RUB 1,124 million in 2000, primarily due to increased expenses related to our agreement with Lazare Kaplan International, a diamond polisher, under which we increased our sales of polished diamonds.

*General and administrative expenses.* General and administrative expenses increased by 110 per cent., or RUB 561 million, to RUB 1,071 million in 2000 from RUB 510 million in 1999. The increase was primarily due to higher bank charges resulting from increased borrowings, as well as an increase in salary payments to administrative employees.

*Gain on net monetary position.* Our gain on net monetary position decreased by 67 per cent., or RUB 3,861 million, to RUB 1,880 million in 2000 from RUB 5,741 million in 1999, primarily as a result of a decrease in the inflation rate from 36.6 per cent. in 1999 to 20.1 per cent. in 2000 and a decrease in our net monetary liabilities position in the beginning of 2000.

*Interest expense.* Our interest expense remained relatively stable from period to period, increasing by 3 per cent., or RUB 53 million, to RUB 2,040 million in 2000 from RUB 1,987 million in 1999. The increase reflects increased borrowings, offset by a decrease in the average interest rate.

### **Liquidity and Capital Resources**

Our consolidated statements of cash flows reflect the effects of operating in a hyperinflationary environment, where financial statements are adjusted for price level changes, as well as the effects of currency fluctuations. The amounts in our consolidated statements of cash flows show actual nominal cash flows, which are restated to reflect the purchasing power of the Rouble as at 30 September 2002. The working capital movements represent the actual nominal increases or decreases in working capital balances at the date they occurred, restated to reflect the purchasing power of the Rouble as at 30 September 2002.

The following table summarizes our statements of cash flows for the nine months ended 30 September 2002 and 2001 and the years ended 31 December 1999, 2000 and 2001.

	For the nine months ended 30 September		For the year ended 31 December		
	2002	2001	2001	2000	1999
	(RUB millions)				
Net cash provided by operating activities . . . . .	5,969	2,315	10,090	9,855	9,409
Net cash used in investing activities	(10,536)	(7,282)	(10,906)	(9,807)	(4,364)
Net cash provided by (used in) financing activities . . . . .	5,329	6,790	1,475	586	(6,238)

#### ***Net cash provided by operating activities***

Net cash provided by operating activities increased by 158 per cent., or RUB 3,654 million, to RUB 5,969 million for the nine months ended 30 September 2002 from RUB 2,315 million in the nine months ended 30 September 2001. This increase was primarily due to a decrease in profit tax paid and changes in our working capital position due to a smaller increase in inventories and accounts receivable from period to period and repayment of deferred royalties in the nine-month period ended 30 September 2001. These factors were offset by the decrease in margins generated by diamond sales and a decrease in taxes payable in the nine-month period ended 30 September 2002, as compared with taxes payable in the nine-month period ended 30 September 2001.

Net cash provided by operating activities increased by 2 per cent., or RUB 235 million, to RUB 10,090 million in the year ended 31 December 2001 from RUB 9,855 million in the year ended 31 December 2000. The increase in operating cash flow, which resulted from changes in our working capital position, includes a decrease in accounts receivable in 2001 as compared to an increase in 2000 and a lower increase in

inventories in 2001 compared to 2000. These effects were offset by the negative impact of working capital changes, a decrease in profit margins and an increase in profit tax paid.

Net cash provided by operating activities increased by 5 per cent., or RUB 446 million, to RUB 9,855 million for the year ended 31 December 2000, from RUB 9,409 million for the year ended 31 December 1999. This increase was primarily due to a decrease in repayment of the diamond loan, an increase in accounts payable in 2000 instead of a decrease in 1999, which was partially offset by the negative impact of working capital changes, reflecting an increase in inventories and accounts receivable.

#### *Net cash used in investing activities*

Net cash used in investing activities was RUB 10,536 million in the nine months ended 30 September 2002 as compared to RUB 7,282 million in the nine months ended 30 September 2001. This represents an increase of 45 per cent., or RUB 3,254 million, which was primarily due to the increase in capital expenditures for construction in connection with the development of the Nyurba diamond mine and the development of other mines, as well as a decrease in non-cash settlement for the purchase of property, plant and equipment.

Net cash used in investing activities was RUB 10,906 million in the year ended 31 December 2001, as compared to RUB 9,807 million in the year ended 31 December 2000, and RUB 4,364 million in the year ended 31 December 1999. The 11 per cent., or RUB 1,099 million, increase in net cash used in investing activities from 2000 to 2001 was due to an increase in expenditures related to reconstruction of apartments destroyed by the flooding in Lensk, capital expenditures relating to the construction of the OAO Viluyskaya GES-3 hydroelectric station, the construction of a gas pipeline and construction of an oil-refinery plant. The 125 per cent., or RUB 5,443 million, increase in net cash used in investing activities from 1999 to 2000 was primarily due to the construction of the International underground mine and construction of a gas pipeline by ALROSA-Gas.

#### *Net cash flows provided by (used in) financing activities*

Net cash provided by financing activities was RUB 5,329 million in the nine months ended 30 September 2002, as compared to RUB 6,790 million in the nine months ended 30 September 2001. This change represents a 22 per cent., or RUB 1,461 million, decrease, and was mainly the result of an increase in cash outflows relating to loans and commercial paper repayments and increases in interest payments due to a decrease in non-cash commercial paper redemption. This was partially offset by additional long- and short-term borrowings and bond issuances.

Net cash provided by financing activities was RUB 1,475 million in the year ended 31 December 2001, as compared to RUB 586 million in the year ended 31 December 2000, an increase of 152 per cent. Funding for our capital expenditure programme in 2000 and 2001 was primarily derived from internally generated cash flow, and partially from additional borrowings.

Net cash used in financing activities was RUB 6,238 million in the year ended 31 December 1999 compared to RUB 586 million net cash provided by financing activities in the year ended 31 December 2000. The main factor contributing to the change was the significant repayment of loans in 1999 made possible by an increase in cash flows from operating activities.

Our overall debt amounted to RUB 25,844 million at 31 December 2001, compared to RUB 21,460 million at 31 December 2000, an increase of 20 per cent. Consistent with our strategy of replacing short-term borrowings with long-term borrowings, the short-term borrowings decreased, as a portion of total debt, from 83 per cent. at 31 December 2000 to 72 per cent. at 31 December 2001. Our long-term debt balance at 31 December 2001 increased primarily due to the issuance of long term-bonds in 2001 in the aggregate amount of RUB 2,016 million. We also obtained a long-term loan of RUB 1,186 million to finance our diamond-cutting operations in the Khanty-Mansiysk region from the Khanty-Mansiysk

Regional Administration. The majority of our long-term loans were secured through the pledge of our assets and receivables in respect of our diamond production.

### **Capital expenditures**

Capital expenditures for the nine months ended 30 September 2002 and years ended 31 December 2001 and 2000 (except for those acquisitions described above in “–Acquisitions”) were as follows:

	For the nine months ended 30 September	For the year ended 31 December	
	2002	2001	2000
	(unaudited)	(RUB millions)	
<b>Capital expenditures:</b>			
Mining operations . . . . .	8,957	7,723	7,977
Non-mining operations . . . . .	1,316	5,306	2,601
Social infrastructure . . . . .	3,178	3,971	2,726
Total . . . . .	13,451	17,000	13,304
Geological exploration . . . . .	725	750	471
R&D expenditures . . . . .	119	176	357

Our business requires a significant amount of capital expenditure in order to maintain existing operations. Substantial capital expenditures are required for the continuous replacement of fully depreciated fixed assets, mining operations in our Mirny and Aikhal subdivisions and development of the Nyurba open-pit mines. We are also obliged to make capital investments in the social infrastructure of these and other communities in Yakutia, including the construction of houses, schools, cultural centres and medical units. The significant increase in social expenditures in 2001 was caused by our reconstruction of the infrastructure of Lensk following flooding in that city in 2001. Capital expenditures in non-mining operations primarily include investments in oil-refinery plant construction, construction of a gas pipeline and a hydroelectric power station.

The following table sets forth our anticipated capital expenditures for the years 2003 to 2005, excluding any amounts for acquisitions and additional capital expenditures relating to any such acquisitions. These estimated capital expenditures are subject to change depending upon factors such as changes in diamond prices and the general economy and business environment. As in 2002, we expect to continue to use internally generated funds as the primary means of financing these capital expenditures.

	Estimated capital expenditures		
	2003	2004	2005
	(RUB millions)		
Mining operations . . . . .	12,502	11,252	13,902
Non-mining operations . . . . .	2,715	2,447	550
Social infrastructure . . . . .	2,077	1,339	1,734
Total . . . . .	17,294	15,038	16,186

In 2003-2005 we expect that our capital expenditures will be primarily used for the development of new diamond fields and the purchase of production-related fixed assets. Our social obligations will also require significant capital expenditures. Capital expenditures in non-mining operations will primarily include investments in gas pipelines, a hydroelectric power station and an oil refinery. The decrease in our estimated capital expenditures from RUB 17,294 million in 2003 to RUB 15,038 million in 2004 is mainly due to the funding of capital projects which were originally planned for the year 2001, but were deferred to 2003 as a result of the significant expenditures required to rebuild facilities in Lensk destroyed by flooding

in 2001, as well as the completion of construction of mining infrastructure and Ore Treatment Plant No. 16 for ALROSA-Nyurba. The increase in our estimated capital expenditures from RUB 15,038 in 2004 to RUB 16,186 in 2005 is mainly due to the expected increase related to the construction of the International underground mine.

#### ***Debt obligations and other commitments***

Our debt obligations, including short- and long-term borrowings, were RUB 35,967 million as of 30 September 2002, and were RUB 25,844 million, RUB 21,460 million and RUB 12,486 million as of 31 December 2001, 2000 and 1999, respectively. The overall increase in our borrowings was attributable to a net increase in both our short- and long-term borrowings. The percentage of total borrowings constituted by short-term borrowings was 71 per cent. as of 30 September 2002, and was 72 per cent., 83 per cent. and 79 per cent. as of 31 December 2001, 2000 and 1999, respectively. This trend reflects, in part, our strategy of refinancing short-term debt with longer-term debt. The new borrowings were primarily used to finance long-term investments, to increase capital expenditures for new construction and to support current production facilities such as those at the Nyurba and International mines, as well as our gas pipeline, hydroelectric power stations and oil refinery. The proceeds were also used to finance increases in our working capital requirements, principally consisting of inventory items.

The following table sets forth our short-term and long-term borrowings, including bonds and commercial paper outstanding as of the dates indicated:

	As of 30 September		As of 31 December	
	2002	2001	2000	1999
	(unaudited)			
		(RUB millions)		
<b>Short-term bank borrowings:</b>				
RUB-denominated borrowings . . . . .	2,421	1,330	741	76
Foreign currency-denominated borrowings . . .	17,957	10,327	6,890	4,539
Current portion of diamond loan . . . . .	—	—	—	2,117
Non-convertible bonds . . . . .	1,158	552	929	695
Commercial paper . . . . .	2,652	4,704	5,894	2,117
Other . . . . .	1,395	1,593	3,378	366
Total short-term debt obligations . . . . .	<u>25,583</u>	<u>18,506</u>	<u>17,832</u>	<u>9,910</u>
<b>Long-term bank borrowings (excluding current portion):</b>				
RUB-denominated borrowings . . . . .	2,880	1,326	199	—
Foreign currency-denominated borrowings . . .	3,942	2,190	1,973	1,586
Non-convertible bonds . . . . .	3,050	1,877	—	—
Commercial paper . . . . .	184	414	829	990
Other . . . . .	328	1,531	627	—
Total long-term debt obligations . . . . .	<u>10,384</u>	<u>7,338</u>	<u>3,628</u>	<u>2,576</u>
Total debt obligations . . . . .	<u><u>35,967</u></u>	<u><u>25,844</u></u>	<u><u>21,460</u></u>	<u><u>12,486</u></u>

The following table sets forth the aggregate principal amount of borrowings outstanding as of 30 September 2002, coming due in the time period indicated:

	As of 30 September 2002 (unaudited) (RUB millions)
<b>Due for repayment:</b>	
Within one year . . . . .	25,583
Between one and two years . . . . .	6,110
Between two and three years . . . . .	3,564
Between three and four years . . . . .	35
After four years . . . . .	675
Total . . . . .	<u>35,967</u>

The following table sets forth our debt profile by interest and currency exposure:

	30 September 2002 (unaudited)	31 December 2001      2000      1999 (RUB millions)		
<b>Short-term loans and current portion of long-term debt</b>				
<b>Banks:</b>				
U.S.\$-denominated floating rate . . . . .	—	665	739	213
U.S.\$-denominated fixed rate . . . . .	13,932	9,010	5,542	3,718
Deutsche Mark-denominated fixed rate . . . . .	—	—	—	80
RUB-denominated fixed rate . . . . .	2,190	671	741	76
	<u>16,122</u>	<u>10,346</u>	<u>7,022</u>	<u>4,087</u>
Non-convertible bonds . . . . .	—	552	929	695
Commercial paper . . . . .	2,652	4,704	5,894	2,117
Other U.S.\$-denominated fixed rate loans . . . . .	611	716	2,636	—
Other . . . . .	784	756	742	366
	<u>20,169</u>	<u>17,074</u>	<u>17,223</u>	<u>7,265</u>
Current portion of long-term debt . . . . .	5,414	1,432	609	528
Current portion of diamond loan . . . . .	—	—	—	2,117
	<u>25,583</u>	<u>18,506</u>	<u>17,832</u>	<u>9,910</u>



	30 September	31 December		
	2002	2001	2000	1999
	(unaudited)	(RUB millions)		
<b>Long-term borrowings</b>				
<b>Banks:</b>				
U.S.\$-denominated floating rate . . . . .	1,055	1,452	1,574	2,114
U.S.\$-denominated fixed rate . . . . .	6,912	1,390	1,008	–
RUB-denominated fixed rate . . . . .	3,111	1,985	199	–
	<u>11,078</u>	<u>4,827</u>	<u>2,781</u>	<u>2,114</u>
Non-convertible bonds . . . . .	4,208	1,877	–	–
Commercial paper . . . . .	184	414	829	990
Diamond loan . . . . .	–	–	–	2,117
Other . . . . .	328	1,652	627	–
	<u>15,798</u>	<u>8,770</u>	<u>4,237</u>	<u>5,221</u>
Current portion of diamond loan . . . . .	–	–	–	(2,117)
Current portion of other long-term debt . . . . .	(5,414)	(1,432)	(609)	(528)
	<u>10,384</u>	<u>7,338</u>	<u>3,628</u>	<u>2,576</u>

## OUR BUSINESS

We are the second largest diamond mining company in the world by diamond production, measured as a multiple of average market prices. In 2001 we produced approximately 20.9 per cent. of the world's rough diamond output, measured as a multiple of average market prices, and approximately 17.3 per cent. by carat volume. Our principal mining operations are located in Yakutia, in north-eastern Siberia. In addition, we hold a 32.8 per cent. interest in Catoca Mining Ltd., a diamond mining joint venture in Angola, and a 71.9 per cent. interest in Severalmaz, a diamond mining company that holds the license to mine the Lomonosov diamond field in the Arkhangelsk region of north-western Russia. We are also engaged in diamond exploration throughout north-eastern Russia. We produce rough gem diamonds and near-gem diamonds, which are cut and used primarily in jewellery, and non-gem diamonds used primarily as industrial abrasives. In 2001, sales of gem and near-gem diamonds, including polished diamonds, accounted for approximately 99.5 per cent. of our total diamond sales. We are one of Russia's largest industrial enterprises by revenue, with 2001 total revenues of RUB 64.3 billion (U.S.\$2.0 billion), and total revenues for the nine months ending 30 September 2002 of RUB 42.0 billion (U.S.\$1.3 billion).

We operate open-pit, underground and alluvial mines, which are located near the cities of Aikhal, Anabar, Mirny, Nyurba and Udachny within Yakutia, and our seven primary ore treatment production plants have an aggregate design capacity to process approximately 30 million tonnes of ore annually. In 2001, our Russian mines processed approximately 24.7 million tonnes of ore to produce rough diamonds which are valued at U.S.\$1.7 billion, based on average market prices, and for the first nine months of 2002 these mines processed 23.6 million tonnes of ore to produce rough diamonds valued at U.S.\$1.1 billion. As of 30 September 2002 we employed 46,527 people, including approximately 14,700 people in connection with our primary Russian mining operations.

We had total sales of diamonds for 2001 and the nine-month period ended 30 September 2002 of RUB 58.5 billion (U.S.\$1.8 billion) and RUB 37.8 billion (U.S.\$1.2 billion), respectively. Exports accounted for approximately 60 per cent. of our 2001 diamond sales of rough gem and near-gem diamonds, and approximately 50 per cent. of our sales of these diamonds for the nine-month period ended 30 September 2002. Our exports have been established pursuant to periodic export quotas imposed by Russia. This year we have been granted a five-year quota for the export of diamonds. In each case, almost all of our exports were through sales to De Beers pursuant to trade agreements. The De Beers Trade Agreement provides for annual sales to De Beers of up to U.S.\$800 million, based on current market prices, over a period of five years. However, the De Beers Trade Agreement remains subject to approval by the Directorate-General of the European Commission. Pending resolution of the Statement of Objections issued by the European Commission relating to the De Beers Trade Agreement, we have made monthly sales to De Beers under *ad hoc* written agreements for each shipment.

Approximately 40 per cent. of our total diamond sales in 2001, and approximately 50 per cent. of our total diamond sales for the nine-month period ended 30 September 2002, were made to domestic purchasers, primarily Russian cutting and polishing companies that process the diamonds for use in jewellery. We also cut and polish some of our rough diamond production primarily through our Brillianty ALROSA division. Our sales of polished diamonds were approximately U.S.\$133.8 million and U.S.\$84.8 million for the year ended 31 December 2001 and the nine-month period ended 30 September 2002, respectively. Our sales of industrial diamonds are conducted almost exclusively through Almaziuvelirexport, a Government of Russia-owned jewellery exporter. In 2001, we sold U.S.\$8.0 million of industrial diamonds, and our sales of such diamonds in the first nine months of 2002 were U.S.\$5.0 million. The sales figures provided in this paragraph are presented on an historical rather than on an inflation-adjusted basis.

Because of the Secrecy Law we are prohibited from disclosing our diamond reserves. However, as certified by the Ministry of Natural Resources of Russia, our proven diamond reserves of categories B and C<sub>1</sub> (see "Industry Overview—Calculation of Diamond Reserves") are sufficient to permit mining of

diamonds until 31 December 2026 in an annual average volume that is not less than the volume of diamonds produced during 2001. The Ministry of Finance of Russia has certified that our proven reserves of natural diamonds (categories A, B and C<sub>1</sub>) are sufficient to permit mining of diamonds until 31 December 2027 in an annual average volume that is not less than the volume of diamonds produced during 2002. The Ministry of Natural Resources of Russia also confirmed that the average value per carat of diamonds to be mined in each of the next 25 years will not be materially less than the average value per carat of the diamonds that we mined during the year ended 31 December 2002. See “–Diamond Reserves” and “Appendix A–Certification of Diamond Deposits”. To increase our reserves, we engage in a variety of exploratory activities. These include geological surveying, detailed prospecting and developmental analysis of current mines.

To reduce our costs and ensure operational support, we are engaged in a number of businesses that provide materials and services to our mining operations, including construction and freight transportation services, timber and logging production, agriculture and food supplies and passenger air transport. We have also developed oil and natural gas extraction and hydroelectric plants to supply a portion of our energy needs. In addition, we continue to maintain for the benefit of our Russian employees certain non-productive, “social” assets, which we inherited from our predecessor entities. We are continuing to transfer to the government of Yakutia the obligation to maintain these assets.

We have established representative offices in London, England; Luanda, Angola; Ramat-Gan, Israel; and Antwerp, Belgium.

### **Our Formation and Development**

The diamond industry in Russia dates back to the mid-1950s, following the discovery of significant diamond deposits in regions comprising the former Soviet Union, including the Mir and Zarnitsa diamond pipes. The former Soviet State-owned diamond mining company, Yakutalmaz, was established in January 1957 and sold its first lot of diamonds on the world markets in 1959.

We were established pursuant to Decree N158S of the President of Russia, dated 19 February 1992 (“Decree N158S”), and were registered as a closed joint stock company in Yakutia on 13 August 1992 under the name “Almazy Rossii-Sakha”, which was changed in 1998 to ALROSA Company Limited. We commenced operations as an independent entity on 1 January 1993. Pursuant to Decree N158S, we took direct control over the exploration, production, marketing and domestic and foreign sales of diamonds, with the objective of ensuring the efficient operation and development of Russia’s diamond industry and strengthening Russia’s position in the world diamond market. Under Decree N158S and a number of resolutions of the Government of Russia, various assets previously operated by the former State enterprise, Yakutalmaz, and the State-owned enterprise, Almaziuevirexport, were transferred to our newly established company, largely by means of a lease. In connection with our formation, we also entered into the Lease Agreement with Yakutia pursuant to which we operate the main part of our mining assets. See “–Regulatory and Environmental Matters–Lease Agreement” below. We conduct almost all of our diamond production in Russia. Except for our majority-owned subsidiaries Severalmaz and ALROSA-Nyurba, only one other company has been granted mining rights in Russia under which it can undertake alluvial mining in the Ural region of Russia.

Our largest shareholders are Russia, which holds 37 per cent. of our shares through its State Property Ministry, and Yakutia, which holds 32 per cent. of our shares through its State Property Ministry. See “Principal Shareholders”. We maintain close ties with the Government of Russia and the government of Yakutia, and in 2002 the Russian First Vice Prime Minister and Minister of Finance, Mr. Alexey Leonidovich Koudrin, was appointed as Chairman of our Supervisory Council.

## Strengths

We believe that we benefit from the following strengths:

- *We have a leading market position in a large and relatively stable market.* We are the second largest producer of rough diamonds in the world, accounting for approximately 20.9 per cent. of world production output in 2001, measured as a multiple of average market prices. As compared with other extractive industries, the market for rough diamonds is characterised by relatively stable prices. We believe that this stability is primarily attributable to the market's system of marketing through the DTC. The DTC purchases and sells rough diamonds and seeks to reduce market price volatility by aggregating supply and demand.
- *We have significant diamond reserves.* We have increased the reserves of our predecessor entities through a combination of successful exploration and investment. We estimate that our total reserves, including the reserves at the Severalmaz sites, represented approximately 20 per cent. of total global reserves as of 30 September 2002, calculated by value. Based upon our internal analyses and certifications of the State Committee on Natural Resources Reserves of Russia, we believe that we have sufficient diamond reserves to continue our Russian mining operations at least through 31 December 2026.
- *Our mines have consistently produced high-quality, high-margin gems.* Other than our smaller alluvial operations, our mines have consistently produced gem and near-gem diamonds with per-carat values ranging from U.S.\$15 to U.S.\$10,000. We believe that the quality of our diamonds is relatively high as compared to the quality of diamonds of other producers. Based on our geological surveys and production experience, we believe that the quality of diamonds generally remains consistent throughout our deposits. Accordingly, we expect to continue to benefit from the production of high quality diamonds in the future.
- *We have a limited number of competitors.* In general, the global diamond mining industry is characterised by a limited number of competitors, which we believe results primarily from a combination of the limited number of diamond deposits suitable for commercial mining and the large capital requirements for exploration and excavation. Within Russia, we hold exclusive prospecting licenses in numerous locations and, to date, no other company has been granted a license to mine diamond pipes other than our majority-owned subsidiaries Severalmaz and ALROSA-Nyurba. Notwithstanding the recent coming into effect of the 2002 Decree which, amongst other things, relaxes export controls relating to rough diamonds, we believe that structural and legal barriers to entry will continue to exist in the rough diamond market in the future, which will assist us in maintaining our market position.
- *We benefit from our export arrangements with De Beers.* De Beers purchases a substantial amount of rough diamonds from us each year, currently pursuant to *ad hoc* written agreements pending the European Commission's review of the De Beers Trade Agreement. We believe that the distribution of our diamonds through De Beers allows us to reduce our distribution costs and to obtain steady inflows of hard currency, as we receive all payments under the agreements with De Beers in U.S. Dollars.
- *We have strong technical mining expertise.* Our predecessor entities have been engaged in diamond mining since 1957. In particular, we have developed unique mining expertise related to the permafrost environment of north-eastern Russia, where winter temperatures can reach  $-50^{\circ}\text{C}$ . In addition, one of our divisions, the Yakutian Scientific and Research Institute, has more than 700 employees engaged in research and development, including development of new techniques of underground mining as well as ore processing. We believe that our experience helps us to increase efficiency and output and makes us an attractive partner for the joint development of mines outside of Russia.

## Strategy

We generally formulate our long-term strategy pursuant to the adoption of five-year strategic plans. These plans provide specific strategic objectives and actions to be strictly followed, although our Supervisory Council may revise the plans to react to significant changes in our industry. Under our current five-year plan we intend to:

- *Complete construction of new mines to enhance production.* We are currently constructing a number of new mines to replace mines which have recently closed and to enhance our long-term production capacity. We are developing a new open-pit mine at the Komsomolskaya diamond pipe and two new open-pit mines in our Nyurba division. In addition, we are constructing a new Mir underground mine to replace our recently closed Mir open-pit mine, as well as increasing the capacity of our Zarnitsa open-pit mine and our International and Aikhal underground mines. We estimate that these projects will increase our overall ore processing by 300,000 tonnes in 2003, and by approximately one million tonnes per year by 2008.
- *Lower costs and seek production efficiencies.* We are engaged in a number of cost-reduction projects. In particular, we intend to continue to focus on reducing our energy costs through our third Russian hydroelectric power station on the Vilyui River in western Yakutia, gas and oil refinery projects and the introduction of energy-saving equipment. We also intend to continue to modernise and automate our ore treatment plants and to implement more efficient technologies developed by our research institute.
- *Divest social assets to improve focus on core business.* We are continuing to transfer to Yakutia and to local governments responsibility for the various social assets which we inherited from our predecessor entities, including residential houses, schools and hospitals. We believe that these transfers will enable us to reduce our maintenance and repair expenses over the long-term. We also plan to increase our focus on core operations by divesting or reducing our participation in business ventures which are ancillary to our diamond production operations.
- *Capitalise on anticipated diamond market liberalisation in Russia.* We believe that the 2002 Decree, which became effective on 6 February 2003, reflects the first step in a programme of liberalisation of the Russian diamond market. See “Industry Overview–Liberalisation of the Russian Diamond Market”. We believe that the 2002 Decree and this liberalisation trend will generally create certain opportunities for our business. For instance, as a result of our receipt of a five-year export quota under the 2002 Decree, we may be able to obtain long-term financing secured by exports, which we believe will reduce our borrowing costs. Based on discussions with officials of the Government of Russia, we believe that the Government of Russia will implement further diamond market liberalisation reforms, and we intend to seek additional opportunities resulting from such market reform if and when they occur.
- *Continue our relationship with De Beers.* We are currently working with De Beers to obtain European Commission approval of the De Beers Trade Agreement. Pending resolution of the Statement of Objections, we intend to continue our monthly sales to De Beers under individual sale agreements. To the extent that we explore opportunities to export our rough diamonds through sales channels other than De Beers in the future, we anticipate that, at least initially, any such sales would be limited to diamonds that are not to be supplied to De Beers.
- *Further diversify geographically.* In addition to exploring regions of Russia outside Yakutia, our control of Severalmaz in the Arkhangelsk region and our participation in Catoca Mining Ltd., we intend to seek geographic diversification by participating in additional joint ventures in key diamond mining regions in other countries. We are currently focused on Angola, where the Catoca mine is entering a second production phase which is expected to double its ore-processing capacity.

We have also entered into an agreement with the Angolan government with respect to the development of the Angolan Lour diamond deposit and other joint ventures.

- *Enhance financial planning and improve the efficiency of our corporate governance.* We have been working to improve our financial planning to strengthen our financial stability. As part of our strategy we intend to continue to restructure our borrowings toward longer-term debt, which we believe will enable us to better manage our cash and enhance our liquidity. We have recently hired a First Vice President and a Vice President who are responsible for the implementation of this restructuring. In addition, we are seeking to improve the efficiency of our corporate governance and financial controls through the introduction of a new integrated accounting software system.

In addition, while our primary focus continues to be on the production of rough diamonds, we have from time to time considered increasing our cutting and polishing operations, either through the expansion of our own facilities or the acquisition of other established polishing businesses. An increase in polishing activities may involve certain benefits, including the generation of higher margins for finished diamonds and an ability to obtain financing secured by finished diamonds. However, our five-year plan does not provide for growth in our polishing operations and our Supervisory Council is not currently reviewing any amendments to the plan in this regard.

The implementation of our strategy is dependent on the availability of funds for capital expenditures. If we experience a significant reduction in revenues in the future, resulting from the occurrence of an event discussed under “Risk Factors” or otherwise, we believe that any such reduction would primarily affect our ability to make capital expenditures in the future.

## Our Mining Operations

### *General description of our mining business*

The following map indicates the location of our principal operations within Yakutia, including our representative office in Yakutsk:





Our primary Russian diamond mining operations are located near the cities of Aikhal, Anabar, Mirny, Nyurba and Udachny in the north-eastern region of Russia. Each of these regions is operated as a division of ALROSA Ltd. In addition, through our 32.8 per cent. ownership interest in Catoca Mining Ltd., a joint venture with Endiama and others, we participate in the mining of the Catoca diamond pipe in Angola. We also hold a 71.9 per cent. interest in Severalmaz, a subsidiary relating to mining operations near Arkhangelsk in north-western Russia. The following table sets forth information for each of these operations:

	Primary Russian Mining Operations						Joint Ventures <sup>(1)</sup>
	Udachny	Mirny	Aikhal	Nyurba <sup>(2)</sup>	Anabar	Total	Catoca <sup>(3)</sup>
<b>Overburden stripped</b>							
<b>(‘000 m<sup>3</sup>):</b>							
Nine months ended							
30 September 2002 . . . .	5,269	1,319	10,408	3,065	612	20,673	–
2001 . . . . .	7,935	1,571	15,887	3,672	701	29,766	4,078
2000 . . . . .	8,154	376	16,067	323	451	25,371	2,598
1999 . . . . .	10,940	1,375	12,246	–	351	24,912	1,231
<b>Ore hauled (‘000 tonnes):</b>							
Nine months ended							
30 September 2002 . . . .	3,198	1,711	8,651	563	901	15,024	–
2001 . . . . .	9,650	879	18,149	–	801	29,479	1,507
2000 . . . . .	9,761	7,360	13,113	–	800	31,034	1,200
1999 . . . . .	9,021	5,148	13,235	–	652	28,056	1,192
<b>Ore processed</b>							
<b>(‘000 tonnes):<sup>(4)</sup></b>							
Nine months ended							
30 September 2002 . . . .	11,000	2,150	9,800	292	337	23,579	–
2001 . . . . .	9,421	2,643	12,271	–	400	24,735	2,643
2000 . . . . .	9,320	2,247	11,334	–	400	23,301	2,592
1999 . . . . .	9,550	2,140	12,057	–	280	24,027	2,003
<b>Value of diamonds extracted</b>							
<b>(U.S.\$ millions):<sup>(5)(6)</sup></b>							
Nine months ended							
30 September 2002 . . . .	584	204	229	70	18	1,105	–
2001 . . . . .	708	578	355	–	25	1,666	110
2000 . . . . .	772	500	334	–	16	1,622	103
1999 . . . . .	832	383	311	–	15	1,541	103
<b>Employees:<sup>(7)</sup></b>							
Nine months ended							
30 September 2002 . . . .	4,865	3,502	5,462	553	347	14,729	–
2001 . . . . .	5,016	3,453	5,469	389	349	14,676	1,911
2000 . . . . .	5,197	3,596	5,552	179	346	14,870	1,660
1999 . . . . .	5,320	3,330	4,989	–	278	13,917	1,390

(1) The table does not include our Severalmaz joint venture, which began limited production in 2002.

(2) The Nyurba division began producing diamonds in significant amounts in 2002.

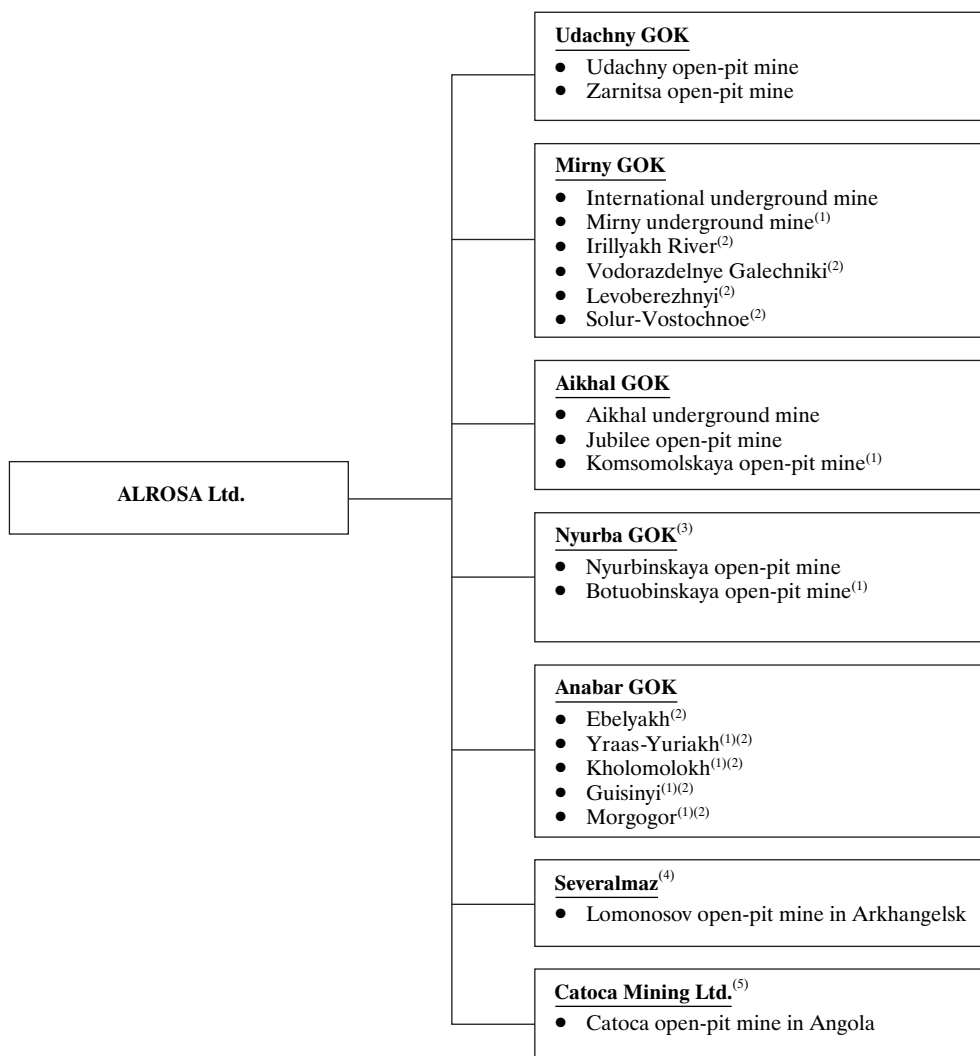
(3) We hold a 32.8 per cent. interest in Catoca Mining Ltd., a joint venture company among ALROSA Ltd. and certain other parties. See “The Catoca mine in Angola”. Figures for the period ending 30 September 2002 are unavailable for Catoca Mining Ltd.

(4) The total tonnes processed may be greater than tonnes hauled due to the processing of existing stockpiles of ore.

(5) Value is determined based upon the average world market prices for rough diamonds.

- (6) Under Russian law we are prohibited from disclosing our diamond production stated in carats, including ore-grade figures. See “Risk Factors–Risks Relating to Our Business–We are prohibited from disclosing our Russian diamond reserves and other information which may be considered material by investors” and “–Diamond Reserves”.
- (7) Total number of employees engaged in primary mining operations at period end.

The following table lists the primary mines operated by each of our divisions and through our Severalmaz subsidiary and our participation in the Catoca Mining Ltd. joint venture:



(1) Under construction.

(2) Alluvial mines. Alluvial mining is seasonal and accounts for only a small portion of our total diamond production.

(3) ALROSA-Nyurba holds the prospecting license under which the Nyurba division operates its mines. ALROSA Ltd. owns 88.2 per cent. of ALROSA-Nyurba. All work at the Nyurba mines is performed by our Nyurba division pursuant to a services agreement with ALROSA-Nyurba.

(4) ALROSA Ltd. owns 71.9 per cent. of Severalmaz.

(5) ALROSA Ltd. owns 32.8 per cent. of Catoca Mining Ltd.

Our mines vary as to mining conditions, yield and quality of diamonds produced. The International mine produces some of our highest quality diamonds with an average per-carat value of U.S.\$130. By comparison, our Anabar alluvial mines produce smaller and lower-quality diamonds with per-carat values

of up to U.S.\$20. Diamond quality within a particular diamond pipe generally tends to be consistent throughout.

## **Mining Operations**

The following discussion describes the basic techniques used in diamond mining operations to extract and process ore. For a description of the geological conditions found in diamond fields, see “Industry Overview–Origin of Diamonds”.

### *Accessing ore*

The primary difference between open-pit, underground and alluvial mining involves the means of accessing the diamond-bearing ore, as described below.

- *Open-pit mining.* In open-pit mining, access to the ore is achieved by stripping the overlying waste rock, or overburden, to expose the ore. Extraction of the ore body involves the same activity as in stripping the overburden. Rock is drilled and blasted and lines are established to demarcate the ore from the waste material. Extraction is generally accomplished using a circular mining system, with excavation starting from the centre of the pit and working outward in concentric circles so that the depth of the pit remains level as it gets deeper. Ore is removed by digging equipment and loaded into dump trucks for transportation to a processing facility. Our open-pit mines are designed to operate continually on a three-shift system.
- *Underground mining.* For our underground mines, we construct vertical shafts which run parallel to the diamond pipe, and the ore body is accessed at various levels via secondary horizontal shafts running from the primary vertical shaft to the diamond pipe. In underground mining, the ore is broken down, off-loaded and hauled to the surface via the vertical shaft. It is then hauled to a processing facility via dump truck. As with the open-pit mines, our underground operations are designed to operate continually on a three-shift system.
- *Alluvial mining.* In alluvial deposits, diamonds are contained within sedimentary gravel which generally lies in or on the banks of streams and rivers. The mining of alluvial gravel initially involves the mechanised removal of overburden (usually sand and rocks) to expose the layer of diamond-bearing gravel, which is then excavated for processing. There are several excavation techniques; however, our alluvial operations generally utilise dredges, which are floating barges that skim gravel from the bottom of the river or stream bed. Because all natural water resources within Yakutia freeze in the winter, our alluvial operations are seasonal. The diamond gravel is either transported to a processing facility or is processed directly on the dredge.

Diamond pipes generally may be mined using an open-pit method or an underground method. Open-pit mining is generally safer and less expensive than underground mining because there is no need for the installation of mechanical lifts or ventilation systems. In addition, open-pit mines typically generate higher volumes of ore than underground mines as underground production is limited by the mine’s capacity to transport ore to the surface through its vertical shaft. However, open-pit mines generate much more overburden, as the mine walls must incline outward from the pit centre to avoid collapse. To maintain the incline, the surface diameter of the open pit must expand as the pit becomes deeper. Thus, an increasing amount of overburden must be removed from open pits, causing a decline in efficiency over the life of the mine. Accordingly, once an open pit attains a certain depth it becomes more efficient to mine the deeper levels of its diamond pipe via an underground mine, if feasible. As our older open-pit mines mature, we are increasingly utilising underground mining to access their diamond deposits.

### ***Ore stocks***

In general, we maintain production stockpiles of ore from our open-pit and underground operations near their related ore treatment facilities. These production stockpiles are typically maintained in an amount equal to three to four months' processing capacity to avoid any temporary shortages of ore for processing. In addition, the maintenance of production stockpiles allows the blending of different grades of ore, which helps increase overall diamond recovery.

Our alluvial operations process diamond-bearing gravel immediately and do not maintain production stockpiles.

### ***Ore processing***

We use the same general processing techniques to process the ore derived from open-pit, underground and alluvial mining. Processing begins with milling—the process of breaking up ore to expose the diamonds contained therein. Russian diamond recovery practice differs in certain respects from that used elsewhere in the world, primarily due to the fact that Russian mining operations are located within a permafrost region. We use an autogeneous, or “self milling”, process whereby ore is broken down in a large tumbler, rather than by crushing. We believe that this process results in less damage to the diamonds contained in the ore. Use of these autogeneous mills also allows the permafrost ore to warm as it spins in the enclosed mill, which makes subsequent processing more efficient.

Once milled, the soft ore, which will not yield diamonds, is removed through a process known as screen sizing. Screen sizing sifts this soft ore to remove the finer dirt particles. The resulting condensed ore then goes through various additional processes to identify and separate the diamonds. Pieces of ore are first separated by size, with larger pieces processed through our proprietary x-ray sorting process. As part of this process, the pieces of ore are transported on a conveyor belt through a sorting machine that subjects the ore to x-rays. These sorters work on the principal that x-rays are absorbed by rock and dirt, but are deflected by diamonds. An optical sensor in the sorting machine identifies the diamonds by these deflected x-rays, which enables the sorter to mechanically separate the diamonds from the ore. Medium- and small-sized pieces of ore are processed using jigs. In this process, ore is placed in a water tank and a vertical agitation of the water, known as jiggling, separates the ore into lighter minerals on the top of the tank and diamonds and other denser minerals (the concentrate) on the bottom. Discharge of the waste and collection of the diamond-bearing concentrate by a skimming apparatus is continuous. Our plants also utilise a gravitational separation process using spirals. As part of this process, ore is suspended in a water tank into which spiral shaped metal tubes are inserted. As these spirals rotate, the motion carries lighter particles up, through and outside of the spirals, while diamonds and other dense minerals accumulate on the inside of the spirals and can be continuously split off.

In addition, Ore Treatment Plant No. 12, which processes ore from the Udachny and Zarnitsa mines, uses a froth flotation process to recover particles as fine as 0.5 millimetres. This process involves the discharge of a water-borne stream of finely ground ore into a tank of water mixed with an oily reagent. Air is injected into the bottom of the tank to form bubbles which rise to the surface. The diamonds adhere to the bubbles and are collected from the froth discharged from the top of the tank. Waste material is drawn off from the bottom of the tank.

In the final stage of processing, the diamonds undergo an acid wash and other treatments, as necessary, to remove any residual waste materials adhered to the diamonds.

### ***Udachny Division***

Over the last 15 years, the Udachny division has been the leading producer of diamonds in Russia, processing 9.4 million tonnes of ore and producing diamonds valued at U.S.\$708 million in 2001, and processing 11.0 million tonnes and producing diamonds valued at U.S.\$584 million in the first nine months

of 2002, based on average market prices. In 1999 and 2000, this division produced diamonds valued at U.S.\$832 million and U.S.\$772 million, respectively, based on average market prices. The Udachny division produced approximately 42.5 per cent. of our total diamond production, by average market value, in 2001, and approximately 52.9 per cent. of our total diamond production for the first nine months of 2002. It accounted for approximately 54.0 per cent. and 47.6 per cent. of our total diamond production in 1999 and 2000, respectively.

### *Udachny mines*

The Udachny division operates the Udachny open-pit mine and the Zarnitsa open-pit mine. Information about each of these mines is set forth in the following table:

	<u>Udachny Mine</u>	<u>Zarnitsa Mine</u>
Year in which mining commenced . . . . .	1968	1999
Explored depth of diamond pipe (metres) <sup>(1)</sup> . . . . .	1,400	400
Mined depth (metres) <sup>(1)</sup> . . . . .	495	45
Target depth (metres) . . . . .	610	200
Ore treatment plant processing mined ore . . . . .	No. 12	No. 12

(1) As of 30 September 2002.

- *Udachny open-pit mine.* The Udachny division is principally engaged in mining the Udachny diamond pipe, which was discovered in 1955 following exploration in the basin of the Daldyn River. This deposit is located in the permafrost zone 12 kilometres south of the Arctic Circle. The Udachny deposit consists of two vertically dipping conjugate ore bodies of oval shape which diverge at a depth of 300 metres.

We currently plan to keep the open-pit mine at Udachny operational until 2008, although it is expected that productivity will decrease until that year. Underground mining is scheduled to commence in Udachny in 2010 or 2011. Total production volume of the underground mine will be substantially lower than current levels of production by the open-pit method. We are currently completing feasibility studies relating to underground mining at this site. Based on our internal assessments, we believe that the diamond reserves accessible at Udachny by underground mining should be sufficient for production to continue for not less than 45 years.

- *Zarnitsa open-pit mine.* Although construction of the Zarnitsa open-pit mine has not yet been completed, this mine began limited production in 1999. This mine relates to the Zarnitsa kimberlite field, which was the first kimberlite field discovered in Siberia. Although discovered first, development of this relatively small field would have been uneconomic if a treatment plant were built specifically for the Zarnitsa field. However, the new Zarnitsa mine is able to utilise the nearby Udachny ore-processing facilities. This deposit is located approximately 15 kilometres east of Udachny. The Zarnitsa open-pit mine currently operates on a part-time basis, depending on the spare processing capacity of Ore Treatment Plant No. 12 and in 2001 approximately 3.7 million tonnes of ore were extracted from this mine. Following completion of construction, the Zarnitsa open-pit mine will have a design capacity for the extraction of up to seven million tonnes of ore per year. However, our future production levels at this mine will continue to depend upon our processing capacity and overall production requirements.

The Udachny earthmoving fleet consists of 86 vehicles, including EKG-5a, 8i, 10, 12.5 and 15 excavators, L1100 and Komatsu-579c loading machines and 120 tonne Komatsu and BelAZ and 134 tonne Caterpillar dump trucks, which are used to clear and transport bedrock.

### ***Udachny ore processing***

Ore extracted from the Udachny and Zarnitsa open-pit mines is processed at Ore Treatment Plant No. 12, which is the largest of our ore treatment facilities, and one of the three largest such facilities in the world, in terms of capacity. This plant, which commenced operations in 1976, is equipped with seven autogeneous mills. In 2002 it began operating at its full design capacity of 11 million tonnes of ore per year. In addition to the separation processes employed by our ore treatment plants, Ore Treatment Plant No. 12 also employs a flotation process to recover the smaller diamonds (as small as 0.5 millimetres) which are commonly found in the Udachny ore. The plant underwent a comprehensive refurbishment between 1986 and 1990, and it currently meets all of our technical requirements. Based on the rate of depletion of the Udachny mine and the expected level of production at Zarnitsa, we project that there will be a sufficient amount of ore to allow this plant to operate at its design capacity for an additional 50 years.

### **Mirny Division**

The Mirny division was established in 1957 to operate the Mir open-pit mine, our first mine, which was closed in 2001. It now operates the recently opened International underground mine and several alluvial mines and is constructing an underground mine at the Mir deposit. In 2001, the Mirny division processed 2.6 million tonnes of ore and produced diamonds valued at approximately U.S.\$578 million, based on average market prices. For the first nine months of 2002, it processed 2.2 million tonnes of ore and produced diamonds valued at approximately U.S.\$204 million, based on average market prices. In 1999 and 2000, this division produced diamonds valued at U.S.\$383 million and U.S.\$500 million, respectively, based on average market prices. The Mirny division produced approximately 34.7 per cent. of our total diamond production, by value, for 2001, and approximately 18.5 per cent. of our total diamond production for the nine-month period ended 30 September 2002. It accounted for approximately 24.9 per cent. and 30.8 per cent. of our total diamond production in 1999 and 2000, respectively.

### ***Mirny mines***

Information about the International underground mine and certain alluvial mines is set forth in the following table. The table does not include the Mir underground mine, which is currently under construction.

	<b>International Mine</b>	<b>Alluvial Mines</b>
Year in which mining commenced . . . . .	2002 <sup>(1)</sup>	1957
Explored depth of diamond pipe (metres) . . . . .	1,220	—
Mined depth (metres) <sup>(2)</sup> . . . . .	284 <sup>(3)</sup>	—
Target depth (metres) . . . . .	1,220	—
Ore treatment plant processing mined ore . . . . .	No. 3	No. 5

(1) Represents date of commencement of full capacity production. The International underground mine had limited commercial production starting in 1999. Open-pit mining of the International diamond pipe ended in 1981.

(2) As of 30 September 2002.

(3) This figure indicates the depth of the open pit. The International underground mine will have a target depth of approximately 1,000 metres. Following completion of the second phase of the International underground mine, we anticipate extracting approximately one million tonnes of ore per year.

- ***International underground mine.*** The International mine was our first underground mine. It relates to the International diamond pipe, a subvertical oval ore body discovered in 1955. The International diamond pipe is located in an area of compact permafrost rock near the city of Mirny. The upper part of the International diamond pipe was excavated using the open-pit method to a depth of 284 metres. Below this level, the cross-section of the diamond pipe varies slightly and a water-bearing level prevents deeper open-pit mining. As a result, the open-pit operations were terminated in 1981.

Access to the underground deposit is gained by means of two vertical shafts. The cage shaft, which is 6.5 metres in diameter and 1,065 metres deep, is used to lower and raise personnel, cargo and equipment and to provide the mine with fresh air. The skip shaft, which is 5.5 metres in diameter and 1,025 metres deep, is used to haul rock, raise personnel in emergencies, deliver fill mixture and extract air from the mine.

In 2002, we completed construction of the second phase of the International underground mine. As part of this second phase the mine became fully operational. It is expected that we will require RUB 3.0 billion (U.S.\$94.8 million) over the next five years for the completion of the second phase. The current mining plan, including the second phase, indicates a further 30 years of production for the International mine at current production levels.

- *Mir underground mine.* The Mir mine relates to the Mir diamond pipe, which is located on the left bank of the Irillyakh River near the town of Mirny. The Mir diamond pipe has confirmed diamond deposits to a depth of 1,265 metres. The Mir diamond pipe was mined as an open pit from 1958 to 2001. Although ore extraction has ceased at this mine, we processed stockpiled ore from Mir open-pit mine in 2002. Construction of the underground mine commenced in 2002 and is expected to cost U.S.\$780 million. Construction is scheduled for completion in 2008. We believe that the underground mine will produce approximately one million tonnes of ore per year, which is substantially less than the 4.5 million tonnes per year produced by the Mir open-pit mine. At this production level, the current mining plan suggests a production life for the Mir underground mine of 41 years. Continued mining of the Mir diamond pipe is expected to be difficult because of the presence of underground water and heavy mineralization throughout the deposit. However, we expect that the additional expenses will be offset by high quality diamonds extracted from the Mir mine.
- *Alluvial mining.* In addition to underground mining, the Mirny division conducts alluvial mining on the river Irillyakh, and on the Vodorazdelnye Galetchniki, Levoberezhnyi and Solur-Vostochnoe alluvial deposits. These operations involve two floating dredges that collect diamond-bearing gravel from the surface of river beds. Each of these dredges has been refurbished within the last eight years, and currently meets our technical requirements. Because the rivers freeze during the winter season, the dredges operate on the rivers only from April through November. We are currently constructing an additional dredge to conduct alluvial mining of the Gornoe deposit. We anticipate that mining operations at Gornoe will begin in 2004.

The Mirny earthmoving fleet consists of 39 underground and surface vehicles, including First Alpine underground combines, loading machines, dump trucks, drilling rigs, EGK-5a and 8i and Caterpillar 50-80 and 988fz surface excavators and 40 tonne dump trucks, which are used to clear and transport bedrock.

### ***Mirny ore processing***

Primary materials from the Mirny division are processed at Ore Treatment Plant No. 3. and Ore Treatment Plant No. 5.

- *Ore Treatment Plant No. 3.* This plant is the largest within the Mirny division, and has been operational since 1966. Plant No. 3 is located near the Mir diamond pipe deposit and was originally established for the Mir open-pit mine. Currently, the plant processes ore extracted from the International underground mine and from Mirny's alluvial operations. In addition, in 2002 it completed processing the ore extracted from the Mir open-pit mine prior to the cessation of mining operations in 2001, which had been stockpiled prior to the closure of that mine. Ore Treatment Plant No. 3 has a design capacity of up to 4.0 million tonnes of ore per year, and in 2001 it processed 2.2 million tonnes of ore. For the first nine months of 2002, it processed 1.7 million tonnes of ore. In 1999 and 2000 it processed 1.8 million and 1.7 million tonnes of ore, respectively. An upgrade to Plant No. 3 is expected to be completed in 2003. The upgrade is intended to increase capacity by 1.7 million tonnes per year and implement technologies to reduce electricity



consumption and the amount of equipment required for processing. Based on the expected productive lives of the mines it currently services and the expected addition of the Mir underground operation, we project that there will be a sufficient amount of ore to allow this plant to operate at its design capacity for an additional 50 years.

- *Ore Treatment Plant No. 5.* This plant processes diamond-bearing gravel from the Mirny alluvial dredges, and commenced operations in 1961. Similar to the operations of the alluvial dredges, its operations are seasonal, generally lasting from May to October. Ore Treatment Plant No. 5 has a design capacity of 450,000 cubic metres of diamond-bearing gravel per season, and in 2002 it began operating at full capacity. We estimate that there will be a sufficient amount of ore to allow this plant to operate at its design capacity for at least an additional six years.

## **Aikhal Division**

The Aikhal division operates the Aikhal and Jubilee mines. In 2001, the Aikhal division processed 12.3 million tonnes of ore and produced diamonds valued at U.S.\$355 million, based on average market prices, including diamonds valued at U.S.\$71 million produced by the Sytykan open-pit mine, which closed in 2001. For the first nine months of 2002, this division processed 9.8 million tonnes of ore and produced diamonds valued at U.S.\$229 million, based on average market prices. In 1999 and 2000, the Aikhal division processed 12.1 million and 11.3 million tonnes of ore, respectively, and produced diamonds valued at U.S.\$311 million and U.S.\$334 million, respectively, based on average market prices. The Aikhal division produced approximately 21.3 per cent. of our total diamond production, by value, for 2001, and approximately 20.7 per cent. of our total production, by value, for the nine-month period ended 30 September 2002. It accounted for approximately 20.2 per cent. and 20.6 per cent. of our total diamond production in 1999 and 2000, respectively.

### ***Aikhal mines***

The Aikhal division operates the Aikhal underground mine, which is currently in a pilot phase, the Jubilee open-pit mine and the Komsomolskaya open-pit mine, which began operations in 2002. Information about the Aikhal, Jubilee and Komsomolskaya mines is set forth in the following table:

	<u>Aikhal Mine</u>	<u>Jubilee Mine</u>	<u>Komsomolskaya</u>
Year in which mining commenced . . . . .	1998 <sup>(1)</sup>	1989	2002
Explored depth of diamond pipe (metres) . . . . .	900	1,100	300 <sup>(2)</sup>
Mined depth (metres) <sup>(3)</sup> . . . . .	350 <sup>(4)</sup>	210	50
Target depth (metres) . . . . .	700	500	250
Ore treatment plant processing mined ore . . . . .	No. 8	No. 14	No. 14

(1) The mine is currently operating in a pilot phase, with full production scheduled to commence in 2006. Upon completion, the mine is expected to produce approximately 0.5 million tonnes of ore per year. From 1961 to 1997, the Aikhal deposit was mined using the open-pit method.

(2) Exploration will be conducted in two stages, and the diamond pipe will be explored to a greater depth in the future.

(3) As of 30 September 2002.

(4) This figure indicates the depth of the open pit. The underground shaft target depth is approximately 700 metres.

- *Aikhal underground mine.* The Aikhal mine relates to the Aikhal diamond pipe, which was discovered in 1960. The Aikhal diamond pipe is located in the permafrost zone, 450 kilometres north of Mirny. Geologically, it is an explosion diamond pipe extending in a north-eastern direction. In December 1997, the open pit reached its target depth of 340 metres, and the decision was made to begin underground mining. We began construction of the Aikhal underground mine in 1998. Currently, the first of three shafts has been completed, along with the lift machine, compressor and ventilation stations. We anticipate that the underground portion of the mine will reach a target depth of approximately 350 metres below the existing floor of the open pit. According to the

development plan for this mine, the Aikhal underground mine will begin full production in 2006. We anticipate that the total cost of construction of the underground mine will be RUB 8.0 billion (U.S.\$265 million). Currently, the Aikhal underground mine is in a pilot phase, in which approximately 220,000 tonnes of ore were produced in 2002, with a projected output of 500,000 tonnes per year starting in 2006. This is the first mine in which production has begun prior to completion of construction. At the projected level of 500,000 tonnes of ore extracted per year, the current plan indicates a further 25 years of productive life for the Aikhal mine.

- *Jubilee open-pit mine.* The Jubilee open-pit mine relates to the large Jubilee diamondiferous ore deposit, discovered in 1975, approximately 15 kilometres northwest of the city of Aikhal. It is one of the largest diamond pipes in Russia. The Jubilee diamond pipe consists of three vertical ore bodies (western, central and eastern), composed of various types of ore. The diamond pipe is located in an area of compact permafrost rock. The current mining plan indicates more than 20 additional years of production for the Jubilee mine at current production levels. The Jubilee deposit is unusual in that the quality of diamonds has increased with the depth of the mine.
- *Komsomolskaya open-pit mine.* In 2002 we began mining operations at the Komsomolskaya diamondiferous ore deposit. The deposit is located approximately eight kilometres northwest of the city of Aikhal. The target depth of the mine is 220 metres, although diamond reserves have been identified at depths of up to 300 metres at this site. The Komsomolskaya open-pit mine began production in 2002, with a production of 500,000 tonnes of ore. In 2002, the Komsomolskaya mine produced diamonds valued at U.S.\$14.7 million, based on average market prices. We anticipate future production levels of 1.3 million tonnes of ore per year beginning in 2003. At projected production levels, we anticipate the Komsomolskaya mine will have a production life of at least 20 years.

The Aikhal earthmoving fleet consists of: 56 heavy-duty and 41 small dump trucks; 24 excavators and loading vehicles, including an H-285S hydraulic shovel with a 16 cubic metre bucket, EGK-5a, 8i, 12.5 and 15 and L-1100 and Caterpillar 570c excavators and loading machines; 120 tonne Komatsu and BelAZ trucks; and underground dump trucks, which are used to clear and transport bedrock.

#### *Aikhal ore processing*

The Aikhal division currently has a relatively large production stockpile of ore. The amount of ore stock awaiting processing is an amount equal to one year's combined processing capacity of the Aikhal treatment plants. Ore from the Aikhal division is processed at Ore Treatment Plant No. 8. and Ore Treatment Plant No. 14.

- *Ore Treatment Plant No. 8.* Ore Treatment Plant No. 8 was constructed in 1966, and it currently processes ore from the Aikhal underground mine. Since 2002, it has also processed ore from the Komsomolskaya open-pit mine. It has a design capacity of 1.6 million tonnes of ore per year, and in each of 2001 and the first nine months of 2002, it processed 1.6 million tonnes of ore. We have adopted a reconstruction and modernisation programme for this plant, which we expect to complete in 2004. Based upon the anticipated depletion rates of the Aikhal and Komsomolskaya diamond pipes, we project that there will be a sufficient amount of ore to allow this plant to operate at its design capacity for an additional 24 years.
- *Ore Treatment Plant No. 14.* Built in 1996, Plant No. 14 has modern wet x-ray sorters which assist us in recovering large, high-quality gem stones. In 1999 Ore Treatment Plant No. 14 processed 9.6 million tonnes of ore. However, it exceeded its design capacity of ten million tonnes of ore per year in 2001, processing 10.7 million tonnes in that year. For the nine-month period ended 30 September 2002, Ore Treatment Plant No. 14 processed 8.2 million tonnes of ore. This plant processes ore primarily from the Jubilee diamond pipe. We are currently engaged in a project to increase the automation in Ore Treatment Plant No. 14 and to increase its capacity to 11.4 million tonnes per year, which is expected to be completed in 2004. This upgrade is anticipated to cost

U.S.\$400,000. Based on the expected rate of depletion of the Jubilee diamond pipe, we estimate that there will be a sufficient amount of ore to allow this plant to operate at its design capacity for at least an additional 25 years.

## Nyurba Division

The Nyurba division operates the partially completed Nyurbinskaya open-pit mine and several alluvial mines. In addition it is constructing the Botuobinskaya open-pit mine. Prior to 2002, the Nyurba division had only limited production. The Nyurba division produced approximately 6.3 per cent. of our total diamond production, by value, in the nine-month period ended 30 September 2002. The current mining plan provides for the development of the Nyurbinskaya diamond pipe followed by the Botuobinskaya diamond pipe. Under the mining plan, these two diamond pipes will produce diamonds at or in excess of current production levels for an additional 22 years.

The prospecting license under which the Nyurba division operates is held by a majority-owned subsidiary, ALROSA-Nyurba. ALROSA Ltd. owns 88.2 per cent. of ALROSA-Nyurba, the local administration owns 10.0 per cent. and the remaining 1.8 per cent. is held by our management and employees. All work at the Nyurba mines is performed by the Nyurba division pursuant to a services agreement with ALROSA-Nyurba.

## Nyurba mines

Information about the Nyurbinskaya and Nyurba alluvial mines is set forth in the following table. The table does not include the Botuobinskaya open-pit mine, which is currently under construction.

	Nyurbinskaya Mine	Alluvial Mines
Year in which mining commenced . . . . .	2002 <sup>(1)</sup>	2002
Explored depth of diamond pipe (metres) . . . . .	870	—
Mined depth (metres) <sup>(2)</sup> . . . . .	20	—
Target depth (metres) . . . . .	360 <sup>(3)</sup>	—
Ore treatment plant(s) processing ore . . . . .	No. 15	No. 15

(1) Represents limited production during the construction of the mine. Upon completion, the mine is anticipated to produce approximately 1.2 million tonnes of ore per year.

(2) As of 30 September 2002.

(3) Represents target depth for open-pit mining.

- *Nyurbinskaya open-pit mine.* The Nyurbinskaya mine, which is expected to be completed in 2004, relates to the Nyurbinskaya diamond pipe located in the Sredne-Markhinsky kimberlite field. This deposit is located in the permafrost zone 175 kilometres south of the Arctic Circle. The field consists of two diamond pipes, the Nyurbinskaya and the Botuobinskaya. The field also contains diamondiferous formations adjacent to the diamond pipes. We plan to develop this diamond pipe using, initially, open-pit mining, followed by underground mining once a depth of 300 to 360 metres is reached.
- *Botuobinskaya open-pit mine.* The Botuobinskaya mine will be put into operation to compensate for the depletion of the Nyurbinskaya deposits. It relates to the Botuobinskaya diamond pipe which was discovered in the Sredne-Markhinsky kimberlite field in 1994. We anticipate that open-pit mining will be used initially, followed by underground mining to develop this diamond pipe. We believe that parallel mining of the deeper levels of the Nyurbinskaya diamond pipe and of the reserves of the Botuobinskaya diamond pipe will make it possible to maintain the aggregate ore yield of the entire facility largely unchanged over time. We expect to complete construction of this mine in 2015, and, once completed, it is expected that it will produce 1.2 million tonnes of ore per year.

Based on geological surveys, we believe that the reserves and the diamond content of the Nyurbinskaya and Botuobinskaya diamond pipes will be comparable or superior to our other deposits and may have a production life of at least 30 years.

- *Alluvial mining.* In addition to open-pit mining, the Nyurba division conducts alluvial mining. In 2002, these alluvial operations produced 455,000 tonnes of diamond-bearing gravel, of which 260,000 tonnes were processed.

The Nyurba earthmoving fleet consists of 15 vehicles, including Caterpillar excavators and 120 tonne Komatsu and BelAZ and 134 tonne Caterpillar dump trucks, which are used to clear and transport bedrock.

#### ***Nyurba ore processing***

Ore from the Nyurba division is processed at Ore Treatment Plant No. 15 and will be processed at Ore Treatment Plant No. 16 when that facility is completed.

- *Ore Treatment Plant No. 15.* Ore Treatment Plant No. 15 commenced operations in July 1999. The plant initially processed ore extracted by our geologists in connection with the exploration of the Nyurbinskaya mine. Once the reserves were proven, the plant began processing production ore in 2001. The design capacity of Ore Treatment Plant No. 15 is 0.3 million tonnes per year, and in 2002, Ore Treatment Plant No. 15 processed approximately 0.3 million tonnes from the Nyurbinskaya mine, as well as the gravel produced by the alluvial operations. This is a seasonal plant because milling takes place outside the main building. Its season of operation runs from June to October. We believe that we could convert this plant into a continually operating facility by constructing a building around the milling equipment, if additional capacity is required. Based upon the anticipated depletion of the Nyurbinskaya and Botuobinskaya diamond pipes, we estimate that there is a sufficient amount of ore to allow this plant to operate at its design capacity for a further 25 years.
- *Ore Treatment Plant No. 16.* Ore Treatment Plant No. 16 is currently under construction and is scheduled to become operational in August 2003, with production beginning later that year. The cost of completion is expected to be U.S.\$146 million. When completed, Ore Treatment Plant No. 16 will have the highest level of automation of any of our ore treatment facilities. The plant will process ore from the Nyurbinskaya and Botuobinskaya mines. It has a design capacity of 1.5 million tonnes of ore per year. Based upon the anticipated depletion rates of the Nyurbinskaya and Botuobinskaya diamond pipes, we estimate that there is a sufficient amount of ore to allow this plant to operate at its design capacity for at least an additional 25 years.

#### **Anabar Division**

The Anabar division was established in 1984. It operates in the far north of Yakutia, and carries out alluvial diamond mining within the Anabar district. In 2001, the Anabar division processed 0.4 million tonnes of diamond-bearing gravel and produced diamonds valued at U.S.\$25 million, based on average market prices, through seasonal production. For the nine-month period ended 30 September 2002 it processed 0.3 million tonnes of ore and produced diamonds valued at U.S.\$18 million, based on average market prices. In 1999 and 2000, this division produced diamonds valued at U.S.\$15 million and U.S.\$16 million, respectively, based on average market prices. The Anabar division accounted for approximately 1.5 per cent. of our total diamond production, by value, for 2001, and produced approximately 1.6 per cent. of our total diamond production, by value, for the first nine months of 2002. The Anabar division accounted for approximately one per cent. of our total diamond production in each of 1999 and 2000.

### ***Anabar alluvial mines***

The Anabar division mines three alluvial deposits on the river Ebelyakh, and is preparing to mine alluvial deposits on the smaller rivers Urass-Yuriakh, Kholomolokh, Istok, Gusinyi and Morgogor. These operations involve an ore-treatment plant and five flushing units, which are used for the preparation and/or processing of ferrous gravel. These units operate during a 100-day season, and have the capacity to process approximately 150,000 cubic metres of sand. The Anabar mines generally produce smaller diamonds, some of which are as small as 0.5 millimetres. As a result, the Anabar diamonds generally have per-carat values of only up to U.S.\$20. However, the operating expenses of alluvial mines are relatively low compared with open-pit and underground mines.

The Anabar division earthmoving fleet consists of 20–30 tonne BelAZ dump trucks and a Komatsu excavator.

### ***Anabar gravel processing***

The gravel extracted from the Anabar alluvial mines is processed at Ore Treatment Plant No. 13. Construction of this plant began in 1997. During 2001, a preparing unit was built at this plant, which was designed to condense extracted gravel by removing the non-diamond-bearing gravel, thereby reducing the cost of transporting gravel from the placer deposit. The design capacity of Ore Treatment Plant No. 13 is approximately 800,000 tonnes per year. Seasonal mining of the Anabar alluvial deposits limits production at the plant to a 100-day period from June to September. Based upon the anticipated depletion of the Anabar alluvial deposits, we anticipate that there will be a sufficient amount of diamond-bearing gravel to allow this plant to operate at its design capacity for an additional 50 years.

### **Our Severalmaz Subsidiary**

We control approximately 71.9 per cent. of Severalmaz, a diamond mining company which holds the license to mine the Lomonosov diamond field in the Arkhangelsk region of north-western Russia. The remaining 28.1 per cent. is owned as to 25.6 per cent. by the administration of the Arkhangelsk region and as to 2.5 per cent. by individuals. Our total investment in Severalmaz at 30 September 2002 was RUB 2,173 million (U.S.\$68.7 million).

The Severalmaz project is currently in its pilot stage. We began construction of an open-pit mine on the site in July 2002, and it is expected that construction will be completed by the end of 2004. In this initial stage, commercial extraction of ore has commenced at low levels, and ore is being processed at a temporary plant. Revenues from the sale of diamonds from this deposit will be used to fund the construction costs, and we do not have any obligations to contribute additional capital to this joint venture. Severalmaz is currently considering seeking a foreign investor for the subsidiary.

Difficult mining conditions exist in the area being developed by Severalmaz, including large volumes of groundwater. Technologies are currently being tested for use in the next stage of full production. These technologies primarily relate to the removal of groundwater from the mining area.

In the next stage of the project, a larger processing plant will be built in connection with the completion of the mine. This plant will have a design capacity sufficient to process approximately one million tonnes of ore per year. The Severalmaz deposit has U.S.\$3.6 billion of proven reserves, based on average market prices of diamonds comparable to those contained in Severalmaz's reserves as of 31 December 2000. To help its initial search for investors, the Severalmaz joint venture received a special exemption from the State secrecy restrictions to disclose this reserve figure.

### **The Catoca Mine in Angola**

In 1989, our predecessor entered into a cooperation agreement with Endiama, Odebrest Mining Services Inc. of Brazil and Israel's Daumonti Financing Company B.V. In 1992, these parties agreed to



establish Catoca Mining Ltd. as a joint venture to mine the Catoca diamond pipe in Angola. This diamond pipe is located in the Luande Norte Province in eastern Angola, approximately 1,000 kilometres north of that nation's capital. Catoca Mining Ltd. is the only company engaged in the development of a diamond pipe within Angola. We currently have a 32.8 per cent. interest in Catoca Mining Ltd. In addition, Endiama owns 32.8 per cent., Odebreest owns 16.4 per cent. and Daumonti Financing Company B.V owns 18.0 per cent. of Catoca Mining Ltd. See "Risk Factors—Risks Relating to Our Business—Catoca Mining Ltd., our minority-owned Angolan subsidiary, is subject to the risks of doing business in Angola".

Catoca Mining Ltd. is self-financing, and we are not required to make additional capital contributions. Currently we receive dividends from this joint venture, which for the years ended 31 December 2000 and 2001 totalled RUB 191 million (U.S.\$6 million) and RUB 294 million (U.S.\$9 million), respectively. We received no dividends in 1999.

The Catoca diamond pipe is one of the largest diamond pipes in the world with a diamond pipe outcrop area covering approximately 657,000 square metres, and the deposit has been explored to a depth of 600 metres. Surveys conducted by our research institution, YakutNiproAlmaz, as confirmed by the Angolan Ministry of Geology, have indicated that the Catoca diamond pipe contains 62 million cubic metres of ore volume at a depth of up to 100 metres, an average diamond content of 0.7 to 0.8 carats per cubic metre and reserves of approximately 60 million carats. We believe that, based on ore body size, mining conditions and the quantity and quality of diamonds, the Catoca diamond pipe is comparable to other diamond mines such as the Orapa in Botswana, the Premier in the Republic of South Africa and our Udachny mine. The venture is operating on a concession basis, and is not required to purchase mineral rights to the Catoca deposit.

The Catoca mine commenced production in August 1997. In the first five years of production, the Catoca mine produced 7.5 million carats of diamonds worth approximately U.S.\$526 million. In 2001, the Catoca mine processed 2.6 million tonnes of ore and produced 2.7 million carats of diamonds. The cost per tonne of ore processed at Catoca for 2001 was U.S.\$12.94. Because resource depletion has been minimal, the current mining plan indicates a further 30 years of production for the Catoca mine at the production levels projected for the second stage of mining. Catoca Mining Ltd. sells its diamonds through ASCORP, an export agency of the Angolan government. As of 30 September 2002, the Catoca operations employed 1,900 persons, including 117 of our employees seconded to the joint venture.

The Catoca Mining Ltd. investors have recently agreed to commence a second phase of development of the Catoca diamond field, which is expected to increase production and processing capacity to seven million tonnes per year through the expansion of its processing plant. The total cost to complete the second phase is expected to be approximately U.S.\$50.8 million, which will be completely self-financed through the revenues of Catoca Mining Ltd. YakutNiproAlmaz is providing all design services in connection with the second phase, and the work is being supervised by our representative.

In addition to the second stage development of the Catoca mine, we have entered into a letter of intent with the Angolan government to jointly develop, through the joint venture entity Hydroshikupa Ltd., a hydroelectric station to supply electricity to Catoca. This project is expected to cost approximately U.S.\$45 million. We have also agreed to construct a new mine in Angola to extract diamonds from the two Lour diamond pipes, which have ore of similar quality to the Catoca diamond pipe. Total capital expenditures for this project are expected to be approximately U.S.\$100 million. The Lour diamond pipes are to be mined by Kamachia-Kamagiku Ltd., a joint venture entity in which we intend to acquire a 25 per cent. interest. There is currently no agreement as to the structure or capital allocation of these projects, including our required investment.

Catoca Mining Ltd. maintains a policy of social responsibility designed to assist the local communities and improve local living standards. This programme entails vocational training, fair wages and free medical care for workers. In addition, Catoca Mining Ltd. provides relief aid to refugees and displaced persons,

restores bridges, builds local water supplies and has begun to build a hospital in Saurimo, the capital of Luanda Norte Province.

### **Diamond Sorting and Valuation**

After rough diamonds have been recovered through the ore treatment processes, the diamonds are sorted in accordance with their value. The valuation of diamonds is conducted by our division, the United Selling Organisation, which maintains sorting facilities in Mirny and in Moscow. As of 30 September 2002, the United Selling Organisation had 1,005 employees, including 136 sorters in Yakutsk and 456 sorters in Moscow.

The Mirny sorting facility receives rough diamonds directly from our Yakutian mining operations and performs the initial valuation of these stones. The diamonds are weighed and the largest stones, those weighing 10.8 carats or more, are forwarded to our valuation experts in Moscow to assign values to these diamonds based on the special methodology adopted by the Ministry of Finance of Russia. All diamonds are individually sorted, except that diamonds weighing three grainers or less are sorted on the basis of representative samples. In this initial sorting, the valuation is made on the basis of 16 categories, including, amongst other things, the quality, size and special characteristics of the diamonds. This valuation is conducted under the supervision of representatives of Gokhran, the diamond depository of Russia, who set the valuation methodology, and the initial values assigned to each stone are based on the Price List which is maintained and updated from time to time by the Ministry of Finance of Russia. We believe that this oversight by Gokhran helps us to ensure that we maintain and consistently comply with the appropriate sorting standards. Our sorting and valuation processes are certified by the Russian Committee for Standards, and they meet the requirements of ISO 9000, an internationally recognised set of instructions for the operation of a quality management system.

Following the first sorting, we send our diamonds by air to Moscow where they are sorted again in our licensed sorting facility. In this second sorting, the diamonds are sorted on the basis of 32 categories and, if necessary, further chemical treatment of the diamonds is performed. As in Mirny, the sorting is monitored by Gokhran representatives. This second sorting verifies and adjusts the initial value assigned to each diamond. Because diamond valuation is based on certain judgements involving the 30,000 to 40,000 characteristics which determine value and because the second sorting involves finer distinctions among stones, there is often a small variation between the first and second valuations, which is generally between 1 per cent. and 3 per cent. of the initial valuation. We use the initial values for internal business planning purposes and for the purpose of insuring the transportation of these diamonds.

We are the only company in Russia which sorts diamonds, and we have received a license from the Government of Russia to conduct these activities. We are in a unique position to operate sorting facilities because of our extensive inventory of rough diamond samples, representing each sorting classification and sub-classification. These samples are referred to by the sorters in order to confirm their classifications. These diamond samples have been taken from our own production, as well as from De Beers' inventory. In addition, we have developed extensive internal know-how with respect to diamond classifications and we maintain an internal programme for training our diamond sorters.

Our 32 category classification system is largely based on the De Beers "sample" system, which was established in 1989 and is generally accepted as the international standard. Because De Beers is continually refining its classification system, we make adjustments from time to time to our system to eliminate discrepancies. However, differences sometimes exist between the De Beers classification system and our own as we implement the necessary adjustments to our system.

Following the second sorting, our gem and near-gem diamonds are grouped into "boxes" of diamonds, and the boxes are collected into lots for sale. Each box contains an assortment of different types of diamonds, having an aggregate weight equal to a standard number of carats. The standard number of carats contained in a box varies depending on the quality of diamonds offered in the box. Within a box, the



individual diamonds may vary widely by weight and other characteristics. All of our gem and near-gem diamonds are individually tracked by computer, and the placement of diamonds into boxes, and the collection of boxes into lots, is determined by this computerised tracking system. Each box is assigned a price based on the aggregate valuation of the diamonds within the box. See “–Sales of Rough and Polished Diamonds–Domestic sales of gem and near-gem rough diamonds”. As part of this process we reserve one-third of our of gem and near-gem diamonds for inclusion in lots to be sold to De Beers. See “–Sales of Rough and Polished Diamonds–Export of gem and near-gem rough diamonds”. In addition, larger diamonds that we are either required to sell by domestic tender or to the Government of Russia are segregated. See “–Regulatory and Environmental Matters–Licenses”.

The lots not assigned to De Beers are offered to domestic purchasers, and preferred customers are typically permitted to review these lots first. Representatives of prospective buyers inspect the boxes on offer, and each buyer generally has the right to reject up to 20 per cent. of the boxes within a lot for any reason. The price of the rejected boxes is then deducted from the total sales price of the lot. As more fully described in “–Sales of Rough and Polished Diamonds”, boxes that are not sold on the domestic market are offered to De Beers.

In addition to sorting, the United Selling Organisation performs additional services. These include arranging the transport of diamonds to purchasers and complying with customs requirements in connection with exported diamonds. The United Selling Organisation also maintains secure facilities in which representatives of De Beers and other diamond buyers can inspect the lots of diamonds being offered.

We do not maintain an inventory of diamonds. However, because several months can elapse between extraction of a diamond and its ultimate sale, we maintain a rolling stock of diamonds which are in the process of being sorted, valued and distributed.

The diamonds extracted from the Catoca mine are sorted by Catoca Mining Ltd. in Angola.

## **Sales of Rough and Polished Diamonds**

*The sales figures provided in this section “Sales of Rough and Polished Diamonds” are presented on an historical rather than on an inflation-adjusted basis.*

Our gem and near-gem rough diamonds are primarily sold in one of the following ways:

- *Exports through De Beers.* In 2001 and during the nine-month period ended 30 September 2002, exports through De Beers accounted for approximately 50 per cent. and 42 per cent., respectively, of our diamond sales. In addition we export polished diamonds, as well as rough diamonds through Almaziuvelirexport and directly export diamonds within the CIS. See “–Export of gem and near-gem rough diamonds” below.
- *Domestic sales.* Approximately 37 per cent. of 2001 diamond sales, amounting to U.S.\$651 million, and approximately 48 per cent. of total diamond sales for the nine-month period ended 30 September 2002, amounting to U.S.\$581 million, were made to domestic purchasers (including diamond sales to CIS customers), primarily Russian cutting and polishing companies that process the diamonds for use in jewellery. In addition, we are required to sell diamonds having a weight of 10.8 carats or more only through auctions held within Russia in accordance with rules and procedures established by the Government of Russia, except for those stones sold by Gokhran and polished by Brillianty ALROSA. See “–Domestic sales of gem and near-gem rough diamonds” below.
- *Sales to the Government of Russia and the government of Yakutia.* The Government of Russia and the government of Yakutia have the right to acquire diamonds from us, including all rare diamonds having “special gemological qualities” as determined by the Ministry of Finance of Russia, at

agreed market prices pursuant to the Lease Agreement and the licenses under which we operate. See “–Regulatory and Environmental Matters–Lease Agreement”. In 2001, we made no diamond sales to Russia and we sold diamonds with an aggregate value of U.S.\$37 million to Yakutia, and for the nine-month period ended 30 September 2002, we made no diamond sales to Russia and our sales to Yakutia amounted to U.S.\$6.2 million. See “–Sales of rough diamonds to Russia and Yakutia”.

- *Sales of polished diamonds through Brillianty ALROSA.* We also cut and polish some of our rough diamond production through our Brillianty ALROSA division, and to a lesser extent through subsidiaries, and sell these stones as finished diamonds. Our sales of polished diamonds were approximately U.S.\$133.8 million in 2001, and U.S.\$84.8 million for the nine-month period ended 30 September 2002. See “–Sales of polished diamonds” below.

The division of our rough diamond production between the domestic and export sales channels is driven to a large extent by domestic demand. In practice, as part of our sorting process we set aside for our sales to De Beers approximately one-third of our total production of gem and near-gem diamonds, excluding diamonds having a weight equal to or more than 10.8 carats, which must be sold through an auction process within Russia. The remaining diamonds are offered to domestic purchasers and, to the extent that these diamonds remain unsold on the Russian market, they are sold to De Beers. As described below in “–Domestic sales of gem and near-gem rough diamonds”, we attempt to manage domestic demand to achieve prices for our diamonds that are no less than the prices established according to the De Beers Trade Agreement.

We have conducted our export sales of industrial diamonds almost exclusively through Almaziuvelirexport, a jewellery exporter owned by the Government of Russia. We sold industrial diamonds with an aggregate value of U.S.\$8 million and U.S.\$5 million in 2001 and during the nine-month period ended 30 September 2002, respectively. See “–Sales of industrial diamonds” below. Under the 2002 Decree, we are now authorised to directly sell our industrial diamonds to purchasers outside Russia and are no longer required to conduct such sales through Almaziuvelirexport, and we are considering plans to directly market these stones.

We have established representative offices in London, England; Luanda, Angola; Ramat-Gan, Israel; and Antwerp, Belgium. We established these offices to maintain a presence in the important jurisdictions involved in the diamond trade, particularly Belgium, where the world’s largest diamond exchange is located. These offices conduct diamond market research, maintain business contacts with local diamond authorities and organisations and conduct marketing and advertising activities for our benefit. In addition, the representative offices cooperate with local media on matters relating to our operations. In anticipation of the liberalisation of the Russian diamond market, our office in Antwerp, Belgium has made experimental purchases and sales of diamonds.

#### ***Export of gem and near-gem rough diamonds***

In the past, we were the only company authorised to export rough diamonds, other than the Government of Russia-owned Almaziuvelirexport. However, the 2002 Decree, which became effective on 6 February 2003, authorised all diamond mining enterprises to export their production, subject to restrictions on sales of large and rare diamonds. See “–Regulatory and Environmental Matters–Licenses” and “Industry Overview–Liberalisation of the Russian Diamond Market”. Currently, the only other diamond mining companies with the right to mine diamond pipes within Russia are our majority-owned subsidiaries Severalmaz and ALROSA-Nyurba. In addition, the 2002 Decree authorises diamond-cutting entities to export up to 15 per cent., by value, of the rough diamonds they purchase in any year from Russian diamond mining companies or from the Government of Russia’s diamond stocks, provided that (i) the diamonds had been offered for sale on the domestic market and were not sold within ten business days and (ii) the export sale price is at least as high as the price at which the diamonds were offered on the domestic market.

The maximum amount of diamonds that we can export each year, by value, is determined pursuant to a periodic export quota set by the Government of Russia. By law, the quota for each period is issued one month prior to the end of the prior period, although, in practice, there may be delays. Historically, we have been granted annual quotas. However, the 2002 Decree authorised the Government of Russia to grant multi-year quotas of up to five years, and in February 2003 we were granted a five-year quota to export up to U.S.\$800 million of diamonds each year, based on current market value. See “Industry Overview—Liberalisation of the Russian Diamond Market”. The quota amounts, as expressed in carats, are protected as State secrets, and are therefore not disclosed. See “Risk Factors—Risks Relating to Our Business—We are prohibited from disclosing our Russian diamond reserves and other information which may be considered material by investors”. Exports of rough diamonds are subject to a customs duty of 6 per cent., calculated on value as stated in the relevant export contract.

Pursuant to the 2002 Decree, we must obtain a certificate from the Government of Russia confirming the origin of the rough diamonds we export. This regulation represents the implementation in Russia of the Kimberley Process, a self-regulatory system devised by the World Diamond Council and the United Nations which relies on certificates of origin in an attempt to eliminate trading in “conflict diamonds”, the name ascribed to diamonds which are extracted in war-torn regions and sold by rebel forces to fund insurrection.

Historically, we have relied on De Beers for the export of our rough gem and near-gem diamonds. In the past our export license agreements required us to make our export sales through De Beers; however, as described below, pursuant to the 2002 Decree, which became effective in February 2003, export restrictions requiring sales through De Beers have been abolished. Our sales to De Beers were approximately U.S.\$869 million in 2001 and U.S.\$501 million for the nine-month period ended 30 September 2002. In 1999 and 2000 such sales were U.S.\$312 million and U.S.\$392 million, respectively. De Beers resells the diamonds that it purchases from us on the world market through the DTC.

On 17 December 2001, we entered into the new five-year De Beers Trade Agreement. Under the De Beers Trade Agreement, we have agreed to sell, and De Beers has agreed to buy, each year, a maximum of U.S.\$800 million in value of our current production of natural rough diamonds. The prices paid by De Beers for our rough diamonds under the agreement are based on a schedule of prices agreed by the parties, which they may agree to amend from time to time. Payment for diamonds is made at the time of shipment, and the cost of transportation of diamonds from our Moscow facilities, including the cost of insurance, is the responsibility of De Beers. Sorting of diamonds under the De Beers Trade Agreement is performed by representatives of both parties based on agreed samples taken from the shipments. Either party can terminate the agreement if they are unable to resolve a disagreement as to sorting relating to more than 5 per cent. of the total value of a shipment or if there is a material breach of the terms of the agreement.

We are required by law to withhold from our lot sales to De Beers “representative control parcels” equivalent to 5 per cent. of such sales, by value. These control parcels of rough diamonds are sold outside of Russia by Almaziuvelirexport as our agent, less a 1.5 per cent. commission. Sales of these control parcels enable the Government of Russia to verify whether the prices paid to us by De Beers for rough diamonds are representative of market prices. The De Beers Trade Agreement allows us to withhold these representative control parcels, which are not counted as part of the export quota and do not affect the total annual volume of trade between us and De Beers.

In anticipation of the 2002 Decree, the De Beers Trade Agreement also contains a provision allowing us to export up to 15 per cent. of our production, in addition to the 5 per cent. control parcels, through channels other than De Beers in the event that we are allowed to do so pursuant to the adoption of a decree on market liberalisation. Although the 2002 Decree, which was adopted after the execution of the De Beers Trade Agreement, eliminated the requirement that we export our rough gem and near-gem diamonds solely through De Beers, we intend to continue to sell substantially all of our exports of rough diamonds through De Beers. To the extent that we explore opportunities to export our rough diamonds

through sales channels other than De Beers in the future, we anticipate that, at least initially, any such sales would be limited to diamonds that are not to be supplied to De Beers. See “Industry Overview–Liberalisation of the Russian Diamond Market”.

Although we entered into the De Beers Trade Agreement on 17 December 2001, that agreement will only become effective if and when we receive confirmation from the Directorate-General that the agreement is consistent with the provisions of the Treaty of the European Communities. The Directorate-General is continuing its investigation into the impact of the De Beers Trade Agreement, and in January 2003 it issued a Statement of Objections which sets forth its initial objections to the implementation of the De Beers Trade Agreement. In view of the Statement of Objections, we can offer no assurance that the De Beers Trade Agreement will be approved on terms acceptable to us, or that it will be approved by the European Commission in any form. Pending the outcome of the investigation, we have been selling diamonds to De Beers on the basis of *ad hoc* written agreements, negotiated with respect to each separate shipment. However, we cannot guarantee that an adverse decision by the Directorate-General will permit us to continue to engage in such *ad hoc* agreements with De Beers. See “Risk Factors–Risks Relating to Our Business–We are dependent on De Beers for the distribution of our diamonds outside of the Commonwealth of Independent States” and “–The De Beers Trade Agreement is subject to European Commission approval”.

#### *Domestic sales of gem and near-gem rough diamonds*

In 2001 and for the nine-month period ended 30 September 2002, we sold approximately U.S.\$647 million and U.S.\$581 million, respectively, of our rough diamonds to domestic purchasers, which includes all purchasers within the CIS. In 1999 and 2000, such sales were U.S.\$564 million and U.S.\$655 million, respectively.

Our domestic sales are primarily made to Russian cutting and polishing companies. We believe that we supply the vast majority of diamonds purchased by these companies. We believe this is partly due to the fact that VAT would apply to the purchase of rough diamonds from sources outside of Russia, which would significantly reduce the margins that these companies could achieve by polishing imported diamonds. Other factors include price disparities between the domestic market and the DTC’s prices in the international market.

Domestic polishing companies specialise in the production of “Russian cut” diamonds. This is a relatively high-quality cut, which requires diamonds of a sufficient size and of sufficiently high quality. However, as an emerging market, Russia consumes mainly lower-value diamonds, including substantial imports from India which dominates the market for polishing smaller, lower-quality diamonds. As a result, the Russian cutting and polishing industry mainly produces polished diamonds for export. We believe that, except for a small number of companies, Russian cutting and polishing operations have minimal working capital, and generally perform work based on advances provided by large diamond companies outside of Russia.

Although there are approximately 100 cutting and polishing facilities registered with the Russian Ministry of Finance of Russia, the domestic industry is dominated by, and our largest customers are:

- *Kristall in Smolensk*. This is one of the largest polishing operations in the world with approximately 900 polishers. Kristall is controlled by the Government of Russia.
- *Tuimada Group in Yakutsk*. This group is estimated to have over 500 polishers. We own approximately 12.7 per cent. of the Tuimada Group.
- *Ruiz Diamond in Moscow*. This facility is controlled by Lev Liviev of Israel.
- *Brillianty ALROSA in Moscow*. Brillianty ALROSA is our branch. It operates a facility with approximately 250 polishers, and it has a long-term contract with Kristall, a polishing company in Barnaul with an additional 180 polishers who polish diamonds for our account.

We maintain an approved list of cutters and polishers to whom we sell diamonds. Diamond polishers may be added to this list, upon request, following our review of their standing in the industry. In general, our larger, established customers have priority in selecting diamond lots for purchase.

We offer to the domestic market our full range of gem and near-gem rough diamond production, with the exception of approximately one-third of our production which is initially set aside for sale to De Beers and rare diamonds which may only be sold to Russia. The prices at which we sell diamonds on the domestic market are established by us with reference to the Price List maintained by the Ministry of Finance of Russia. However, we make adjustments to the prices specified in the Price List by establishing correction factors by which the Price List figures are multiplied. Based upon changes in market conditions, our marketing department periodically suggests new correction factors, which may be made effective by order of our president. The correction factor system helps us to react promptly to changes in the domestic rough diamond market, as it often takes one to three months for these changes to be reflected in an updated Price List.

In setting these correction factors, our objective is to manage the allocation between the domestic and export markets so that the prices we receive domestically are not less than the prices we could receive from sales to De Beers. Our correction factors include a premium for diamonds which are in demand among Russian polishers. By participating in the Russian polishing industry through Brillianty ALROSA, we are better able to assess this demand and to seek higher overall domestic prices. We estimate that the capacity of Russian diamond polishers is greater than the amount of diamonds that we supply to the domestic market.

We believe that, even where our domestic prices contain a premium over the prices at which we sell diamonds to De Beers, our domestic prices generally are lower than the prices of other potential suppliers to Russian polishers, including the DTC's prices. Diamonds which remain unsold on the domestic market are offered to De Beers, which then seeks to resell these diamonds at a higher price through the DTC.

We are required by law to conduct auctions within Russia for the sale of diamonds weighing 10.8 carats or more, except for stones of special gemological interest which can only be sold to Gokhran and those stones sold by Gokhran and polished by Brillianty ALROSA. See “–Regulatory and Environmental Matters–Licenses”. Diamonds weighing at least 10.8 carats account for approximately 3 per cent. of our total production, by value, and less than 1 per cent. in carats. As an initial matter, we must obtain administrative approval to commence each auction process relating to diamonds weighing at least 10.8 carats. This approval is routinely granted, and its purpose is to confirm that the diamonds being auctioned are not gems of special gemological interest. See “–Sales of rough diamonds to Russia and Yakutia”. At these auctions, diamonds are sold to the highest bidder. The main participants in these auctions have been the large Russian polishing companies, including Kristall in Smolensk, which polish these rough diamonds on behalf of foreign companies. However, as a result of the 2002 Decree, non-Russian persons and entities are now authorised to participate in our auctions of rough diamonds weighing 10.8 carats or more and to export such diamonds, so long as the purchase price is above the minimum price set by us and by the Ministry of Finance of Russia in its Price List. See “Industry Overview–Liberalisation of the Russian Diamond Market”.

Also as a result of the 2002 Decree, Russian diamond-cutting entities may export up to 15 per cent., by value, of the rough diamonds they purchase in any year from Russian diamond-mining companies or from the Government of Russia's stocks, subject to certain conditions. See “Industry Overview–Liberalisation of the Russian Diamond Market”.

#### ***Sales of rough diamonds to Russia and Yakutia***

As described in “–Regulatory and Environmental Matters–Licenses”, Russia has the right to purchase diamonds from us. Pursuant to the federal law of the Russian Federation No. 41-FZ “On Precious Metals and Precious Stones” dated 26 March 1998 (“Federal Law on Precious Stones”), Russia has the right at any time to acquire any of our output of Russian diamonds. In addition, diamonds of special gemological



interest can be sold only to Russia. These are diamonds that have characteristics which make them particularly rare, and they include all diamonds weighing more than 50 carats. Both of these rights require Russia to pay us the full market value of the diamonds to be purchased. This market price is agreed between us and Russia. It is expected that this price would generally reflect the prices set forth in the Price List. However, the Price List contains prices for diamonds only up to 10.79 carats. Mathematical formulae approved by the Ministry of Finance of Russia are used to calculate a representative price for larger diamonds based on the size and other characteristics of these diamonds.

In 2001, we sold U.S.\$37 million to Yakutia, and U.S.\$6 million for the nine-month period ended 30 September 2002. In 1999 and 2000 diamond sales to Yakutia were U.S.\$370 million and U.S.\$389 million, respectively. We had sales to the Government of Russia in 1999 of U.S.\$93 million and in 2000 of U.S.\$0.8 million. In addition, in 1999 and 2000 we repaid the April 1993 diamond loan from Russia, and the repayments were recorded as sales totalling U.S.\$97 million in 1999 and U.S.\$44 million in 2000.

### *Sales of polished diamonds*

We cut and polish some of our diamonds mainly through our branch, Brillianty ALROSA, and also through our subsidiaries ALROSA-Neva and Orel-ALROSA. In 2001 and for the nine-month period ended 30 September 2002, we sold approximately U.S.\$133.8 million and U.S.\$84.8 million, respectively, of polished diamonds. This represented approximately 7 per cent. of our diamond sales for each of 2001 and the nine-month period ended 30 September 2002. In 1999 and 2000 our sales of polished diamonds were U.S.\$42.0 million and U.S.\$89.1 million, respectively. This represented approximately 3 per cent. and 6 per cent. of our total sales for 1999 and 2000, respectively. For 2000 and 2001 our total expenses relating to polishing diamonds through Brillianty ALROSA were RUB 152 million (U.S.\$4.8 million) and RUB 279 million (U.S.\$8.8 million), respectively, not including the value of the rough diamonds which were polished. This increase reflects an increase in the volume of diamonds polished by Brillianty ALROSA. For the nine-month period ended 30 September 2002, these expenses were RUB 195 million (U.S.\$6.2 million). We primarily sell our polished diamonds to jewellery companies and diamond-trading firms located outside Russia.

Our cutting and polishing operations are ancillary to our main business of producing rough diamonds. However, we believe that maintaining these polishing operations provides several significant benefits. By polishing a portion of our production, we limit the supply of rough diamonds available to the domestic market, which we believe has a positive effect on domestic rough diamond prices. Brillianty ALROSA also helps us to understand the domestic polishing industry and to better assess domestic demand.

Brillianty ALROSA cuts and polishes diamonds at our Moscow polishing facility, which is located in premises leased from Almazny Mir Company. As of 30 September 2002, Brillianty ALROSA employed approximately 250 polishers. In addition, we have a long-term contract with Kristall, a company in Barnaul with 180 polishers, which polishes diamonds for our account.

We have recently upgraded our Moscow polishing facility. In the future we may consider increasing our cutting and polishing capacity further, either through additional expansion or the acquisition of other established polishing operations.

We are also considering the spin-off of Brillianty ALROSA into a separate subsidiary. We believe that this separation would allow Brillianty ALROSA to compete more effectively. In particular, if Brillianty ALROSA were a separate subsidiary, it would be able to tender for diamonds weighing 10.8 carats or more that we sell by tender within Russia in accordance with Russian law. See “–Regulatory and Environmental Matters–Licenses” below. We believe that being able to cut and polish these larger stones would enhance the reputation of Brillianty ALROSA and assist it in building a brand identity. See “Risk Factors–Risks Relating to Our Business–Our activities with respect to diamond cutting and polishing subject us to additional risks which may increase in the future”.

Brilliantly ALROSA maintains a small inventory of cut diamonds awaiting sale, which was valued at approximately U.S.\$8.8 million as of 30 September 2002.

### *Sales of industrial diamonds*

For the years 1999, 2000 and 2001, direct sales of industrial diamonds, including sales through Almaziuvelirexport, amounted to U.S.\$9 million, U.S.\$9 million and U.S.\$8 million, respectively. Such sales for the nine-month period ended 30 September 2002 were U.S.\$5 million. In addition, we are engaged, to a limited extent, in the production and sale of industrial diamond-related products. These include diamond tools for medical use produced by our subsidiary EPL Diamond.

### **Diamond Reserves**

Historically, we have estimated our diamond reserves by the use of mapping, drilling, sampling and evaluation methods consistent with standard Russian methodology, which differs from international practice in certain respects. For a description of these differences, see “Industry Overview–Calculation of Diamond Reserves”. Accordingly, our proven and probable reserve figures may not be comparable to similarly titled measures of other mining companies.

We are prohibited under Russian law from disclosing information concerning diamond reserves located in Russia, including the grade of deposits and production volume in carats. See “Risk Factors–Risks Relating to Our Business–We are prohibited from disclosing our Russian diamond reserves and other information which may be considered material by investors”. However, as certified by the Ministry of Natural Resources of Russia, the proven diamond reserves of categories B and C<sub>1</sub> (see “Industry Overview–Calculation of Diamond Reserves”) are sufficient to permit mining of diamonds until 31 December 2026 in an annual average volume that is not less than the volume of diamonds produced during 2001. The Ministry of Finance of Russia has certified that our proven reserves of natural diamonds (categories A, B and C<sub>1</sub>) are sufficient to permit mining of diamonds until 31 December 2027 in an annual average volume that is not less than the volume of diamonds produced during 2002. The Ministry of Natural Resources of Russia also confirmed that the average value per carat of diamonds to be mined in each of the next 25 years will not be materially less than the average value per carat of the diamonds that we mined during the year ended 31 December 2002. See “Appendix A–Certification of Diamond Deposits”.

**Information and statements set forth in the preceding paragraph are included herein as public official statements made on the authority of the Ministries. The Notes have not been guaranteed by Russia, the Ministries or any other agency or political subdivision of Russia, and do not represent obligations of any such body.**

In addition to physical reserves, calculated as the aggregate amount of carats underground, we track each mine’s reserves by the realisable value of its deposits. This calculation is based on the physical reserves figure in carats, determined in accordance with Russian geological practice as described in “Industry Overview–Calculation of Diamond Reserves”, and the projected average per carat value of the diamonds within the deposit. The average per carat value is determined by the Ministry of Finance of Russia, the technical committee of the Ministry of Natural Resources of Russia and Gokhran based on their analysis of a representative sample of diamonds extracted from the deposit and by reference to the prices set forth in the Price List.

The calculation of the realisable value of reserves is necessary in order to obtain a certification of reserves from the Ministry of Natural Resources of Russia. To obtain a license for the extraction of these reserves, we first prepare a report for submission to the Ministry of Natural Resources of Russia, which includes an analysis of the deposit’s physical reserves, taking into account the geological, mining and technological conditions of the relevant site and a feasibility study. The report must be prepared in accordance with special instructions adopted by the Ministry of Natural Resources of Russia, and it includes a business case analysis for the deposit utilising the realisable value of the deposit’s proven



reserves (categories A, B and C<sub>1</sub>, as described in “Industry Overview–Calculation of Diamond Reserves”). The business case analysis indicates projected future revenues and expenses, based on the measurement of the reserves, and utilises a six-year amortisation of assets and other parameters. The report is submitted to the Ministry of Natural Resources of Russia, which reviews it for accuracy and retains independent experts to physically verify the determination of proven reserves. If necessary, the Ministry of Natural Resources of Russia will prepare and submit to us a list of objections and request additional information relating to the report. Following the issuance of a statement of objections, a working group is assembled to discuss issues relating to the report. The working group includes our representatives and representatives from the Ministry of Natural Resources of Russia, and may include the independent experts who reviewed our report and members of a relevant scientific institute. The working group’s proposals for the resolution of the issues identified in the statement of objections is then submitted to a general meeting of the Ministry of Natural Resources of Russia. The general meeting can approve or amend the resolutions of the working group, and certify the reserve figures by majority vote of the officers of the relevant Ministry of Natural Resources of Russia. To be certified, it must be demonstrated that reserves are sufficient to support production for at least 25 years. The decision of the Ministry of Natural Resources of Russia with respect to the certification of reserves is final. However, we can request that the Ministry of Natural Resources of Russia reconsider a determination in the event there is a change in circumstances relating to the reserves, such as a change in market prices or projected mining costs. A change may also result from our reclassification of some of the deposit’s probable reserves as proven reserves due to changes in our ability to extract the reserves.

Our mining licenses are typically granted for a period of 13 to 25 years. However, some of these licenses require periodic review and confirmation of reserves within the relevant diamond pipes, as a condition to continued mining under the licenses. We are currently confirming the reserves of the Jubilee mine, and the shape of the Jubilee diamond pipe, to the Ministry of Natural Resources of Russia under the relevant license. Our mining licenses generally may be revoked if we are deemed to have materially breached environmental laws or failed to exploit the relevant diamond deposit by mining in a technically inefficient manner. None of our mining licenses has been revoked.

Our Moscow-based analytical department monitors world rough diamond prices, and periodically recalculates the realisable value of our reserves based on new price levels. We are required to submit a report of our reserves to the Ministry of Natural Resources of Russia each year. In connection with an application for renewal of any of our licenses, it may be determined that the relevant diamond deposit is no longer economically viable, in which case the Government of Russia could refuse to renew our licenses with respect to such deposit. At no time have any of our mines been found, as a consequence of a recalculation of the realisable value of their reserves (including the recalculation relating to the severe decline in world market prices for rough diamonds following the events of 11 September 2001 in the United States, when such prices fell by more than 14 per cent.), to be unable to support further production. However, we cannot provide any assurance as to the effect of any severe decline in world market prices of rough diamonds in the future. See “Risk Factors–Risks Relating to Our Business–Our business is particularly susceptible to fluctuations in diamond prices”.

## **Exploration and Development**

### ***Exploration activities***

In Russia, as in most other diamond-producing regions of the world, the majority of diamond reserves are found in primary deposits. We estimate that there are nearly 700 diamond pipes in Yakutia. A significant number of deposits are also located in the Arkhangelsk region, and a very small number of deposits are located within the Perm region. However, only a small portion of these deposits could be mined profitably. We believe that the vast majority of the major commercially attractive deposits in Russia are located within Yakutia.

We constantly seek to increase our Russian reserves through the utilisation of underground mining at mature diamond pipes that have been excavated to a depth at which open-pit mining is no longer economically feasible, such as the International and Aikhal mines; exploitation of primary diamond deposits and diamond-bearing placer deposits; and growth of reserves through the addition of newly discovered diamond deposits. We conduct exploration on the basis of state licenses issued by the Ministry of Natural Resources of Russia on an auction basis. See “–Regulatory and Environmental Matters–Licenses”. Our exploration activities are currently concentrated in and around the Mirny, Aikhal and Udachny regions.

Under Russian law, we may be granted priority rights to receive mining licenses covering smaller deposits that we discover at our own expense. However, if funds provided by the Government of Russia are used to locate new deposits, or if large deposits are discovered, a license can only be issued on the basis of an auction. We conduct all of our current prospecting efforts without State funding.

We employ a number of techniques to locate new deposits. These include surveys of the tectonic characteristics of regions to identify conditions suitable for the formation of diamonds, as well as the identification of minerals which are usually found near diamond pipes. We maintain three exploratory expeditions, located in Mirny (1,500 employees), Udachny/Aikhal (1,100 employees) and Arkhangelsk (400 employees). Our geological service consists of a research facility that carries out research work using its own resources and cooperates with other Russian geological research centres. We incurred expenses of approximately RUB 725 million (U.S.\$22.9 million) in the nine months ended 30 September 2002 with respect to our geological prospecting activities. In 2000 and 2001, our expenditures on exploration were RUB 471 million (U.S.\$14.9 million) and RUB 750 million (U.S.\$23.7 million), respectively.

Diamond exploration is a capital-intensive undertaking that involves many risks and we can give no assurances that any of our new or ongoing exploration programmes will result in additional diamond-producing operations.

### ***Research and development***

Our research and development division, the Yakutian Scientific and Research Institute (the “Institute” or “YakutNiproAlmaz”), has principal responsibility for research as well as for designing and implementing research and development projects and creating long-term plans for production processes. Our research and development focuses primarily on mining, ore treatment, automation of production processes, reserves forecasts and environmental control. These projects focus on efficiency improvements, decreasing costs and improving diamond yield. The Institute has considerable expertise in operations involving permafrost ground. Its recent activities include:

- the improvement of techniques to develop open pits with steeply pitched walls, which reduce expenses by requiring the removal of less overburden;
- work on techniques to reduce damage to the natural qualities of diamonds resulting from extraction and ore dressing;
- the development of techniques of water-free (dry) dressing of ore containing a very low diamond content, which may be efficient in developing certain deposits;
- techniques relying on new physical methods to regulate and stabilise the physical and chemical properties of flush water in ore dressing processes; and
- improvement of methods and techniques to extract diamonds using radiometric separation.

Including its work in Angola, over the last 40 years the Institute has prepared 18 mines and processing plants, as well as all the towns and settlements surrounding our operations.

The Institute is located in Mirny, with a branch in St. Petersburg, and another branch is being established in Novosibirsk. As of 30 September 2002, the Institute had 702 employees, including ten

doctors of engineering science. From time to time the Institute also subcontracts work to up to 50 subcontractors in a year, including the various institutes of the Russian Academy of Sciences. In 2001, we incurred expenses of RUB 176 million (U.S.\$5.6 million) relating to scientific research and RUB 541 million (U.S.\$17.1 million) on project works. For the nine-month period ended 30 September 2002, we incurred expenses of RUB 119 million (U.S.\$3.7 million) relating to scientific research and RUB 436 million (U.S.\$13.8 million) on project works.

Recently the Institute entered into a five-year cooperation agreement with De Beers to share technologies and to jointly research issues of interest to both parties. The Institute holds a number of patents, including seven foreign patents.

## **Supporting Operations**

### ***Transportation of supplies and resources***

Materials and supplies used in our mining operation are shipped by rail to the river port at Osetrovo, then transported by the river Lena to our port at Lensk and delivered to the mines by truck. During the river navigation season, which lasts from May through September, the volume of cargo (600,000 to 800,000 tonnes) is shipped by river. Mirny, Aikhal and Udachny can be reached from Lensk by means of a year-round gravel road and a network of winter motor roads running in frozen river beds. Urgent cargoes are delivered by air transport, with airports located in Mirny, Vitim, Lensk, Aikhal, Polyarny and Saskylakh. Equipment from Asia generally comes via sea to Vladivostok, then by air. We transport approximately one-half of our supplies by river on our own vessels, and we generally use our own aircraft for the transportation of goods by air. In the first three quarters of 2002 we received approximately 297,000 tonnes of supplies other than fuel.

### ***Supply of energy and water***

The provision of fuel and energy is essential to our mining operations. Fuel and energy costs represented approximately 17.6 per cent. of our total cost of sales in 2001, and approximately 15.5 per cent. for the nine-month period ended 30 September 2002 in each case excluding payments made under our Lease Agreement. Our operations use electricity, oil and natural gas. In addition, our mining operations use a substantial amount of water. In order to reduce our fuel and energy costs and to reduce our dependence on outside suppliers, we have engaged in a number of projects related to the supply of fuel, energy and water, which are described below.

- *Electricity.* In 2001, we used over 2.2 billion kilowatt hours of electricity, and approximately 1.49 billion kilowatt hours during the nine-month period ended 30 September 2002. Over 30 million kilowatt hours used in 2001 were generated by our two diesel electric power plants, and we produced 27.3 million kilowatt hours in the nine-month period ended 30 September 2002. Our remaining energy needs were supplied by Yakutskenergo, the regional power-generation and distribution company. Electricity is supplied to our operations over dedicated 110 kV and 220 kV power lines, with three 220 kV lines assigned to Aikhal and Udachny, two 220 kV lines to Mirny and two 110 kV lines to Lensk. We believe that the total supply of electricity within our power distribution area substantially exceeds our foreseeable needs.

We are currently completing a third hydroelectric station on the Vilyui River, which is expected to supply up to 270 million kilowatt hours of electricity in 2003, and up to 1.2 billion kilowatt hours of electricity by 2012, within the western power distribution province of Yakutia. This will supplement the existing hydroelectric plants owned by Yakutskenergo, the Yakutian energy utility, located in Tchernyshevsky. We purchased the partially completed station from Yakutskenergo for RUB 940 million (U.S.\$29.7 million). We estimate that the cost to complete this project is approximately U.S.\$40 million. We are currently working together with Yakutskenergo to create a joint venture to operate a power-generating facility for the western Yakutia power distribution province consisting of our three hydroelectric power stations, the Mirny power plant and the

existing power distribution companies. We have negotiated a non-binding letter of intent for this project, although the economic terms have not yet been agreed. We believe that the creation of this venture will increase the reliability of electricity supplies within western Yakutia, and reduce our usage charges and overall electricity costs.

- *Natural gas.* Our Mirny division makes extensive use of natural gas for the generation of heat and for its technological needs. Mirny has four operating natural gas heat-generation plants, supplying virtually all of its heating requirements. As part of our effort to ensure the reliability of power supplies to Aikhal and Udachny and to reduce heating costs in these areas, we began constructing a 500 kilometre natural gas pipeline in 1999 to link Mirny and Udachny. The gas pipeline is currently under construction, as are gas boiler houses in the towns of Aikhal and Udachny. We anticipate that our Aikhal division will begin using natural gas for its heating needs in 2004 and Udachny will begin using natural gas in 2006, upon completion of the pipeline to that city. We expect that the total cost of completion of the pipeline and the heat-generation plants in Aikhal and Udachny will be U.S.\$30 million.

The natural gas we use is currently supplied to Mirny, and will be subsequently supplied to Aikhal and Udachny, from the Srednebotuobin Oil and Gas Condensate Field, located 140 kilometres from Mirny. This field has proven natural gas reserves of more than 80 billion cubic metres. Our majority-owned subsidiary, ALROSA-Gas, holds a license to extract gas within a section of the field that has reserves of more than 20 billion cubic metres. We hold a 53 per cent. interest in ALROSA-Gas and Yakutia owns a 47 per cent. interest. Recently, we signed a non-binding memorandum of intention to sell our stake in ALROSA-Gas to Gazprom. Although the basic economic terms are subject to agreement of the parties, the memorandum provides that we would be entitled to stable gas prices for the next 50 years, with inflation adjustments only. The sale of ALROSA-Gas would include the transfer of all of its gas pipelines connecting to the natural gas field. We believe that we would benefit from the divestiture of this non-core asset, and intend to use the proceeds from the anticipated sale to finance capital expenditures. We have not yet begun negotiations with respect to the final terms of this sale, and, accordingly, we can give no assurance as to when this sale will be completed, if at all.

- *Oil.* Oil is used as fuel for gas boiler houses and furnaces in Aikhal and Lensk. The oil is supplied from the Irillyakh and Srednebotuobin Oil and Gas Condensate Fields. The Irillyakh Field, which has estimated reserves of more than 24 million tonnes, is operated by our wholly owned subsidiary, Irillyakhneft. In order to meet our needs for diesel fuel and petrol, a refinery is being constructed near Mirny, with a design capacity to process 250,000 tonnes of crude oil per year. We are currently seeking third-party financing for this project, and we anticipate that construction will take three years to complete. The unrefined oil to be used by the refinery will be supplied by the Irillyakh Field. The residual fuel (masout) by-product of the refining process will be used in our boiler houses in Lensk.
- *Water.* Drinking water used in our facilities and by the local communities surrounding our operations, as well as the water we use for our industrial and technological needs, is supplied from natural reservoirs. Aikhal has two fresh water reservoirs and each of Mirny and Udachny has one. Our ore-processing facilities recycle water, using fresh water only when necessary. In 2001, water intake from the reservoirs was approximately 38.7 million cubic metres.

We continue to work to reduce our energy and water consumption. An example is our increasing use of frequency-regulated drives designed to conserve energy during start-up of heavy ore-processing equipment. At Ore Processing Plant No. 12, a drive has been installed on the primary conveyors and sediment machines and other mechanisms. Moreover, all of our newly-designed facilities are fitted with this type of drive. Some of our industrial facilities also have heating systems which use infrared electric irradiators and we are considering a gas-based system to heat the air supplied to underground mines. These devices are more energy efficient and we believe that they will reduce our energy costs.

### ***Equipment purchases***

We purchase our vehicles and other mining equipment from a number of suppliers. These include Komatsu, Caterpillar and BelAZ for ore transport vehicles, and KrAZ, Maz of Belorussia, Volvo and Manesman for lorries and dump trucks. We purchase drilling equipment from Tamrock, Bumer, Voronezh and Karpin, and purchase milling equipment from Rockail of Japan, Svedala of Sweden, and the Syzran engineering plant of Russia. Purchases are made pursuant to individually negotiated agreements, and in 2001 we incurred expenses of approximately RUB 3,886 million (U.S.\$123 million) relating to equipment purchases. During the nine-month period ended 30 September 2002, we purchased equipment in the amount of RUB 2,176 million (U.S.\$69 million). Our U.S. equipment purchases have been financed through credits received from the Export-Import Bank of the United States. See “Description of Existing Material Agreements–Material Financing Agreements” below.

We make our equipment purchases through a department responsible for purchases of materials and equipment, which attempts to obtain bulk purchase discounts where possible. We do not generally order custom-made equipment; however, the equipment we purchase is typically modified by the manufacturer to work in cold climates. All of our principal mining equipment must operate in temperatures as low as –50°C.

### ***Maintenance of equipment***

All of our mining, transportation, technological and earthmoving equipment is maintained regularly according to a set schedule. All repair work is performed at facilities which service our Udachny, Aikhal and Mirny operations. As at 30 September 2002, these repair and maintenance facilities employed 1,516 persons. In order to carry out specialist repair operations, we retain independent repair contractors (pursuant to applicable safety requirements imposed by law). Repair and maintenance quality is supervised by the State Technical Supervisory Committee (*Gostekhnadzor*) and the State Technical Mining Supervisory Committee (*Gosgortekhnadzor*).

## **Regulatory and Environmental Matters**

### ***Licenses***

Russian legislation provides that “all underground resources within the territory of the Russian Federation are State property and cannot be sold, purchased or pledged. Mined resources may, however, be the property of the producer unless otherwise specified in a license granted by the federal or regional authorities”. We were granted licenses to explore and develop diamond deposits and to conduct our mining activities in accordance with the Federal Law. These licenses generally cover the productive life of the diamond deposits we mine.

We have historically been required to obtain annually a new export license which sets forth our export quota. However, the 2002 Decree authorised the grant of multi-year quotas of up to five years. In February 2003 we received a five-year quota for the export of up to U.S.\$800 million of diamonds per year, based on current market prices. We believe that this new five-year quota will assist us in securing long-term financing secured by exports, which we believe will lower our borrowing costs. See “–Sales of Rough and Polished Diamonds–Export of gem and near-gem rough diamonds” and “Risk Factor–Risks Relating to Our Business–We are dependent on licenses and quotas issued by the Government of Russia and the government of Yakutia to conduct our business”. We will still be required to obtain annual licenses under this new five-year quota.

Pursuant to the Federal Law on Precious Stones, Russia is entitled at any time to acquire any part of our domestic output of diamonds at market prices as agreed between us and the Government of Russia. In addition, diamonds of special gemological interest can be sold only to Russia. These are diamonds that have characteristics which make them particularly rare, such as their colour, and they include all diamonds



weighing more than 50 carats. See “–Sales of Rough and Polished Diamonds–Sales of rough diamonds to Russia and Yakutia”.

Resolution No. 233 also provides that diamonds of 10.8 carats or more must be sold on an auction basis within Russia, except for stones of special gemological interest which can only be sold to Gokhran and those stones purchased from Gokhran and polished by Brillianty ALROSA. See “–Sales of Rough and Polished Diamonds–Domestic sales of gem and near-gem rough diamonds”. In addition, it provides that Almaziuvelirexport is responsible for selling the representative control parcels of diamonds extracted from deliveries to De Beers for our account, less a commission of 1.5 per cent. Almaziuvelirexport is wholly owned by the Government of Russia. See “–Sales of Rough and Polished Diamonds–Export of gem and near-gem rough diamonds”.

### *Lease Agreement*

On 19 January 1993, we entered into the 25-year Lease Agreement with Yakutia, pursuant to which we lease production and non-production assets used by our predecessor entities in connection with their exploration and mining activities. Under the Lease Agreement we:

- lease the assets of Yakutalmaz, and companies comprising it, as well as other assets identified by the parties; and
- obtain the use of land, diamond deposits and minerals and other natural resources, including timber, which we require for our business.

Under the Lease Agreement, we are subject to annual royalty payments and other payments in connection with our use of mineral and water resources, the use of land and logging areas and the disposal and burial of waste. The current terms of the Lease Agreement, as amended in 2002, provide that we must make lease payments, including royalty and ecology fund payments but excluding extraction tax, to Yakutia in 2002 of up to RUB 10,070 million (U.S.\$318 million), inclusive of VAT. This also includes RUB 914 million (U.S.\$28.9 million), which is to be contributed to the ecology fund for the mitigation of any environmental damage resulting from our operations and to promote the social and economic development of the nine regions of the “diamond-bearing province”. In addition, under applicable legislation, we pay taxes to Russia and Yakutia at the rates established by the Government of Russia and the government of Yakutia, respectively, including:

- an extraction tax of 8 per cent. of the value of diamonds extracted;
- a land use tax; and
- a tax in connection with the use of logging areas, conventional mineral deposits, associated minerals and water taken from natural reservoirs for industrial needs.

The laws of Russia provide for an exemption from mineral resources payments during an initial period of development of mineral deposits. We have been entitled to receive subsidies from Yakutia for our exploration activities in an amount equal to 1.5 per cent. of the amount we pay towards the recovery of mineral resources in Yakutia, which subsidies would be offset against our royalty payments to Yakutia. However, these subsidies were abolished in 2002.

The following table sets forth the expense incurred by us under the Lease Agreement, expressed in thousands of Roubles and as a percentage of diamond sales and excluding VAT:

	For the nine months ended 30 September	For the year ended 31 December		
	2002	2001	2000	1999
		(RUB thousands)		
Royalty payments . . . . .	6,173	10,075	11,531	11,518
Ecology fund . . . . .	535	943	1,187	1,185
Extraction tax <sup>(1)</sup> . . . . .	3,402	6,053	6,687	6,910
Total . . . . .	10,110	17,071	19,405	19,613

(1) In 2002 resource recovery tax and non-recoverable resource tax were replaced with the extraction tax.

The principal economic terms of the Lease Agreement are subject to renegotiation every five years, with the next renegotiation scheduled to occur in 2006. However, the terms may be amended at any time by the parties. The terms have been amended four times in the ten years since the Lease Agreement became effective.

We are required to return the leased production assets and certain owned assets to Yakutia at the end of the lease term, unless we exercise a purchase option relating to these assets prior to the expiration of the term of the Lease Agreement. The mechanism for determining the value of the leased assets to be returned to Yakutia is currently being negotiated between us and Yakutia. As of 30 September 2002, the carrying value of the assets subject to the Lease Agreement was RUB 15.1 billion (U.S.\$477.2 million), including owned assets valued at RUB 3,659 million (U.S.\$115.6 million).

#### ***Environmental matters***

As part of our mining operations, we use various chemicals and produce overburden and wastewater which could have a negative impact on wildlife and vegetation in adjacent areas if improperly discharged. In addition, we use hazardous materials, such as solvents, to clean, refurbish and maintain our equipment. Through Irillyakhneft, we are engaged in oil extraction and refinement, and we dispense petroleum products from underground storage tanks on our sites. These and other activities are subject to various laws and regulations concerning environmental protection.

The mitigation of the ecological effects of mining on the environment in the Udachny and Mirny areas presents a particular challenge for us. Because the wastewater from these operations has a high salt content it cannot be discharged into the river system or onto the adjacent land. To address this problem, the Udachny and Mirny mines operate a system of underground storage of brines in the geological fractures of permafrost rock. We consider this method to be the most effective way to dispose of the mineralised water. In 1995 we engaged independent environmental consultants from the United States to conduct an environmental audit of the Udachny mine. On the basis of the consultants' analysis, we believe that our mining operations at Udachny satisfied all applicable environmental requirements.

We have adopted a long-term programme, guided by international standards, to address environmental concerns and follow a policy aimed at protecting water and air quality in order to minimise the impact of our activities on the local environment and to improve our employees' working conditions. Although we believe there are no existing material liabilities relating to non-compliance with environmental laws and regulations, there can be no assurance that there are no undiscovered potential liabilities or that future uses or conditions will not result in the imposition of environmental liability upon us or expose us to third-party actions. Furthermore, we can provide no assurance that changes in environmental regulations in the future will not require us to make significant capital expenditures to



change our methods of disposal of hazardous materials or otherwise alter aspects of our operations. See “Risk Factors–Risks Relating to Our Business–We may be subject to environmental liabilities”.

### ***Health and safety***

Mining is an inherently dangerous activity. As with any construction or excavation work, there is the general risk of accidents involving the heavy equipment, machines and structures used in the mining industry. In particular, each year we use approximately 20,000 tonnes of explosives which creates additional dangers. Employees working above the site floor are subject to accidents involving falls and those below, to cave-ins. In addition, as the depth of our mine pits increases, a number of problems often arise, the principal one being the resulting reduction in natural ventilation and deterioration of air quality in the working zones of the pit. The air quality is affected by the exhaust gases from the large trucks used in the pit and the gaseous by-products of blasting. In addition, in open-pit mines sudden air temperature changes can lead to deep inversions of the atmosphere in the pit with the difference between the surface temperature and the lower-level temperature being as great as 10°C to 20°C, resulting in ventilation problems. See “Risk Factors–Risks Relating to Our Business–We are subject to general mining risks”.

Various Russian laws govern workplace safety. With respect to mining activities, the approval of the Russian Mining Supervisory Committee is required to commence any mining project. The Committee has the power to inspect facilities and wide powers to take remedial measures. These powers include ordering site closure and terminating the employment of violators. In the past five years, we have not had any serious accidents and the Mining Supervisory Committee has not taken any material action with respect to our operations.

We have instituted a general programme to improve worksite safety. As part of this programme, every mining employee certifies each calendar quarter his knowledge of our safety procedures.

### ***Non-Mining Activities***

#### ***Commercial and ancillary services***

We operate a number of commercial businesses ancillary to, and for the benefit of, our mining operations and the surrounding communities. The primary purpose of these operations is to help us to reduce our operating costs. Although these businesses occasionally provide services to third parties, including local governments, the third party revenues are not material. These commercial businesses are described below.

- *Construction services.* As of 30 September 2002 we had 6,038 employees performing construction services. We maintain a construction division which is engaged in the construction and expansion of our mines. However, this division also performs ancillary work, such as constructing temporary housing for workers exploring or developing a mining deposit in a new region and maintaining the non-mining properties owned by us and our affiliates. The construction division was instrumental in rebuilding our port city of Lensk, which was completely destroyed by flooding in 2001. As part of this effort, the division constructed a dam surrounding Lensk, which was designed to prevent future flooding. In addition, our construction subsidiary OAO Vilugesstroi provides construction services to us and to external customers. For the first nine months of 2002, this subsidiary had total sales of RUB 787 million (U.S.\$24.9 million), including intercompany sales of RUB 359 million (U.S.\$11.3 million). However, revenues from these activities are not material. In 2001, the expenses related to work performed by our construction divisions for us and our affiliated and related entities amounted to RUB 12,481 million (U.S.\$394 million). Expenditures for the nine-month period ended 30 September 2002 were RUB 10,780 million (U.S.\$341 million).
- *Transportation services.* We maintain a fleet of cargo ships and lorries, as well as aircraft designed to carry freight, in order to transport supplies and materials for our mining and other activities,

including our construction division. The activities of the transportation division are coordinated by our Material Supply and Logistics Department. In 2001, we transported approximately 528,000 tonnes of freight at a cost of RUB 557 million (U.S.\$14.9 million), and in the nine-month period ended 30 September 2002 we transported approximately 415,000 tonnes at a cost of RUB 700 million (U.S.\$22 million).

- *Agriculture and food supplies.* Through wholly owned subsidiaries, we operate retail food stores for the benefit of our employees in the cities in which we operate in Yakutia. We estimate that our stores supply approximately one-half of the food sold in those cities. In addition, we engage in agricultural operations which grow fresh produce in greenhouses to meet the needs of our employees within Yakutia.
- *Logging and timber production.* ALROSA-Lesprom, our subsidiary in which we hold a 82.5 per cent. interest, is engaged in the processing of timber within Yakutia. The timber products of ALROSA-Lesprom are intended primarily for use by our construction division, particularly for the construction of wooden temporary housing for workers engaged in the development of mines within newly settled areas of Yakutia. However, a small portion of the timber produced by ALROSA-Lesprom is sold to non-affiliated third parties.
- *Passenger air transport.* To support our transportation requirements, we have established our own airline as a division under the ALROSA name. This airline currently has 40 aircraft and operates regularly scheduled flights involving eight routes from Mirny and two routes from Polyarny. To support air travel in Yakutia we maintain small airports in Vitim, Lensk, Aikhal and Saskylakh. The airline division receives fees from third parties who use these airport facilities. In 2001 and in the nine-month period ended 30 September 2002, the ALROSA airline transported 243,000 and 257,000 passengers, respectively.

### ***Social services***

To support habitation and encourage employees to relocate to these mining areas, our predecessor entities created a complete local infrastructure in Mirny, Udachny, Aikhal and Lensk. Upon our formation, we assumed responsibility for these assets, which included hostels, residential houses, schools, hospitals, hotels, cultural centres and retail shops. In 2001 and for the nine-month period ended 30 September 2002, we incurred expenses of RUB 2,618 million (U.S.\$83 million) and RUB 1,820 million (U.S.\$58 million), respectively, to support and maintain these assets, net of reimbursed expenses.

By the end of 1996, we had transferred most of these social assets to the local authorities of Yakutia, and the transfer was effected by decree of the government of Yakutia. Included in the transfer were all housing units built prior to 1993; these are considered to be State property as they were constructed during Soviet times. In addition, we transferred our interest in retail shops to majority-owned subsidiaries.

In 1999, we began negotiating with Yakutia for the transfer to Yakutia, in stages, all of our remaining social assets, which are primarily residential housing units, and also include sports complexes and cultural facilities, such as cinemas and theatres. This transfer has been substantially completed. However, we remain responsible for the maintenance of certain of these assets. In addition, to minimise its expected costs, Yakutia has required, as a condition to transfer, that we renovate and modernise the properties to be transferred.

As of 30 September 2002, we owned approximately 288,800 square metres of housing space. The houses and apartments owned by us have been allocated to the employees of our structural divisions. Housing space is allocated to employees pursuant to a joint decision by us and our local trade union. Employees living in this housing do not pay rent, but are responsible for their utilities costs and maintenance payments. Utilities rates are established by Yakutia.

With respect to the properties which we lease to employees, we are obligated to pay the majority of the utilities costs. Work has proceeded to reduce our subsidy payments, but wage and salary levels in Yakutia are a stumbling block to any such measure.

In addition to housing, we also typically fund some maintenance of roads. Local municipalities and Yakutia generally finance the upkeep of roads. However, where there is a shortfall in budgeted funds, we have contributed in the past, and expect to continue to contribute to, maintenance expenses. We estimate that we finance approximately one-half of the maintenance costs of the roads within and connecting the cities of our operations in Yakutia.

## **Competition**

The world diamond mining industry is highly concentrated, and the number of mining companies is limited by, among other things, the high capital costs required, the limited number of economically feasible mining sites and limited access to distribution channels. We believe that only four companies produce the majority of the world's diamond production: De Beers, ALROSA, ASCORP and Rio Tinto/Argyle. See "Industry Overview—Major Producers of Rough Diamonds". We expect that the number of diamond mining companies will continue to be limited due to high barriers to entry, including the high capital costs involved and the limited access to licenses or concessions to develop commercially feasible diamond deposits.

We are the second largest diamond mining company in the world, based on value of production. In 2001 we produced approximately 20.9 per cent. of the world's rough diamond output, measured as a multiple of average market prices, and approximately 17.3 per cent. by carat volume. We believe that only the diamonds produced in Botswana are of a higher quality, on average, than the rough diamonds that we produce. Accordingly, we believe that the quality of our diamonds represents an important competitive advantage for our business.

Unlike commodity markets, competition in the world diamond market involves the system of common marketing. See "Industry Overview—Marketing and Role of the DTC". Through the DTC, the supply of diamonds is monitored and aggregated supply is matched to aggregated demand. By aggregating supply and demand, the DTC is able to create market efficiencies, with reduced price volatility and higher levels of output, which tends to promote relatively stable pricing. Under normal circumstances, the DTC supplies approximately 60 per cent. to 65 per cent. of the world's rough gem diamonds. Almost all of our diamonds not sold within the CIS are currently sold to De Beers and distributed through the DTC.

## **Insurance**

We use a specialist transport company, a division of the Russian Ministry of Communications, to transfer our diamonds by air from Mirny to Moscow. For domestic sales of gem and near-gem diamonds, the customer is generally required to assume the risk of transport of diamonds from our Moscow facilities. Similarly, our agreements with De Beers provide that De Beers is responsible for the risk of loss from the transport of diamonds from our Moscow premises.

We insure our diamond products, including all rough diamonds, against all types of risks during transportation from our mining operations in Yakutia to the customs warehouse in Moscow. Our total insurance expense was RUB 123.9 million (U.S.\$3.9 million) in 2001 and RUB 105.4 million (U.S.\$3.3 million) for the nine-month period ended 30 September 2002.

We also maintain general liability insurance in an amount that we believe is sufficient with respect to our mining operations. However, few of our operating assets are insured, and, in the case of assets which are insured, the insurance is generally insufficient to cover replacement costs. Accordingly, we can offer no assurance that we will not incur losses beyond the limits of, or outside the coverage of, our insurance

policies. See “Risk Factors—Risks Relating to Our Business—We could be subject to liabilities which are not covered by insurance”.

We maintain carrier liability insurance with respect to our airline, and we insure our airplanes.

## Financial Reporting and Information Management

ALROSA is comprised of 37 structural divisions, each responsible for our quarterly financial reporting. Divisions which account for nearly 99 per cent. of our revenues have been included in our integrated financial system, which allows real-time access to accounting information. The remaining divisions report their quarterly figures to our central accounting department in Mirny via paper forms or electronic media, such as diskette. We expect to include these remaining divisions into the integrated system over the next two years.

## Properties

We currently have seven operational ore treatment plants, each located near one of our principal mining operations. The following table provides capacity and other information for each of these plants. Several of our older ore treatment plants have been closed or are used for experimental processing. The following table sets out information for the ore treatment plants currently utilised in production:

Ore Treatment Plant	Year Built	Primary Mines Served	Annual Processing ('000 tonnes)			
			For the nine months ended 30 September 2002	For the year ended 31 December		
				2001	2000	1999
No. 3 . .	1966	International and alluvial gravel from Mirny	1,700	2,241	1,743	1,782
No. 5 . .	1961	Alluvial gravel from Mirny	450	402	504	358
No. 8 . .	1966	Aikhal and Komsomolskaya	1,600	1,565	1,630	2,450
No. 12 . .	1976	Udachny and Zarnitsa	11,000	9,421	9,320	9,550
No. 13 . .	1997	Alluvial gravel from Anabar	337	400	400	280
No. 14 . .	1996	Jubilee	8,200	10,706	9,704	9,607
No. 15 . .	1999	Nyurbinskaya	292 <sup>(1)</sup>	—	—	—

(1) Actual processing is lower due to seasonal operation.

We lease Ore Treatment Plant Nos. 3, 5, 8, 12 and 14 pursuant to the Lease Agreement, and we own Ore Treatment Plant Nos. 13 and 15. Plant No. 3 is currently being upgraded to increase its design capacity to 1.7 million tonnes of ore annually and to implement technologies to reduce electricity consumption and the amount of equipment required for processing. This upgrade is expected to be completed in 2003. We have also adopted a reconstruction and modernisation programme for Ore Treatment Plant No. 8, which is expected to be completed in 2004. The design capacity of Ore Treatment Plant No. 13 is being upgraded to approximately one million tonnes of ore per year, and we expect this upgrade to be completed in 2003. We are currently engaged in a project to increase the automation in Ore Treatment Plant No. 14 and to increase its capacity to 12.0 million tonnes of ore per year, which is expected to be completed in 2004. In addition, Ore Treatment Plant No. 16 is currently under construction. Its completion is anticipated to be in August 2003, with production beginning later that year. When completed, it will have a design capacity of 1.5 million tonnes of ore per year. We believe that, with these improvements, our ore treatment facilities will have sufficient capacity to meet our needs for the foreseeable future.

Our diamond polishing division, Brillianty ALROSA, leases a building of approximately 5,285 square metres in Moscow for its diamond-cutting and polishing operations from Almazny Mir Company. We pay rent of RUB 35 million (U.S.\$1.1 million) per year for the use of these premises, and this lease is renewed on an annual basis.

In addition, we maintain corporate offices in Moscow, Mirny and Yakutsk, and lease representative offices in London, England; Luanda, Angola; Ramat-Gan, Israel; and Antwerp, Belgium.

Applicable Russian federal law has required that rights to real property be registered since January 1998. However, much of our real property is located in Yakutia, where this registration system has only been in place since 2000. As with many Russian companies extensively using real property, we have only recently been able to register our real property rights. Although we have established an internal department to effect these registrations, a considerable part of our real estate rights are not yet registered and, therefore, the validity of our title has not yet been confirmed. As a result, we can give no assurance that the validity of these unregistered real property rights are not subject to challenge prior to such registration.

## **Legal Matters**

### ***Litigation***

In addition to litigation arising in the ordinary course of business, we are involved in a civil claim relating to the technologies used at our Nyurba mines. In January 2003 we received notice that Bateman has instituted arbitration proceedings against us. Bateman was the outside construction firm involved in the development of our Nyurba processing plant. Bateman alleges that technology used in our Nyurba plant infringes its intellectual property rights. The claim seeks damages of approximately U.S.\$43 million and requests that the arbitration panel issue an order to prevent us from performing further work on the construction of the Nyurba diamond processing plant.

If we are unable to resolve this claim through negotiation, the claim will be heard by one or more arbitration panels of the Stockholm Chamber of Commerce. No date has been set for the arbitration hearing.

In addition, we are currently cooperating with the European Commission with respect to its investigation of the De Beers Trade Agreement. See “–Sales of Rough and Polished Diamonds” and “Risk Factors–Risks Relating to Our Business–The De Beers Trade Agreement is subject to European Commission approval”.

### ***Tax claims***

In March 2002, ALROSA Ltd. was subject to a comprehensive tax audit by the Department of the Ministry of Taxes and Duties of the Russian Federation for the Republic of Sakha (the “Ministry of Taxes in Yakutia”) covering taxable years 1999 to 2001. As a result of this audit the Ministry of Taxes in Yakutia issued two Acts of Audit (the “Acts of Audit”) to us, dated 14 November 2002 and 15 November 2002, for the underpayment of profits tax, VAT, corporate property tax and certain other taxes in the amount of RUB 17,619,408,220 (U.S.\$556,871,309), plus late payment interest in the amount of RUB 9,377,246,100 (U.S.\$296,373,138), and tax penalties in the amount of RUB 3,113,038,040 (U.S.\$98,389,319). In addition, the Ministry of Taxes in Yakutia sought to impose a penalty for currency law violations in the amount of U.S.\$25,736,690. Accordingly, the total amount assessed under the Acts of Audit was approximately U.S.\$977.3 million.

At the end of November 2002 we formally protested the Acts of Audit. In response, the Ministry of Taxes in Yakutia issued two decisions (the “Decisions”) at the end of December 2002, conceding the currency law violation claims and significantly reducing their overall tax claims to RUB 1,006,003,500 (U.S.\$31,795,307) for outstanding taxes, RUB 518,199,100 (U.S.\$16,377,974) for late payment interest and to RUB 357,761,200 (U.S.\$11,307,244) for tax penalties.

In January 2003, the Ministry of Taxes in Yakutia issued final (revised) demand notices to us reflecting the amounts set forth in the Decisions in the amount of RUB 1,524,215,600 (U.S.\$48,173,691). Pursuant to our application in January 2003, the Ministry of Taxes in Yakutia agreed to a further offset of



RUB 1,194,244,300 (U.S.\$37,744,763) against the Decisions claims. In addition, ALROSA Ltd. paid local taxes pursuant to the demand notices in the amount of RUB 30,663,900 (U.S.\$969,150).

At the end of January 2003 we filed a higher-level administrative appeal against the Decisions with the Ministry of Taxes and Duties of the Russian Federation. In this appeal, we challenged the imposition of most of the remaining claims for tax underpayments, late payment interest and penalties in the Decisions. The total amount challenged was RUB 1,253,048,000 (U.S.\$39,603,286). As a tactical move, we did not administratively challenge the additional taxes and late payment interest in the amount of RUB 133,835,089 (U.S.\$4,229,933). If the Ministry of Taxes and Duties of the Russian Federation does not agree with this appeal, then we intend to contest in court the full amount set forth in the Decisions, including the amount not currently challenged in the current administrative appeal with the Ministry of Taxes and Duties of the Russian Federation. At present, it is not possible to predict the likelihood that we will prevail in either the current administrative appeal or in a court claim contesting the Decisions should we decide to proceed with such a court claim. It is also not possible to predict whether the Ministry of Taxes in Yakutia will raise any of the issues contained in the Acts of Audit or the Decisions in any future tax audits relating to taxable years after 2001. In the event that we are not successful in either the administrative appeal or in any court claim, we potentially could owe approximately RUB 299.3 million (U.S.\$9.5 million) as additional taxes and late payment interest. In addition, the Ministry of Taxes in Yakutia could file a claim in court against us for the collection of tax penalties which could amount to RUB 357,761,200 (U.S.\$11,307,244) in the event that we are not successful in either the administrative appeal or in any court claim that we may file with respect to the additional taxes.

#### ***The Audit Chamber***

The Audit Chamber is an independent authority in Russia, which is authorised to investigate Russian agencies and other entities associated with the Government of Russia. The Audit Chamber may report its findings and make recommendations to such entities; however, these recommendations do not carry the force of law and are, therefore, not mandatory.

On 15 December 2002, the Audit Chamber issued the Audit Chamber Report to the Government of Russia and to us. Amongst other things, the Audit Chamber Report recommended that we generally promote more rational expenditures, reduce overhead, minimise non-production costs, rationalise our corporate structure and replenish our internal working capital. The Audit Chamber Report also recommended that we apply stringent financial controls relating to our sales to the Tuimada diamond-polishing group of Yakutia, as their trade debt had increased in recent years, and consider a reduction in sales to Yakutian diamond-cutting operations which have experienced credit difficulties in the past. In addition, the Audit Chamber Report concluded that the initial placement of shares by ALROSA Ltd. violated certain technical requirements of Russian law. Accordingly, the Audit Chamber Report further recommended that we strictly observe legal procedures in any purchase of shares from our officers or employees to the extent that the suggestions to the Government of Russia concerning share transfers (discussed below) are implemented.

The Audit Chamber Report also made recommendations to the Government of Russia, including the following:

- *Transfer assets underlying the Lease Agreement.* The Audit Chamber Report reviewed the Lease Agreement under which we currently lease underground resources, assets and facilities from Yakutia. The report noted that, pursuant to an agreement with the Government of Russia prior to our founding, Yakutia received all of the assets of Yakutalmaz, one of our predecessor entities, and these constitute a significant part of the assets subject to the Lease Agreement. The Audit Chamber Report concluded that this contribution to Yakutia was unconstitutional because Russia received none of the assets, which contradicts the Russian Constitutional principle which states that underground resources are the joint property of Russia and the relevant local subdivision. In

addition, the Audit Chamber Report concluded that Russian law does not provide for the lease of underground resources, and states that the only legal way to use underground resources is pursuant to an applicable license. The Audit Chamber also found that the payments we make under the Lease Agreement do not correspond with the system of payments for use of underground resources under Russian law. Based on these findings, the Audit Chamber recommended that the Yakutalmaz assets be transferred from Yakutia to the Russian Federation.

- *Amend the Lease Agreement.* In connection with the transfer of assets described above, the Audit Chamber Report recommended that the Lease Agreement be amended to entitle the Government of Russia to any future lease payments made with respect to our lease of the Yakutalmaz assets.
- *Invalidate initial purchases of our shares.* The Audit Chamber Report states that the distribution of our shares to non-governmental entities and individuals contravenes the Russian Supreme Council Resolution No. 3020-1 dated 27 December 1991, which prohibits the privatisation of mining enterprises. The Audit Chamber Report also concluded that the controlling share in ALROSA Ltd. should have been issued to the Government of Russia. As a remedy, the Audit Chamber Report recommended that the Government of Russia seek to invalidate the purchase of our shares by the local districts within Yakutia and transfer such shares to federal ownership in order to increase the Government of Russia's ownership in us to 51 per cent.
- *Change representatives on our Supervisory Council.* The Audit Chamber Report concluded that the membership of our Supervisory Council is not in accordance with Presidential Decree No. 1481 dated 26 November 1992, which established the Supervisory Council. Accordingly, the Audit Chamber recommended that Russia change its representatives on our Supervisory Council to ensure the protection of its interests.
- *Confirm status of ALROSA Ltd. as a closed joint stock company.* The Audit Chamber Report referred to Russian laws requiring certain joint stock companies to be in the form of open joint stock companies. These include joint stock companies with more than 50 shareholders, those owned by the Government of Russia and companies formed from formerly State-owned enterprises. According to the Audit Chamber Report, it is not entirely free from doubt that the available exemptions from these laws apply to us. Accordingly, the Audit Chamber Report recommended that the Government of Russia submit to the Federal Assembly of Russia legislative amendments to confirm that our status as a closed joint stock company is in compliance with Russian law.

The Audit Chamber also expressed its opinion that we need to increase the volume of our diamond exports, and that De Beers purchases rough diamonds from us at prices which are below market value.

In November 2002, the Government of Russia assumed ownership of our shares previously owned by the Russian Servicemen's Fund. In addition, based on discussions with representatives of the Ministry of Finance of Russia, we believe that the Government of Russia has considered the conversion of ALROSA Ltd. from a closed joint stock company into an open joint stock company, although it has no immediate plans to do so. We believe that it is unlikely that the Government of Russia will seek to implement any other recommendation of the Audit Chamber. However, we can give no assurance in this regard. See "Risk Factors—Risks Relating to Our Business—The Audit Chamber has issued a series of recommendations which, if implemented by the Government of Russia, would change our relationship with Yakutia, the ownership of our shares, the membership of our Supervisory Council and our ability to export diamonds".

In addition to the issue of the Audit Chamber Report in December 2002, the Audit Chamber has examined the 1993 contract under which we were required to sell approximately U.S.\$1.2 billion of diamonds on behalf of Almaz-Export. In connection with the Audit Chamber's review we were not able to supply records confirming all of these sales because, under our record retention policy, we do not maintain records dating back to the time of these sales. Based on the absence of records, the Audit



Chamber issued a report which concluded that we may have breached certain contractual obligations in connection with our sale of diamonds on behalf of Almaziuvelirexport. Although the Audit Chamber has submitted this claim to the General Prosecutor's Office, we do not expect that the General Prosecutor's Office will institute any claim against us with respect to these sales.

## MANAGEMENT AND EMPLOYEES

### Supervisory Council

Under our charter, the Supervisory Council consists of 15 members elected by cumulative voting from candidates nominated by the shareholders. Each member has one vote. The Supervisory Council is headed by the Chairman who is entitled to cast a tie-breaking vote. Its members are elected for a period ending upon the occurrence of the next annual shareholders' meeting and may be re-elected without limitation thereafter. The Supervisory Council exercises general guidance over our activities in accordance with the authority provided under Russian federal legislation, and controls our executive bodies. The Supervisory Council does not, however, supervise the day-to-day running of our business. The present term of the Supervisory Council members will expire on the date of the next annual general shareholders' meeting, which we expect will take place in June 2003.

The Supervisory Council is managed by the Chairman (Alexey Leonidovich Koudrin), First Deputy Chairman (Vyacheslav Anatolyevich Shtyrov) and Deputy Chairman (Andrei Dmitrievich Kirillin).

The present members of the Supervisory Council are:

Name	Member Since	Principal Occupation
Vladimir Tikhonovitch Kalitin <sup>(1)</sup> . . . . .	June 2002	President of ALROSA Ltd.
Vyacheslav Anatolyevich Shtyrov <sup>(2)</sup> . . . . .	July 1992	President of Yakutia, First Deputy Chairman of the Supervisory Council
Varvara Andreevna Petrova <sup>(3)</sup> . . . . .	June 2002	Head of the Local Administration of the Nyurbinsky Ulus
Aleksander Pavlovich Morozkin <sup>(1)</sup> . . . . .	June 2002	First Vice President, Executive Director of ALROSA Ltd.
Gennadyi Fedorovitch Alekseev <sup>(2)</sup> . . . . .	June 2002	Minister of Property of Yakutia
Ernest Borisovitch Beriozkin <sup>(2)</sup> . . . . .	June 2002	Minister of Finance of Yakutia
Egor Afanasyevitch Borisov <sup>(2)</sup> . . . . .	June 2002	First Deputy Chairman of the government of Yakutia
Aleksandr Anatolievitch Ogly <sup>(2)</sup> . . . . .	June 2002	Minister of Industry of Yakutia
Aleksey Leonidovitch Koudrin <sup>(4)</sup> . . . . .	June 2002	Minister of Finance, First Deputy Prime Minister of Russia; Chairman of the Supervisory Council
Leonid Fedorovitch Tolpezhnikov <sup>(1)</sup> . . . . .	June 2002	Head of the Department of the Ministry of Finance of Russia
Andrei Dmitrievich Kirillin <sup>(1)</sup> . . . . .	August 1993	Deputy Chairman of the Supervisory Council
Aleksander Vasilievitch Tikhonov <sup>(4)</sup> . . . . .	June 2001	Head of the Department of the Ministry of Property of Russia
Ivan Sergeyevitch Materov <sup>(4)</sup> . . . . .	June 1997	First Deputy Minister of Economic Development and Trade of Russia
Aleksandr Vasilievitch Anoshkin <sup>(4)</sup> . . . . .	June 2002	Assistant to the Head of Administration of the President of Russia
Yuri Mitrofanovitch Medvedev <sup>(4)</sup> . . . . .	June 1999	First Deputy Minister of the Ministry of Property of Russia

(1) Nominee of the shareholder employees.

(2) Nominee of Yakutia.

(3) Nominee of the administrations of the local districts of Yakutia.

(4) Nominee of Russia.

The members of the Supervisory Council can be contacted at the address of ALROSA Ltd., 10/12 1<sup>st</sup> Kazachy per., Moscow 109017, Russia.

*Vladimir Tikhonovitch Kalitin*, President. Mr. Kalitin has been a member of the Supervisory Council since June 2002. As President, Mr. Kalitin is responsible for the day-to-day management of ALROSA Ltd.

He served as Chief Engineer from 1996 to 2002. In addition, he is Chairman of the Board of Directors of Viluigesstroi, a company engaged in construction of diamond industry-related facilities. He has been Chairman of the Board of Directors of the Joint Mongolian-Russian company, M and Diamond, since 2002 and is also a member of the Supervisory Board of Severalmaz.

*Vyacheslav Anatolyevich Shtyrov*, First Deputy Chairman of the Supervisory Council. Mr. Shtyrov became a member of the Supervisory Council in July 1992. He served as President of ALROSA Ltd. from 1995 to 2002. He is also the current President of Yakutia and a member of the Supervisory Board of ALROSA-Nyurba, a company engaged in diamond mining.

*Varvara Andreevna Petrova*, Head of the Local Administration of the Nyurbinsky Ulus since 1995. She became a member of the Supervisory Council in June 2002 and currently also serves as a member of the Board of Directors of ALROSA-Nyurba. In addition, she serves as a member of the Supervisory Board of Konezavod im. Stepana Vasilieva, a company engaged in agricultural production.

*Aleksander Pavlovich Morozkin*, First Vice President, Executive Director. As our First Vice President, Mr. Morozkin is responsible for all of our industrial activities in Western Yakutia. He became a member of the Supervisory Council in June 2002 and served as Vice President from 1998 to 2002. He currently serves as the Chairman of the Board of Directors of Upravlenie Rabotchego Snabzhenija, a company engaged in the supply of goods and materials required for our activities, as Chairman of the Board of Directors of Lenskaya Optovo-Torgovaya Kontora, a company engaged in the wholesale of goods, and Chairman of the Board of Directors of Irilyakhneft, a company engaged in oil refining. He is also President of the Board of Directors of Vilyuiskaya GES-3, a company which, after completion of its construction of a hydroelectric power station, will supply electricity for our activities. In addition, he is a member of the Board of Directors of ALROSA-Nyurba, and he serves as a member of the Board of Directors of ALROSA-Gas, a company engaged in gas extraction. Mr. Morozkin has also been a member of the Board of Directors of the Mirninsky Commercial Bank MAK-Bank ("MAK-Bank") since 2002.

*Gennadyi Fedorovitch Alekseev*, Minister of Property of Yakutia. Mr. Alekseev became a member of the Supervisory Council in June 2002. He currently serves as a member of the Board of Directors of Vilyuiskaya GES-3 and is a member of the Board of Directors of the Open Joint Stock Company Respublikanskaya Investizionnaya Kompanija SakhaKapital ("SakhaKapital"), an investment company.

*Ernest Borisovitch Beriozkin*, Minister of Finance of Yakutia. He became a member of the Supervisory Council in June 2002 and also serves as a member of the Board of Directors of SakhaKapital.

*Egor Afanasyevitch Borisov*, First Deputy Chairman of the government of Yakutia. He became a member of the Supervisory Council in June 2002. He does not currently hold any managerial positions with any other companies.

*Aleksander Anatolievitch Ogly*, Ministry of Industry of Yakutia. He became a member of the Supervisory Council in June 2002. He does not currently hold any managerial positions with any other companies.

*Aleksey Leonidovitch Koudrin*, Chairman of the Supervisory Council. Mr. Koudrin became a member of the Supervisory Council in June 2002. He is also the Minister of Finance and First Deputy Prime Minister of Russia. He does not currently hold any managerial positions with any other companies.

*Leonid Fedorovitch Tolpezhnikov*, Head of the Department of the Ministry of Finance of Russia. He became a member of the Supervisory Council in June 2002. Mr. Tolpezhnikov is also the Head of Department of Precious Metals and Gems at the Ministry of Finance of Russia. He served as Director of the Center of marketing research and Director of the Analytic Center of ALROSA Ltd. from 1996 to 2000. He does not currently hold any managerial positions with any other companies.

*Andrei Dmitrievich Kirillin*, Deputy Chairman of the Supervisory Council. He became a member of the Supervisory Council in August 1993. He does not currently hold any managerial positions with any other companies.

*Aleksandr Vasilievitch Tikhonov*, Head of the Department of the Ministry of Property of Russia. Mr. Tikhonov became a member of the Supervisory Council in June 2001. He does not currently hold any managerial positions with any other companies.

*Ivan Sergeyevitch Materov*, First Deputy Minister of Economic Development and Trade of Russia. Mr. Materov became a member of the Supervisory Council in June 1997. He served as the Co-Chairman of the Supervisory Board from 1998 to 2000. He does not currently hold any managerial positions with any other companies.

*Alexander Vasilievitch Anoshkin*, Assistant to the Head of Administration of the President of Russia. He became a member of the Supervisory Council in June 2002. He does not currently hold any managerial positions with any other companies.

*Yuri Mitrofanovitch Medvedev*, First Deputy Minister of the Ministry of Property of Russia. He became a member of the Supervisory Council in June 1999. He does not currently hold any managerial positions with any other companies.

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Most of the companies in which members of our Supervisory Council hold management positions are subsidiaries of ALROSA Ltd. See “Subsidiaries”.

## **Management Board**

Our Management Board is responsible for our general management, except for those matters that, as a matter of law, are reserved to the shareholders or the Supervisory Council. Thus, the Management Board is responsible for our day-to-day operations. Our charter states that the Supervisory Council determines the total number of members of the Management Board. The members of the Management Board are appointed by the Supervisory Council, and the term of their service shall be determined in the relevant contract with each member. Each member of the Management Board has one vote and decisions are taken by simple majority. The Management Board is headed by the President, who is entitled to cast a tie-breaking vote. Meetings of the Management Board are required to be held at least quarterly. Currently, the Management Board has 25 members.

The present members of the Management Board are:

Name	Age	Responsibility
Vladimir Tikhonovich Kalitin . . . . .	56	President and Chairman
Aleksander Pavlovich Morozkin . . . . .	54	First Vice President, Executive Director
German Serapionovich Kuznetsov . . . . .	55	First Vice President for corporate governance, long-term investments and circulation of securities
Nikolay Nikolayevich Ermolayev <sup>(1)</sup> . . . . .	51	Vice President, Chief Manager of the Moscow Representative Office
Fedor Borisovich Andreev . . . . .	36	First Vice President
Victor Yegorovich Sofronov . . . . .	38	Vice President
Dmitry Konstantinovich Novikov . . . . .	33	Vice President
Sergei Aramovich Ulin . . . . .	52	Vice President
Yuri Aleksandrovich Dudenkov . . . . .	60	Vice President
Ivan Kirillovich Demyanov . . . . .	60	Vice President
Gustav Afanasievich Iakovlev . . . . .	64	Vice President, Head of the Yakutsk Representative Office
Vasily Mikhailovich Vlasov . . . . .	57	Vice President
Gennady Anatolyevich Melnik . . . . .	60	Chief Engineer
Pyotr Andreevich Galaev . . . . .	56	Vice President
Olga Alekseevna Liashenko . . . . .	55	Chief Accountant
Pyotr Mikhailovich Glagolev . . . . .	47	Head of Almazdortrans Department
Semen Fedotovitch Ponomarev <sup>(1)</sup> . . . . .	53	Director of Aikhal GOK
Anatoly Tarasovitch Popov <sup>(1)</sup> . . . . .	56	Head of Administration of Mirninsky Ulus
Valentina Anatolievna Potrubeyko <sup>(1)</sup> . . . . .	41	Vice President
Pavel Antonovitch Tretyakov <sup>(1)</sup> . . . . .	48	Head of the trade union “ProfAlmaz”
Aleksander Vladimirovitch Kozupeev . . . . .	40	Director of Anabar GOK
Yuri Anatolyevich Petrov . . . . .	43	Director of Udachny GOK
Sergy Grigorievitch Aliabiev . . . . .	50	Director of Nyurba GOK
Yuri Ivanovich Popov . . . . .	49	Director of the Capital Construction Department for ALROSA Ltd.
Hamlet Vaginakovich Akopian . . . . .	47	Head of the Legal Department for ALROSA Ltd.

(1) Appointment of these members of the Management Board must be approved by the Supervisory Council. Such approval is expected to be granted at the end of April 2003.

*Vladimir Tikhonovich Kalitin*, President and Chairman. Mr. Kalitin is responsible for the general management of ALROSA Ltd. He became a member of the Management Board in 1996. He served as Chief Engineer from 1996-2002. He does not currently hold any managerial positions with any other companies.

*Alexander Pavlovich Morozkin*, First Vice President, Executive Director. Mr. Morozkin is responsible for the operation of ALROSA Ltd.’s divisions in the Republic of Sakha. He became a member of the Management Board in 1998. He was Vice President of ALROSA Ltd. from 1998-2002. Since 2002, he has been the Chairman of the Board of Directors of Upravlenie Rabochego Snabzheniya, which is engaged in the supply of goods and materials required for our activities. In addition, he is Chairman of the Board of Directors of Lenskaya Optovo-Torgovaya Kontora, a subsidiary of ALROSA Ltd. engaged in the wholesale of goods. He is Chairman of the Board of Directors of Irillyakhneft, a company engaged in oil refining. Mr. Morozkin is a Member of the Board of Directors of ALROSA-Nyurba, and a member of the Board of Directors of MAK-Bank. He is also President of the Board of Directors of Vilyuiskaya GES-3 and a member of the Board of Directors of ALROSA-Gas.

*German Serapionovich Kuznetsov*, First Vice President responsible for corporate governance, long-term investments and circulation of securities. He became a member of the Management Board in 2002.

*Nikolay Nikolayevich Ermolaev*, Vice President, Chief Manager of the Moscow Representative Office. Mr. Ermolaev is responsible for the management of ALROSA Ltd.'s activities in the European part of the Russian Federation. He became a member of the Management Board in 2003. He does not currently hold any managerial positions with any other companies.

*Fedor Borisovich Andreev*, First Vice President. Mr. Andreev is responsible for all financing issues. He became a member of the Management Board in 2002. Since 2002, he has been a member of the Board of Directors of the Moscow Bank of Reconstruction and Development.

*Victor Yegorovich Sofronov*, Vice President. Mr. Sofronov is responsible for short-term financing programmes. He became a member of the Management Board in 1995. He has also been a member of the Board of Directors of Vostok-Kapital since 2001. In addition, Mr. Sofronov has been a member of the Board of Directors of MAK-Bank since 2002, and has been a member of the Board of Directors of the commercial bank of social development, Yakimanka, since 2001. Mr. Sofronov left ALROSA Ltd. in March 2003. A formal decision of the Supervisory Council is required to terminate Mr. Sofronov's membership of the Management Board. Such a Supervisory Council decision is expected in early April 2003.

*Dmitry Konstantinovich Novikov*, Vice President. Mr. Novikov is responsible for our investment projects and leasing. He became a member of the Management Board in 2002. Prior to 2002 he was Chairman of the Board of Directors of an investment company, IK Vostok-Capital.

*Sergei Aramovich Ulin*, Vice President. Mr. Ulin is responsible for our external relations, including relations with De Beers. He became a member of the Management Board in 1993. Mr. Ulin was a President of the Russian Diamond Chamber, a Russian diamond exchange.

*Yuri Aleksandrovich Dudenkov*, Vice President. Mr. Dudenkov is responsible for sales and marketing. He became a member of the Management Board in 1998. Since 2002, Mr. Dudenkov has also been a member of the Board of Directors of Orel-ALROSA, a company engaged in diamond polishing. In addition, since 2002, he has been a member of the Board of Directors of the Closed Joint Stock Company Promyshlennaya-investitsionnaya kompaniya Orel-Almaz, and a member of the Board of Directors of Almaznyi Mir Company, companies whose activities are linked to diamond polishing.

*Ivan Kirillovich Demyanov*, Vice President. Mr. Demyanov is responsible for social issues. He became a member of the Management Board in 2002. Since 2002, Mr. Demyanov has also been Chairman of the Board of Directors of the State pension fund Almaznaya Osen and a member of the Board of Directors of MAK-Bank. Since 2002, Mr. Demyanov has also been a member of the Board of Directors of Sanatoriy Leninogorskiy, a leisure resort. In addition, he has been a member of the Board of Directors of SAPI-Polis, an insurance company, since 2002.

*Gustav Afanasievich Iakovlev*, Vice President, Head of the Yakutsk Representative Office. Mr. Iakovlev is responsible for our relationship with the authorities of Yakutia. He became a member of the Management Board in 1993. He is a member of Board of Directors of Tuimada Diamond, a company engaged in the polishing and sale of diamonds.

*Vasily Mikhailovich Vlasov*, Vice President. Mr. Vlasov is responsible for our relationships with local districts of the Republic of Sakha. He became a member of the Management Board in 2002. Mr. Vlasov also served as Co-Chairman of the Supervisory Council from 1998 to 2002. He has been a member of the Board of Directors of the insurance company SAPI-Polis since 2002. In addition, he has been Chairman of the Board of Directors of SakhaKapital since 2002. Mr. Vlasov also became a member of the Board of Directors of Tuimada Diamond in 2002.



*Gennady Anatolyevich Melnik*, Chief Engineer. Mr. Melnik is responsible for the production activities and technical development of ALROSA Ltd. in Yakutia. He became a member of the Management Board in 1995. Since 2002, he has also been a member of the Board of Directors of Vilyuiskaya GES-3 and Chairman of the Board of Directors of the research-and-production activities of Burevestnik, a company which is engaged in the production of electronic equipment.

*Pyotr Andreevich Galaev*, Vice President. Mr. Galaev is responsible for resources supply, transport and trade. He became a member of the Management Board in 2002. He has also been a member of the Board of Directors of Aikhalskiy Otdel Rabochego Snabjeniya, a company which is engaged in diamond trading and polishing, since 2002. In 2002, he became a member of the Board of Directors of Udachninskiy Kombinat Pischevyh Predpriyatiy, which is engaged in diamond trading and polishing, and a member of the Board of Directors of Udachninskiy Otdel Rabochego Snabjeniya, which is engaged in the wholesale supply of goods. He has been Chairman of the Board of Directors of Mirninsky otdel rabochego snabjeniya, which is engaged in the wholesale supply of goods, since 2002 and is a member of the Board of Directors of Sudokhodnaya kompaniya ALROSA-Lena, a company which is engaged in shipping.

*Olga Alekseevna Liashenko*, Chief Accountant. Mrs. Liashenko is responsible for our accounting department. She became a member of the Management Board in 1993. She does not currently hold any managerial positions with any other companies.

*Pyotr Mikhailovich Glagolev*, Head of Almazdortrans Department. Mr. Glagolev is responsible for shipping operations and transportation of goods and resources by car in Western Yakutia. He became a member of the Management Board in 1996. In 2002, Mr. Glagolev became a Member of the Board of Directors of Lenskaya Optovo-Torgovaya Kontora, a company engaged in wholesale trade, and Chairman of the Board of Directors of ALROSA-Lesprom. He also became a member of the Board of Directors of Sudokhokhnaya kompaniya ALROSA-Lena in 2002.

*Semen Fedotovitch Ponomarev*, Director of Aikhal GOK. Mr. Ponomarev is responsible for the management and production activities of Aikhal GOK. He became a member of the Management Board in 2003.

*Anatoly Tarasovitch Popov*, Head of Administration of Mirninsky Ulus. He became a member of the Management Board in 2003. He does not currently hold any managerial positions with any other companies.

*Valentina Anatilievna Potrubeyko*, Vice President. Mrs. Potrubeyko is responsible for economy and planning for ALROSA Ltd. She became a member of the Management Board in 2003. She does not currently hold any managerial positions with any other companies.

*Pavel Antonovitch Tretyakov*, Head of the trade union "ProfAlmaz". He became a member of the Management Board in 2003. He does not currently hold any managerial positions with any other companies.

*Aleksander Vladimirovitch Kozupeev*, Director of Anabar GOK. Mr. Kozupeev is responsible for the management and production activities of Anabar GOK. He became a member of the Management Board in 2003.

*Yuri Anatolyevich Petrov*, Director of Udachny GOK. Mr. Petrov is responsible for the management and production activities of Udachny GOK. He became a member of the Management Board in 2002. In addition, he served as the Head of the industry-technical department of Mirninsky GOK from 1997 to 2001. Mr. Petrov also became Chairman of the Board of Directors of Udachninskiy Kombinat Pischevyh Predpriyatiy, a company engaged in diamond trading and polishing and Chairman of the Board of Directors of Udachninskiy Otdel Rabochego Snabjeniya, a company engaged in the diamond trade, in 2002.

*Sergy Georgievich Aliabiev*, Director of Nyurba GOK. Mr. Aliabiev is responsible for the management and production activities of Nyurba GOK. He became a member of the Management Board in 2002 and served as the Deputy General Director from 1996 to 2001. He became Director of Nyurba GOK in 2001 and has been a member of the Board of Directors of Almazy Anabary since 2002. Mr. Aliabiev became Chairman of the Board of Directors of Konezavod im. Stepana Vasilyeva, a company engaged in horse breeding, in 2002.

*Yuri Ivanovich Popov*, Director of the Capital Construction Department of ALROSA Ltd. Mr. Popov is responsible for the construction activities of ALROSA Ltd. He became a member of the Management Board in 2000. He also served as Chief Engineer of the Capital Construction Department from 1996 to 2000. In 2002, Mr. Popov became a member of the Board of Directors of Irilyakhneft, a company engaged in oil extraction, a member of the Board of Directors of ALROSA-Lenskstroy, a member of the Board of Directors of Viluigesstroi and a member of the Board of Directors of ALROSA-Nyurba. In addition, he became a member of the Board of Directors of ALROSA-Lesprom and a member of the Board of Directors of Vilyuiskaya GES-3 in 2002. Mr. Popov has also been a member of the Board of Directors of ALROSA-Gas since 2002.

*Hamlet Vaginakovich Akopian*, Head of the Legal Department. Mr. Akopian is responsible for all legal issues. He became a member of the Management Board in 2002. In addition, in 2002, he became a member of the Board of Directors of Burevestnik, a company engaged in the production of electronic equipment.

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Most of the companies in which members of our Management Board hold management positions are subsidiaries of ALROSA Ltd. See “Subsidiaries”.

#### **Compensation of the Members of the Supervisory Council and Management Board**

Total aggregate compensation, including salary and bonuses and other deferred compensation, paid to members of our Supervisory Council and Management Board during the nine-month period ended 30 September 2002 was approximately RUB 48 million (U.S.\$1.5 million). There are no outstanding loans made by us to any of such members, and we have given no guarantees in respect of obligations of any of such members to third parties. Members of the Management Board are eligible to participate in our pension plan.

#### **Board Practices**

We do not enter into service contracts with the members of our Supervisory Board. Our Management Board members enter into employment contracts which set forth their compensation and annual performance goals. However, these contracts do not obligate these members to work for us for any specified length of time.

#### **Auditing Committee**

Our Auditing Committee was elected by the general shareholders’ meeting in accordance with our charter in order to exercise control over our financial and economic activities. Under our charter, the Auditing Committee consists of five members elected at a shareholders’ meeting for a term ending on the date of the next annual general shareholders’ meeting. The current term of the Auditing Committee will expire in June 2003.

The present members of the Auditing Committee are:

Name	Responsibility
Galina Innokentyevna Danchikova . . . . .	Deputy Head of the government of Yakutia–First Deputy Head of the Permanent Representation of Yakutia with the President of the Russian Federation
Lyudmila Afanasyevna Nikolaeva . . . . .	Deputy Head of the Department of Strategic Planning, Analysis and Prognosis of the Administration of the President of Yakutia
Anna Ivanovna Yezhova . . . . .	Chief Accountant of USO ALROSA
Valery Vladimirovitch Eliseev . . . . .	Deputy Head of Department of Precious Metals and Gems, Ministry of Finance of Russia
Kirill Borisovitch Nikolayev . . . . .	Consultant of the Department of Property of the Energy Industry of the State Property Ministry of Russia

### Employees

The following table sets forth our employees as at 30 September 2002 and as at 31 December 1999, 2000 and 2001:

	As of 30 September	As of 31 December		
	2002	2001	2000	1999
<b>Employees</b>				
Mining Activities				
Udachny . . . . .	4,865	5,016	5,197	5,320
Mirny . . . . .	3,502	3,453	3,596	3,330
Aikhal . . . . .	5,462	5,469	5,552	4,989
Nyurba . . . . .	553	389	179	–
Anabar . . . . .	347	349	346	278
United Selling Organisation . . . . .	1,005	1,018	1,010	1,078
Maintenance . . . . .	4,109	4,174	4,157	3,872
Construction . . . . .	6,038	7,465	6,579	5,250
Transport . . . . .	6,554	6,937	6,683	6,332
Geology . . . . .	3,061	2,969	2,771	2,384
Management in Moscow and Mirny . . . . .	509	501	464	407
Supply . . . . .	982	1,023	989	1,137
Other <sup>(1)</sup> . . . . .	3,520	3,147	2,875	1,980
Subsidiary employees . . . . .	6,020	5,770	5,268	702
<b>Total . . . . .</b>	<b>46,527</b>	<b>47,680</b>	<b>45,666</b>	<b>37,059</b>

(1) Includes employees employed in our diamond sorting facilities in Mirny, Brillianty ALROSA, our YakutNiproAlmaz Institute and in our representative offices in Russia and abroad.

We intend to significantly reduce our number of employees over the next ten years through divestiture of non-core business ventures, such as ALROSA-Gas, as well as expected productivity gains. We anticipate that, other than with respect to divestitures, this reduction will be accomplished primarily through normal employee turnover rather than redundancies.

Our non-executive management employees are represented by ProfAlmaz, the Russian diamond workers labour union. However, these employees are not required to join the union. Relations with employees are governed by the terms of a rate agreement, which provides the framework for relations

between the employees and our management personnel, including wages and salaries, benefits, pensions, training and safety matters. In 2001, we signed a five-year development plan with ProfAlmaz, setting forth the terms of employment for union members. We have not experienced any disruption in operations as a result of any labour dispute, strike or employee legal action, and we believe relations with employees are good.

We maintain a comprehensive training programme, which includes sponsorship of promising students, as well as worker training. In 2001, we incurred approximately RUB 31 million (U.S.\$1 million) in expenses relating to this programme, and almost 6,000 of our employees including 300 specialists and managers participated in training courses.

The average wage for our employees is approximately RUB 15,000 (U.S.\$468) per month. Russian legislation also requires us to pay for the cost of one trip by employees and their families once every two years or, in lieu thereof, to pay employees a pre-determined travel allowance. The destination may be any place within Russia. In addition, for workers with health problems, we will pay 70 per cent. of the cost for the employee and one non-working family member to visit a sanatorium within Russia, selected from an approved list, that specialises in the relevant medical condition.

Each employee with more than 15 years of service is entitled to continued benefits after retirement based on their final salary and location. Because of work in the harsh conditions in northern Yakutia, female employees who have worked for at least 15 years in this region are entitled by law to retire at the age of 50, which is five years earlier than the normal Russian retirement age. The retirement age for male employees who have worked for at least 15 years in this region is 55. Employees within this northern region also qualify for relocation expenses, should they decide to relocate to another region upon retirement.

Since 1999 we have operated a defined contribution plan through our consolidated subsidiary Almaznaya Osen. We are obligated to make an annual contribution to the plan in an amount equal to 0.3 per cent. of our diamond revenues. We have no legal obligation to support the plan if we are unable to pay amounts due to the plan beneficiaries.

## PRINCIPAL SHAREHOLDERS

We are a closed joint stock company and, therefore, our shares may be transferred only in compliance with our shareholders' right of first refusal and in accordance with our charter. Our shareholders are currently considering the conversion to an open joint stock company structure which would allow the transfer of our shares, free of the existing shareholders' right of first refusal; however, no decision has been made in this regard. The following table sets forth the ownership of our ordinary share capital as at 26 February 2003.

	Number of Shares	Per cent.
The State Property Ministry of Russia <sup>(1)</sup> . . . . .	74,000	37.0
The State Property Ministry of Yakutia . . . . .	64,000	32.0
Administrations of eight local districts ("ulusy") of Yakutia . . . . .	16,000	8.0
Other shareholders <sup>(2)</sup> . . . . .	46,000	23.0
Total . . . . .	<u>200,000</u>	<u>100.0</u>

(1) Formerly the State Property Management Committee. Until November 2002, the Russian Servicemen's Fund owned 5 per cent. of ALROSA Ltd.'s shares. In November 2002, these shares were transferred to the State Property Ministry of Russia.

(2) Consist primarily of former and current employees of ALROSA Ltd. and its predecessor entities.

On 15 December 2002 the Audit Chamber issued the Audit Chamber Report to the Government of Russia, recommending certain changes in our shareholding structure. See "Our Business—Legal Matters—The Audit Chamber".

### Shares held by Board Members

As of 30 September 2002, the members of the Supervisory Council beneficially owned in the aggregate 620 shares of ALROSA Ltd. and the members of the Management Board beneficially owned in the aggregate 1,855 shares of ALROSA Ltd.

### Shareholders' Meetings

Shareholders' meetings may be convened by the Supervisory Council upon its own initiative, upon the request of shareholders holding more than 10 per cent. of the voting shares of ALROSA Ltd., upon the request of our internal auditing committee or upon the request of an external auditor. The general shareholders' meeting takes place each year not earlier than two months, and no later than six months, after the end of the financial year. Each ordinary share of ALROSA Ltd. carries the right to cast one vote at the general meeting.

## **CERTAIN TRANSACTIONS WITH RELATED PARTIES**

Because our shareholders include Russia and Yakutia, and our mining business requires us to obtain concessions from both of these entities, we have engaged in several transactions with these related parties. For a description of the licenses and lease involving Russia and Yakutia under which we operate, please see “Our Business—Regulatory and Environmental Matters—Licenses” and “—Lease Agreement” above. For a description of our sales to these entities, please see “Our Business—Sales of Rough and Polished Diamonds—Sales of rough diamonds to Russia and Yakutia”.

For a description of the loan transactions we have entered into with Sobinbank, our non-consolidated affiliate, see “Description of Material Agreements—Material Financing Agreements—U.S. Dollar-denominated borrowings”.

Beginning in 2000, our diamond-polishing division, Brillianty ALROSA, leased approximately 5,285 square metres in Moscow for its diamond-cutting and polishing operations from Almazny Mir Company, which is wholly owned by the Government of Russia. Payments under the lease were RUB 34.5 million (U.S.\$1.1 million) and RUB 14.0 million (U.S.\$0.4 million) for the years 2001 and 2000 respectively.

We sell rough diamonds to the Tuimada Group in Yakutsk, a group of diamond polishers controlled by Yakutia and in which we have a 12.7 per cent. interest. Total sales to the Tuimada Group were RUB 1,551 million (U.S.\$49.0 million) in 2001, RUB 2,432 million (U.S.\$76.9 million) in 2000 and RUB 1,900 million (U.S.\$60.0 million) in 1999. These entities generated accounts receivable totalling RUB 614 million (U.S.\$19.4 million), RUB 948 million (U.S.\$29.9 million) and RUB 901 million (U.S.\$28.5 million) as of 31 December 2001, 2000 and 1999, respectively.

We sell rough diamonds to Kristall, a diamond-polishing company controlled by the Government of Russia. Total sales were RUB 5,253 million (U.S.\$166 million) in 2001, RUB 6,267 million (U.S.\$198.1 million) in 2000 and RUB 5,484 million (U.S.\$173.3 million) in 1999. Accounts receivable for Kristall totalled RUB 331 million (U.S.\$10.5 million), RUB 548.8 million (U.S.\$17.3 million) and RUB 753 million (U.S.\$23.8 million) as of 31 December 2001, 2000 and 1999, respectively.

We also sell rough diamonds to ZAO PIC Orel-Almaz, a non-consolidated subsidiary. Total sales were RUB 82 million (U.S.\$2.6 million) in 2001, RUB 325 million (U.S.\$10.3 million) in 2000 and RUB 333 million (U.S.\$10.5 million) in 1999. Accounts receivable for ZAO PIC Orel-Almaz totalled RUB 170 million (U.S.\$5.4 million), RUB 208 million (U.S.\$6.6 million) and RUB 169 million (U.S.\$5.3 million) as at 31 December 2001, 2000 and 1999, respectively.

We are required by Russian law and our charter to obtain the approval of disinterested directors or shareholders for transactions “with interested parties”. In general terms, “interested” parties include any of our shareholders, together with their affiliates, that own at least 20 per cent. of our voting shares, as well as members of our Supervisory Council and Management Board, our President and any entities in which these entities or individuals own a specified interest or occupy specified positions. Due to the technical requirements of Russian law, these same parties may also be deemed to be “interested parties” with respect to certain transactions between entities within our group.



## DESCRIPTION OF EXISTING MATERIAL AGREEMENTS

### Material Agreements Relating to Operational Matters

For a description of the Lease Agreement under which we lease production assets from Yakutia, see “Our Business—Regulatory and Environmental Matters—Lease Agreement”. For a description of the De Beers Trade Agreement for the export of diamonds, see “Our Business—Sales of Rough and Polished Diamonds—Export of gem and near-gem rough diamonds”.

#### *Export licenses*

We are awaiting the issuance of a number of export licenses by the Ministry of Economic Development and Trade of Russia for the calendar year 2003. These cover the export of diamond powder, industrial rough diamonds and non-industrial rough diamonds.

#### *Construction services*

*DSK.* On 19 June 2001, we entered into an agreement with Joint Stock Company DSK, a construction company, for the construction by DSK of housing in Lensk for an aggregate consideration of RUB 564 million (U.S.\$17.8 million).

*Rostovshakhtostroi.* On 6 August 2001 we entered into an agreement relating to the Mir open-pit mine with Joint Stock Company Rostovshakhtostroi, a construction company. This contract required Rostovshakhtostroi to construct a reinforced shaft using special construction techniques, in exchange for aggregate consideration of RUB 963.3 million (U.S.\$30.4 million).

### Other Material Agreements

*AO Vilyuiskaya GES-3.* On 16 November 2000, we entered into an agreement in which ALROSA Ltd. extended credit to the Vilyuiskaya GES-3 in the form of an intercompany loan. The purpose of this loan was to finance our capital investments in the construction and assembly of the hydroelectric station. The pricing terms will be set forth in a separate agreement to be negotiated by the parties.

*Yakutskenergo.* On 11 May 2000 we entered into an agreement for the sale and purchase of shares in OAO Vilyuiskaya GES-3. The consideration for the purchase of these shares was RUB 940 million (U.S.\$29.7 million).

### Material Financing Agreements

As of 1 March 2003, we had total indebtedness of U.S.\$1.1 billion.

#### *U.S. Dollar-denominated borrowings*

*Sobinbank.* On 31 July 2002, we entered into an unsecured credit agreement in the amount of U.S.\$20 million, bearing 12 per cent. interest. The credit agreement was intended to finance our current commercial activities, and required us to use the loan proceeds for this purpose. The loan must be repaid by 27 August 2004.

*Sberbank.* On 9 July 2001, we entered into a U.S.\$70 million non-revolving credit line with Sberbank. The purpose of this credit line was to finance expenses incurred due to flooding in Lensk. This credit line has a floating interest rate of between 12 per cent. and 14 per cent. The interest rate fluctuates based on the average quarterly turnover of ALROSA Ltd.’s bank account with Sberbank. The credit line carries a fee of 0.1 per cent. of the amount of the credit line. Sberbank is entitled to suspend this credit and to demand repayment under the credit agreement if our aggregate credit turnover for any quarter is less than

RUB 11 million (U.S.\$347,661). The credit line is expressed to be secured by pledges of (i) promissory notes of ALROSA Ltd.; (ii) two buildings located in Moscow; (iii) our building located at 10% B. Polyanka, Moscow; (iv) seven of our airplanes; and (v) goods in circulation. The credit line has been extended and expires on 31 May 2004.

*Trust and Investment Bank.* On 9 January 2003 we entered into a loan agreement with the Trust and Investment Bank for short-term loans in the amount of U.S.\$30 million. The interest rate on the loan is 12 per cent. The loan term expires on 30 June 2003. On 4 March 2003 we entered into three additional loan agreements with the Trust and Investment Bank in the amounts of U.S.\$20 million, U.S.\$20 million and U.S.\$10 million, respectively, each with an interest rate of 10 per cent. Each of the loans expires on 4 March 2004.

*International Moscow Bank.* On 17 July 2002 we entered into a U.S. Dollar-denominated credit agreement with the International Moscow Bank for the granting of credit in the amount of U.S.\$18 million. The purpose of this credit was to finance our working capital. The interest rate for this loan is LIBOR plus 5 per cent., or LIBOR plus 5.5 per cent., in the event our quarterly revenue for the prior quarter is less than U.S.\$24 million. The commission fee payable for this loan was U.S.\$125,000. This loan is secured by a pledge of rough diamonds. The lender may demand payment of additional sums if its expenses increase or its revenue decreases due to changes in Russia. The loan expires on 17 July 2004.

*Bank of Moscow.* On 5 September 2002, we entered into a credit agreement with a syndicate of banks led by the Moscow Municipal Bank (the "Bank of Moscow") in the amount of U.S.\$91.5 million. The interest rate on this syndicated loan is 11.5 per cent. The commission fee is 1 per cent. of the unused portion of the credit facility. This loan is secured by a pledge of rough diamonds in an amount of no less than 150 per cent. of the amount of the credit limit and interest for the period of credit. The loan is also secured by a pledge of receivables. This agreement provides for an event of default if there are changes in our legal status or in the composition of our shareholders, if such changes are deemed to negatively affect our payment ability. This syndicated loan expires 720 days after the date of the first disbursement, which occurred on 16 September 2002.

*ROSBANK.* On 14 March 2003 we entered into a loan agreement with ROSBANK in the amount of U.S.\$20 million. The loan carries an interest rate of 11 per cent., and its term expires on 21 March 2005. On 7 April 2003 we entered into another loan agreement in the amount of U.S.\$10 million, with an interest rate of 7 per cent. The loan term expires on 7 May 2003.

*Vneshtorgbank.* On 21 June 2002, we entered into a secured term credit agreement with a syndicate of banks led by Vneshtorgbank in the amount of U.S.\$60 million. The interest rate on this loan is LIBOR plus 8.61 per cent. It is secured by a pledge of rough diamonds and a pledge of receivables related to contracts for the sale of diamonds. Under the terms of this credit agreement, we undertake not to change our legal form without prior written consent of the bank syndicate. This loan expires 720 days after the first disbursement, which occurred on 28 June 2002. This loan is to be repaid in 18 equal instalments, the first of which is to be paid on the last day of the seventh month after the drawdown date.

On 7 February 2003 we entered into a credit agreement with Vneshtorgbank in the amount of U.S.\$10 million. This agreement carries an interest rate of 10.5 per cent. and expires on 8 May 2003. On 14 February 2003 we entered into a U.S.\$5 million credit agreement with a 10.5 per cent. interest rate, expiring on 19 May 2003. On 14 February 2003 we entered into an additional credit agreement in the amount of U.S.\$10 million. The credit agreement has an interest rate of 10.5 per cent., and its term expires on 21 May 2003.

On 6 March 2002, we entered into a number of credit agreements with Vneshtorgbank pursuant to which Vneshtorgbank agreed to provide us with financing on various dates in the future, namely: (i) U.S.\$6,892,370, available from 1 August 2003 until 31 August 2003; (ii) U.S.\$6,646,158, available from 1 February 2004 until 29 February 2004; (iii) U.S.\$6,377,043, available from 1 August 2004 until

31 August 2004; and (iv) U.S.\$6,119,379, available from 1 February 2005 until 28 February 2005. All the amounts drawn down under these credit agreements will carry an interest rate of 13 per cent. and shall be repaid within 30 days of the drawdown date.

*Bank Menatep SPb.* We have entered into the following credit agreements with Bank Menatep:

- On 21 May 2002, we entered into five credit agreements, each with a credit amount of U.S.\$10 million and subject to an interest rate of 11.5 per cent. These loans were secured by pledges of rough diamonds. Two of these loans have been repaid, two are due on 20 June 2003 and one is due on 15 July 2003.
- On 13 June 2002, we entered into a credit agreement in the amount of U.S.\$10 million. This loan carries interest at a rate of 11 per cent., and is secured by a pledge of rough diamonds. The loan expires on 13 May 2003.
- On 5 February 2003 we entered into a credit agreement with Bank Menatep in the amount of U.S.\$10 million. This loan carries an interest rate of 11.25 per cent., and is secured by the pledge of rough diamonds. The loan expires on 4 February 2004.
- On 27 March 2003 we entered into a credit agreement with Bank Menatep in the amount of U.S.\$50 million. This loan carries an interest rate of 9.25 per cent., and is secured by the pledge of rough diamonds. The loan expires on 15 April 2004.

*Commerzbank (Eurasija) ZAO.* On 29 May 2002, we entered into an agreement pursuant to which Commerzbank granted to us a credit line in the amount of U.S.\$10 million. The interest rate for this line of credit is LIBOR plus 5 per cent. This credit line expires on 28 May 2003.

*Promyshlenno-Stroitelny Bank.* On 17 October 2002, we entered into a credit agreement with Promyshlenno-Stroitelny Bank (“Promstroybank”) for the extension of a revolving credit facility in the maximum principal amount of U.S.\$25 million. This facility has a fixed interest rate of 11.16 per cent. and is subject to a commission fee in the amount of 0.2 per cent. of the advanced funds. Pursuant to the terms of this agreement, we must maintain turnover at our account in Promstroybank of no less than U.S.\$37.5 million in each three-month period during the term of the facility. The lender may require us to prepay the advances in the event our revenue decreases by more than 20 per cent. in any quarter during the term. The facility is secured by a pledge of rough diamonds and expires on 1 December 2003.

*Export-Import Bank of the United States/The Chase Manhattan Bank.* On 28 February 2001, we entered into a medium term credit facility agreement to finance exports from the United States to Russia. Pursuant to this agreement we have borrowed: (i) U.S.\$7,340,988 and U.S.\$7,803,567, each of which is to be repaid in ten equal semi-annual instalments, beginning on 25 July 2001; (ii) U.S.\$8,424,761, (iii) U.S.\$5,428,391; (iv) U.S.\$5,513,442; and (v) U.S.\$10,606,725, which are to be repaid in ten equal semi-annual instalments, beginning 15 July 2003. Additionally, we borrowed the sum of U.S.\$9,339,934, which is to be repaid in nine equal semi-annual instalments, beginning 15 July 2004.

#### ***Rouble-denominated borrowings***

*Sberbank.* On 15 August 2002, we entered into a further agreement with Sberbank, for the granting of a non-revolving credit line in the amount of RUB 2.5 billion (U.S.\$79.0 million). This credit line carried a 21 per cent. rate of interest for the period between the disbursement date and 30 September 2002. From 1 October 2002, this credit line carries a variable rate of interest based on the average quarterly turnover of ALROSA Ltd.’s bank account. This credit line carries a fee of 0.1 per cent. of the unused portion of the credit amount. This credit line is secured by our pledges of: (i) promissory notes of ALROSA Ltd. and rough diamonds; (ii) three of our airplanes; and (iii) two buildings located in Moscow. Sberbank may cancel our credit and demand repayment of outstanding amounts in the event our quarterly income is less

than U.S.\$47 million, or in the event of a decrease in our charter capital. This credit line expires on 15 December 2004.

*Apparel.* On 26 June 2001, we entered into an agreement with Apparel pursuant to which we advanced funds to enable it to purchase RUB 805 million (U.S.\$25.4 million) in aggregate principal amount of our promissory notes. This loan is to be repaid either in cash or in our promissory notes, and Apparel provided a bank guarantee of its obligations under the agreement. The interest rate on our loan is 0.2 per cent. of the outstanding principal amount. On 31 August 2001 we entered into a further agreement with Apparel in the amount of RUB 858.0 million (U.S.\$27.1 million) upon the same terms. These agreements expire on 24 June 2011 and 5 September 2011, respectively.

*Leasinvest.* On 10 August 2001, we entered into a Loan Agreement with OAO Leasinvest in the amount of RUB 1 billion (U.S.\$31.6 million). The interest rate for this loan is fixed at 64 per cent. of the refinancing rate of the Central Bank of Russia. This loan was drawn down in four tranches. This loan has been converted into Rouble-denominated bonds, which we issued on 17 April 2002, in the total amount of RUB 1,050,000,000 (maturity dates of 12 January 2004; 12 July 2004; 11 October 2004; 4 December 2004; 10 January 2005; 11 April 2005; 11 July 2005; and 10 October 2005).

*Bank Menatep SPb.* On 4 April 2003 we entered into three credit agreements with Bank Menatep for the extension of credit in the amounts of RUB 500 million (U.S.\$15.8 million), RUB 400 million (U.S.\$12.6 million) and RUB 100 million (U.S.\$3.2 million). Each of the loans carries an interest rate of 12 per cent., and the loan terms expire on 27 June 2003.

*Bank of Moscow.* On 17 May 2002, we entered into a credit agreement with the Bank of Moscow for the extension of a revolving facility in the maximum principal amount of RUB 900 million (U.S.\$28.4 million). This facility carries a rate of interest equal to the refinancing rate of the Central Bank less 2 per cent. and a commitment fee in the amount of 0.75 per cent. Pursuant to the terms of the facility, we are required to maintain turnover at our account in the Bank of Moscow at a level that is no lower than the maximum principal amount of the facility in each quarter during the term of the facility. The lender may require us to prepay the amounts drawn down in the event that we incur a net operating loss in each calendar quarter during the term of the facility, or in the event that our right to sell diamonds is substantially restricted. This facility is secured by a pledge of rough diamonds and expires on 15 October 2003.

***Rouble-denominated bonds***

As of 1 March 2003, we had a total of RUB 6.75 billion (U.S.\$213.3 million) of Rouble-denominated bonds issued and outstanding, due as follows:

<b>Principal Amount</b>	<b>Guarantor</b>	<b>Interest Rate</b>	<b>Maturity</b>	<b>Redemption</b>
RUB 600 million (U.S.\$19.0 million)	–	24.0 per cent. for the first coupon, which is adjusted for subsequent coupons based on fluctuations of the average yield of certain bonds issued by Russia; the interest rate is 13.23 per cent. for the final coupon	14 May 2003	–
RUB 600 million (U.S.\$19.0 million)	–	23.0 per cent. for the first coupon, which is adjusted for subsequent coupons based on fluctuations of the average yield of certain bonds issued by Russia	3 July 2003	–
RUB 500 million (U.S.\$15.8 million)	–	21.5 per cent. for the first coupon, which is adjusted for subsequent coupons based on fluctuations of the average yield of certain bonds issued by Russia; the interest rate is 18.19 per cent. for the final coupon	25 November 2003	26 November 2002 at par
RUB 500 million (U.S.\$15.8 million)	–	13.8 per cent.	17 February 2005	21 August 2003 at par
RUB 500 million (U.S.\$15.8 million)	Investment Banking Group NIKoil (OAO)	18.0 per cent. for the first coupon, which is adjusted for subsequent coupons based on fluctuations of the average yield of certain bonds issued by Russia	9 March 2004	–
RUB 175 million (U.S.\$5.5 million)	OAO Investment Group ALROSA	16.0 per cent. for the first coupon; subsequent coupons carry interest at 64.0 per cent. of the then current refinancing rate of the Central Bank	12 January 2004	–
RUB 125 million (U.S.\$4.0 million)	OAO Investment Group ALROSA	16.0 per cent. for the first coupon; subsequent coupons carry interest at 64.0 per cent. of the then current refinancing rate of the Central Bank	12 April 2004	–
RUB 125 million (U.S.\$4.0 million)	OAO Investment Group ALROSA	16.0 per cent. for the first coupon; subsequent coupons carry interest at 64.0 per cent. of the then current refinancing rate of the Central Bank	12 July 2004	–

<u>Principal Amount</u>	<u>Guarantor</u>	<u>Interest Rate</u>	<u>Maturity</u>	<u>Redemption</u>
RUB 125 million (U.S.\$4.0 million)	OA Investment Group ALROSA	16.0 per cent. for the first coupon; subsequent coupons carry interest at 64.0 per cent. of the then current refinancing rate of the Central Bank	11 October 2004	–
RUB 125 million (U.S.\$4.0 million)	OA Investment Group ALROSA	16.0 per cent. for the first coupon; subsequent coupons carry interest at 64.0 per cent. of the then current refinancing rate of the Central Bank	10 January 2005	–
RUB 125 million (U.S.\$4.0 million)	OA Investment Group ALROSA	16.0 per cent. for the first coupon; subsequent coupons carry interest at 64.0 per cent. of the then current refinancing rate of the Central Bank	11 April 2005	–
RUB 125 million (U.S.\$4.0 million)	OA Investment Group ALROSA	16.0 per cent. for the first coupon; subsequent coupons carry interest at 64.0 per cent. of the then current refinancing rate of the Central Bank	11 July 2005	–
RUB 125 million (U.S.\$4.0 million)	OA Investment Group ALROSA	16.0 per cent. for the first coupon; subsequent coupons carry interest at 64.0 per cent. of the then current refinancing rate of the Central Bank	10 October 2005	–
RUB 3.0 billion (U.S.\$94.8 million)	OA Investment Group ALROSA	16.0 per cent.	23 October 2005	24 October 2003 at 97.2 per cent. of par

The bonds contain limited covenants and do not restrict asset dispositions, payments to third parties or the incurrence of indebtedness, and they do not contain negative pledge covenants. The terms of the bonds are governed by Russian law.

As of 1 March 2003, the weighted average interest rate of these bonds was 15.51 per cent. RUB 3.5 billion (U.S.\$110.6 million) in aggregate principal amount of these bonds have fixed interest rates ranging from 13.8 per cent. to 23 per cent. RUB 3.25 billion (U.S.\$102.7 million) in aggregate principal amount of these bonds carry floating rates of interest, other than certain fixed coupon payments, which are based on the refinancing rate of the Central Bank.

The bonds generally may not be redeemed prior to their maturity.

#### ***Promissory notes***

In the past, we issued promissory notes, primarily to investment banks and other professionals as payment for their services. We no longer issue promissory notes. Currently, there are RUB 6.0 billion (U.S.\$189.6 million) in aggregate principal amount of promissory notes outstanding. In 2003, RUB 2.0 billion (U.S.\$63.2 million) of the promissory notes will become payable.



### ***Guarantees of indebtedness***

We have provided several guarantees as security for the indebtedness of our subsidiaries. Currently, three such guarantees are in force, with the following amounts and termination dates: (i) U.S.\$2.0 million, expiring 30 June 2003; (ii) U.S.\$1.9 million, expiring 20 June 2003; and (iii) U.S.\$500,000, expiring 20 January 2005.

## SUBSIDIARIES

### Material Subsidiaries

Most of our assets are included in, and almost all of our revenues are derived from, ALROSA Ltd. However, ALROSA Ltd. has the following subsidiaries and associates which are considered to be material to its operations:

*ALROSA-Nyurba.* ALROSA-Nyurba was formed as an open joint stock company under Russian law. It holds the prospecting license under which our Nyurba division operates its mines. See “Our Mining Operations–Nyurba Division”. ALROSA Ltd. owns 88.2 per cent. of ALROSA-Nyurba, the local administration owns 10.0 per cent. and the remaining 1.8 per cent. is held by our management and employees. All work at the Nyurba mines is performed by our Nyurba division pursuant to a services agreement with ALROSA-Nyurba.

*Severalmaz.* Severalmaz is a diamond mining company, formed as an open joint stock company under Russian law, which holds the license to mine the Lomonosov diamond field in the Arkhangelsk region of north-western Russia. ALROSA Ltd. owns 71.9 per cent. of Severalmaz, the administration of the Arkhangelsk Region owns 25.6 per cent. and individuals own the remaining 2.5 per cent. The principal business address of Severalmaz is 36, Pomorskaya Street, Arkhangelsk, 163061, Russia.

*Catoca Mining Ltd.* Catoca Mining Ltd. was established in 1992 as a joint venture for the purpose of mining the Catoca diamond pipe in Angola. ALROSA Ltd. currently owns a 32.8 per cent. interest in Catoca Mining Ltd. In addition, Endiama owns 32.8 per cent., Odebreest Mining Services, Inc. owns 16.4 per cent. and Daumonti Financing Company B.V. owns 18.0 per cent. of Catoca Mining Ltd. The principal business address of Catoca Mining Ltd. is Rua Major Kanhangulo, 100-4º, Luanda, Angola.

ALROSA Ltd. has a number of additional direct and indirect subsidiaries which are primarily engaged in the performance of ancillary activities relating to our diamond mining operations. Our current structure is primarily the result of our consolidation of the operations of our predecessor entities, and we have recently initiated a process to simplify and rationalise this corporate structure as part of our current five-year plan.

### Consolidated Subsidiaries

Certain consolidated financial information for ALROSA Ltd. is set forth in “Selected Financial and Operating Information”. The consolidated subsidiaries of ALROSA Ltd. are:

Name	Percentage ownership
OAo “ALROSA-Torg” . . . . .	100
OAo “Mirny ORS” . . . . .	100
OAo “LOTK” . . . . .	100
OAo “Aikhal ORS” . . . . .	100
OAo “Irelyahski ORS” . . . . .	100
ZAO “ALROSA’s hotels” . . . . .	100
ZAO “Irillyakhneft” . . . . .	100
OAo “ALROSA-Lena” . . . . .	100
OAo “Udachninski bakers combinat” . . . . .	100
ZAO “Sanatoriy Golubaya Volna” . . . . .	100
OAo “Udachninski ORS” . . . . .	99
OAo “ALROSA-Lenskstroy” . . . . .	98
Pension Fund “Almaznaya Osen” . . . . .	97
OAo “ALROSA-Yakutnab” . . . . .	97

<u>Name</u>	<u>Percentage ownership</u>
ZAO “Northern Exploration Company “Terra”” . . . . .	92
OAo “Viluygesstroy” . . . . .	90
ZAO “Vostok-Kapital” . . . . .	88
OAo “ALROSA-Nyurba” . . . . .	88
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All of the foregoing entities were formed under the laws of Russia. The percentage ownership of these entities was determined based on the voting share of ALROSA Ltd. and/or its subsidiaries in such entities. For a description of the basis of consolidation, see “Management’s Discussion and Analysis of Financial Condition and Results of Operations–Basis of Presentation and Critical Accounting Policies–Principles of consolidation”. In addition to the consolidated entities, ALROSA Ltd. accounts for its minority-owned Catoca Mining Ltd. subsidiary under the equity method, based on its 32.8 per cent. interest in Catoca Mining Ltd.

## TERMS AND CONDITIONS OF THE NOTES

*The following is the text of the terms and conditions of the Notes which, subject to amendment, will be endorsed on each Note Certificate (as defined below) and will be attached and (subject to the provisions thereof) apply to the Global Note.*

The U.S.\$500,000,000 8.125 per cent. Guaranteed Notes due 2008 (the “**Notes**”, which expression includes any further Notes issued pursuant to Condition 16 and forming a single series therewith) of ALROSA Finance S.A. (the “**Issuer**”) were authorised by a written resolution of the Board of Directors of the Issuer dated 18 September 2002, and the guarantee of the Notes (the “**Guarantee**”) was authorised by a resolution of the Supervisory Council of AK “ALROSA” (ZAO) (the “**Guarantor**”) passed on 28 April 2003. The Notes are constituted by a trust deed dated 2 May 2003 (the “**Trust Deed**”) between the Issuer, the Guarantor and Deutsche Trustee Company Limited (the “**Trustee**”, which expression shall include all persons for the time being the trustee or trustees under the Trust Deed) as trustee for the holders of the Notes. These terms and conditions include summaries of, and are subject to, the detailed provisions of the Trust Deed. The Issuer and the Guarantor have entered into an agency agreement dated 2 May 2003 (the “**Agency Agreement**”) with the Trustee, Deutsche Bank AG London, as registrar (the “**Registrar**”), Deutsche Bank AG London, as principal paying agent (the “**Principal Paying Agent**”) and transfer agent, and Deutsche Bank Luxembourg S.A., as a paying agent in Luxembourg (together with the Principal Paying Agent, the “**Paying Agents**”) and transfer agent (together with Deutsche Bank AG London, the “**Transfer Agents**”). The Registrar, Paying Agents and Transfer Agents are together referred to herein as the “**Agents**”. Copies of the Trust Deed and the Agency Agreement are available for inspection during normal business hours at the specified office of the Trustee, being at the date hereof Winchester House, 1 Great Winchester Street, London EC2N 2DB, United Kingdom, and at the specified offices of the Agents. The Noteholders (as defined below) are entitled to the benefit of, are bound by, and are deemed to have notice of, all the provisions of the Trust Deed and are deemed to have notice of those provisions of the Agency Agreement applicable to them. Capitalised terms used but not defined in these Terms and Conditions shall have the respective meanings given to them in the Trust Deed.

### 1 Form and Denomination

The Notes are in registered form, without interest coupons attached, in denominations of U.S.\$1,000 or integral multiples thereof (“**authorised denominations**”). A certificate (each a “**Note Certificate**”) will be issued to each Noteholder in respect of its registered holding or holdings of Notes. Each Note Certificate will be numbered serially with an identifying number which will be recorded in the register (the “**Register**”) which the Issuer shall procure to be kept by the Registrar.

### 2 Guarantee and Status

#### (a) Guarantee

The Guarantor has in the Trust Deed unconditionally and irrevocably guaranteed the payment when due of all sums expressed to be payable by the Issuer under the Trust Deed and the Notes (the “**Guarantee**”). The Guarantor’s obligations in respect of the Guarantee are contained in the Trust Deed.

The Guarantor has undertaken in the Trust Deed that so long as any of the Notes remains outstanding (as defined in the Trust Deed) it will not take any action for the liquidation or winding-up of the Issuer.

#### (b) Status

The Notes constitute (subject to Condition 4) unsecured obligations of the Issuer and shall at all times rank *pari passu* and without any preference among themselves. The payment obligations of

the Issuer under the Notes and of the Guarantor under the Guarantee shall, save for such exceptions as may arise by mandatory operation of law and subject to Condition 4, at all times rank at least equally with all other present and future unsecured and unsubordinated obligations of the Issuer and the Guarantor, respectively.

### **3 Register, Title and Transfers**

#### **(a) Register**

The Registrar shall maintain the Register in respect of the Notes in accordance with the provisions of the Agency Agreement. The Register shall be kept at the specified office for the time being of the Registrar and shall record the names and addresses of the holders of the Notes, particulars of the Notes and all transfers thereof. In these Conditions, the “**holder**” of a Note means the person in whose name such Note is for the time being registered in the Register (or, in the case of a joint holding, the first named thereof) and “**Noteholder**” shall be construed accordingly.

#### **(b) Title**

Title to the Notes will pass by and upon registration in the Register. The holder of each Note shall (except as otherwise required by a court of competent jurisdiction or applicable law) be treated as the absolute owner of such Note for all purposes (whether or not it is overdue and regardless of any notice of ownership, trust or any other interest therein, any writing on the Note Certificate relating thereto (other than the endorsed form of transfer) or any notice of any previous loss or theft of such Note Certificate) and no person shall be liable for so treating such holder.

#### **(c) Transfers**

Subject to Conditions 3(f) and 3(g) below, a Note may be transferred in whole or in part in an authorised denomination upon surrender of the relevant Note Certificate representing that Note, together with the form of transfer (including any certification as to compliance with restrictions on transfer included in such form of transfer endorsed thereon) (the “**Transfer Form**”), duly completed and executed, at the specified office of any Transfer Agent or of the Registrar, together with such evidence as such Agent or the Registrar may reasonably require to prove the title of the transferor and the authority of the persons who have executed the Transfer Form. Where not all the Notes represented by the surrendered Note Certificate are the subject of the transfer, a new Note Certificate in respect of the balance not transferred will be delivered by the Registrar to the transferor in accordance with Condition 3(d). Neither the part transferred nor the balance not transferred may be less than the applicable authorised denomination.

#### **(d) Registration and delivery of Note Certificates**

Within five business days of the surrender of a Note Certificate in accordance with Condition 3(c) above, the Registrar shall register the transfer in question and deliver a new Note Certificate to each relevant holder at the specified office of the Registrar or (at the request of the relevant Noteholder) at the specified office of any Transfer Agent or (at the request and risk of such relevant holder) send it by uninsured first class mail (airmail if overseas) to the address specified for the purpose by such relevant holder.

#### **(e) No Charge**

The registration of the transfer of a Note shall be effected without charge to the holder or transferee thereof, but against such indemnity from the holder or transferee thereof as the

Registrar may require in respect of any tax or other duty of whatsoever nature which may be levied or imposed in connection with such transfer.

**(f) Closed periods**

Noteholders may not require the transfer of a Note to be registered during the period of 15 days ending on the due date for any payment of principal or interest in respect of such Note.

**(g) Regulations concerning Transfer and Registration**

All transfers of Notes and entries on the Register are subject to the detailed regulations concerning the transfer and registration of Notes set out in the First Schedule to the Agency Agreement. The regulations may be changed by the Issuer and the Guarantor with the prior written approval of the Trustee, the Paying Agents, the Transfer Agents and the Registrar; *provided* that any such change will continue to permit registration and transfer of the Notes in Luxembourg. A copy of the current regulations will be sent by the Registrar free of charge to any person who so requests and will be available at the specified office of the Registrar in London and at the specified office of the Transfer Agent in Luxembourg.

**4 Negative Pledge**

So long as any of the Notes remains outstanding (as defined in the Trust Deed):

- (a)** neither the Issuer, the Guarantor nor any Material Subsidiary (as defined below) will create or permit to exist any mortgage, charge, pledge, lien or other form of encumbrance or security interest (a “**Security Interest**”) other than a Permitted Security Interest upon the whole or any part of its property, assets or revenues, present or future, to secure:
  - (i)** payment of any sum due in respect of any Indebtedness of the Issuer, the Guarantor or any Material Subsidiary; or
  - (ii)** any payment under any indemnity or other like obligation relating to any Indebtedness of the Issuer, the Guarantor or any Material Subsidiary; and
- (b)** each of the Issuer and the Guarantor will procure that no person (other than the Guarantor) gives any guarantee of, or indemnity in respect of, any of the Issuer’s or the Guarantor’s Indebtedness (except for Indebtedness relating to a specific asset or project in respect of which a guarantee of an export development agency has been given and except for Indebtedness incurred specifically to finance a particular shipment or shipments of diamonds and guaranteed by a party which has committed contractually to purchase such shipment or shipments),

without in any such case at the same time according to the Notes, to the satisfaction of the Trustee, either an equivalent and rateable security, guarantee or indemnity as is granted or is given in respect of such other Indebtedness, indemnity or other like obligations or such other security, guarantee or indemnity as the Trustee in its discretion shall reasonably deem to be not materially less beneficial to the Noteholders or as shall be approved by an Extraordinary Resolution (as defined in the Trust Deed).

The Issuer and the Guarantor have undertaken in the Trust Deed to deliver to the Trustee from time to time upon request of the Trustee certificates prepared by each of them as to compliance with this Condition 4. The Trustee is not obliged independently to monitor compliance with this Condition 4 and shall be entitled to rely on such certificates and need not enquire further as regards the circumstances then existing.



## **5 Covenants**

### **(a) Asset Sales**

So long as any amount remains outstanding hereunder, the Guarantor shall not, and shall ensure that no member of the Group engages in, an Asset Sale, in each case if such Asset Sale has a Material Adverse Effect.

### **(b) Business Activities**

So long as any of the Notes remains outstanding (as defined in the Trust Deed), the Guarantor will not, and will not permit any of its Subsidiaries to, engage in any business other than a Permitted Business.

### **(c) Maintenance of Authorisations**

So long as any of the Notes remains outstanding (as defined in the Trust Deed), the Issuer and the Guarantor shall take all necessary action to maintain, obtain and promptly renew, and do or cause to be done all things reasonably necessary to ensure the continuance of, all consents, licenses, approvals and authorisations, and make or cause to be made all registrations, recordings and filings, which may at any time be required to be obtained or made in the Grand Duchy of Luxembourg and the Russian Federation (including, for the avoidance of doubt, with the Central Bank of the Russian Federation) for (i) the execution, delivery or performance of the Trust Deed, the Agency Agreement, the Notes and the Guarantee, or for the validity or enforceability thereof or (ii) the conduct by it of the Permitted Business, but only if the failure to maintain, obtain, renew or ensure the continuance of such consents, licenses, approvals and authorisations, registrations, recordings and filings would have a Material Adverse Effect.

### **(d) Maintenance of Property**

So long as any of the Notes remains outstanding (as defined in the Trust Deed), the Group shall cause all property used in the carrying on by it of its Permitted Business for the time being to be kept in good repair and working order as, in the judgement of the Guarantor, may be reasonably necessary so that the Permitted Business may be carried on, but only if the failure to keep such property in such condition would have a Material Adverse Effect.

### **(e) Maintenance of Insurance**

So long as any of the Notes remains outstanding (as defined in the Trust Deed), the Group shall continue to maintain, with respect to those of its properties and assets which it currently insures against loss or damage, such insurance with insurers who implement good business practices and are believed by the Guarantor to be responsible against loss or damage in amounts equivalent to, and upon terms at least as favourable to the Group as, the insurance maintained by the Group on the Closing Date.

### **(f) Transactions with Affiliates**

So long as any of the Notes remains outstanding (as defined in the Trust Deed), the Guarantor will not, and will not permit any of its Subsidiaries to, make any payment to, or sell, lease, transfer or otherwise dispose of any of its properties or assets to, or purchase any properties or assets from, or enter into or make or amend any transaction, contract, agreement, understanding, loan,

advance or guarantee with or for the benefit of, any Affiliate (each, an “**Affiliate Transaction**”) unless:

- (i) such Affiliate Transaction is on terms that are no less favourable to the Guarantor or the relevant Subsidiary than those that would have been obtained in a comparable transaction by the Guarantor or such Subsidiary with an unrelated Person; and
- (ii) the Guarantor:
  - (A) with respect to any Affiliate Transaction or series of related Affiliate Transactions to which the Guarantor or the relevant Subsidiary is a party and which constitute “interested party transactions” under applicable Russian legislation involving aggregate consideration in excess of U.S.\$15,000,000, will deliver to the Trustee resolutions or other evidence of requisite approval by the particular governing body of the Guarantor or such relevant Subsidiary required under applicable Russian legislation to approve such Affiliate Transaction or series of related Affiliate Transactions; and
  - (B) with respect to any Affiliate Transaction or series of related Affiliate Transactions involving aggregate consideration in excess of U.S.\$30,000,000, will deliver to the Trustee an opinion as to the fairness to the Noteholders of such Affiliate Transaction from a financial point of view issued by an Independent Appraiser.

The following items shall not be deemed to be Affiliate Transactions and, therefore, will not be subject to the provisions of this Condition 5(f):

- (1) any compensation or employment agreement entered into by any member of the Group in the ordinary course of its business or in existence on the Issue Date (as defined below) and agreements relating to employment matters of the Guarantor and any of its Subsidiaries;
- (2) transactions between or among all or any of the Guarantor and/or its Subsidiaries (including, without limitation, any Sale and Leaseback Transaction);
- (3) transactions between a Receivables Subsidiary and any Person in which the Receivables Subsidiary has an Investment;
- (4) payment of reasonable directors’ fees to Persons who are not otherwise Affiliates of the Guarantor or its Subsidiaries;
- (5) sales of Equity Interests (or grants of options for the purchase thereof) of the Guarantor or its Subsidiaries to Affiliates of the Guarantor or Affiliates of its Subsidiaries;
- (6) transactions with a Person that is an Affiliate of the Guarantor or a Subsidiary of the Guarantor solely because the Guarantor or such Subsidiary owns an Equity Interest in such Person;
- (7) Restricted Payments that are permitted by Condition 5(g) or Permitted Investments;
- (8) transactions relating to any Social Business; and
- (9) transactions pursuant to agreements and arrangements existing on the Issue Date.

**(g) Restricted Payments**

The Guarantor will not, and will not permit any of its Subsidiaries to, directly or indirectly:

- (1) declare or pay any dividend or make any other payment or distribution (a) on account of the Guarantor’s or any of its Subsidiaries’ Equity Interests or (b) to the direct or indirect holders of the Guarantor’s or any of its Subsidiaries’ Equity Interests in their capacity as such, in each case, other than dividends, payments or distributions payable in Equity Interests (other

than Disqualified Stock) of the Guarantor or payable to the Guarantor or a Subsidiary of the Guarantor;

- (2) purchase, redeem or otherwise acquire or retire for value any Equity Interests of the Guarantor (other than any such Equity Interests owned by the Guarantor or a Subsidiary of the Guarantor);
- (3) make any payment on or with respect to, or purchase, redeem, defease or otherwise acquire or retire for value, any Subordinated Indebtedness, except for scheduled payments of interest or payments of the principal thereof at Stated Maturity or within 30 days of the date of any such scheduled payment or Stated Maturity; or
- (4) make any Restricted Investment (all such payments and other actions set forth in clauses (1) through (4) above being collectively referred to as “**Restricted Payments**”),

unless, at the time of and after giving effect to such Restricted Payment:

- (i) no Default or Event of Default shall have occurred and be continuing or would occur as a consequence thereof; and
- (ii) the Guarantor would, at the time of such Restricted Payment and after giving *pro forma* effect thereto as if such Restricted Payment had been made at the beginning of the applicable Four Quarter Period (as defined below in the definition of Fixed Charge Coverage Ratio), have been permitted to incur at least U.S.\$1.00 of Indebtedness (including Permitted Indebtedness) pursuant to Condition 5(h); and
- (iii) such Restricted Payment, together with (without duplication) the aggregate amount of all other Restricted Payments made by the Guarantor and its Subsidiaries after the date of the Trust Deed (excluding Restricted Payments permitted by clauses (2) and (3) of the next succeeding paragraph), shall not exceed the sum (without duplication) of:
  - (a) 50 per cent. of the Adjusted Consolidated Net Income of the Guarantor for the period (taken as one accounting period) from the beginning of the first six-month period for which the Guarantor produces IAS unaudited interim financial statements following the Issue Date to the end of the Guarantor’s most recently ended financial six-month period or year, as the case may be, for which financial statements are available at the time of such Restricted Payment (or, if such Adjusted Consolidated Net Income for such period is a deficit, less 100 per cent. of such deficit); plus
  - (b) 100 per cent. of the aggregate net cash proceeds (including Cash Equivalents) received by the Guarantor from the issue or sale (other than to a Subsidiary) of or from capital contributions with respect to Equity Interests of the Guarantor (other than Disqualified Stock and other than Capital Stock of the Guarantor owned by employees to the extent the purchase of such Capital Stock is financed with the proceeds of loans or advances from the Guarantor or a Subsidiary of the Guarantor), in each case after the Issue Date; plus
  - (c) 100 per cent. of the aggregate principal amount (or accreted value, if less) of Indebtedness of the Guarantor or any Subsidiary of the Guarantor issued for cash since the Issue Date (other than to a Subsidiary of the Guarantor) that has been converted or exchanged into Equity Interests (other than Disqualified Stock) of the Guarantor; plus

- (d) 100 per cent. of the aggregate net cash and Cash Equivalents received by the Guarantor or a Subsidiary since the Issue Date (to the extent not included in Adjusted Consolidated Net Income) from a Restricted Investment, whether through interest payments, principal payments, dividends or other distributions and payments or the sale or other disposition (other than to a Subsidiary) thereof made by the Guarantor and its Subsidiary.

So long as no Default or Event of Default has occurred and is continuing or would be caused thereby, the preceding provisions will not prohibit:

- (1) the payment of any dividend within 12 months after the date of declaration thereof, if at the date of declaration such payment would have complied with the provisions of these Conditions;
- (2) the redemption, repurchase, retirement or other acquisition of any Subordinated Indebtedness of the Issuer or the Guarantor, or of any Equity Interests of the Guarantor in exchange for, or out of the net cash proceeds of the substantially concurrent sale (other than to a Subsidiary of the Guarantor) of, Equity Interests of the Guarantor (other than Disqualified Stock); *provided* that the amount of any such net cash proceeds that are utilised for any such redemption, repurchase, retirement or other acquisition shall be excluded from clause (iii)(b) of the preceding paragraph;
- (3) the payment of any dividend by a Subsidiary of the Guarantor to the holders of its ordinary Equity Interests on a *pro rata* basis;
- (4) the repurchase, redemption or other acquisition or retirement for value of any Equity Interests of the Guarantor held by any director or officer of the Guarantor or any of its Subsidiaries pursuant to any management equity subscription agreement or stock option agreement; provided that the aggregate price paid for all such repurchased, redeemed, acquired or retired Equity Interests shall not exceed U.S.\$5,000,000 in any 12-month period and shall not exceed U.S.\$10,000,000 in the aggregate;
- (5) purchases of all or a portion of any Equity Interests in a Subsidiary of the Guarantor that are held by a Person that is not a Group member;
- (6) the redemption, repurchase, retirement or other acquisition of any Permitted Indebtedness consisting of Subordinated Indebtedness, in exchange for, or out of the net cash proceeds of, an incurrence of Permitted Refinancing Indebtedness; and
- (7) Restricted Payments pursuant to agreements and arrangements existing on the Issue Date.

The amount of all Restricted Payments (other than cash) shall be the fair market value on the date of the Restricted Payment of the asset(s) or securities proposed to be transferred or issued to or by the Guarantor or such Subsidiary, as the case may be, pursuant to such Restricted Payment. The fair market value of any assets or securities that are required to be valued by this Condition 5(g) shall be determined by (i) the Management Board of the Guarantor in respect of amounts up to and including U.S.\$25,000,000 and (ii) the Supervisory Council of the Guarantor in respect of amounts in excess of U.S.\$25,000,000. Not later than 30 days after the date of making any Restricted Payment, the Issuer and the Guarantor shall deliver to the Trustee an Officers' Certificate stating that such Restricted Payment is permitted and setting forth the basis upon which the calculations required by this Condition 5(g) were computed, together with a copy of any fairness opinion or appraisal required by the Trust Deed.

Notwithstanding anything herein to the contrary, nothing in this Condition 5(g) shall prohibit the declaration and/or payment by the Guarantor of any dividend of the Guarantor in respect of the year

ended 31 December 2002, in an aggregate amount not greater than the amount permitted under applicable Russian law.

**(h) Incurrence of Indebtedness**

The Guarantor will not, and will not permit any of its Subsidiaries to, directly or indirectly, create, incur, issue, assume, guarantee or otherwise become directly or indirectly liable, contingently or otherwise, with respect to (collectively, “**incur**”) any Indebtedness (including Acquired Debt) except for Permitted Indebtedness; *provided* that the Guarantor may incur Indebtedness (including Acquired Debt) if the Fixed Charge Coverage Ratio of the Guarantor would be at least 3.5 to 1.0.

The accrual of interest and the accretion or amortisation of original issue discount will not be deemed to be an incurrence of Indebtedness for purposes of this Condition 5(h); *provided*, in each such case, that the amount thereof is included, as accrued, in Fixed Charges of the Guarantor.

For purposes of determining compliance with this Condition, if an item of proposed Indebtedness is entitled to be incurred pursuant to this Condition, the Issuer or the Guarantor will be permitted to classify such item of Indebtedness on the date of its incurrence, or later reclassify all or a portion of such item of Indebtedness, in any manner that complies with this Condition.

For purposes of this Condition 5(h), the Dollar-equivalent amount of any non-Dollar-denominated Indebtedness will be calculated based on the relevant currency exchange rate in effect on (i) the Issue Date (in the case of Indebtedness incurred on or before the Issue Date), or (ii) the date such Indebtedness was incurred (in the case of Indebtedness incurred after the Issue Date).

**(i) Financial Statements etc.**

So long as any of the Notes remain outstanding (as defined in the Trust Deed), the Issuer, failing whom the Guarantor, shall deliver to the Trustee:

- (1) not later than seven months after the end of the Guarantor’s financial year, copies of the Guarantor’s audited consolidated financial statements for such financial year, prepared in accordance with IAS consistently applied, together with the corresponding financial statements for the preceding period, and all such annual financial statements of the Guarantor shall be accompanied by the report of the Auditors thereon;
- (2) not later than 120 days after the end of the first six months of each of the Guarantor’s financial years, copies of its unaudited consolidated financial statements for such six-month period, prepared in accordance with IAS consistently applied, together with the corresponding financial statements for the preceding period; and
- (3) in the case of every other item referred to below, not later than 20 days after their initial distribution to any of the persons referred to below,

three copies in English of every balance sheet, profit and loss account and, to the extent permitted by applicable law, every report or other notice, statement or circular issued, or which legally should be issued, to the members or holders of securities (generally) of the Issuer or the Guarantor or any holding company thereof generally in their capacity as such.

**(j) Sale and Leaseback Transactions**

The Guarantor will not, and will not permit any of its Subsidiaries to, enter into any Sale and Leaseback Transaction; *provided* that the Guarantor or any of its Subsidiaries may enter into a Sale and Leaseback Transaction if:

- (1) the Guarantor or such Subsidiary could have (a) incurred Indebtedness in an amount equal to the Attributable Debt relating to such Sale and Leaseback Transaction under Condition 5(h) and (b) incurred a Security Interest to secure such Indebtedness pursuant to Condition 4;
- (2) the gross cash proceeds of such Sale and Leaseback Transaction are at least equal to the Fair Market Value (as determined in accordance with the definition of such term, the results of which determination shall be set forth in an Officers' Certificate delivered to the Trustee) of the property that is the subject of such Sale and Leaseback Transaction; and
- (3) the transfer of assets in that Sale and Leaseback Transaction is not prohibited by Condition 5(a).

Sale and Leaseback Transactions solely between or among all or any of the Guarantor and/or its Subsidiaries shall not be subject to the provisions of this Condition 5(j).

**(k) Limitation on Merger and Consolidation**

The Issuer and the Guarantor shall not and the Guarantor shall procure that no other Material Subsidiary shall, without the prior consent of the Trustee, engage in the following transactions (each such transaction or series of transactions, a “**Merger**”):

- (1) merge, consolidate, amalgamate or otherwise combine with or into another Person (whether or not the Issuer, Guarantor or such Material Subsidiary is the surviving entity); or
- (2) sell, assign, transfer, convey or otherwise dispose of (or cause or permit any Material Subsidiary to sell, assign, transfer, convey or otherwise dispose of) all or substantially all of the properties or assets of the Group, in one or more related transactions, to another Person,

unless:

- (A) the Issuer, the Guarantor or such Material Subsidiary, as the case may be, is the surviving entity;
- (B) the Person formed by or surviving any such consolidation or merger (if other than the Issuer, the Guarantor or such Material Subsidiary) or the Person to which such sale, assignment, transfer, conveyance or other disposition shall have been made assumes all the obligations (if any) of the Issuer, the Guarantor or such Material Subsidiary, as the case may be, under the Notes, the Trust Deed and the Guarantee pursuant to agreements reasonably satisfactory to the Trustee;
- (C) immediately after such transaction no Default or Event of Default exists; and
- (D) the Guarantor or, if the Guarantor engages in a Merger, the surviving entity or the Person to which such sale, assignment, transfer, conveyance or other disposition shall have been made:
  - (i) will have Adjusted Consolidated Net Worth immediately after the transaction equal to or greater than the Adjusted Consolidated Net Worth of the Guarantor immediately preceding the transaction and
  - (ii) will, on the date of such transaction after giving pro forma effect thereto and any related financing transactions as if the same had occurred at the beginning of the applicable Four-Quarter Period, be permitted to incur at least U.S.\$1.00 of additional Indebtedness pursuant to the Fixed Charge Coverage Ratio test set forth in Condition 5(h).



Notwithstanding the foregoing, nothing in these Conditions shall prohibit the reorganisation of the Guarantor involving its conversion from a “Closed Joint-Stock Company” to an “Open Joint-Stock Company” for purposes of the JSC Law.

This Condition 5(k) will not apply to a Merger between or among the Guarantor and any of its Wholly Owned Subsidiaries.

## **6 Interest**

The Notes bear interest from the Issue Date at the rate of 8.125 per cent. per annum, payable in equal instalments semi-annually in arrear on 6 May and 6 November in each year, commencing on 6 November 2003. Each Note will cease to bear interest from the due date for redemption unless, upon due presentation, payment of principal is improperly withheld or refused. In such event it shall continue to bear interest at such rate (both before and after judgment) until whichever is the earlier of (a) the day on which all sums due in respect of such Note up to that day are received by or on behalf of the relevant holder, and (b) the day seven days after the Trustee or the Principal Paying Agent has notified Noteholders of receipt of all sums due in respect of all the Notes up to that seventh day (except to the extent that there is failure in the subsequent payment to the relevant holders under these Conditions). If interest is required to be calculated for a period other than a semi-annual interest period, it will be calculated on the basis of a 360-day year consisting of 12 months of 30 days each and, in the case of an incomplete month, the number of days elapsed.

## **7 Redemption and Purchase**

### **(a) Final redemption**

Unless previously redeemed, or purchased and cancelled, the Notes will be redeemed at their principal amount on 6 May 2008.

### **(b) Redemption for tax reasons**

The Notes may be redeemed at the option of the Issuer in whole, but not in part, at any time, on giving not less than 30 nor more than 60 days' notice to the Noteholders (which notice shall be irrevocable) at the principal amount thereof, together with interest accrued to the date fixed for redemption, if (i) the Issuer satisfies the Trustee immediately prior to the giving of such notice that it (or, if the Guarantee was called, the Guarantor) has or will become obliged to pay additional amounts as provided or referred to in Condition 9 as a result of any change in, or amendment to, the laws or regulations of The Grand Duchy of Luxembourg or the Russian Federation or any political subdivision or any authority thereof or therein having power to tax, or any change in the application or official interpretation of such laws or regulations, which change or amendment becomes effective on or after 6 May 2003 and (ii) such obligation cannot be avoided by the Issuer (or the Guarantor, as the case may be) taking reasonable measures available to it; provided that no such notice of redemption shall be given earlier than 90 days prior to the earliest date on which the Issuer (or the Guarantor, as the case may be) would be obliged to pay such additional amounts were a payment in respect of the Notes (or the Guarantee, as the case may be) then due. Prior to the publication of any notice of redemption pursuant to this Condition, the Issuer shall deliver to the Trustee (i) a certificate signed by two directors of the Issuer (or the President of the Guarantor, as the case may be) stating that the Issuer is entitled to effect such redemption and setting forth a statement of facts showing that the conditions precedent to the right of the Issuer so to redeem have occurred and the Trustee shall be entitled to accept such certificate as sufficient evidence of the satisfaction of such conditions precedent, in which event it shall be conclusive and binding on the Noteholders and (ii) an opinion of independent legal advisers of recognised standing to the effect that the Issuer (or the

Guarantor, as the case may be) has or will become obliged to pay such additional amounts as a result of such change or amendment. All Notes in respect of which any such notice of redemption is given under this Condition shall be redeemed on the date specified in such notice in accordance with this Condition.

**(c) Redemption at the option of the Issuer**

The Issuer shall not be entitled to redeem the Notes otherwise than as provided in paragraphs (a) and (b) above. All Notes in respect of which any such notice of redemption is given under this Condition shall be redeemed on the date specified in such notice in accordance with this Condition.

**(d) Purchase**

The Issuer, the Guarantor and any of their respective Subsidiaries may at any time purchase Notes in the open market or otherwise at any price.

**(e) Cancellation**

All Notes redeemed or purchased pursuant to this Condition 7 shall be cancelled forthwith and may not be held or resold. Any Notes so cancelled may not be reissued.

**8 Payments**

**(a) Principal**

Payments of principal (whenever due) and interest due on redemption shall be made by the Paying Agents by U.S. dollar cheque drawn on a bank in New York City, or by transfer to a U.S. dollar account maintained by the payee with, a bank in New York City and shall only be made upon surrender (or, in the case of part payment only, endorsement) of the relevant Note Certificates at the specified office of any Paying Agent.

**(b) Interest**

Payments of interest (other than interest due on redemption) shall be made by the Paying Agents by U.S. dollar cheque drawn on a bank in New York City, or by transfer to a U.S. dollar account maintained by the payee with, a bank in New York City not later than the due date for such payment.

**(c) Payments subject to fiscal laws**

All payments in respect of the Notes are subject in all cases to any applicable fiscal or other laws and regulations, but without prejudice to the provisions of Condition 9. No commissions or expenses shall be charged to the Noteholders in respect of such payments.

**(d) Payments on business days**

If the due date for any payment of principal or interest under this Condition 8 is not a business day, the holder of a Note shall not be entitled to payment of the amount due until the next following business day and shall not be entitled to any further interest or other payment in respect of any such delay. In this Condition, “**business day**” means any day on which banks are open for business in the place of the specified office of the relevant Paying Agent and, in the case of payment by transfer to a U.S. dollar account as referred to above, on which dealings in foreign currencies may be carried on both in New York City and in such other place.

(e) **Record date**

Each payment in respect of a Note will be made to the person shown as the holder in the Register at the opening of business (in the place of the Registrar's specified office) on the fifteenth day before the due date for such payment. Any cheque will be mailed to the holder of the relevant Note at his address appearing in the Register.

(f) **Agents**

The initial Agents and their initial specified offices are listed below. The Issuer and the Guarantor, acting together, reserve the right to vary or terminate the appointment of all or any of the Agents at any time and appoint additional or other payment or transfer agents, provided that they will maintain (i) a Principal Paying Agent, (ii) Paying and Transfer Agents having specified offices in at least two major European cities approved by the Trustee, including Luxembourg so long as the Notes are listed on the Luxembourg Stock Exchange and the rules of such Exchange so require and (iii) a Paying Agent with a specified office in a European Union member state that will not be obliged to withhold or deduct tax pursuant to any European Union Directive on the taxation of savings implementing the conclusions of the ECOFIN Council meeting of 26-27 November 2000 or any law implementing or complying with, or introduced in order to conform to, such Directive. Notice of any such change will be provided as described in Condition 17 below.

**9 Taxation**

All payments of principal and interest in respect of the Notes by the Issuer or under the Guarantee by the Guarantor shall be made free and clear of, and without withholding or deduction for, any taxes, duties, assessments or governmental charges of whatsoever nature imposed, levied, collected, withheld or assessed by or within The Grand Duchy of Luxembourg or the Russian Federation or any political subdivision or any authority thereof or therein having power to tax, unless such withholding or deduction is required by law. In that event, the Issuer or (as the case may be) the Guarantor shall increase the relevant payment so as to result in the receipt by the Noteholders of such amounts as would have been received by them if no such withholding or deduction had been required, except that no such additional amounts shall be payable in respect of any Note:

- (a) held by a holder which is liable to such taxes, duties, assessments or governmental charges in respect of such Note or the Guarantee by reason of its having some connection with The Grand Duchy of Luxembourg or (as the case may be) the Russian Federation other than the mere holding of such Note or the benefit of the Guarantee; or
- (b) where (in the case of a payment of principal or interest on redemption) the relevant Note Certificate is surrendered for payment more than 30 days after the Relevant Date except to the extent that the relevant holder would have been entitled to such additional amounts if it had surrendered the relevant Note Certificate on the last day of such period of 30 days; or
- (c) where such withholding or deduction is imposed on a payment to an individual and is required to be made pursuant to any European Union Directive on the taxation of savings implementing the conclusions of the ECOFIN Council meeting of 26-27 November 2000 or any law implementing or complying with, or introduced in order to conform to, such Directive; or
- (d) by or on behalf of a Noteholder who would have been able to avoid such withholding or deduction by presenting the relevant Note Certificate to another Paying Agent in a member state of the European Union.

In these Conditions, "**Relevant Date**" means whichever is the later of (a) the date on which the payment in question first becomes due and (b) if the full amount payable has not been received in New York City by or for the account of the Principal Paying Agent or the Trustee on or prior to such due date, the date on which (the full amount having been so received) notice to that effect has been given to the Noteholders.

Any reference in these Conditions to principal or interest shall be deemed to include any additional amounts in respect of principal or interest (as the case may be) which may be payable under this Condition.

If the Issuer or the Guarantor becomes subject at any time to any taxing jurisdiction other than (or in addition to) The Grand Duchy of Luxembourg or the Russian Federation, respectively, references in these Conditions to The Grand Duchy of Luxembourg or the Russian Federation shall be construed as references to The Grand Duchy of Luxembourg or (as the case may be) the Russian Federation and/or such other jurisdiction.

## **10 Events of Default**

The Trustee at its discretion may, and if so requested in writing by the holders of not less than one-quarter in principal amount of the Notes then outstanding or if so directed by an Extraordinary Resolution (subject in each case to being indemnified to its satisfaction) shall, give notice to the Issuer that the Notes are, and they shall immediately become, due and repayable at their principal amount together with accrued interest if any of the following events occurs and is continuing (each, an “**Event of Default**”):

- (a) the Issuer fails to pay any amounts payable on any of the Notes when due and, in the case of payment of interest, such failure continues for a period of five business days; or
- (b) the Issuer or the Guarantor does not perform or comply with any one or more of its other obligations in the Notes or the Trust Deed which default (i) is (in the opinion of the Trustee) incapable of remedy and, in the case of a breach of an obligation under the Trust Deed, materially prejudicial to the interests of the Noteholders or (ii) if in the opinion of the Trustee capable of remedy, is not in the opinion of the Trustee remedied within 30 days (or such longer period as the Trustee may in its sole discretion determine) after notice of such default shall have been given to the Issuer or the Guarantor by the Trustee; or
- (c) any Indebtedness of the Issuer, the Guarantor or any Material Subsidiary is not paid when due, or within any originally applicable grace period, or any Indebtedness of the Issuer, the Guarantor or any Material Subsidiary is either declared to be or otherwise becomes due and payable prior to its specified maturity otherwise than at the option of the Issuer, the Guarantor or any Material Subsidiary (as the case may be) or (provided that no event of default, howsoever described, has occurred) any person entitled to such Indebtedness; provided, however, that the total amount of such Indebtedness which is not paid when due or becomes due and payable prior to its specified maturity is equal to or greater than U.S.\$10,000,000 (or its equivalent in another currency) disregarding any guarantee of such Indebtedness by the Issuer, the Guarantor or any Material Subsidiary (as the case may be); or
- (d) a judgment or order of a court of competent jurisdiction for the payment of any amount in excess of U.S.\$20,000,000 or its equivalent (as reasonably determined by the Trustee, such determination to be binding on the Issuer, Guarantor and the Noteholders) is rendered against the Issuer, the Guarantor or any Material Subsidiary and continues unsatisfied and unstayed or uncontested for a period of 45 days after the date thereof or, if later, the date therein specified for payment or on which such judgment or order otherwise becomes enforceable; or
- (e) any mortgage, charge, pledge, lien or other encumbrance, present or future, created or assumed by the Issuer or the Guarantor or any Material Subsidiary in respect of any Indebtedness in an aggregate principal amount in excess of U.S.\$20,000,000 or its equivalent (as determined by the Trustee, such determination to be binding on the Issuer, Guarantor and the Noteholders) becomes enforceable and any step is taken to enforce it (including the taking of possession or the appointment of a receiver, manager or other similar person) and such enforcement is not stayed

or discharged within 45 days (or such longer period as the Trustee may consider appropriate in relation to the jurisdiction concerned) of such step having been taken unless, and for so long as, the Trustee is satisfied that it is being contested in good faith and diligently; or

- (f) (i) the Issuer or any of its Subsidiaries is unable to pay its Indebtedness as it falls due or is declared insolvent or bankrupt by a competent court or judiciary or petitions the courts for a suspension of payments or suspends payments of its Indebtedness generally or makes any agreement for the deferral, rescheduling or other readjustment of all of its Indebtedness or all of a particular type of its Indebtedness which it will or might otherwise be unable to pay when due or makes a general assignment or arrangement or composition with or for the benefit of its creditors in respect of its Indebtedness generally or a moratorium or suspension of payments is agreed or declared in respect of or affecting its Indebtedness generally; or (ii) the Guarantor or any Material Subsidiary is unable to pay its Indebtedness as it falls due or is declared insolvent or bankrupt by an appropriate judicial body or petitions the courts for a suspension of payments or suspends payments of its Indebtedness generally or makes any agreement for the deferral, rescheduling or other readjustment of all of its Indebtedness (or all of a particular type of its Indebtedness the deferral, rescheduling or other readjustment of which is, in the opinion of the Trustee, materially prejudicial to the interests of the Noteholders) which it will or might otherwise be unable to pay when due or makes a general assignment or arrangement or composition with or for the benefit of its creditors in respect of its Indebtedness generally or a moratorium or suspension of payments is agreed or declared in respect of its Indebtedness generally and, following the occurrence of any of the events specified in this clause (ii) in relation to a Material Subsidiary, the Trustee is of the opinion that such occurrence is materially prejudicial to the interests of the Noteholders; or
- (g) an order of a court of competent jurisdiction is made or an effective resolution is passed for the winding-up, liquidation or dissolution of the Issuer, the Guarantor or any Material Subsidiary which (in the case of a Material Subsidiary) is (in the opinion of the Trustee) materially prejudicial to the interests of the Noteholders, or (ii) the Issuer, the Guarantor or any Material Subsidiary ceases to carry on all or a substantial part of its business or operations which cessation (in the case of a Material Subsidiary) is (in the opinion of the Trustee) materially prejudicial to the interests of the Noteholders, except, in each case, for the purpose of and followed by a reconstruction, amalgamation, reorganisation, merger or consolidation (A) on terms approved by the Trustee or by an Extraordinary Resolution of the Noteholders or (B) in the case of a Material Subsidiary, whereby the undertaking and assets of such Subsidiary are transferred to or otherwise vested in the Issuer, the Guarantor or another of their respective Subsidiaries; or
- (h) by or under the authority of any agency, authority, central bank, department, government, legislature, minister, ministry, official or public or statutory person (whether autonomous or not) of, or of the government of, a state (an "Agency") the authority of the Issuer, the Guarantor or any Material Subsidiary in the conduct of its business is wholly or substantially curtailed or any Agency seizes, compulsorily acquires, expropriates or nationalises all or any substantial part of the assets or shares of the Issuer, the Guarantor or any Material Subsidiary or any such Agency takes any step for or with a view to any of the foregoing and such curtailment, seizure, compulsory acquisition, expropriation, nationalisation or step is in the opinion (such opinion to be expressed in writing) of the Trustee materially prejudicial to the interests of the Noteholders; or
- (i) the Issuer ceases (directly or indirectly) to be wholly owned and controlled by the Guarantor; or
- (j) any action, condition or thing (including the obtaining or effecting of any necessary consent, approval, authorisation, exemption, filing, license, order, recording or registration) at any time required to be taken, fulfilled or done in order (i) to enable the Issuer and the Guarantor lawfully

to enter into, exercise their respective rights and perform and comply with their respective obligations under the Notes and the Trust Deed, (ii) to ensure that those obligations are legally binding and enforceable and (iii) to make the Notes and the Trust Deed admissible in evidence in the courts of The Grand Duchy of Luxembourg and the Russian Federation, is not taken, fulfilled or done; or

- (k) it is or will become unlawful for the Issuer or the Guarantor to perform or comply with any one or more of its obligations under any of the Notes or the Trust Deed which is (in the opinion of the Trustee) materially prejudicial to the interests of the Noteholders; or
- (l) the Guarantee is not (or is claimed by the Guarantor not to be) in full force and effect; or
- (m) any event occurs with respect to any member of the Group which under the laws of any relevant jurisdiction has an analogous effect to any of the events referred to in any of the foregoing paragraphs.

The Issuer and the Guarantor have each covenanted in the Trust Deed that at any time after an Event of Default or potential Event of Default has occurred pursuant to this Condition 10 or if the Trustee believes that such an event has occurred, they will, so far as permitted by applicable law, allow, and procure that each Material Subsidiary will allow, *inter alia*, the Trustee access to its books of account (other than books of account containing information access to which is restricted by applicable law, including Russian law).

## **11 Prescription**

Claims for the payment of principal and interest in respect of any Note Certificate shall be prescribed unless made within 10 years (for claims for the payment of principal) or five years (for claims for the payment of interest) of the appropriate Relevant Date.

## **12 Replacement of Note Certificates**

If any Note Certificate is lost, stolen, mutilated, defaced or destroyed, it may be replaced at the specified office of the Registrar, subject to all applicable laws and stock exchange requirements, upon payment by the claimant of the expenses incurred in connection with such replacement and on such terms as to evidence, security, indemnity and otherwise as the Issuer and the Guarantor may reasonably require. Mutilated or defaced Note Certificates must be surrendered before replacements will be issued.

## **13 Meetings of Noteholders, Modification and Waiver**

### **(a) Meetings of Noteholders**

The Trust Deed contains provisions for convening meetings of Noteholders to consider matters affecting their interests, including the sanctioning by Extraordinary Resolution of a modification of any of these Conditions or any provisions of the Trust Deed. Such meetings shall be held in accordance with the provisions set out in the Trust Deed. Such a meeting may be convened by Noteholders holding not less than 10 per cent. in principal amount of the Notes for the time being outstanding. The quorum at any meeting convened to vote on an Extraordinary Resolution will be two or more persons holding or representing a clear majority in principal amount of the Notes for the time being outstanding, or at any adjourned meeting two or more persons being or representing Noteholders whatever the principal amount of the Notes held or represented, unless the business of such meeting includes consideration of proposals, *inter alia*, (i) to modify the maturity of the Notes or the dates on which interest is payable in respect of the Notes, (ii) to reduce or cancel the principal amount of, or interest on, the Notes, (iii) to alter the method of calculating the amount of any payment in respect of the Notes, (iv) to change the currency of



payment of the Notes, (v) to modify the provisions concerning the quorum required at any meeting of Noteholders or the majority required to pass an Extraordinary Resolution, or (vi) to modify or cancel the Guarantee, in which case the necessary quorum will be two or more persons holding or representing not less than 75 per cent., or at any adjourned meeting not less than 25 per cent., in principal amount of the Notes for the time being outstanding. Any Extraordinary Resolution duly passed shall be binding on Noteholders (whether or not they were present at the meeting at which such resolution was passed).

**(b) Modification and Waiver**

The Trustee may agree, without the consent of the Noteholders, to (i) any modification of any of the provisions of the Trust Deed or the Notes which is of a formal, minor or technical nature or is made to correct a manifest error, and (ii) any other modification (except as mentioned in the Trust Deed), and any waiver or authorisation of any breach or proposed breach of any of the provisions of the Notes or the Trust Deed which is in the opinion of the Trustee not materially prejudicial to the interests of the Noteholders. Any such modification, authorisation or waiver shall be binding on the Noteholders and, if the Trustee so requires, shall be notified to the Noteholders as soon as practicable.

**(c) Substitution**

The Trust Deed contains provisions permitting the Trustee to agree with the Issuer and the Guarantor, subject to such amendment of the Trust Deed and such other conditions as the Trustee may require, but without the consent of the Noteholders, to the substitution of certain other entities in place of the Issuer, or of any previous substituted company, as principal debtor under the Trust Deed and the Notes. In the case of such substitution, the Trustee may agree with the Issuer and the Guarantor, without the consent of the Noteholders, to a change of law governing the Notes and/or the Trust Deed, provided that such change would not in the opinion of the Trustee be materially prejudicial to the interests of Noteholders. Notice of any such substitution will be provided as described in Condition 17 below.

**(d) Entitlement of the Trustee**

In connection with the exercise of its functions (including but not limited to those referred to in this Condition) the Trustee shall have regard to the interests of the Noteholders as a class and shall not have regard to the consequences of such exercise for individual Noteholders and the Trustee shall not be entitled to require, nor shall any Noteholder be entitled to claim, from the Issuer, the Guarantor, the Trustee or any other Person, any indemnification or payment in respect of any tax consequences of any such exercise upon individual Noteholders.

**14 Enforcement**

At any time after the Notes become due and payable, the Trustee may, at its discretion and without further notice, institute such proceedings against the Issuer and/or the Guarantor as it may think fit to enforce the terms of the Trust Deed and the Notes (whether by arbitration pursuant to the Trust Deed or by litigation), but it need not take any such proceedings unless (a) it shall have been so directed by an Extraordinary Resolution or so requested in writing by Noteholders holding at least one-quarter in principal amount of the Notes outstanding and (b) it shall have been indemnified to its satisfaction. No Noteholder may proceed directly against the Issuer or the Guarantor unless the Trustee, having become bound so to proceed, fails to do so within a reasonable time and such failure is continuing.

## **15 Indemnification of the Trustee**

The Trust Deed contains provisions for the indemnification of the Trustee and for its relief from responsibility. The Trustee is entitled to enter into business transactions with the Issuer, the Guarantor and any entity related to the Issuer or the Guarantor without accounting for any profit.

## **16 Further Issues**

The Issuer may from time to time, without the consent of the Noteholders, create and issue further securities having the same terms and conditions as the Notes in all respects (or in all respects except for the first payment of interest) and so that such further issue shall be consolidated and form a single series with the outstanding Notes. References in these Conditions to the Notes include (unless the context requires otherwise) any other securities issued pursuant to this Condition. Any such other securities shall be constituted by a deed supplemental to the Trust Deed.

## **17 Notices**

Notices to the Noteholders shall be valid if sent to them by first class mail (airmail if overseas) at their respective addresses on the Register. Any such notice shall be deemed to have been given on the fourth day after the date of mailing. In addition, notices will be published (so long as the Notes are listed on the Luxembourg Stock Exchange and the rules of that exchange so require) in a leading newspaper having general circulation in Luxembourg (which is expected to be the *Luxemburger Wort*). Any such notice shall be deemed to have been given on the date of such publication or, if published more than once or on different dates, on the first date on which publication is made.

## **18 Currency Indemnity**

If any sum due from the Issuer in respect of the Notes or any order or judgment given or made in relation thereto has to be converted from the currency (the “first currency”) in which the same is payable under these Conditions or such order or judgment into another currency (the “second currency”) for the purpose of (a) making or filing a claim or proof against the Issuer, (b) obtaining an order or judgment in any court or other tribunal or (c) enforcing any order or judgment given or made in relation to the Notes, the Issuer, failing whom the Guarantor, shall indemnify each Noteholder, on the written demand of such Noteholder addressed to the Issuer and the Guarantor and delivered to the Issuer and the Guarantor or to the specified office of the Registrar, against any loss suffered as a result of any discrepancy between (i) the rate of exchange used for such purpose to convert the sum in question from the first currency into the second currency and (ii) the rate or rates of exchange at which such Noteholder may in the ordinary course of business purchase the first currency with the second currency upon receipt of a sum paid to it in satisfaction, in whole or in part, of any such order, judgment, claim or proof.

This indemnity constitutes a separate and independent obligation of the Issuer or, as the case may be, the Guarantor and shall give rise to a separate and independent cause of action.

## **19 Contracts (Rights of Third Parties) Act 1999**

No person shall have any right to enforce any term or condition of the Notes under the Contracts (Rights of Third Parties) Act 1999.

## **20 Arbitration**

(a) Subject to Condition 20(c), any dispute or difference of whatever nature howsoever arising between the Issuer or, as the case may be, the Guarantor and any Noteholder (subject to Condition 14) under, out of or in connection with the Notes or the Guarantee (including a

dispute or difference as to the breach, existence, termination or validity of the Notes or the Trust Deed or the Guarantee) (each a “Dispute”) shall (regardless of the nature of the Dispute) be referred to and finally settled by arbitration in accordance with the UNCITRAL Arbitration Rules (the “Rules”) as at present in force (which Rules are deemed to be incorporated by reference into this Condition 20(a)) by a panel of three arbitrators appointed in accordance with the Rules.

- (b) The seat of arbitration shall be London, England. The procedural law of any reference to arbitration shall be English law. The language of the arbitration shall be English. The appointing authority for the purposes set forth in the Rules shall be the London Court of International Arbitration.
- (c) The Issuer and the Guarantor each hereby irrevocably agrees for the benefit of each of the Trustee and the Noteholders that (i) before the giving of the notice of arbitration pursuant to the Rules or (ii) if the Trustee or the Noteholders (as the case may be) receive a notice of arbitration from the Issuer or, as the case may be, the Guarantor, within 14 days of receipt of such notice of arbitration, the Trustee or the relevant Noteholder(s) (as the case may be and, in the case of the Noteholders, subject to Condition 14) may elect, by notice in writing to the Issuer or, as the case may be, the Guarantor, that the Dispute be resolved by litigation and not by arbitration.

## **21 Governing Law, Jurisdiction, Consent to Enforcement and Waiver of Immunity**

### **(a) Governing law**

The Notes (including for the avoidance of doubt Condition 20) and the Trust Deed are governed by, and shall be construed in accordance with, English law.

### **(b) Jurisdiction**

Subject to Condition 20, the courts of England are to have jurisdiction to settle any disputes which may arise out of or in connection with the Notes or the Trust Deed and accordingly any legal action or proceedings arising out of or in connection with the Notes or the Trust Deed (“Proceedings”) may be brought in such courts. Each of the Issuer and the Guarantor has in the Trust Deed irrevocably submitted to the jurisdiction of such courts and waives any objection to Proceedings in such courts whether on the ground of venue or on the ground that the Proceedings have been brought in an inconvenient forum. These submissions are made for the benefit of each of the Noteholders and shall not limit the right of any of them to take Proceedings in any other court of competent jurisdiction nor shall the taking of Proceedings in one or more jurisdictions preclude the taking of Proceedings in any other jurisdiction (whether concurrently or not).

### **(c) Agent for Service of Process**

Each of the Issuer and the Guarantor has appointed Law Debenture Corporate Services Limited at its registered office (being, at the date hereof, Fifth Floor, 100 Wood Street, London EC2V 7EX, England) as its agent in England to receive service of process in any Proceedings in England in connection with the Notes or the Trust Deed.

### **(d) Consent to enforcement etc.**

The Issuer and the Guarantor consent generally in respect of any Proceedings or Disputes to the giving of any relief or the issue of any process in connection with such Proceedings or Disputes including (without limitation) the making, enforcement or execution against any property

whatsoever (irrespective of its use or intended use) of any judgment or award which may be made or given in such Proceedings or Disputes.

**(e) Waiver of immunity**

To the extent that either the Issuer or the Guarantor may in any jurisdiction claim for itself or its assets or revenues immunity from suit, execution, attachment (whether in aid of execution, before the making of a judgment or an award or otherwise) or other legal process including in relation to the enforcement of an arbitration award and to the extent that such immunity (whether or not claimed) may be attributed in any such jurisdiction to the Issuer, the Guarantor or their respective assets or revenues, the Issuer and the Guarantor agree not to claim and irrevocably waive such immunity to the full extent permitted by the laws of such jurisdiction.

## **22 Definitions**

In these Conditions, the following terms shall have the following meanings:

**“Acquired Debt”** means, with respect to any specified Person, Indebtedness of any other Person existing at the time such other Person is merged, consolidated, amalgamated or otherwise combined with or into, or becomes a Subsidiary of, such specified Person, in each case other than Indebtedness incurred in connection with, or in contemplation of, such other Person merging, consolidating, amalgamating or combining with or into, or becoming a Subsidiary of, such specified Person;

**“Adjusted Consolidated Cash Flow”** means, with respect to any Person for any period, the sum (without duplication) of (i) Adjusted Consolidated Net Income, (ii) to the extent Adjusted Consolidated Net Income has been reduced thereby, (A) all income taxes of such Person and its Subsidiaries paid or accrued as determined on a consolidated basis in accordance with IAS for such period, (B) Adjusted Consolidated Interest Expense and (C) Adjusted Consolidated Non-Cash Charges, less any non-cash items increasing Adjusted Consolidated Net Income for such period, and (iii) dividends or distributions paid in cash to such Person or its Subsidiary by another Person who is not a Subsidiary of such Person;

**“Adjusted Consolidated Interest Expense”** means, with respect to any Person for any period, the sum (without duplication) of:

- (a) the consolidated interest expense of such Person and its Subsidiaries for such period, whether paid or accrued (including, without limitation, amortisation of original issue discount, non-cash interest payments, the interest component of any deferred payment obligations, the interest component of any Qualified Receivables Transaction and the interest component of all payments associated with Capital Lease Obligations, commissions, discounts and other fees and charges incurred in respect of a letter of credit or bankers’ acceptance financings, but excluding amortisation of debt issuance costs); and
- (b) the consolidated interest expense of such Person and its Subsidiaries that was capitalised during such period;

**“Adjusted Consolidated Net Income”** means, with respect to any Person for any period, the aggregate of the net profit (or loss) of such Person and its Subsidiaries for such period, on a consolidated basis, determined in accordance with IAS; *provided* that there shall be excluded therefrom, without duplication:

- (a) after-tax gains and losses from Asset Sales or abandonments or reserves relating thereto;
- (b) after-tax items classified as extraordinary or non-recurring gains (and, solely for purposes of calculation of Fixed Charge Coverage Ratio only, extraordinary or non-recurring losses);

- (c) the net income of any Person acquired in a “pooling of interests” transaction accrued prior to the date it becomes a Subsidiary of the referent Person or is merged or consolidated with it or any of its Subsidiaries;
- (d) any net income or loss of any Subsidiary, if such Subsidiary is subject to restrictions, directly or indirectly, on the payment of dividends or the making of distributions (by loans, advances, intercompany transfer or otherwise) by such Subsidiary, directly or indirectly, to the Guarantor, except that the Guarantor’s equity in the net income of any such Subsidiary for such period shall be included in such Adjusted Consolidated Net Income up to the aggregate amount of cash which could actually have been distributed by such Subsidiary during such period to the Guarantor as a dividend or other distribution (by loans, advances, intercompany transfer or otherwise) for so long as so permitted;
- (e) the net income (and, solely for purposes of calculation of Fixed Charge Coverage Ratio only, losses) of any Person other than a Subsidiary;
- (f) any restoration to income of any contingency reserve, except to the extent that provision for such reserve was made out of Adjusted Consolidated Net Income accrued at any time following the Issue Date; and
- (g) for purposes of Condition 5(g), in the case of a successor to the referent Person by consolidation or merger or as a transferee of the referent Persons’ assets, any earnings of such successor corporation prior to such consolidation, merger or transfer of assets;

“**Adjusted Consolidated Net Worth**” means, with respect to any specified Person as of any date, the sum of:

- (a) the consolidated equity of the common stockholders of such Person and its consolidated Subsidiaries as of such date; plus
- (b) the respective amounts reported on such Person’s balance sheet as of such date with respect to any series of preferred stock (other than Disqualified Stock) that by its terms is not entitled to the payment of dividends unless such dividends may be declared and paid only out of net earnings in respect of the year of such declaration and payment, but only to the extent of any cash received by such Person upon issuance of such preferred stock;

“**Adjusted Consolidated Non-Cash Charges**” means, with respect to any Person for any period, the aggregate depreciation, amortisation and any other non-cash expenses of such Person and its Subsidiaries for such period determined on a consolidated basis in accordance with IAS (excluding any such charge which requires an accrual of a reserve for a cash charge for any future period);

“**Affiliate**”, in respect of any specified Person, means any other Person directly or indirectly controlling or controlled by or under direct or indirect common control with such specified Person, and, in the case of a natural Person, any immediate family member of such Person. For purposes of this definition, “**control**”, as used with respect to any Person, shall mean the possession, directly or indirectly, of the power to direct or cause the direction of the management or policies of such Person, whether through the ownership of voting securities, by agreement or otherwise; *provided* that, for purposes of Condition 5(f) and any Asset Sale, beneficial ownership of 10 per cent. or more of the Voting Stock of a Person shall be deemed to be control. For purposes of this definition, the terms “**controlling**”, “**controlled by**” and “**under common control with**” shall have correlative meanings. No Person (other than the Issuer, the Guarantor or any Subsidiary of the Guarantor) in whom a Receivables Subsidiary makes an Investment in connection with a Qualified Receivables Transaction will be deemed to be an Affiliate of the Guarantor or any of its Subsidiaries solely by reason of such Investment;

**“Asset Acquisition”** means (i) an Investment by the Guarantor or any Subsidiary in any other Person pursuant to which such Person shall become a Subsidiary of or shall be consolidated or merged with the Guarantor or any Subsidiary or (ii) the acquisition by the Guarantor or any Subsidiary of assets of any Person which constitute all or substantially all of the assets of such Person or which comprise a division or line of business of such Person;

**“Asset Sale”** means any sale, lease, transfer or other disposal (including, without limitation, by way of a Sale and Leaseback Transaction) in one or more transactions or series of transactions (whether related or not) by the Guarantor or any other member of the Group to a Person that is not a member of the Group of all or any of the Capital Stock of any Subsidiary or any other property, assets or revenues of the Guarantor or any other member of the Group; provided that **“Asset Sale”** shall not include:

- (a) sales, leases, transfers or other disposals of inventory, stock-in-trade, goods, services and other current assets in the ordinary course of business, and assignments of or other arrangements over the rights or revenues arising therefrom;
- (b) sales of accounts receivable and related assets of the type specified in the definition of **“Qualified Receivables Transaction”** to a Receivables Subsidiary for the Fair Market Value thereof, including monetary consideration (including, without limitation, payment in instalments) in an amount at least equal to 70 per cent. of the book value thereof as determined in accordance with IAS; or
- (c) transfers of accounts receivable and related assets under a Qualified Receivables Transaction; or
- (d) sales, leases, transfers or other disposals of property, assets or revenues of any Social Business;

**“Attributable Debt”** in respect of a Sale and Leaseback Transaction means, at the time of determination, the present value of the obligation of the lessee for net rental payments during the remaining term of the lease included in such Sale and Leaseback Transactions, including any period for which such lease has been extended or may, at the option of the lessor, be extended. Such present value will be calculated using a discount rate equal to the rate of interest implicit in such transaction, determined in accordance with IAS;

**“Board of Directors”** means: with respect to the Guarantor, its Supervisory Council; with respect to a corporation, the board of directors or managers of the corporation and, in the case of any other corporation having both a supervisory board and an executive or management board, the executive or management board (except where the supervisory board is expressly indicated); with respect to a partnership, the board of directors of the general partner of the partnership; and with respect to any other Person, the board or committee of such Person serving a similar function;

**“business day”** means (except where expressly defined otherwise) a day on which commercial banks are open for business (including dealings in foreign currencies) in the city where the Registrar has its specified office;

**“Capital Lease Obligation”** means, at the time any determination thereof is to be made, the amount of the liability in respect of a capital lease that would at that time be required to be capitalised on a balance sheet in accordance with IAS;

**“Capital Stock”** means: in the case of a corporation, corporate stock; in the case of a company, share capital; in the case of an association or business entity, any and all shares, interests, participations, rights or other equivalents (however designated) of corporate stock; in the case of a partnership or limited liability company, partnership or membership interests (whether general or limited); and any other interest or participation in the nature of an equity interest in the issuing Person or that confers on a Person the right to receive a share of the profits and losses of, or distributions of assets of, the issuing Person;



**“Cash Equivalents”** means:

- (a) securities issued or directly and fully guaranteed or insured by the government of (a) any of the United States of America or any member state of the European Union or (b) any agency or instrumentality of any of the foregoing (provided that the full faith and credit of the relevant jurisdiction is pledged in support thereof) or by any European Union central bank, and in each case having maturities of not more than one year from the date of acquisition;
- (b) certificates of deposit, time deposits and money market deposits with maturities of one year or less from the date of acquisition, bankers’ acceptances with maturities not exceeding six months and overnight bank deposits, in each case, with a commercial bank or trust company having one of the two highest rating categories obtainable from Moody’s or S&P;
- (c) repurchase obligations with a term of not more than seven days for underlying securities of the types described in clauses (a) and (b) above entered into with any financial institution having one of the two highest rating categories obtainable from Moody’s or S&P;
- (d) commercial paper having a rating at the time of the investment of at least “P-1” from Moody’s or “A-1” from S&P or, if no rating is available in respect of the commercial paper, the issuer of which has, in respect of its long-term debt obligations, an equivalent rating and in each case maturing within twelve months after the date of acquisition; and
- (e) money market funds at least 95.0 per cent. of the assets of which constitute Cash Equivalents of the kinds described in clauses (a) through (d) of this definition;

**“Control”** shall have the meaning provided in the definition of **“Affiliate”** and **“controlled”** shall be construed accordingly;

**“Default”** means any event that is, or with the giving of notice or the passage of time or both would be, an Event of Default;

**“Disqualified Stock”** means any Capital Stock that, by its terms (or by the terms of any security into which it is convertible, or for which it is exchangeable, in each case at the option of the holder thereof), or upon the happening of any event, matures or is mandatorily redeemable, pursuant to a sinking fund obligation or otherwise, or redeemable at the option of the holder thereof, in whole or in part, on or prior to the date that is 180 days after the date on which the Notes mature. Notwithstanding the preceding sentence, any Capital Stock that would constitute Disqualified Stock solely because the holders thereof have the right to require the repurchase of such Capital Stock upon the occurrence of a change of control or an asset sale shall not constitute Disqualified Stock if the terms of such Capital Stock provide that any such Capital Stock may not be repurchased or redeemed pursuant to such provisions unless such repurchase or redemption complies with Condition 5(g);

**“Equity Interests”** means Capital Stock and all warrants, options or other rights to acquire Capital Stock (but excluding any debt security that is convertible into, or exchangeable for, Capital Stock);

**“European Union”** means the European Union, including the countries of Austria, Belgium, Denmark, France, Finland, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden and the United Kingdom but not including any country which becomes a member of the European Union after the Issue Date;

**“Fair Market Value”** means, with respect to any property, asset or Investment, the fair market value of such asset or Investment at the time of the event requiring such determination, as determined in good faith by the Issuer or the Guarantor, or, with respect to any asset or Investment in excess of U.S.\$10,000,000 (other than cash or Cash Equivalents), as determined by an Independent Appraiser;

**“Fixed Charges”** means, with respect to any Person for any period, the sum, without duplication, of:

- (i) Adjusted Consolidated Interest Expense for such period; and
- (ii) the product of (x) the amount of all dividend payments on Preferred Stock (other than dividends paid in Capital Stock that is not Disqualified Stock) of such Person or on Disqualified Stock of such Person held by Persons other than the Parent or any of its Restricted Subsidiaries paid, accrued or scheduled to be paid or accrued during such period and (y) a fraction, the numerator of which is one and the denominator of which is one minus the then current combined federal and local tax rate of such Person, expressed as a decimal, in each case, computed on a consolidated basis and in accordance with IAS;

**“Fixed Charge Coverage Ratio”** means with respect to any Person for the two consecutive six month fiscal periods (the **“Four Quarter Period”**) ending on or prior to the date of determination, the ratio of the Adjusted Consolidated Cash Flow of such Person for such period to the Fixed Charges of such Person and its Subsidiaries for such period.

For purposes of this definition, **“Adjusted Consolidated Cash Flow”** and **“Fixed Charges”** shall be calculated on a *pro forma* basis after giving effect to:

- (1) the incurrence of Indebtedness of such Person and its Subsidiaries (and the application of the proceeds therefrom) giving rise to the need to make such calculation and any incurrence (and the application of the proceeds therefrom) or repayment or redemption of Indebtedness, other than the incurrence or repayment of Indebtedness pursuant to working capital facilities, occurring at any time subsequent to the beginning of the Four Quarter Period and on or prior to the date of determination, as if such incurrence and issuance (and the application of the proceeds thereof), or the repayment or redemption, as the case may be, occurred on the first day of the Four Quarter Period;
- (2) any Asset Sales or Asset Acquisitions (including, without limitation, any Asset Acquisition giving rise to the need to make such calculation as a result of such Person or one of its Subsidiaries (including any Person that becomes a Subsidiary as a result of such Asset Acquisition) incurring, assuming or otherwise becoming liable for Indebtedness) at any time on or subsequent to the first day of the Four Quarter Period and on or prior to the transaction date, as if such Asset Sale or Asset Acquisition (including the incurrence, assumption or liability for any Indebtedness and also including any Adjusted Consolidated Cash Flow associated with such Asset Acquisition) occurred on the first day of the Four Quarter Period; and
- (3) discontinued operations determined in accordance with IAS at any time on, or subsequent to, the first day of the Four Quarter Period and on, or prior to, the date of determination, as if such discontinued operations had occurred on the first day of the Four Quarter Period (but with respect to Fixed Charges, only to the extent that the obligations giving rise to such Fixed Charges will not be obligations of the specified Person or any of its Subsidiaries following the date of determination).

If such Person or any of its Subsidiaries directly or indirectly guarantees any Indebtedness of a third Person, the Fixed Charge Coverage Ratio shall give effect to the incurrence of such guaranteed Indebtedness as if such Person or Subsidiary had directly incurred such guaranteed Indebtedness. If, since the beginning of a Four Quarter Period, any Person that subsequently became a Subsidiary or was merged with or into the Guarantor or any of its Subsidiaries since the beginning of such Four Quarter Period shall have made any Investment in a Subsidiary, acquisition, disposition, merger or consolidation or determined a discontinued operation that would have required adjustment pursuant to this definition, then the Fixed Charge Coverage Ratio shall be calculated giving *pro forma* effect thereto for such period as if such Investment, acquisition, disposition, merger or consolidation or discontinued operations had occurred at the beginning of the applicable Four Quarter Period.

For purposes of this definition, whenever *pro forma* effect is to be given to an acquisition or disposition of assets or other transaction for purposes of calculating the Fixed Charge Coverage Ratio, the *pro forma* calculations shall be determined in good faith by an Officer of the Guarantor on the basis of reasonable assumptions.

Furthermore, in calculating “**Adjusted Consolidated Interest Expense**” for purposes of the calculation of “**Fixed Charge Coverage Ratio**”, interest determined on a fluctuating basis as of the date of determination (including Indebtedness actually incurred on the date of the transaction giving rise to the need to calculate the Fixed Charge Coverage Ratio) and which will continue to be so determined thereafter shall be deemed to have accrued at a fixed rate per annum equal to the rate of interest on such Indebtedness as in effect on the date of determination;

“**Group**” means the Guarantor and its Consolidated Subsidiaries;

“**guarantee**” means a guarantee other than by endorsement of negotiable instruments for collection in the ordinary course of business, direct or indirect, in any manner including, without limitation, by way of a pledge of assets or through letters of credit or reimbursement agreements in respect thereof, of all or any part of any Indebtedness;

“**Hedging Obligations**” means, with respect to any Person, the obligations of such Person under:

- (a) interest rate swap agreements, interest rate cap agreements and interest rate collar agreements;
- (b) other agreements or arrangements designed to protect such Person against fluctuations in interest rates; and
- (c) any foreign currency futures contract, option or similar agreement or arrangement designed to protect such Person against fluctuations in foreign currency rates;

“**IAS**” means International Accounting Standards as in effect from time to time, and which are consistent with the accounting principles and practices then applied by the Guarantor, and any variation to such accounting principles and practices which is not material;

“**Indebtedness**” means, without duplication, with respect to any specified Person, any indebtedness of such Person, whether or not contingent (including, without limitation, guarantees):

- (a) in respect of moneys borrowed or raised;
- (b) evidenced by bonds, notes, debentures, loan stock or similar instruments or letters of credit (or reimbursement agreements in respect thereof);
- (c) in respect of bankers’ acceptances;
- (d) in respect of the balance deferred and unpaid of the purchase price of any property, except any such balance that constitutes an accrued expense or trade payable;
- (e) representing Capital Lease Obligations;
- (f) representing any Hedging Obligations; and
- (g) representing the proceeds received by the Guarantor or any Subsidiary from a Qualified Receivables Transaction not otherwise giving rise to Indebtedness under items (a) through (f) above,

in each case, if and to the extent any of the preceding items (other than letters of credit, guarantees and Hedging Obligations) would appear as a liability upon a balance sheet of the specified Person prepared in accordance with IAS.

In addition, the term “Indebtedness” includes all indebtedness of others secured by a lien on any asset of the specified Person (whether or not such Indebtedness is assumed by the specified Person) and, to

the extent not otherwise included, any guarantee by the specified Person of any Indebtedness of any other Person. The amount of any Indebtedness outstanding as of any date shall be: (1) the accreted value thereof, in the case of any Indebtedness issued with original issue discount; and (2) the principal amount thereof, together with any interest thereon that is more than 30 days past due, in the case of any other Indebtedness. The term “Indebtedness” does not include trade payables or current liabilities (other than short-term debt and the current portion of long-term debt) or indebtedness to the federal budget, regional budgets, local budgets and non-budgetary funds on account of current taxes which are not overdue;

“**Independent Appraiser**” means any of PricewaterhouseCoopers LLC, KPMG LLC, Deloitte & Touche LLP, Ernst & Young LLP or such other investment banking, accountancy or appraisal firm of international standing selected by the Guarantor (with the prior written consent of the Trustee, which consent shall not be unreasonably withheld), *provided* it is not an Affiliate of the Issuer, the Guarantor or any Material Subsidiary;

“**Investments**” means, with respect to any Person, all direct or indirect investments by such Person in other Persons (including Affiliates) in the forms of (a) Equity Interests and the making of capital contributions, (b) corporate bonds, promissory notes, commercial paper, certificates of deposit and other securities, (c) the granting of loans and the making of advances (excluding commission, travel and similar advances to officers and employees made in the ordinary course of business), (d) the extension of credit (including, without limitation, commodity credits) and (e) holding the benefit of any Indebtedness (including guarantees, indemnities or other like obligations), together with all items that are or would be classified as investments on a balance sheet prepared in accordance with IAS. If the Guarantor or any Subsidiary of the Guarantor sells or otherwise disposes of any Equity Interests of any direct or indirect Subsidiary of the Guarantor such that, after giving effect to any such sale or disposition, such Person is no longer a Subsidiary of the Guarantor, the Guarantor shall be deemed to have made an Investment on the date of any such sale or disposition equal to the fair market value of the Equity Interests of such Subsidiary not sold or disposed of in an amount determined as provided in the final paragraph of Condition 5(g). The acquisition by the Guarantor or any Subsidiary of the Guarantor of a Person that holds an Investment in a third Person shall be deemed to be an Investment by the Guarantor or such Subsidiary in such third Person in an amount equal to the fair market value of the investment held by the acquired Person in such third Person determined as provided in the final paragraph of Condition 5(g);

“**Issue Date**” means 6 May 2003;

“**Material Adverse Effect**” means a material adverse effect on (a) the financial condition or operations of the Guarantor or any of its Material Subsidiaries, (b) the ability of the Guarantor to perform its obligations under the Guarantee, (c) the ability of the Issuer to perform its obligations under the Trust Deed and the Notes or (d) the validity or enforceability of the Trust Deed, the Notes and the Guarantee, or the rights or remedies of the Noteholders thereunder;

“**Material Subsidiary**” means at any relevant time a Subsidiary of the Guarantor:

- (a) whose total assets or gross revenues (or, where the Subsidiary in question prepares consolidated accounts, whose total consolidated assets or gross consolidated revenues, as the case may be) represent not less than 5 per cent. of the total consolidated assets or the gross consolidated revenues of the Guarantor and its Subsidiaries, all as calculated by reference to the then latest audited accounts (or consolidated accounts, as the case may be) (in each case, produced on the basis of IAS, consistently applied) of such Subsidiary and the then latest audited consolidated accounts of the Guarantor (produced on the basis of IAS, consistently applied) and its consolidated Subsidiaries; or

- (b) to which is transferred all or substantially all the assets and undertaking of a Subsidiary which immediately prior to such transfer is a Material Subsidiary.

For the purposes of this definition, a report of the Auditors or the Chief Accountant of the Guarantor that in their or his or her opinion a Subsidiary of the Guarantor is or is not or was or was not a Material Subsidiary shall without further enquiry or evidence and in the absence of manifest error, be conclusive and binding on the Issuer, the Guarantor, the Trustee and the Noteholders;

**“Moody’s”** means Moody’s Investors Service, Inc.;

**“Obligations”** means any principal, interest, penalties, fees, indemnifications, reimbursements, damages and other liabilities payable under the documentation governing any Indebtedness;

**“Officer”** means, with respect to any Person, any Managing Director, Director, the Chairman of the Board, the President, any Vice President, the Chief Financial Officer, the Controller, the Treasurer or the Secretary of such Person or any general partner or other person holding a corresponding or similar position of responsibility;

**“Officers’ Certificate”** means, as applied to any Person, a certificate executed on behalf of such Person by two Officers; provided that every Officers’ Certificate with respect to the compliance with the Trust Deed shall include (i) a statement that the Officers making or giving such Officers’ Certificate have read such condition and any definitions or other provisions contained in the Trust Deed relating thereto, (ii) a statement that, in the opinion of the signers, they have made or have caused to be made such examination or investigation as is necessary to enable them to express an informed opinion as to whether or not such condition has been complied with, and (iii) a statement as to whether, in the opinion of the signers, such condition has been complied with;

**“Permitted Business”** means any business which is the same as or related, ancillary or complementary to any of the businesses of the Guarantor and its Subsidiaries on the Issue Date (including, without limitation, (i) downstream marketing activities relating to diamonds and diamond jewellery and (ii) industrial and energy-related activities the primary purpose of which is the supply and support of the activities of the Guarantor and its Subsidiaries);

**“Permitted Indebtedness”** means the following Indebtedness (each of which shall be given independent effect):

- (a) Indebtedness of up to U.S.\$1,200,000,000 in aggregate principal amount at any time outstanding;
- (b) Indebtedness owed by the Guarantor to any Subsidiary, or Indebtedness owed by any Subsidiary to the Guarantor or any other Subsidiary of the Guarantor; provided that any subsequent issuance or transfer of Equity Interests that results in any such Indebtedness being held by a Person other than a Group member and any sale or other transfer of any such Indebtedness to a Person that is not a Group member (other than a pledge or other transfer of such Indebtedness intended to create a Security Interest therein) will be deemed, in each case, to constitute an incurrence of Indebtedness that was not permitted by this paragraph (b); and
- (c) Permitted Refinancing Indebtedness;

**“Permitted Investments”** means:

- (a) any Investment in the Guarantor or in a Subsidiary (including in any Equity Interests of a Subsidiary);
- (b) any Investment in cash or in Cash Equivalents;
- (c) any Investment in securities issued or directly and fully guaranteed or insured by the government of the Russian Federation or any agency or authority (whether federal, regional or local) or the Central Bank of the Russian Federation (provided that the full faith and credit of the government

of the Russian Federation is pledged in support thereof), or promissory notes, certificates of deposit, time deposits, money market deposits and other bank deposits with or of any Russian commercial bank included in the first category of reliability established by the Central Bank of the Russian Federation, *provided* that any such Investment must be capable of being liquidated, at the option of the Person making such Investment, within a period of 7 days;

- (d) any Investment by the Guarantor or any Subsidiary in a Person, if as a result of such Investment (a) such Person becomes a Subsidiary or (b) such Person in one transaction or a series of substantially concurrent related transactions, is merged, consolidated or amalgamated with or into, transfers or conveys substantially all of its assets to, or is liquidated into, the Guarantor or a Subsidiary;
- (e) Investments solely in exchange for the issuance of Equity Interests (other than Disqualified Stock) of the Guarantor;
- (f) loans or advances to officers and employees made in the ordinary course of business in an aggregate amount up to U.S.\$10,000,000 at any time outstanding, and not otherwise excluded from the definition of Investment;
- (g) Investments in stock, obligations or securities received in settlement of debts created in the ordinary course of business and owing to the Guarantor or any Subsidiary or in satisfaction of judgments or pursuant to any plan of reorganisation or similar arrangement upon the bankruptcy or insolvency of a debtor;
- (h) Investments in receivables owing to the Guarantor or any Subsidiary, if created or acquired in the ordinary course of business;
- (i) the acquisition by a Receivables Subsidiary in connection with a Qualified Receivables Transaction of Equity Interests of a trust or other Person established by such Receivables Subsidiary to effect such Qualified Receivables Transaction; and any other Investment by the Issuer, the Guarantor or a Subsidiary of the Guarantor in a Receivables Subsidiary or any Investment by a Receivables Subsidiary in any other Person in connection with a Qualified Receivables Transaction; provided, that such other Investment is in the form of a note or other obligation that the Receivables Subsidiary or other Person is required to repay as soon as practicable from available cash collections less amounts required to be established as reserves pursuant to contractual agreements with entities that are not Affiliates of the Issuer or the Guarantor entered into as part of a Qualified Receivables Transaction;
- (j) Hedging Obligations;
- (k) Any Investment made as a result of the receipt of non-cash consideration from an Asset Sale that was made in compliance with Condition 5(a);
- (l) Investments existing on the Issue Date; and
- (m) Investments not to exceed, taken together with all other Investments made pursuant to this clause (m) and at the time of determination outstanding, U.S.\$10,000,000 in the aggregate (with the Fair Market Value of each Investment being measured at the time made and without giving effect to subsequent changes in value);

**“Permitted Refinancing Indebtedness”** means any Indebtedness issued in exchange for, or the net proceeds of which are used to extend, refinance, renew, replace, defease or refund, other Indebtedness (other than intercompany Indebtedness); *provided* that:

- (a) the principal amount of such Permitted Refinancing Indebtedness does not exceed the principal amount (or accreted value, if applicable) of the Indebtedness extended, refinanced, renewed,



replaced, defeased or refunded (plus all accrued interest on the Indebtedness and the amount of all expenses and premiums incurred in connection therewith);

- (b) such Permitted Refinancing Indebtedness has a final maturity date equal to or later than the final maturity date of, and has a Weighted Average Life to Maturity equal to or greater than the Weighted Average Life to Maturity of, either (i) the Indebtedness being extended, refinanced, renewed, replaced, defeased or refunded or (ii) the Notes;
- (c) if the Indebtedness being extended, refinanced, renewed, replaced, defeased or refunded is subordinated in right of payment to the Notes, such Permitted Refinancing Indebtedness is subordinated in right of payment to the Notes on terms at least as favourable to the Noteholders as those contained in the documentation governing the Indebtedness being extended, refinanced, renewed, replaced, defeased or refunded; and
- (d) such Indebtedness is incurred by the Guarantor, the Issuer or another Group member who is the obligor on the Indebtedness being extended, refinanced, renewed, replaced, defeased or refunded;

**“Permitted Security Interest”** means:

- (a) any Security Interest in existence on the Issue Date;
- (b) any Security Interest in respect of Indebtedness created by a Person prior to it becoming a Material Subsidiary or otherwise being acquired by any Group member, *provided* that such Security Interest was not created in contemplation thereof or in connection therewith;
- (c) any Security Interest on property existing at the time of acquisition of such property by the Guarantor or any Subsidiary, *provided* that such Security Interest was not created in contemplation of such acquisition or in connection therewith;
- (d) any Security Interest arising from a purchase money mortgage or other purchase money lien of the Guarantor or any Material Subsidiary; *provided* that (i) the related Indebtedness shall not be secured by any property or assets of the Guarantor or any Material Subsidiary other than the property and assets so acquired and (ii) the Security Interest securing such Indebtedness shall be created within 90 days of such acquisition;
- (e) any Security Interest created or permitted to be outstanding by the Issuer, the Guarantor or a Material Subsidiary in respect of Indebtedness issued, borrowed or raised to finance the ownership, acquisition, development and/or operation of an asset or project where there is no recourse whatsoever for repayment thereof other than:
  - (i) recourse to the issuer or borrower thereof for amounts limited to the cash flow or net cash flow from such assets or projects (including insurance proceeds); and/or
  - (ii) recourse of the issuer or borrower thereof for the purpose only of enabling amounts to be claimed in respect of such Indebtedness over such asset or project or the income, cash flow or other proceeds deriving therefrom to secure such Indebtedness, *provided* that the extent of such recourse to the issuer or borrower thereof is limited solely to the amount of any recoveries made on any such enforcement;
- (f) any Security Interest created or permitted to exist over goods and products in commercial turnover (including, without limitation, rough diamonds in their natural form and/or being processed) or over accounts receivable (whether denominated in Russian Roubles or in U.S. Dollars or other convertible currency) of the Guarantor or any of its Subsidiaries (including any Receivables Subsidiary) in connection with a Qualified Receivables Transaction; *provided* that the aggregate value of such goods and products in commercial turnover or accounts receivable which is subject to such Security Interest or Security Interests and is securing Indebtedness due in

the current financial year shall not exceed the lesser of (i) 70 per cent. of the sum of (A) the aggregate annual goods and products in commercial turnover and (B) the aggregate annual accounts receivable, which are, in each case, subject to the grant of a security interest, transferred, or subject to the grant of a participation or beneficial interest, by the Guarantor or any of its Subsidiaries (including, without limitation, any Receivables Subsidiary) in connection with any Qualified Receivables Transaction and (ii) such aggregate value of such Security Interests of the type described in this clause (f) as shall secure Indebtedness in a maximum aggregate principal amount of U.S.\$400,000,000;

- (g) any other Security Interest created in respect of any other Indebtedness incurred after the Issue Date up to an aggregate principal amount of U.S.\$30,000,000 outstanding at any time;
- (h) any Security Interest in favour of the Guarantor or any of its Subsidiaries;
- (i) any Security Interest created to secure liabilities under letters of credit issued in connection with the acquisition and disposal of inventory, stock-in-trade, goods, services and other current assets in the ordinary course of business;
- (j) any Security Interest for taxes, assessments or governmental charges or claims that are not yet delinquent or that are being contested in good faith by appropriate proceedings promptly instituted and diligently conducted, *provided* that any reserve or other appropriate provision as may be required in conformity with IAS or with RAR has been set aside;
- (k) any Security Interest arising by operation of law, including, without limitation, Security Interests of landlords, unpaid vendors, carriers, warehousemen, mechanics, suppliers, materialmen or repairmen arising in the ordinary course of business for sums not yet delinquent or being contested in good faith, *provided* that any reserve or other appropriate provision as may be required in conformity with IAS or with RAR has been set aside;
- (l) any Security Interest to secure the performance of tenders, statutory obligations, surety or appeal bonds, bids, leases, governmental contracts, performance and return of money bonds or other obligations of a like nature (exclusive of obligations for the payment of borrowed money) incurred in the ordinary course of business;
- (m) any easements, rights of way, municipal and zoning ordinances, utility agreements, reservations, encroachments, restrictions and similar charges, encumbrances, title defects or other irregularities that do not materially interfere with the ordinary course of business of the Guarantor or any of its Subsidiaries;
- (n) any Security Interest granted or deposit made in the ordinary course of business in connection with workers' compensation, unemployment insurance and other types of statutory obligations, including any Security Interest securing letters of credit issued in the ordinary course of business in connection therewith; or
- (o) any extension, renewal or replacement in whole or in part of any Security Interest referred to in the foregoing clauses (a) through (n), inclusive, *provided, however*, that the principal amount of Indebtedness secured thereby shall not exceed the principal amount of Indebtedness so secured at the time immediately preceding the time of such extension, renewal or replacement, and that such extension, renewal or replacement shall be limited to all or a part of the assets (or to similar assets of no greater value than those) which comprised the Security Interest so extended, renewed or replaced;

**“Person”** means any individual, corporation, partnership, joint venture, association, joint stock company, trust, unincorporated organisation, limited liability company or government or other entity;

**“Preferred Stock”** of any Person means any Capital Stock of such Person that has preferential rights to any other Capital Stock of such Person with respect to dividends or redemptions or upon liquidation;

**“Qualified Receivables Transaction”** means any transaction or series of transactions entered into by the Guarantor or any of its Subsidiaries with any Person (including, without limitation, any Receivables Subsidiary) pursuant to which the Guarantor or any of its Subsidiaries (a) creates or permits to exist any Security Interest over, (b) sells, conveys or otherwise transfers or (c) grants a participation or beneficial interest in, its goods in commercial turnover and/or accounts receivable (whether now existing or arising in the future) and any assets related thereto (including, without limitation, all collateral securing such goods in commercial turnover and accounts receivable, all contracts and all guarantees or other obligations in respect of such goods in commercial turnover and accounts receivable, the proceeds of such goods in commercial turnover and accounts receivable, and other assets which are customarily subject to the grant of a Security Interest, transferred or subject to the grant of a participation or beneficial interest, in connection with financing transactions involving goods in commercial turnover and accounts receivable);

**“RAR”** means accounting rules and standards generally applicable in the Russian Federation;

**“Receivables Subsidiary”** means a Subsidiary of the Guarantor which engages in no activities other than in connection with the financing of accounts receivable and which is designated by the Board of Directors of the Guarantor (as provided below) as a Receivables Subsidiary (a) no portion of the Indebtedness or any other obligations (contingent or otherwise) of which (i) is guaranteed by the Guarantor or any Subsidiary of the Guarantor (excluding guarantees of obligations (other than the principal of, and interest on, Indebtedness) pursuant to representations, warranties, covenants and indemnities entered into in the ordinary course of business in connection with a Qualified Receivables Transaction) and excluding guarantees by any other Receivables Subsidiary, (ii) provides recourse to or obligates the Guarantor or any Subsidiary of the Guarantor in any way other than pursuant to representations, warranties, covenants and indemnities entered into in the ordinary course of business in connection with a Qualified Receivables Transaction, or (iii) subjects any property or asset of the Guarantor or any Subsidiary of the Guarantor (other than accounts receivable and related assets as provided in the definition of “Qualified Receivables Transaction”), directly or indirectly, contingently or otherwise, to the satisfaction thereof, other than pursuant to representations, warranties, covenants and indemnities entered into in the ordinary course of business in connection with a Qualified Receivables Transaction, (b) with which neither the Guarantor nor any Subsidiary of the Guarantor has any material contract, agreement, arrangement or understanding other than on terms no less favourable to the Guarantor or such Subsidiary than those that might be obtained at the time from Persons who are not Affiliates of the Guarantor, other than fees payable in the ordinary course of business in connection with servicing accounts receivable, and (c) with which neither the Guarantor nor any Subsidiary of the Guarantor has any obligation to maintain or preserve such Subsidiary’s financial condition or cause such Subsidiary to achieve certain levels of operating results. Any such designation by the Board of Directors of the Guarantor will be evidenced to the Trustee by filing with the Trustee a certified copy of the resolution of the Board of Directors of the Guarantor giving effect to such designation and an Officers’ Certificate certifying that such designation complied with the foregoing conditions;

**“Restricted Investment”** means an Investment other than a Permitted Investment;

**“S&P”** means Standard & Poor’s Ratings Services;

**“Sale and Leaseback Transaction”** means any direct or indirect arrangement with any Person or to which any such Person is a party, providing for the leasing to the Guarantor or any of its Subsidiaries of any property, whether owned by the Guarantor or such Subsidiary at the Issue Date or later acquired, which has been or is to be sold or transferred by the Guarantor or such Subsidiary to such Person or to any other Person from whom funds have been or are to be advanced by such Person;

**“Social Business”** means any business or operations conducted by the Guarantor or any of its Subsidiaries solely for the purpose of providing transportation of materials and supplies used in mining operations (including auto transport, marine transport and aviation); electricity generation and transmission; production of natural gas and the operation of natural gas heat generation plants; production and refining of oil; and other activities in support of the employees who work in the exploration, production and transport of diamonds, including pension services, housing, road maintenance and the renovation of various social assets, such as sports complexes and cultural facilities; and other support services facilitating the infrastructure and operations of the Group; in each case in connection with the operation by the Group of the Permitted Business;

**“Stated Maturity”** means, with respect to any instalment of interest or principal on any Indebtedness, the date on which such payment of interest or principal was scheduled to be paid in the original documentation governing such Indebtedness, and shall not include any contingent obligations to repay, redeem or repurchase any such interest or principal prior to the date originally scheduled for payment thereof;

**“Subordinated Indebtedness”** means any Indebtedness of the Issuer or the Guarantor, as the case may be (whether outstanding on the Issue Date or thereafter incurred), that is subordinate or junior in right of payment to the Notes and the Guarantee, as the case may be, pursuant to a written agreement;

**“Subsidiary”** means, in relation to any Person (the **“first person”**), at any particular time, any other Person (the **“second person”**) (i) which the first person controls or has the power to control and (ii) which is (or is required under IAS to be) consolidated in or with the financial statements of the first person;

**“U.S. dollars”**, **“dollars”** or the sign **“\$”** means such coin or currency of the United States of America as at the time of payment shall be legal tender for the payment of public and private debts;

**“Voting Stock”** of any Person as of any date means the Capital Stock of such Person that is at the time ordinarily entitled to vote in the election of the Board of Directors of such Person;

**“Weighted Average Life to Maturity”** means, when applied to any Indebtedness at any date, the number of years obtained by dividing:

- (a) the sum of the products obtained by multiplying (i) the amount of each then remaining instalment, sinking fund, serial maturity or other required payments of principal, including payment at final maturity, in respect of the Indebtedness, by (ii) the number of years (calculated to the nearest one-twelfth) that will elapse between such date and the making of such payment; by
- (b) the then outstanding principal amount of such Indebtedness; and

**“Wholly Owned Subsidiary”** of any specified Person means a Subsidiary of such Person all of the outstanding Capital Stock or other ownership interests of which shall at the time be owned by such Person or by one or more Wholly Owned Subsidiaries of such Person.

*There will appear at the foot of the Conditions endorsed on each Note Certificate the name and specified office of the Agents as set out at the end of this Offering Circular.*

## **SUMMARY OF THE PROVISIONS RELATING TO THE NOTES IN GLOBAL FORM**

The Global Note contains provisions which apply to the Notes in respect of which it is issued, some of which modify the effect of the Terms and Conditions set out in this Offering Circular. Terms defined in the Terms and Conditions have the same meanings in the paragraphs below. The following is a summary of those provisions:

### **1 Payments**

Payments of principal in respect of Notes represented by the Global Note will be made against presentation and surrender of the Global Note at the specified office of any Paying Agent and shall be effective to satisfy and discharge the corresponding liabilities of the Issuer in respect of the Notes. Payments of interest in respect of a Global Note shall be made to the holder thereof in accordance with the Terms and Conditions. Condition 8 will apply to Notes represented by Note Certificates only.

### **2 Notices**

So long as the Notes are represented by the Global Note and the Global Note is held on behalf of a clearing system, notices to holders of Notes represented by a beneficial interest in the Global Note may be given by delivery of the relevant notice to that clearing system for communication by it to entitled accountholders in substitution for notification as required by the Terms and Conditions except that so long as the Notes are listed on the Luxembourg Stock Exchange and the rules of that exchange so require, notices shall also be published in a leading newspaper having general circulation in Luxembourg (which is expected to be the *Luxemburger Wort*).

### **3 Prescription**

Claims against the Issuer in respect of principal and interest on the Notes while the Notes are represented by the Global Note will become void unless it is presented for payment within a period of ten years from the appropriate Relevant Date (as defined in Condition 9).

### **4 Meetings**

The registered holder of the Global Note will be treated as being two persons for the purposes of any quorum requirements of a meeting of Noteholders.

### **5 Purchase and Cancellation**

Cancellation of any Note required by the Terms and Conditions to be cancelled following its purchase or redemption will be effected by reduction in the principal amount of the Global Note.

### **6 Transfers**

Transfers of book-entry interests in the Notes will be effected through the records of Euroclear, Clearstream, Luxembourg and their respective participants in accordance with the rules and procedures of Euroclear, Clearstream, Luxembourg and their respective direct and indirect participants.

### **7 Exchange of Interests in Global Notes for Note Certificates**

Registration of title to Notes initially represented by the Global Note in a name other than the nominee of the common depository for Euroclear and Clearstream, Luxembourg will not be permitted unless (i) Euroclear or Clearstream, Luxembourg is closed for business for a continuous period of 14 days (other than by reason of legal holidays) or announces an intention permanently to cease business or (ii) an event of default occurs as set out in Condition 10 of the Notes.

In such circumstances, the Global Note shall be exchanged in full for Note Certificates and the Issuer will, at the cost of the Issuer (but against such indemnity as the Registrar may require in respect of any tax or other duty of whatever nature which may be levied or imposed in connection with such exchange), cause

sufficient Note Certificates to be executed and delivered to the Registrar for completion, authentication and dispatch to the relevant Noteholders. A person having an interest in the Global Note must provide the Registrar with a written order containing instructions and such other information as the Issuer and the Registrar may require to complete, execute and deliver such Note Certificates.

The Registrar will not register the transfer of interests in the Global Note for a period of 15 calendar days ending on the due date of any payment of principal.



## TAXATION

*Prospective purchasers of the Notes are advised to consult their own tax advisers as to the consequences under the tax laws of the country of which they are resident of a purchase of Notes, including, but not limited to, the consequences of the receipt of interest and the sale or redemption of Notes. The following is a general description of certain tax laws relating to the Notes and the Intercompany Loan, as in effect on the date hereof, and does not purport to be a comprehensive discussion of the tax treatment of the Notes.*

### **Russian Federation**

The following is a summary of certain Russian tax considerations relevant to the purchase, ownership and disposition of Notes by non-resident holders, including information regarding the taxation of payments on the Intercompany Loan. The summary is based on the laws of Russia in effect on the date of this Offering Circular. The summary does not seek to address the applicability of, and procedures in relation to, taxes levied by regions, municipalities or other non-federal level authorities of Russia, nor does the summary seek to address the availability of double tax treaty relief in respect of the Notes, or practical difficulties involved in obtaining such double tax treaty relief. Prospective investors should consult their own tax advisers regarding the tax consequences of investing in the Notes in their own particular circumstances. No representation with respect to the Russian tax consequences to any particular holder is made hereby.

Many aspects of Russian tax law are subject to significant uncertainty. Further, the substantive provisions of Russian tax law applicable to financial instruments may be subject to more rapid and unpredictable change and inconsistency than in jurisdictions with more developed capital markets. In this regard, the interpretation and application of such provisions will in practice rest substantially with local tax inspectorates.

For the purposes of this summary, a “non-resident holder” means an individual actually present in Russia for an aggregate period of less than 183 days in a given calendar year (not counting days of arrival into Russia but counting days of departure from Russia) or a legal entity or organisation in each case not organised under Russian law which holds and disposes of the Notes other than through its permanent tax establishment in Russia.

The Russian tax treatment of interest payments made by ALROSA Ltd. to the Issuer under the Intercompany Loan Agreement may affect the holders of the Notes. See “–Taxation of interest on the Intercompany Loan” below.

### ***Taxation of the Notes***

A non-resident holder will not be subject to any Russian taxes in respect of payments of interest and principal on the Notes received from the Issuer.

A non-resident holder also generally should not be subject to any Russian taxes in respect of gain or other income realised on a redemption, sale or other disposition of the Notes outside of Russia, provided that the proceeds of such disposition are not received from a source within Russia.

In the event that proceeds from a disposition of Notes are received from a source within Russia, a non-resident holder that is a legal entity or organisation should not be subject to any Russian taxation in respect of such proceeds, provided that no portion thereof is attributable to accrued interest. There is some residual uncertainty regarding the treatment of the portion of such proceeds, if any, that is attributable to accrued interest, and such portion may be taxed at a rate of 20 per cent., even if the disposal results in a capital loss. Non-resident holders that are legal entities or organisations should consult their own tax advisers with respect to this possibility.

A non-resident holder who is an individual will generally be subject to tax at a rate of 30 per cent., subject to any available double tax treaty relief, in respect of gross proceeds from such disposal of the Notes less any available cost deduction if the proceeds are received from a source within Russia. In this regard, if the Notes are disposed of in Russia for Russian personal income tax purposes, the proceeds of such disposition are likely to be regarded as received from a Russian source. In certain circumstances, if the disposal proceeds are payable by a Russian legal entity, individual entrepreneur or a Russian permanent establishment of a foreign organisation, the payer may be required to withhold this tax. In such a situation, there is a risk that the taxable base may be affected by changes in the exchange rates between the currency of acquisition of the Notes, the currency of sale of the Notes and Roubles. Non-resident holders who are individuals should consult their own tax advisers with respect to this possibility.

#### ***Resident holders***

A holder of a Note who is an individual or legal entity resident in Russia for tax purposes is subject to all applicable Russian taxes.

#### ***Taxation of interest on the Intercompany Loan***

In general, payments of interest on borrowed funds by a Russian entity to a non-resident entity are subject to Russian withholding tax at the rate of 20 per cent., subject to reduction or elimination pursuant to the terms of an applicable double tax treaty. Based on professional advice it has received, ALROSA Ltd. believes that payments of interest on the Intercompany Loan should not be subject to withholding under the terms of the double tax treaty between Russia and Luxembourg. However, there can be no assurance that such relief will be obtained. In addition, if interest under the Intercompany Loan becomes payable to the Trustee pursuant to the Terms and Conditions, any benefit of the double tax treaty between Russia and Luxembourg will cease and payments of interest could be subject to Russian withholding tax.

Prior to 1 January 2002, a claim for treaty relief from Russian corporate withholding tax was subject to preliminary approval by the Russian tax authorities after review of relevant contracts and tax residency certificates. As of 1 January 2002, such preliminary approval from and contract disclosure to the Russian tax authorities is no longer required. As a result of this new procedure, the Russian tax authorities may review the Issuer's eligibility for treaty relief in greater detail during tax audits of ALROSA Ltd.

If payments under the Intercompany Loan are subject to any withholding of Russian tax (as a result of which the Issuer would reduce payments under the Notes in the amount of such withholding), ALROSA Ltd. is obliged (subject to certain conditions) to increase payments as may be necessary so that the net payments received by the Noteholders will be equal to the amounts they would have received in the absence of such withholding. It should be noted, however, that gross-up provisions may not be enforceable under Russian law. If ALROSA Ltd. is obliged to increase payments, it has the right, subject to certain conditions, to prepay the Intercompany Loan in full. In such case, all outstanding Notes would be redeemable at par with accrued interest.

VAT is not applied to the rendering of financial services involving the provision of a loan in monetary form. Therefore, no VAT will be payable in Russia on interest on the Intercompany Loan.

#### ***Taxation of payments under the Guarantee***

Payments on account of interest under the Guarantee are likely to be characterised as Russian source income. Accordingly, such payments should be subject to a withholding tax rate of 20 per cent. in the event that a payment under the Guarantee is made to a non-resident holder that is a legal entity or organisation and 30 per cent. in the event that a payment under the Guarantee is made to an individual, subject to reduction or elimination further to the provisions of any applicable double tax treaty. We cannot offer any assurance that such withholding tax would not be imposed upon the full payment under the Guarantee, including with respect to the principal amount of the Notes.

Payments under the Guarantee should not be subject to Russian VAT.

## **Luxembourg**

The following is a general discussion of certain Luxembourg income tax consequences of the acquisition, ownership and disposition of Notes by original purchasers who are not residents of Luxembourg. For this purpose, a tax resident of Luxembourg is a person whose residence, customary place of abode, seat or place of management is located in Luxembourg. The summary is based on laws currently in force and as applied in practice on the date of this Offering Circular, all of which are subject to change, possibly with retroactive effect. The information provided below does not purport to be a complete, exhaustive or final summary of the tax law and practice currently applicable in Luxembourg, and prospective investors should consult their own tax advisers regarding the tax consequences of investing in the Notes in their own particular circumstances.

Under current law, payments of interest on the Notes to persons who are not tax residents of Luxembourg and have no connection with Luxembourg other than the receipt of such payments will generally be exempt from Luxembourg taxation.

Under current law, persons who are not tax residents of Luxembourg and have no connection with Luxembourg other than the holding of the Notes will not be subject to Luxembourg tax on any capital gains from a sale or other disposition of Notes.

There is no Luxembourg registration tax, capital tax, stamp duty or any other similar tax or duty (other than nominal court fees and contributions for registration with the Chamber of Commerce) payable in Luxembourg in respect of or in connection with the execution, delivery and enforcement by legal proceedings (including any foreign judgment in the courts of Luxembourg) of the Notes or the performance of the Issuer's obligations under the Notes, except that in the case of court proceedings in a Luxembourg court or the presentation of the documents relative to the Note issue to an *autorité constituée*, such court or *autorité constituée* may require registration thereof, in which case the documents will be subject to registration duties depending on the nature of the documents and, in particular, a loan will be subject to an *ad valorem* registration duty of 0.24 per cent., calculated on the amounts mentioned therein.

## **European Union**

The Council of the European Union has agreed to adopt a revised directive regarding the taxation of savings income. It is proposed that, subject to a number of important conditions being met, Member States will be required to provide to the tax authorities of another Member State details of payments of interest (or other similar income) paid by a person within its jurisdiction to an individual resident in that other Member State, except that Belgium, Luxembourg and Austria will instead operate a withholding system for a transitional period in relation to such payments. The proposed directive is not yet final, and may be subject to further amendment.

Noteholders should consult their own tax advisers regarding the implications of the proposed directive in their particular circumstance.

## **PLAN OF DISTRIBUTION**

ING Bank N.V., London Branch, Commerzbank Aktiengesellschaft, Deutsche Bank AG London, J.P. Morgan Europe Limited and UBS Limited (the “Managers”) have, pursuant to a Subscription Agreement dated 2 May 2003, jointly and severally agreed with the Issuer and the Guarantor, subject to the satisfaction of certain conditions, to subscribe and pay for the Notes at the issue price of 98.996 per cent. of their principal amount, less a combined management, underwriting and selling commission of 0.70 per cent. of such principal amount. In addition, the Guarantor has agreed to reimburse the Managers for certain of their expenses in connection with the issue of the Notes. The Subscription Agreement entitles the Managers to be released and discharged from their obligations thereunder in certain circumstances prior to payment being made to the Issuer.

### **United States**

The Notes and the Guarantee have not been and will not be registered under the Securities Act and may not be offered or sold within the United States or to, or for the account or benefit of U.S. persons except in certain transactions exempt from the registration requirements of the Securities Act. Terms used in this paragraph have the meanings given to them by Regulation S.

The Notes are being offered and sold outside the United States to non-U.S. persons in reliance on Regulation S. Each Manager has represented that, except as permitted by the Subscription Agreement, it will not offer and sell the Notes (i) as part of their distribution at any time or (ii) otherwise until 40 days after the later of the commencement of the Offering and the Closing Date, within the United States, or to, or for the account or benefit of, U.S. persons, and it will have sent to each dealer to which it sells Notes during the distribution compliance period a confirmation or other notice setting forth the restrictions on offers and sales of the Notes within the United States or to, or for the account or benefit of, U.S. persons. Terms used in this paragraph have the meanings given to them by Regulation S.

In addition, until 40 days after the commencement of the Offering of the Notes, an offer or sale of Notes within the United States by a dealer that is not participating in the offering may violate the registration requirements of the Securities Act.

### **United Kingdom**

Each Manager has represented, warranted and agreed that:

1. it has not offered or sold and, prior to the expiry of a period of six months from the issue date of the Notes, will not offer or sell, any Notes to persons in the United Kingdom except to persons whose ordinary activities involve them in acquiring, holding, managing or disposing of investments (as principal or agent) for the purposes of their businesses or otherwise in circumstances which have not resulted and will not result in an offer to the public in the United Kingdom within the meaning of the Public Offers of Securities Regulations 1995;
2. it has only communicated or caused to be communicated and will only communicate or cause to be communicated any invitation or inducement to engage in investment activity (within the meaning of section 21 of the FSMA) received by it in connection with the issue or sale of any Notes in circumstances in which section 21(1) of the FSMA does not apply to the Issuer or the Guarantor; and
3. it has complied and will comply with all applicable provisions of the FSMA with respect to anything done by it in relation to the Notes in, from or otherwise involving the United Kingdom.

### **The Russian Federation**

Each Manager has agreed that the Notes have not and will not be offered, sold or transferred as part of their initial distribution or at any time thereafter to or for the benefit of any persons (including legal

entities) resident, incorporated, established or having their usual residence in Russia or to any person located within the territory of Russia unless and to the extent otherwise permitted under Russian Law.

Since no Russian issue prospectus has been registered or is intended to be registered with respect to the Notes, no person should at any time carry out any activities in breach of restrictions set out above.

### **Luxembourg**

The Notes are not being offered to the public in Luxembourg and each Manager has represented, warranted and agreed that it will not offer the Notes or cause the offering of the Notes or contribute to the Offering of the Notes to the public in Luxembourg, unless all the relevant legal and regulatory requirements have been complied with. In particular, this offer has not been and will not be announced to the public and offering material will not be made available to the public. A listing of the Notes on the Luxembourg Stock Exchange does not necessarily imply that a public offering in Luxembourg has been authorised.

### **The Netherlands**

These Notes may not be offered, sold, transferred or delivered in or from The Netherlands as part of their initial distribution or at any time thereafter, directly or indirectly, other than to individuals or legal entities who or which trade or invest in securities in the conduct of their profession or business, which include but are not limited to banks, brokers, dealers, institutional investors, large corporations with a treasury department and investment institutions. Any distribution of the Notes after the initial distribution must be made in compliance with applicable Dutch law. This statement shall be mentioned in all offers and offer documents.

Any offer of the Notes in The Netherlands after the initial distribution may be made provided that such offer complies with the requirements of an exception or exemption from the prohibition contained in article 3 paragraph 1 of The Netherlands Act on the Supervision of the Securities Trade 1995 (*Wet toezicht effectenverkeer 1995*) or is made pursuant to an individual dispensation from such prohibition granted by The Netherlands Financial Markets Authority (*Autoriteit Financiële Markten*) and is in compliance with any restrictions and conditions applicable to such dispensation.

### **France**

Each of the Managers has represented and agreed that (i) it has not offered or sold and will not offer or sell, directly or indirectly, any Notes to the public in France, and (ii) offers and sales of Notes in France will be made in accordance with Articles L.411-1, L.411-2 and L.412-1 of the French Monetary and Financial Code and Decree of 1 October 1998 relating to offers to qualified investors.

In addition, each of the Managers has represented and agreed that it has not distributed or caused to be distributed and will not distribute or cause to be distributed in France, this Offering Circular or any other offering material relating to the Notes other than to investors to whom offers and sales of Notes in France may be made as described above.

### **Germany**

The Notes have not been and will not be publicly offered in the Federal Republic of Germany (“Germany”) and, accordingly, no securities sales prospectus (*Verkaufsprospekt*) for a public offering of the Notes in Germany in accordance with the Securities Sales Prospectus Act of 9 September 1998, as amended (*Wertpapier-Verkaufsprospektgesetz*, the “Prospectus Act”), has been or will be published or circulated in Germany. Each Manager has represented and agreed that it has only offered and sold and will only offer and sell the Notes in Germany to persons who purchase and sell securities as part of their profession or business either for their own account or for the account of a third person pursuant to

Section 2, No. 1 of the Prospectus Act, and in accordance with the provisions of the Prospectus Act and any other laws applicable in Germany governing the issue, sale and offering of securities. Any resale of the Notes in Germany may only be made in accordance with the provisions of the Prospectus Act and any other laws applicable in Germany governing the sale and offering of securities.

### **Italy**

Each Manager has represented, warranted and agreed that the offering of the Notes in the Republic of Italy (“Italy”) has not been registered with the *Commissione Nazionale per le Società e la Borsa* (“CONSOB”) pursuant to Italian securities legislation and, accordingly, that it has not offered, and will not offer, any Notes in Italy in a solicitation to the public at large (*sollecitazione all’investimento*) within the meaning of Article 1, paragraph 1, letter (r) of Legislative Decree no. 58 of 24 February 1998, that such Notes shall not be placed, sold and/or offered, either in the primary or in the secondary market, to individuals resident in Italy and that sales of Notes in Italy will only be:

- (1) negotiated on an individual basis with “Professional Investors” (*operatori qualificati*), as defined under Article 31, paragraph 2, of CONSOB Regulation no. 11522 of 1 July 1998, as amended;
- (2) effected in compliance with Article 129 of the Legislative Decree no. 385 of 1 September 1993 and the implementing instructions of the Bank of Italy, pursuant to which the issue or offer of securities in Italy is subject to prior notification to the Bank of Italy, unless an exemption, depending *inter alia* on the amount of the issue and the characteristics of the securities, applies;
- (3) effected in accordance with any other Italian securities, tax and exchange control and other applicable laws and regulations and any other applicable requirement or limitation which may be imposed by CONSOB or the Bank of Italy; and
- (4) made by an investment firm, bank or financial intermediary permitted to conduct such activities in Italy in accordance with the relevant provisions of Italian law.

### **Austria**

The Notes may not be publicly offered pursuant to the Austrian Capital Markets Act (*Kapitalmarktgesetz*, “KMG”) in Austria (whether presently or in the future). In particular, no offering or marketing materials relating to the Notes may be made publicly available or distributed in any way which could constitute a public offer pursuant to the KMG. Furthermore, no public advertisements relating to the Notes may be made.

### **Hong Kong**

Each Manager has represented, warranted and agreed that (i) it has not offered or sold and will not offer or sell in Hong Kong, by means of any document, the Notes other than to persons whose ordinary business is to buy or sell shares or debentures, whether as principal or agent, or in circumstances which do not constitute an offer to the public within the meaning of the Companies Ordinance (Cap. 32) of Hong Kong and (ii) it has not issued and will not issue any advertisement, invitation or document relating to the Notes, whether in Hong Kong or elsewhere, which is directed at, or the contents of which are likely to be accessed or read by, the public in Hong Kong (except if permitted to do so under the securities laws of Hong Kong) other than with respect to Notes which are or are intended to be disposed of only to persons outside Hong Kong or only to “professional investors” within the meaning of the Securities and Futures Ordinance (Cap. 571) of Hong Kong and any rules made thereunder.

### **Indonesia**

The Notes have not been, and will not be, registered under the Indonesian Capital Markets Law and its implementing regulations. Each Manager has represented and agreed that this Offering Circular may



not be distributed in Indonesia and the Notes may not be offered or sold in Indonesia or to Indonesian citizens wherever domiciled, or to Indonesian residents in a manner which constitutes a public offer under Indonesian law.

### **Philippines**

Each Manager has represented, warranted and agreed that (i) the Notes are not intended to be registered with the Philippine Securities and Exchange Commission under the Philippines' Republic Act No. 8799 (the "Securities Regulation Code"), pursuant to which securities are not permitted to be sold or offered for sale or distribution within the Philippines, without a registration statement duly filed with, and approved by, the Philippine Securities and Exchange Commission unless such securities are exempt securities under Section 9 of the Securities Regulation Code or are sold in an exempt transaction under Section 10 of the Securities Regulation Code and that (ii) accordingly, each Manager may offer the Notes in the Philippines under an exempt transaction pursuant to Section 10.1(L) of the Securities Regulation Code.

### **Singapore**

This Offering Circular has not been registered as a prospectus with the Monetary Authority of Singapore. Accordingly, this Offering Circular and any other document or material in connection with the offer or sale, or invitation for subscription or purchase, of the Notes may not be circulated or distributed, nor may the Notes be offered or sold, or be made the subject of an invitation for subscription or purchase, whether directly or indirectly, to the public or any member of the public in Singapore other than (i) to an institutional investor or other person specified in Section 274 of the Securities and Futures Act, Chapter 289 of Singapore (the "SFA"); (ii) to a sophisticated investor, and in accordance with the conditions, specified in Section 275 of the SFA; or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA.

### **General**

Each Manager has agreed that it will, to the best of its knowledge and belief, comply with all applicable laws and regulations in each country or jurisdiction in which it purchases, offers, sells or delivers Notes or distributes material relating to the Notes.

## GENERAL INFORMATION

1. The issue of the Notes has been authorised by a resolution dated 18 September 2002 of the Management Board of ALROSA Finance S.A. The Guarantee was authorised by a resolution dated 28 April 2003 of the Supervisory Council of ALROSA Ltd.
2. Application has been made to list the Notes on the Luxembourg Stock Exchange. In connection therewith, the charter documents of the Issuer and ALROSA Ltd., as well as a legal notice relating to the issuance of the Notes, have been deposited prior to listing with the *Régistre de Commerce et des Sociétés à Luxembourg*, from which copies thereof may be obtained on request.
3. The Notes have been accepted for clearance through the Euroclear and Clearstream, Luxembourg systems with a Common Code of 016796735. The ISIN for the Notes is XS0167967354.
4. Except as disclosed or provided for herein, there has been no material adverse change in the financial or trading position of ALROSA Ltd. since 30 September 2002 and no material adverse change in the financial or trading position of the Issuer since 17 April 2003, the date of its formation.
5. The Notes are expected to be accepted for listing on the Luxembourg Stock Exchange. So long as any Notes are listed on the Luxembourg Stock Exchange and the rules governing the listing of the Notes on such exchange so require, we will maintain a paying agent and a transfer agent in Luxembourg. We have appointed Deutsche Bank Luxembourg S.A. as our listing agent, paying agent and transfer agent in Luxembourg. We have also appointed Deutsche Bank AG London as paying agent in London, England. We reserve the right to vary such appointment. The paying agent in Luxembourg will act as intermediary between the Noteholders and us.
6. Neither ALROSA Ltd. nor any of its subsidiaries, including the Issuer, is involved in, nor do we have knowledge of any threat of, any legal, arbitration, administrative or other proceedings (whether as defendant or otherwise) the outcome of which may be material in the context of the issue of the Notes.
7. So long as the Notes are listed on the Luxembourg Stock Exchange and the rules of such stock exchange shall so require, copies of the following will be available for inspection, and may be obtained free of charge, during normal business hours on any weekday, at the specified office of the paying agent in Luxembourg:
  - the charter documents of the Issuer and the Guarantor;
  - the Trust Deed expected to be entered into with the trustee on or about 6 May 2003, which includes the Guarantee; and
  - copies of all of our most recent accounts and interim financial statements.

We prepare annual consolidated financial statements, which are audited in accordance with IAS, as well as annual unconsolidated financial statements prepared pursuant to Russian Accounting and Reporting Rules and audited in accordance with the Russian federal Law “On Auditing Activity”, federal Auditing Standards and International Standards on Auditing. We also prepare non-consolidated quarterly financial statements in accordance with Russian Accounting and Reporting Rules. The Issuer will prepare audited annual financial statements. Our first published financial statements after this Offering will be those for the year ended 31 December 2002, which will be made available, without charge, at the specified office of the paying agent in Luxembourg on 1 July 2003. The Issuer’s first published financial statements after this Offering will be those for the year ended 31 December 2003. These statements will be made available, without charge, at the specified office of the paying agent in Luxembourg on or about 30 June 2004.

### **INDEPENDENT ACCOUNTANTS**

Our consolidated financial statements as of 31 December 1999, 2000 and 2001 and for each of the three years in the period ended 31 December 2001, included in this Offering Circular, have been audited by PricewaterhouseCoopers, independent accountants, as stated in their report appearing herein.

### **LEGAL MATTERS**

The validity of the Notes and the Guarantee will be passed upon by Baker & McKenzie, as to matters of English law. Certain legal matters in connection with the Offering of the Notes will be passed on for the Issuer and ALROSA Ltd. by Baker & McKenzie, London, England, as to matters of English law; Moscow, Russia, as to matters of Russian law; and Amsterdam, The Netherlands, as to matters of Dutch law. Certain legal matters in connection with the Offering of the Notes will be passed on for the Issuer and ALROSA Ltd. by Arendt & Medernach as to Luxembourg law. Certain legal matters in connection with the Offering of the Notes will be passed on for the Managers by Linklaters, London, England and Moscow, Russia.

## INDUSTRY OVERVIEW

*Data on diamond reserves and production output in Russia are an official State secret. See “Risk Factors–Risks Relating to Our Business–We are prohibited from disclosing our Russian diamond reserves and other information which may be considered material by investors”. Accordingly, any data discussed below in respect of diamond reserves or production in Russia is based on non-Russian sources.*

### Introduction

The diamond industry is comprised of several distinct segments, including prospecting, mining, sorting, production, cutting, polishing and selling. After gold, diamonds are the second highest contributor to revenue from newly mined precious metals and minerals. In 2001, according to Terraconsult, a group of geological consultants specialising in the evaluation of diamond deposits, total revenue from diamond mining was U.S.\$7.9 billion.

### Origin of Diamonds

Diamonds are the hardest naturally occurring substance. Chemically, diamonds are carbon in relatively pure form. However, during crystallisation, various elements other than carbon may be incorporated into the diamond matrix. These impurities may have a significant effect on the physical properties of a diamond.

Primary diamond deposits are located on the cratons of present-day continents. A craton consists of the exposed pre-Cambrian Shield and surrounding platform sedimentary rocks which form the nucleus of a continent. Diamonds are brought to the earth's surface through a few relatively small, explosive volcanoes whose magma is known as peridotite or lamproite. These volcanoes are a rare phenomenon and only about 5,000 are known around the world. Fewer than 1,000 of these contain any measurable amount of diamonds and only 60 or so have been economic to mine so far.

Diamonds are mostly found, and have their origin, in a dark, green-blue, soft, weathered and mica-bearing ultramafic rock. This rock was named “kimberlite” after the town of Kimberley which had been established near the diamond diggings on the farm of Jan de Beer in South Africa. All subsequent primary diamond deposits were found in similar kimberlitic rocks until 1978 when a significant diamond deposit was discovered at Argyle in north-western Australia, in lamproite, another type of ultramafic rock.

Typically, diamond pipes occur in fields some 50 kilometres or more in diameter, each containing between 50 and 100 individual kimberlitic intrusions randomly scattered with a variety of diamond and indicator-mineral content. Within a field, clusters of one to 20 distinct diamond pipes can occur within one kilometre of each other, separated by two kilometres or more from another cluster. The discovery of one diamond pipe therefore generally indicates that others will be found in the vicinity. The classic diamond pipe has an almost circular horizontal section commonly less than 500 metres in diameter at its widest, which in three dimensions has a conical shape. Experience has shown that where some diamond pipes in the cluster are diamondiferous, the largest diamond pipe in the cluster is most likely to be economically suitable for mining. Evaluation of kimberlite demonstrates that there is little correlation between the number of diamond pipes, the percentage of those that are diamondiferous and the percentage that are economically suitable for mining.

### Identification of Diamond Deposits

The process of finding diamond deposits is laborious, often involves work under severe environmental conditions, and commences with geophysical surveys. Surface sampling then occurs and sampling for kimberlite indicator minerals. Core drilling takes place, particularly with respect to the most promising anomalies, and small test amounts of core are processed for diamonds. The best diamond pipes are

subjected to bulk sampling through which it is possible to estimate the value of the diamond-bearing rock and the approximate minimal value of diamonds that can be recovered.

## **The World Diamond Industry**

### ***World diamond reserves***

Total world diamond reserves are estimated at 7,910 million carats, excluding proven Russian reserves. Reserves of Yakutia have been estimated to account for 35 per cent. of total world diamond reserves. Outside Russia, central Africa has the largest diamond reserves estimated at 1,540 million carats, followed by southern Africa with estimated reserves in the region of 1,450 million carats.

### ***Diamond mine evaluation***

In addition to the importance of overall tonnage and grade in evaluating a diamond deposit, the value per carat of individual stones is also an important economic factor. The term “grade” refers to the number of carats per specified weight of ore. Typically, grade is based on carats per tonne (ct/t) and carats per 100 tonnes (CPHT). The value per carat is the value of the diamonds in the deposit divided by the number of carats they represent. In the case of alluvial deposits, industry practice is to quote grades in carats per tonne or carats per cubic metre. In terms of quality, the diamonds from a mine are broadly categorised as gem, near-gem and industrial, with gem diamonds varying in value according to their carat weight, clarity and colour.

Because the overall value of production depends on the quality and, therefore, value of the stones, high-grade diamond pipes with low-quality diamonds can have ore of less value than low-grade diamond pipes with a large percentage of gems. For example, the Argyle diamond deposit in Australia has an extremely rich grade at 600 ct/100t, but most of the diamonds are of the industrial variety, with the result that the average value per carat mined is only U.S.\$11. In contrast, the Kimberley mine in South Africa has a grade of 100 CPHT, but many stones are gem quality and the average value per carat mined is U.S.\$110.

## **Structure of World Diamond Output**

There are more than 5,000 recognised types of diamonds with a wide variety of characteristics and grades, and significantly different values. Prices vary from U.S.\$0.5 per carat for poor quality industrial stones to tens of thousands of dollars per carat for large, uncut diamonds. The following table gives information in respect of world diamond output by quality in 2002, the most recent year for which such information is available.

	<b>By weight</b>	<b>By value</b>	<b>Avg. price</b>
	<b>(per cent.)</b>	<b>(per cent.)</b>	<b>per carat</b>
			<b>(U.S.\$)</b>
Gems . . . . .	15	75	31.9
Near Gems . . . . .	39	20	30.7
Industrial Diamonds . . . . .	46	5	2.7

*Source:* Note on World Diamond Industry, published by ALROSA Ltd.

## Supply of Diamonds

The following table gives information as to global rough diamond output in millions of carats from 1890 to 2001.

1890	1900	1910	1920	1930	1940	1950	1960	1970	1980	1990	2000	2001
2.5	2.1	5.7	3.2	7.5	13	15.2	27.7	42.5	43	101.6	107.5	117

Source: Yorkton Securities; U.S. Geological Survey Minerals Handbook, 2001.

It is estimated that more than 95 per cent. of the diamonds that have ever been produced have been produced since 1900. However, despite the fact that the number of diamond producing countries has increased in recent years, the bulk of rough diamond production is concentrated in seven countries which together account for 85 per cent. of output by volume in 2001. In order of volume, the main diamond producers are Australia, the Democratic Republic of Congo, Botswana, Russia, South Africa, Angola and Namibia. In order of value they are Botswana, Russia, South Africa, Namibia, Angola and Australia. According to Terraconsult, in 2001, the top three diamond producing countries were Botswana, Russia and South Africa, with each producing diamonds worth in excess of U.S.\$1 billion.

## Major Producers of Rough Diamonds

There are more than one hundred companies involved in various aspects of diamond mining, including exploration. The largest diamond producers in the world by value are Debswana, ALROSA, De Beers, Namdeb, Democratic Republic of Congo, BHP, Rio Tinto, ASCORP and Trans Hex. De Beers owns Debswana jointly with the Government of Botswana and Namdeb jointly with the Government of Namibia.

De Beers has been involved in all areas of the diamond industry for more than 100 years. Today, De Beers is the largest diamond mining organisation in the world, producing about half of the world's gem diamonds, by value, from its mines in South Africa and, in partnership with the respective governments, in Botswana, Namibia and Tanzania. In southern Africa, De Beers is currently involved in 18 diamond mining operations including open-pit, underground, alluvial, coastal and subsea mines. De Beers, through its mines in South Africa and through Debswana and Namdeb, accounts on average for 25 per cent., in carats and about 50 per cent., by value of all diamonds produced. Botswana diamond production is controlled by Debswana, a joint venture between De Beers and the Government of Botswana. Diamonds sold from Debswana account for over 20 per cent. of the world gem quality diamonds. In 2001, we accounted for approximately 17.3 per cent. by carat volume and 20.9 per cent. by value of all diamond output produced worldwide.

ASCORP is a joint venture, which was established in 2000 among Sodiam, Angola's State-owned diamond monopoly, Lev Leviev and Sylvain Goldberg. ASCORP markets all of the diamonds produced in Angola, including those produced by the Catoca mine, which accounts for approximately 10 per cent. to 12.5 per cent. by value of all diamond output produced worldwide.

Rio Tinto is relatively new to the diamond industry; however, it has strong mineral resources base, containing 100 million tons of commercial ore reserves and 260 million carats of diamonds with an average value of U.S.\$30 per carat. Rio Tinto owns 100 per cent. of the Argyle and Merlin mines in Australia, 78 per cent. of the Murowa mine in Zimbabwe, 60 per cent. of the Diavik mine in Canada, 40 per cent. of the Kempaka mine in Indonesia and a 33 per cent. interest in the SDM mine in Angola. In addition, Rio Tinto owns the Argyle European Selling Office ("AESO"), which markets almost all of the diamonds produced from the Argyle and Merlin mines. Collectively, Rio Tinto accounted for approximately 5 per cent. of world diamond production by value in 2001 and 24 per cent. in carats. In 2001, it mined approximately U.S.\$400 million worth of rough diamonds. The majority of Rio Tinto's production is supplied to the Indian market.



BHP owns 80 per cent. of the Ekati mine in the Northwest Territories, Canada. Similar to Rio Tinto, BHP has been present in the rough diamond market for only a short time. It currently has all of the marketing rights to the Ekati production. BHP accounted for approximately 2.5 per cent. to 5 per cent. by value in 2001 of all diamond output produced worldwide.

The Democratic Republic of Congo is another major source of diamonds to the world market, supplying approximately 2.5 per cent. to 5 per cent. by value of all diamond output produced worldwide.

Trans Hex is the second largest rough diamond producer in South Africa, specialising in very high quality diamonds. In 2000 it supplied less than 1 per cent. by value of all world diamond output.

### **Marketing and Role of the DTC**

The marketing structure, which was established under the guidance and supervision of De Beers, has been aimed at reducing price volatility and the efficient operation of the market through aggregating supply and demand. The DTC, a wholly owned subsidiary of De Beers, buys, sorts and values diamonds prior to marketing. The DTC is involved in approximately 60 per cent. to 65 per cent. of rough diamond sales internationally.

The DTC sells uncut gem diamonds at regular, approximately five-week intervals, ten times per year. These sales, known as “sights”, are held in London, with smaller offerings made in Kimberley, South Africa and Lucerne, Switzerland. The uncut gemstones offered in these sights are generally offered in lots, or “boxes”, which are individually tailored to reflect the DTC’s perception of market conditions and the individual requirements of each attendant as communicated to the DTC prior to the sight. The DTC only plays a modest role in the cut diamond market, mainly through its Antwerp-based polishing company Diatrada.

In addition to agreements with mines operated by De Beers in Botswana, Namibia and South Africa, the DTC has contractual agreements for the majority of diamond exports from Russia and Tanzania. The DTC’s agents compete with independent dealers, buying much of the production (mostly locally, but also in the major diamond centres such as Antwerp and Amsterdam) from a number of placer deposits in countries such as Angola, Ghana, Guyana, Liberia, Sierra Leone, Venezuela and the Democratic Republic of Congo. The DTC fulfils an important role in the world rough diamond market by purchasing diamonds, largely regardless of the state of the diamond market and world economy and by global advertising of diamonds.

### ***Demand for diamonds***

Since 1980, world consumption of retail diamonds, expressed in terms of aggregate sales in nominal U.S. Dollars, has more than doubled, from an estimated U.S.\$21.4 billion in 1980 to approximately U.S.\$55.9 billion in 2001. The following table shows diamond consumption by region in billions of U.S. Dollars from 1980 to 2001.

	<u>U.S.A.</u>	<u>Europe</u>	<u>Japan</u>	<u>South East Asia</u>	<u>Others</u>	<u>Total</u>
	(U.S.\$ billions)					
1980 .....	6.5	3.8	5.6	0.6	4.8	21.4
1985 .....	10.8	2.8	5.8	0.6	4.7	24.7
1990 .....	14.2	8.2	15.0	2.1	7.8	47.3
2000 .....	26.0	8.2	10.8	3.0	10.8	58.8
2001 .....	25.7	7.9	9.4	2.7	10.1	55.9

*Source:* De Beers and the World Diamond Industry, Directory and Yearbook.

## **Russian Diamond Industry and Regulation**

### ***Overview***

The modern diamond industry in Russia dates from the mid-1950s with the discovery of the Zarnitsa and Mir diamond pipes. The former Soviet diamond mining company was established in January 1957 and sold its first lot of diamonds on the world market in 1959. Since then, the Russian diamond industry has gone through five major phases.

During the first phase, which lasted until the late 1960s, exploration and mining operations were developed. Industrial diamonds were widely used in this period, especially in the strategically important Russian defence industries. During this period, rough diamonds were also increasingly sold into the world diamond markets.

The second phase, from the late 1960s to the mid-1980s, was characterised by the expansion and development of domestic cutting and polishing operations. During this period, large cutting factories were built and a domestic training system was established for the education of diamond cutters. As a result, high quality polished diamonds were produced in large quantities, with most of the output sold in the export markets. Quality diamonds gave a strong boost to the development of the domestic jewellery industry which started to emerge during this period.

The third phase commenced in 1988 with the Soviet government's decision to establish Glavalmazoloto, the State Committee of the Soviet Union for Diamonds and Gold, and ended in 1991 with the dissolution of the Soviet Union. The main objective of Glavalmazoloto was to manage the production of gold, rough diamonds, cut diamonds and jewellery and the wholesale trade in rough and cut diamonds. This integration failed fully to attain those objectives, mainly due to the fact that, under the Glavalmazoloto system, retail trade was separated from jewellery production. As a result of the lack of communication between retail and cutting and polishing centres, Russian diamond-cutting enterprises produced valuable gem diamonds which were mismatched to domestic market demand.

The fourth phase started in 1992 and lasted until 1995. The main feature of this period was a general lack of direction and co-ordination in the activities of the Russian diamond industry. The dissolution of Glavalmazoloto in 1991 left the industry with no effective co-ordinating body, whilst at the same time communication between segments of the industry was further hampered by the general decline in economic activity in the country. In 1992 we were established as a closed joint stock company by Russia and Yakutia in order to manage the production of rough diamonds in Russia.

The fifth and current phase started in 1996 and has been characterised by an industry-wide effort to consolidate resources. Once established, we played a pivotal role in contributing to the initiation of this phase, which has included the development of a medium- to long-term policy of restructuring and modernising all sectors of the Russian diamond industry. In addition, we have been engaged in continuous dialogue with the Government of Russia and De Beers.

### ***Gokhran and Roskomdragmet***

Until 1991, the Precious Metals and Precious Stones Depository of the former Soviet Union, known as Gokhran, had been responsible for the management of state reserves of precious metals and precious stones, and Almaziuvirexport had been responsible for the export of these reserves in accordance with government policy. In 1992, Gokhran and the Precious Metals and Precious Stones Committee were merged to form a new State Committee of Russia for Precious Metals and Stones, known as Roskomdragmet. This merger marked the first time that the functions of control over transactions related to diamonds, on the one hand, and the sale of them from state reserves, on the other, had come under the jurisdiction of a single entity. After the abolition of Glavalmazoloto in 1991, Roskomdragmet also assumed responsibility for the management of diamond-cutting firms. Roskomdragmet was disbanded in 1996 and Gokhran resumed its role as Russia's diamond depository.

### ***Creation of cutting factories with foreign capital participation***

Following its establishment, Roskomdragmet began to involve foreign diamond cutters in Russian operations and, by 2001, there were more than 100 diamond-cutting factories registered in Russia, with an aggregate annual production capacity to produce between U.S.\$650 million to U.S.\$750 million of polished diamonds. These enterprises were provided with priority access to rough diamonds, 40- to 60-day delayed payment terms for diamonds supplied from the State reserves, the right to export some rough diamonds and prices fixed at 10 per cent. below world prices. These incentives led to a growth in the number of domestic cutters operating outside of the DTC's marketing system. Most of the gems polished in Russia are exported to foreign markets.

### ***Restrictions on foreign ownership of Russian diamond mining companies***

Under Article 4(2) of the Federal Law on Precious Stones, no person may engage in the business of mining diamonds within Russia except an entity in which the majority of the voting capital is held solely or in the aggregate by: (i) the Government of Russia or the government of a regional territory within Russia or (ii) Russian persons or (iii) Russian entities without foreign shareholders.

### ***The Secrecy Law***

The Secrecy Law was enacted in 1993. Article 5 of the Secrecy Law lists certain types of data which are considered to be state secrets. In particular, information, expressed in carats, on the volumes of the deposits, extraction, disposition and consumption of diamonds, as well as other strategic minerals (in accordance with lists established by the Government of Russia), is deemed a state secret.

A 1995 Presidential decree more specifically provides for secrecy as to deposits of precious stones (including diamonds) in Russia, certain production data relating to the Russian state diamond reserves and data relating to deposits of diamonds in excess of 25 million carats. See "Risk Factors—Risks Relating to Our Business—We are prohibited from disclosing our Russian diamond reserves and other information which may be considered material by investors".

### ***Calculation of Diamond Reserves***

We estimate our diamond reserves in accordance with standard Russian methodology, which differs in some material respects from the methodology used in other countries. The primary difference is that the Russian methodology relies on "geometrical" methods to determine reserves, as opposed to international practice, which utilises sampling and extrapolation techniques. As a result, Russian geometrical calculations can be verified by physical analysis, which allows the Ministry of Natural Resources of Russia to independently verify our reserve calculations. We believe that the Russian method of verifying reserves is more conservative than international methodology as it generally results in a smaller portion of total reserves being classified as proven rather than probable.

*Russian methodology for the calculation of mineral reserves.* According to Russia's 1997 Classification of Solid Mineral Reserves and Forecast Resources, mineral resources are separated into different categories, depending on the methods used to evaluate those resources. Initially, these resources are grouped within one of the following four classes, based on the complexity of their geological structure:

- *First.* The first class consists of deposits with a simple geological structure. These include very large, large or, more rarely, medium-sized mineral bodies having an unbroken, or almost unbroken, bedding. These deposits are characterised by a consistent thickness, internal fabric and mineral quality, as well as an even distribution of basic valuable components.
- *Second.* The second class consists of deposits having a more complex geological structure. These are large and medium-sized mineral bodies with a broken bedding. This class is characterised by an inconsistent thickness, internal fabric and mineral quality, as well as an uneven distribution of basic

valuable components. The second class also comprises deposits of coal, fossil, salt and other minerals, which make mining conditions difficult or very difficult.

- *Third.* The third class consists of deposits with a complex geological structure. These are medium-sized or small mineral bodies with a heavily disrupted bedding. The third class is characterised by a widely varied thickness and internal fabric, a substantially inconsistent mineral quality and an uneven distribution of basic valuable components.
- *Fourth.* The fourth class consists of deposits with a very complex geological structure. These are small or, more rarely, medium-sized mineral bodies which have an extremely disrupted bedding. Fourth class deposits are characterised by abrupt variations in their thickness and internal fabric, extremely inconsistent mineral quality and uneven distribution of basic valuable components.

The complexity classification may take into account quantitative results measuring the inconsistencies in the basic features of mineralization (i.e., classification of diamonds according to their size and average content in the rock). This initial classification is intended to identify those resources warranting further study. Depending on the extent of further exploration, mineral resources are subsequently divided between “proven” and “evaluated” reserves. Proven reserves are those which have been sufficiently explored to proceed with a feasibility study relating to commercial development. Evaluated reserves are those which have been explored to the extent necessary to determine whether continued exploration is warranted. Identified resources that fail to meet the criteria of proven and evaluated reserves are deemed to be only projected resources.

Proven and evaluated reserves are further categorised based on the type, quantity and quality of the measurements taken to evaluate the reserves. Proven reserves are divided into categories A, B and C<sub>1</sub> while Category C<sub>2</sub> relates to evaluated reserves.

- *Category A (proven reserves).* Category A reserves include only proven deposits falling within the first complexity class described above. Category A reserves must meet the following criteria:
  - the sizes, forms and bedding conditions of the mineral body have been determined; the nature and regularities in their morphology and internal fabric have been studied; the barren and off-grade segments within the mineral bodies have been detected and mapped; and the locations and fault amplitudes of dislocations with a break have been identified;
  - the natural varieties of the minerals within the body have been determined; its categories and grades have been identified and mapped; its compositions and properties have been verified; and the quality of all categories and grades of the identified minerals have been characterised in terms of all parameters stipulated by industrial regulations;
  - the distribution and forms of those valuable and noxious components found in the mineral body and products of its processing have been investigated; and
  - the mineral reserves have been mapped based on test wells, mine workings and detailed trial runs.
- *Category B (proven reserves).* Category B reserves include only proven deposits falling within the first and second complexity classes described above. Category B reserves have been subject to a high level of investigation; however, their boundaries have been determined with less accuracy than Category A reserves. Category B reserves meet the criteria established for Category A, except that Category B reserves may contain a limited extrapolation zone that is substantiated on the basis of geological criteria and geophysical and geochemical research.
- *Category C<sub>1</sub> (proven reserves).* Category C<sub>1</sub> reflects a slightly lower level of accuracy than the determination of Category B reserves. Most of the proven deposits within the first three complexity

classes are Category C<sub>1</sub> reserves. Category C<sub>1</sub> reserves meet the criteria established for Category B, except that additional extrapolation is permitted in mapping the mineral deposit.

- *Category C<sub>2</sub> (evaluated reserves).* Category C<sub>2</sub> reserves are identified, but are not considered to have been proven, and these constitute the bulk of reserves within the fourth complexity class. Category C<sub>2</sub> reserves must meet the criteria established for Category C<sub>1</sub>, except that:
  - the sizes, forms, internal fabric and bedding conditions of the mineral body are confirmed by means of only a limited number of test wells and core samples; and
  - the boundaries of the deposit (including core samples and outcroppings) are mapped based on data gathered from only a limited number of test wells, and a geologically substantiated extrapolation of deposit parameters is permitted.

*Our calculation of reserves.* Due to the unique geological conditions of diamond pipes, we do not use Category A with respect to these deposits. Accordingly, we use only Categories B, C<sub>1</sub> and C<sub>2</sub> in our reserve determinations. However, we will only proceed with the commercial development of deposits which have been classified as Category C<sub>1</sub> or above. In addition, only Categories B and C<sub>1</sub> were considered in connection with the confirmations of the Ministry of Natural Resources of Russia set forth in “Appendix A–Certification of Diamond Deposits”.

**We calculate our reserves based on standard Russian methodology. These reserves have not been presented in accordance with Industry Guide 7 of the Securities Act, and are not based on the definitions adopted by the Society for Mining, Metallurgy and Exploration (“SME”) or the Council of Mining and Metallurgical Institutions (“CMMI”). Accordingly, our reserve information is not comparable to the reserve information of other mining companies that follow Industry Guide 7 under the Securities Act or the practices of the SME or CMMI.**

#### *Underground and extracted resources*

Federal legislation gives a measure of autonomy to regional and local authorities in relation to the exercise of rights over the use of land and natural resources and provides that the use of the subsoil is under the joint jurisdiction of the federal and regional authorities. In general, authorities at the regional and local level, with jurisdiction over the specific area in which a development project or other enterprise is located, have substantial powers. Such authorities grant subsoil resource licenses in co-operation with the relevant federal authority. In addition, such authorities usually control local land use transfer and have powers in respect of employees’ health and safety, social security and certain fiscal matters. The conditions applicable to our operations in a particular locale will depend in large measure on the relationships among the relevant federal, regional and local authorities and between us and each of such authorities.

#### *Prospecting and licensing*

The Federal Law contains a licensing system for prospecting for, and producing, natural resources. The use of underground resources in Russia is based on the following main principles:

- joint ownership of underground resources by Russia and its federal subjects;
- licensing of mining concessions; and
- payment for concessions.

This law also establishes a framework under which all operating, mining, extractive and other enterprises that had obtained and implemented the right to use underground resources prior to its enactment could apply for and obtain underground licenses and land use permissions.

Any mining concessions are granted on the basis of tender results jointly by the executive body of the relevant area in which the concession is effective and the federal Ministry of Natural Resources or its local

division. The tender terms are determined by the federal Ministry of Natural Resources of Russia or its regional authorities and agreed upon with the relevant federal bodies. Environmental protection requirements are also established with the relevant federal bodies. Concession rates are agreed with the federal bodies of economic management.

The Government of Russia grants several types of licenses for the use of underground resources: licenses for geological survey, licenses for exploration and production and combined licenses (for geological survey, exploration and production). Such licenses are granted either for a definite term, or without term limits. As a general rule, licenses for geological surveys are issued for a term of up to five years and licenses for exploration and production are issued for the period of full depletion of subsoil deposit. Such licenses may in certain circumstances be extended. The terms of mineral licenses include conditions to the subsoil activities, subsoil plot borders, a defined license term, deadlines for commencement of work/stages, terms and conditions of payment for use, agreed production levels and provisions regarding title to extracted production, title to geological data, environmental, subsoil protection and safety requirements, preparation of an abandonment plan and recultivation of lands. Licensees also have to make payments for subsoil operations, one time and regular license payments, payments for geological data, tender or auction participation fees and license issuance fees, as well as a tax on production of mineral resources. A tax on production of mineral resources is levied with regard to diamonds and other precious stones in an amount equal to 8 per cent. of the value of production.

### ***Environmental regulations***

There are a number of federal laws and regulations establishing environmental rules and standards, including one which establishes a “pay-to-pollute” regime administered by the Ministry of Ecology and local authorities. Fees are assessed for exceeding agreed limits on emissions and effluents and the revenues are divided between federal and local budgets. Currently these fees are generally small in relation to the cost of environmental protection equipment and it is generally less expensive to pay the fees than to install anti-pollution devices. Further, this law does not generally include clear clean-up requirements, and, when clean-up is required, the applicable laws provide no guidance as to the extent to which the clean-up must be carried out. However, as the economic situation in Russia improves, enforcement of existing legislation and licenses may become more stringent and more comprehensive legislation may be adopted.

In connection with obtaining a license to explore or develop mining deposits, we are generally required to make environmental commitments. The fees for failing to comply with these commitments are generally low and any clean-up requirements are generally limited. In addition, we contribute to a restoration fund under the terms of our license agreement with the government of Yakutia. See “Our Business–Regulatory and Environmental Matters–Lease Agreement”.

### **Liberalisation of the Russian Diamond Market**

On 30 November 2002, the Russian President signed the 2002 Decree liberalising the Russian diamond market. The 2002 Decree, which became effective on 6 February 2003, provides for the following changes:

- *Exports of rough diamonds.* The 2002 Decree authorises all diamond mining enterprises in Russia to export their rough diamond production in accordance with any applicable subsoil licenses; provided that: (i) diamonds weighing 10.8 carats or more must be sold pursuant to the established auction process; (ii) diamonds with “special characteristics” can be sold only to the Government; and (iii) sales of control parcels under our agreements with De Beers are to be sold only through Almaziuvirexport, a Government of Russia-owned jewellery exporter. Prior to the 2002 Decree, only we and Almaziuvirexport were allowed to export rough diamonds from Russia.



- *Diamond auction participants.* Non-Russian entities are authorised to participate as bidders in our auctions of rough diamonds weighing 10.8 or more carats and to export such diamonds, so long as the purchase price is above the minimum price set by us and the Ministry of Finance of Russia.
- *Multi-year export quotas.* The 2002 Decree authorises multi-year export quotas of up to five years, which may be granted by the Government of Russia in “exceptional cases”.
- *Exports by diamond-cutting companies.* Diamond-cutting entities may export up to 15 per cent., by value, of the rough diamonds they purchase in any year from Russian diamond mining companies or from the Government of Russia’s diamond stocks, provided that: (i) the diamonds are offered for sale on the domestic market and are not sold within ten business days and (ii) the export sale price is at least as high as the price at which the diamonds were offered on the domestic market.
- *Industrial diamond sales.* The 2002 Decree allows the direct sale of industrial diamonds to third parties. Previously, industrial diamonds could be sold only through Almaz-Unionexport.
- *Importation of diamonds.* Russian companies are authorised to import rough and cut diamonds without restriction or license, provided that the imported diamonds are sorted by a state organisation organised under the Ministry of Finance of Russia and Russian customs law is observed.
- *Reclassification of small diamonds.* The 2002 Decree also lowered the minimum size for a diamond to be deemed suitable for use in jewellery. This change is expected to result in more of our small diamonds being classified as gem and near-gem stones rather than less valuable industrial diamonds.

Notwithstanding the 2002 Decree, we remain subject to various governmental controls, including, amongst other things, export quotas, secrecy laws regarding reserves and production expressed in carats, a mandatory Price List and restrictions on our ability to sell larger diamonds (10.8 carats or more).

Based on our discussions with officials of the Government of Russia, we expect additional liberalisation measures to be adopted in the future, which may result from Russia’s application for membership in the WTO, and our strategy considers ways in which we could capitalise on the additional flexibility that liberalisation of the Russian diamond industry would create. See “Our Business-Strategy”. However, we can offer no assurance as to when or if further liberalisation will be adopted.

## THE RUSSIAN FEDERATION

*The following information has been extracted from publicly available sources.*

### General

Russia is a sovereign and democratic federal republic, consisting of 89 sub-federal political units (the “Federation Subjects”), and is constituted as a federation of republics, territories, regions, cities of federal importance and autonomous regions. It is the largest state to emerge from the former Soviet Union, covering an area of approximately 17.1 million square kilometres. Russia covers one-tenth of the world’s land surface, making it the largest country in the world, almost twice the size of the United States.

Of the population of approximately 145 million, approximately 82 per cent. is ethnic Russian and a high percentage (approximately 73 per cent.) live in cities and towns. The two largest cities are Moscow, with approximately 11 million inhabitants, and St. Petersburg, with approximately 4.7 million inhabitants.

Russia is a leading world producer of natural resources. The diamond industry plays an important role in the domestic economy. There are also substantial mineral deposits including iron, nickel, copper and gold, as well as timber.

### The Republic of Sakha (Yakutia)

Yakutia is one of the largest regions within Russia. It covers an area of 3,103,200 square kilometres, representing approximately 18 per cent. of the Russian territory. Yakutia lies in the north-eastern part of Asia, and Yakutsk, its capital, is 8,468 kilometres from Moscow. Over 40 per cent. of the territory of Yakutia lies within the Arctic Circle and all of the territory of Yakutia lies in the zone of permafrost. Yakutia is the coldest part of Russia. However, seasonal temperature variation may exceed 80°C. Winter is long, with the average temperatures from –40°C to –50°C. Summer is short and dry with relatively high temperatures (+31°C to +38°C).

The population of Yakutia is slightly above one million people. Ethnic Sakha (Yakuts) constitute 33 per cent. of Yakutia’s population, and Russians constitute approximately 50 per cent. The remaining portion is made up of other nationalities, including Ukrainians, Tatars, Belorussians and the indigenous people of the North, Yukagir, Even, Evenk and Chukchi. Two-thirds of the total population of Yakutia live in cities.

Yakutia is rich in mineral resources. It possesses the largest diamond reserves in Russia. Gold mining is the second most important industrial sector. It is also an area rich in silver with reserves of around 50,000 tonnes. Yakutia is also rich in non-ferrous metals including tin and antimony. Niobium and rare-earth metal deposits were recently discovered in the north-west of Yakutia. One-third of Yakutia’s territory contains oil and gas. Yakutia also possesses coal resources which have been estimated at more than ten million tonnes.

### International Relations

Russia is a member of the United Nations (and a permanent member of the Security Council), the International Monetary Fund, the World Bank, the International Finance Corporation and the European Bank for Reconstruction and Development. Russia succeeded to the former Soviet Union’s “observer status” to the General Agreement on Tariffs and Trade (currently, the World Trade Organisation) which was granted in May 1990 and, in June 1993, made an official announcement of its intention to join the General Agreement on Tariffs and Trade. Discussions regarding Russia’s admission to the World Trade Organisation were held between 1995 and 1998 and the latest round of negotiations occurred in December 2002. Russia has also been awarded Most Favoured Nation status by several members of the Organisation for Economic Co-operation and Development (“OECD”). Russia has been granted observer status in a number of OECD committees and formally applied for membership in May 1996.

## **Political Structure and Recent Political Developments**

### ***Federal structure***

In 1990, Russia declared its sovereignty (though not its independence from the Soviet Union). Thereafter, Russia, Belarus and Ukraine joined together to dissolve the Soviet Union and form the CIS. The CIS was subsequently joined by another nine former Soviet republics. Members of the CIS have entered into a series of political and economic agreements among themselves.

The Federation Treaty of 31 March 1992, signed by the majority of the Federation Subjects, initially gave to each a measure of control over budgetary and external policy as well as over the natural resources of their territories. The Constitution of Russia (the “Constitution”), and individual treaties between the Federation and some of the Federation Subjects subsequently confirmed and refined the terms of the division of authority between the Federation and its subjects.

In general, disputes between the federal authorities and Federation Subjects have been resolved peacefully through a political process. The military confrontation in the Chechen Republic has been the exception. There has been military confrontation in the Chechen Republic between December 1994 and August 1996 (followed by a peace treaty in May 1997) and then again from August 1999 to date, with the fighting now reduced to sporadic outbreaks. In January 2001, President Putin announced plans for a significant reduction in troop numbers and an eventual end to anti-terrorist operations. A local police force is being formed to gradually take over the maintenance of order from the Russian military, and almost 15 billion Roubles (almost U.S.\$500 million) has been promised in aid for reconstruction of the Chechen Republic. However, the situation is not stable and there have been no official talks between the federal authorities and rebel leaders. Terrorism by Chechen rebels remains a threat, and in October 2002, rebels seized control of a Moscow theatre, taking over 700 hostages. It is expected that the future of the Chechen Republic will only be decided after the completion of operations by the Russian interior and military troops.

### ***Constitution***

The Constitution provides for a tripartite governmental structure in which the power of the State is divided between the executive, legislative and judicial branches, each independent of the others. The Constitution also establishes a federal system, allocating responsibilities between federal and sub-federal authorities and setting out the principles of local government.

### ***Executive, legislative and judicial branches***

The Executive branch consists of the President and the Government of Russia.

The President of Russia has broad powers. The President is Head of State and Supreme Commander of the Armed Forces, with authority to declare states of military emergency and other states of emergency, subject to approval by the Federation Council, and has responsibility for foreign policy and national defence. The President has the power to issue decrees and orders having the force of law (although these may not contradict the Constitution or federal legislation), to suspend acts of sub-federal executive authorities and to call a national referendum on matters of special importance. The President also has the power to veto bills passed by the Federal Assembly and, under certain circumstances, to dissolve the State Duma. The President also enjoys significant powers of appointment, including the power to appoint the Prime Minister (with the consent of the Duma) and other members of the Government of Russia (who are nominated by the Prime Minister). The President may also dismiss prime ministers and federal ministers at any time. In addition, the President nominates candidates for Chairman of the Central Bank (for appointment by the Duma) and the Prosecutor General (for appointment by the Federation Council) and also nominates judges for the Constitutional Court, the Supreme Court and the Supreme Arbitration Court (for appointment by the Federation Council).

The President is elected in a national election for a term of four years. The Constitution provides for the early termination of the President's term of office in the event of his death, resignation or impeachment, or if he is persistently unable to exercise his powers for reasons of health, in which case the Prime Minister fulfils the responsibilities of the President until a new President is elected. New presidential elections must be held within three months of any such early termination.

The Government of Russia comprises the Prime Minister, deputy prime ministers and federal ministers, all of whom are appointed by the President as described above. The Government of Russia is automatically dissolved after each presidential election, in order to permit the President to form a new Government of Russia. The Government of Russia is responsible for implementing federal laws, presidential decrees and international agreements. In particular, the Government of Russia is responsible for preparing and implementing the federal budget, establishing a unified financial, credit and monetary policy, carrying out social policy, preserving public order and defending the rights and freedoms of citizens.

The Legislative branch is the Federal Assembly, which consists of a lower chamber, the State Duma, and an upper chamber, the Federation Council.

The State Duma consists of 450 deputies elected by a mixed system of majority vote and proportional representation. Half of the deputies are elected by majority vote in individual electoral districts. The other half are chosen from "party lists" on the basis of a nationwide election, with seats being allocated in proportion to the number of votes received by the party. Generally, only parties receiving more than 5 per cent. of the votes qualify for these "party list" seats. "Party list" deputies are free to change their party affiliations during their terms in office without the need for a new election. The State Duma sits for four years and no person may simultaneously serve as a State Duma deputy and hold a position in the Government of Russia.

The Federation Council represents Russia's 89 Federation Subjects. Each Federation Subject has two representatives on the Federation Council, one representing its legislative body and the other representing its executive branch.

The Judicial branch is represented by the Constitutional Court, the Supreme Court and the Supreme Arbitration Court, as well as lower courts of general jurisdiction and arbitration courts.

### ***Political parties and elections***

Presidential elections were most recently held on 26 March 2000. The elections were scheduled to take place in the summer of 2000, but the premature resignation of President Yeltsin on 31 December 1999 brought these elections forward to March. At the time of President Yeltsin's resignation, Vladimir Putin was the Prime Minister and, therefore, was elevated to the post of acting President.

Mr. Putin was successful in the first round of voting for the Presidential elections and secured over 52 per cent. of the votes cast, with a turnout of 68.7 per cent. (a majority of more than 50 per cent. of the votes cast is required in order to be elected). His nearest challenger was the Communist candidate Gennady Zyuganov, who received almost 30 per cent. of the votes.

The Government of Russia was appointed between May and July 2000. It has embarked on a course of significant reforms comparable to those in early 1992 aimed at strengthening the unity of the State and tightening federal control over the Federation Subjects.

In May 2000, President Putin established the structure of Presidential representatives in the regions. The Federation Subjects were divided into seven "federal areas" and authorised representatives with broad powers were appointed by the President to each federal area. The rights of the authorised representatives of the President include the right to participate in all activities of representative bodies of the Federation Subjects, to control the implementation of Presidential decrees and orders and federal economic programmes, and to control the use of federal property and federal funds by the Federation Subjects. The

authorised representatives of the President in the Federation Subjects are financed by the Administration of the President.

The Duma elections were held on 19 December 1999, with the following results: the Communist party led by Gennady Zyuganov won 24.3 per cent. of the votes cast; the Unity party led by Sergei Shoigou, the Minister of Emergency Situations, 23.2 per cent.; the Fatherland-All Russia party led by former prime minister Yevgeny Primakov, Moscow Mayor Yuri Luzhkov and St Petersburg Mayor Vladimir Yakovlev, 13.1 per cent.; the Union of Right Forces led by former prime minister Sergei Kiriyenko, 8.6 per cent.; the Yabloko party led by Grigory Yavlinsky, 5.9 per cent. and the “Zhirinovskiy bloc” led by Vladimir Zhirinovskiy, 6.4 per cent. Other parties received the remaining 18.5 per cent.

As a result of the distribution of seats among political parties and winners in majority vote constituencies, the communists and their allies lost control over the Duma, which now has a broadly pro-Presidential majority.

### *Economic conditions and recent economic developments*

Following the dissolution of the Soviet Union, particularly during 1991 and 1992, Russia experienced an economic crisis, evidenced by a decline in industrial production and GDP, significant price increases, a decline in the average standard of living and an increase in foreign debt. In response, the Government of Russia instituted a series of measures designed to achieve financial stabilisation and price liberalisation and to create an impetus for a transition to a market economy. The Government of Russia has freed wholesale and retail prices, reduced defence allocations, cut state subsidies, introduced a substantial value-added tax, removed most non-tariff restrictions on foreign trade and launched a broad privatisation effort.

Russia's financial stabilisation programme came under severe pressure in the second half of 1997 and the first half of 1998, when the repercussions of the Asian currency and financial crisis and sharp falls in world prices for oil and other commodities adversely affected the Government of Russia's ability to continue to finance its budget deficits and to maintain the value of the Rouble against the U.S. Dollar. On 17 August 1998, the government and the Central Bank announced a three-part programme intended to address these pressures. First, the Rouble trading corridor was revised from 5.25 Roubles to 7.15 Roubles per U.S. Dollar to 6.00 Roubles to 9.5 Roubles per U.S. Dollar. This corridor was subsequently abandoned. Second, domestic GKO/OFZ bonds issued prior to 17 August 1998 and maturing before 31 December 1999 were to be restructured into new longer-term instruments and trading of these instruments were suspended pending the restructuring. Finally, for a period of 90 days Russian private sector residents were restricted from conducting certain foreign exchange operations of a capital nature, including payments of foreign currency under forward contracts and repurchase agreements and principal payments on long-term credits.

The events of 17 August 1998 led to:

- a severe devaluation of the Rouble;
- a sharp increase in the rate of inflation;
- the near collapse of the country's banking system;
- significant defaults by Russian public and private borrowers on their foreign currency obligations;
- dramatic declines in the prices of Russian debt and equity securities (including eurobonds issued by Russia); and
- an inability of Russian borrowers to raise funds internationally.

The situation stabilised rapidly, however, and 1999 and 2000 witnessed several positive developments. These included:

- a slow-down in the decline, and then a stabilisation, in the value of the Rouble against the U.S. Dollar (and appreciation of the value of the Rouble against the U.S. Dollar in real terms);
- a decline in consumer price inflation;
- an increase in real industrial output, resulting in part from the devaluation of the Rouble;
- an improved balance of trade, resulting in part from the devaluation of the Rouble and a significant increase in oil prices;
- improved tax collection, resulting in a significant primary fiscal surplus;
- increasing prices for Russian debt and equity securities;
- a decrease in the share of barter transactions, both in inter-enterprise transactions and in the execution of regional budgets; and
- the restructuring of a significant portion of Russia's Rouble-denominated domestic indebtedness and the reduction and restructuring of its London Club indebtedness.

President Putin's government has announced plans for substantial economic reforms (including tax reform, pension reform and housing and utilities reform) and has begun the process of implementing some of these reforms.

### ***Privatisation***

Russia commenced its privatisation programme in early 1992. About 15,000 medium- and large-scale enterprises, employing more than 70 per cent. of the industrial workforce, had been privatised through the mass voucher privatisation programme by mid-1994. In a relatively short period of time, the companies in which the Government of Russia had had less than a majority equity came to represent over 50 per cent. of both gross domestic product and employment.

The first stage of the Russian privatisation process, the so-called voucher privatisation, was completed in the summer of 1994. The second (post-voucher) phase of the privatisation process started in late July 1994, consisting of cash sales to domestic and foreign strategic investors, with the primary objective of transferring control over the privatised companies to private management and ownership. The transfer of assets from state to private control continued in 1995 through a loans for shares programme, cash auctions and investment tenders. As of 31 December 2002, there were more than 900 joint stock companies which were 25 per cent. to 50 per cent. state-owned and 371 joint stock companies which were more than 50 per cent. state-owned.

In 2002 a new privatisation law came into effect. The new law provides for several methods to privatise state-owned enterprises, including cash auctions, commercial tenders, contributions of state-owned assets to the charter capital of open joint-stock companies, sale of shares of open joint-stock companies at specialised auctions, sale of shares of open joint-stock companies outside Russia, sale of shares of open joint-stock companies on stock exchanges, sale of state or municipal property by way of a public offer, sale of state or municipal property without a price announcement, and sale of shares of open joint-stock companies as a result of trust management.

The August 1998 financial crisis resulted in the suspension of several planned privatisation tenders. Gradually they were restored and implemented by the Government of Russia. In the privatisation programme for 2002 the Government of Russia has returned to some of its privatisation plans, with the sale of its interest in oil companies Lukoil (5.9 per cent.) and Slavneft (75.0 per cent.).



### **Gross Domestic Product**

The following table sets forth certain information regarding Russia's nominal GDP for the years 1996 to 2000:

	2001	2000	1999	1998	1997
Nominal GDP (Roubles in billions)	9,040.8	7,063.4	4,545.5	2,696.4	2,478.6
Nominal GDP per capita (Roubles) . . . . .	62,739.7	48,780.4	31,068.0	18,355.0	16,826.4
Consumer Price Index <sup>(1)</sup> (per cent.)	121.5	120.8	145.6	127.8	114.7
Total population, millions (end of period) . . . . .	144.1	144.8	145.6	146.3	146.7

Source: Central Bank website, 15 November 2002; Goskomstat's website, 15 November 2002.

(1) Average on an annual basis (Source: Central Bank website, 15 November 2002).

### **Employment**

Employment has declined in Russia since reforms were initiated. The level of unemployment increased in 1998 due to the Russian financial crisis, and the labour market still remains relatively depressed. According to the Central Bank figures (based on the methodology of the International Labour Organisation), the total number of unemployed at the end of September 2002 was 5.4 million (7.5 per cent. of the labour force), compared to 8.9 million (12.2 per cent. of the labour force) at the end of 1999 and 7.3 million (10 per cent. of the labour force) at the end of 1996.

### **Balance of payments**

The following table sets forth Russia's consolidated balance of payments for the years 1996 to 2001. Certain data presented in this table differs from previously published data due to revisions made by the Central Bank.

	Consolidated Balance of Payments				
	2001	2000	1999	1998	1997
	(in U.S.\$ millions)				
Current account . . . . .	35,092	46,405	24,731	659	2,032
Goods and non-factor services . . . .	39,251	53,072	31,845	12,786	11,080
Trade balance . . . . .	49,429	60,703	36,129	16,869	17,025
Non-factor services . . . . .	(10,177)	(7,631)	(4,284)	(4,083)	(5,945)
Income . . . . .	(3,888)	(6,736)	(7,716)	(11,790)	(8,692)
Current transfers . . . . .	(272)	69	601	(337)	(356)
Capital and financial account . . . . .	(26,041)	(37,050)	(17,695)	8,425	2,818
Capital account . . . . .	(9,356)	10,955	(328)	(382)	(797)
Financial account . . . . .	(16,686)	(48,005)	(17,367)	8,807	3,615
Direct investments . . . . .	(78)	(494)	1,102	1,492	1,681
Portfolio investments, net . . . . .	(917)	(10,303)	(946)	8,618	45,775
Other investments . . . . .	(7,302)	(21,215)	(15,569)	(6,558)	(41,884)
Reserve assets . . . . .	(8,212)	(16,010)	(1,778)	5,305	(1,936)
Adjustments of reserve assets <sup>(1)</sup> . . .	(177)	17	(176)	(50)	(20)
Errors and omissions, net . . . . .	(9,050)	(9,355)	(7,036)	(9,084)	(4,851)

Source: Herald of the Bank of Russia, Issue 26-27 605-605, 15 May 2002.

(1) Adjustments of the reserve assets were introduced in order to reconcile the data in the payment balance and international investment position of Russia formed in accordance with the IMF guidelines with the national official statistical data on international reserves.

### *Official international reserves*

The following table sets forth information with respect to official reserves as at the dates indicated:

	Official international reserves				
	1 January 2002	1 January 2001	1 January 2000	1 January 1999 <sup>(2)</sup>	1 January 1998 <sup>(1)</sup>
	(in U.S.\$ millions)				
Gold and currency reserves . . . . .	36,622	27,972	12,456	12,223	17,784
Currency reserves . . . . .	32,542	24,264	8,457	7,801	12,895
Foreign currency . . . . .	32,538	24,263	8,455	7,800	12,771
SDRs . . . . .	3	1	1	–	122
Reserve position on IMF . . . . .	1	1	1	1	1
Gold <sup>(3)</sup> . . . . .	4,080	3,708	3,998	4,422	4,889

Source: Central Bank's website (15 November 2002).

(1) From 1 January 1998, deposited gold is included in the international reserves figures.

(2) From 1 January 1999, the amount of reserves excludes foreign currency balances in correspondent accounts of resident banks with the Central Bank, except for the funds transferred to Vnesheconombank for the purposes of servicing state external debt.

(3) Valuing gold at U.S.\$300 per fine troy ounce.

### *Monetary policy*

The decrease of the budget deficit between 1992 and 1997 and its elimination in 2000 and 2001, and the increased access of the Government of Russia to financing from sources other than the Central Bank, have reduced the pace of monetary expansion. Prior to the 1998 financial crisis, slower monetary growth and increased exchange rate stability have helped the Russian Central Bank to reduce inflation from over 2,000 per cent. in 1992 to 11 per cent. in December 1997. In 1998, however, inflation rose sharply again. After the crisis, the Government of Russia changed its policy towards the Rouble and proclaimed a debt moratorium and a mandatory restructuring of a significant share of domestic Rouble debt. The annualised inflation rate in 2002 was reduced to 15.1, as compared to 18.8 per cent. in 2001, 20.1 per cent. in 2000 and 36.5 per cent. for the year 1999.

The Central Bank introduced a currency intervention band in July 1995. Another two half-year currency bands followed at the end of 1995 and in mid-1996. As confidence in the continuity of the exchange rate policy grew, the Central Bank introduced a full-year band for 1997. In November 1997, exchange rate policy was adjusted further, to allow the authorities more flexibility in accommodating shifts in short-term capital flows. The new (flat) trading band was announced for the three years from 1998 to 2000. This was supposed to help sustain the decline in inflation and domestic interest rates. However, in 1998 the Government of Russia dropped the currency trading band and allowed the Rouble to float freely. By the end of 1999, the Rouble had stabilised at around 25 Roubles per U.S. Dollar. Since then, the Central Bank has conducted a tight monetary policy through a system of barriers to limit the flow of currency out of Russia and direct currency interventions helping to reduce inflation and keep the Rouble under control.

The Rouble was redenominated, 1,000-fold, effective as of 1 January 1998. The old bills were in circulation until 1999 and were accepted by the Central Bank until 2002.

The Rouble is fully convertible for current account transactions. In June 1996, the Government of Russia committed itself to compliance with the obligations of Article VIII of the IMF Charter.

### *External debt*

As at 1 October 2002, the external debt of Russia amounted to U.S.\$149.7 billion (including indebtedness of the former Soviet Union accepted by Russia). A significant proportion of that debt

(U.S.\$37.6 billion) is owed to the Paris Club of sovereign creditors. The Government of Russia has been making efforts to restructure this Paris Club debt and reschedule payments. However, these efforts have not so far been successful. If the Paris Club debt is not restructured, Russia will face substantial foreign debt payments in 2003.

### ***Social conditions***

The Russian standard of living declined with the beginning of economic reform amid the country's severe economic problems. This decline has primarily affected the elderly and other segments of the population that are dependent on benefits from the Government of Russia. While reported real wages dropped sharply as a result of price liberalisation, Russian consumers have benefited from the wider range and improved quality of products available to them. Today, imported and domestic consumer products are available, although many goods are often beyond the means of most Russians and the market share of imported goods has been decreasing.

### ***Legal environment***

Russian law has undergone radical changes in recent years. Whole bodies of law unknown in the Soviet era have been adopted, covering a wide range of areas including corporate, securities, anti-trust, privatisation, property, banking and bankruptcy law. The adoption of the first, second and third parts of the new Civil Code, the Securities Market Law and the Joint Stock Companies Law are further important steps in establishing a comprehensive legal framework. At the same time, confusion and uncertainty continue to exist with respect to the law in Russia, not least because the pace of its development often results in ambiguities and inconsistencies.

Much business-related legislation remains to be put in place. The absence of comprehensive business laws and regulations presents particularly difficult problems for businesses operating in Russia. Business-related legislation is also susceptible to revision in reaction to political influences and the pressure on the Government of Russia to generate revenue or to conserve foreign currency. In addition, a significant amount of Russian legislation has been adopted based on a more or less explicit understanding that it would serve as a general framework, with more detailed issues to be subsequently clarified by amendment or administrative regulation. In many cases, this clarification is yet to occur.

Regulations are interpreted and applied with little consistency and the decisions of one Government of Russia official may be overruled or contested by another. Moreover, many of the new Russian laws have never been interpreted by courts or administrative bodies. Both the Soviet experience and recent Russian practice suggest that the enforcement of legal rights in Russia will continue to be subject to greater discretion and political influence than is usual for most Western jurisdictions.

### **Exchange Controls and Repatriation**

Russian currency exchange legislation limits the exchangeability of Roubles for foreign currency and the use of foreign currency in Russia. Russian currency legislation currently permits, and Russian foreign investment legislation currently guarantees, the right of foreign investors to convert Rouble income received on investments in Russia (including dividends, profits and interest) and to transfer it abroad. However, the actual repatriation of proceeds from the sale of certain investments may be postponed for as long as 365 days.

Foreign currency may be freely exchanged for Roubles in Russia but the exchange of Roubles for foreign currency in Russia is restricted and Roubles may not be exported or exchanged outside Russia. Non-residents may freely convert foreign currency into Roubles, but may only do so through Rouble accounts which are subject to strict regulations.

The currency exchange rules govern transactions in foreign currencies and currency valuables (including foreign currency-denominated securities) between Russian residents (including citizens, permanent residents and legal entities established under Russian law) and foreign currency and Rouble transactions between residents and non-residents. Russian currency legislation distinguishes between “current” foreign currency transactions and foreign currency transactions involving a “movement of capital”.

“Current” foreign currency transactions generally may be freely carried out between residents and between residents and non-residents. “Movement of capital” transactions in foreign currency, including the purchase and sale of securities and real estate transactions, generally require a license from the Central Bank. The prevailing view is that the license is only required for Russian residents involved in such “movement of capital” transactions. Cash transactions in foreign currency are generally prohibited within Russia. However, certain obligations may be paid in foreign currency by means of credit cards or wire transfers.

Following the financial crisis of 1998, additional regulations on foreign currency exchange were enacted. For example, the mandatory exchange of 75 per cent. of export revenues of Russian companies was required to be effected through the domestic foreign currency market. This requirement has been assisting the Central Bank in increasing its foreign currency reserves. The mandatory exchange requirement has been recently reduced to 50 per cent. of export revenues. For Russian importers, a mandatory deposit of 100 per cent. of the value of foreign currency being purchased is now required to be made with an authorised Russian bank. The deposit is refundable on presentation of a notarised customs receipt for the imported goods. This regulation was introduced to prevent capital flight through “fake” import contracts.

### **Taxation and Duties**

The current Russian system of taxation has been characterised by rapid and unpredictable changes, and the Government of Russia has an acute need for revenues because of the large deficit in public finance at all levels. Thus, the nature and amount of taxes applicable to a business’ activities could ultimately turn out to be different from what is expected. Widespread non-compliance with tax laws and inconsistent enforcement by tax inspectorates contribute to the system’s shortcomings. While taxation of non-income operations has been significantly reduced, businesses are still required to pay significant taxes even if they realise no profits.

The first part of the new Tax Code, dealing mainly with procedural rules and definitions, became effective in 1999. Certain chapters of the second part of the new Tax Code, covering VAT, the Unified Social Tax, the Individual Income Tax and the Excise Tax, became effective in 2001. Additional chapters of the second part, covering the Corporate Profits Tax, the Mineral Extraction Tax and the Sales Tax, became effective in 2002. The main objectives of the Tax Code are to reduce the total number of taxes (from about 200 existing in 1999), to improve the stability, transparency and fairness of the tax system by eliminating many tax exemptions and to reduce the overall tax burden on the Russian economy. The Ministry of Finance of Russia and the Russian Duma have continued to work on the tax system by reducing considerably the number of laws, and by rationalising the system of taxation. In addition, the Customs Code is in the process of being substantially revised by the Russian Duma.

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## **APPENDIX A—CERTIFICATION OF DIAMOND DEPOSITS**

### **MINISTRY OF NATURAL RESOURCES OF THE RUSSIAN FEDERATION STATE COMMITTEE ON NATURAL RESOURCES RESERVES**

**54 B. Polyanka, Moscow 109180**

**Tel: 238-58-56**

**Fax: (095) 230-73-44**

**E-mail: reserves.gkz@mtu-net.ru**

Date: 5 February 2003

No. sr-6/44

To No. FA-01/25-130 of 28.01.03

To: F. B. Andreyev  
First Vice President  
AK ALROSA  
10-12 1<sup>st</sup> Kazachy per.  
109017 Moscow

In connection with the resolution of AK ALROSA relating to the offering of its eurobonds and the related issue and listing of the securities, the State Committee on Natural Resources Reserves of the Ministry of Natural Resources of the Russian Federation hereby confirms that:

- ALROSA's proven reserves (categories B and C<sub>1</sub>) of diamonds are sufficient to permit mining of diamonds during the next 25 years, i.e., until 31 December 2026, in an annual average volume that is not less than the volume of diamonds produced during 2001;
- the average value per carat of diamonds to be mined by AK ALROSA in each of the subsequent 25 years will not be materially less than the average value per carat of diamonds mined by AK ALROSA during the year ended 31 December 2002.

The State Committee on Natural Resources Reserves of the Ministry of Natural Resources of the Russian Federation hereby consents to the inclusion of this letter and the information and statements set forth herein in the Offering Circular and other documents to be prepared in connection with the proposed offering of unsecured bonds guaranteed by AK ALROSA, and acknowledges that such information will be included in the Offering Circular as a public official statement made within the authority of the State Committee on Natural Resources Reserves of the Ministry of Natural Resources of the Russian Federation.

For the avoidance of doubt, nothing contained herein shall imply any undertaking by the State Committee on Natural Resources Reserves of the Ministry of Natural Resources of the Russian Federation or any other agency or state authority of the Russian Federation to guarantee the payment of any obligations in respect of amounts of interest and principal owing on the securities of AK ALROSA, and the securities do not represent obligations of any such authority.

Deputy Chairman of the Committee  
on the Natural Resources Reserves

/s/ V. I. VOROPAYEV

V. I. Voropayev

[seal]: seal of the State Committee on Natural  
Resources Reserves of the Ministry of Natural  
Resources of the Russian Federation



**THE MINISTRY OF FINANCE OF THE RUSSIAN FEDERATION**

**FIRST DEPUTY MINISTER**

**9 Ilyinka Street, Moscow 103097**

**Teletype: 112008**

**Telefax: 9250889**

Date: 31 March 2003

No. 23-02-05/323

To: F. B. Andreyev

First Vice President

AK ALROSA

10-12 1<sup>st</sup> Kazachy per.

109017 Moscow

Dear Fyodor Borisovich

In connection with the resolution of AK ALROSA relating to the offering of its eurobonds and the related issue and listing of the securities, the Ministry of Finance of the Russian Federation hereby confirms that AK ALROSA's proven reserves of natural diamonds (categories A, B and C<sub>1</sub>) are sufficient to permit mining of diamonds during the next 25 years, i.e., until 31 December 2027, in an annual average volume that is not less than the volume of diamonds produced during 2002.

The Ministry of Finance of the Russian Federation hereby consents to the inclusion of this letter and the information and statements set forth herein in the Offering Circular and acknowledges that such information will be included in the Offering Circular as a public official statement made within the authority of the Ministry of Finance of the Russian Federation.

For the avoidance of doubt, nothing contained herein shall imply any undertaking by the Ministry of Finance of the Russian Federation or any other agency or state authority of the Russian Federation to guarantee the payment of any obligations in respect of amounts of interest and principal owing on the securities of AK ALROSA, and the securities do not represent obligations of any such authority.

By: \_\_\_\_\_ /s/ A. V. ULYUKAEV  
A. V. Ulyukaev

## APPENDIX B–GLOSSARY OF TECHNICAL TERMS

<b>Alluvial</b>	Pertaining to material eroded from its primary source, transported by natural earth processes and deposited in stream sediments.
<b>Carat</b>	A unit of weight for diamonds, equivalent to 0.2 of a gram.
<b>Dredge</b>	A floating vessel used to recover valuable minerals from stream sediments.
<b>Flush water</b>	Water used to assist the flow of materials in chutes, such as in the process of gravitational separation.
<b>Froth flotation</b>	A water-borne stream of finely ground ore is discharged into a tank (cell) of water mixed with an oily reagent. Air is injected into the bottom of the cell to form bubbles which rise to the surface. The diamonds adhere to the bubbles and are collected from the froth discharged from the top of the cell. Waste material is drawn off from the bottom of the cell.
<b>Grainer</b>	A unit of weight measurement with respect to diamonds of 1.8 carats or less. There are four grainers in one carat.
<b>Ground subsidence</b>	Where the ground sinks gradually, generally caused by draining under ground water, natural gas and water for irrigation, and the settling of structures.
<b>Jigs and jigging</b>	The treatment of a stream of ore materials by passing it over a screen bed mounted near the top of a water bank (the jig) to which a vertical agitation of the water (jigging) can be applied. The jigging motion separates the stream into lighter minerals on the top and denser minerals (the concentrate) on the screen bed. Discharge of the waste and collection of the concentrate is continuous.
<b>Kimberlite</b>	A volcanic rock originating from the earth's mantle composed of olivine, phlogopite, diopside and minor accessory minerals, including occasional diamond.
<b>Lamproite</b>	A volcanic rock originating from the earth's mantle composed of olivine, diopside, phlogopite, richterite, leucite, sanidine, wadeite and priderite, plus accessory minerals, including occasional diamond.
<b>Mantle</b>	Intermediate zone of the earth, resting on the earth's core at a depth of about 2,900 kilometres, and surrounded by the earth's crust.
<b>Mill</b>	Industrial equipment used to grind ore finely after being crushed.
<b>Mineral deposit</b>	A mineralised ore body which has been identified by a sufficient number of closely-spaced drill holes and/or underground sampling to contain sufficient tonnage and ore grade to warrant further exploration or development. Mineral deposits or mineralised materials do not qualify as commercially mineable ore body reserves, as prescribed under standards generally applied within the mining industry, until a final and comprehensive economic, technical and legal feasibility study based upon the test results has been concluded.

<b>Ore</b>	A deposit of rock containing a mineral or aggregate of minerals from which metals can be mined or extracted.
<b>Ore dressing</b>	The process of cleaning ore and removing waste material.
<b>Overburden</b>	The waste rock overlying and surrounding an ore body which in open-pit mining has to be removed to allow mining of the ore.
<b>Pipe</b>	A tabular or cylindrical rock body, usually vertical.
<b>Placer deposit</b>	A glacial or alluvial deposit of sand or gravel containing eroded particles of valuable minerals.
<b>Probable reserves</b>	That material for which tonnage and grade are computed partly from specific measurements, samples or production data, and partly from projection for a reasonable distance on geological evidence, and for which the sites available for inspection, measurement and sampling are too widely or otherwise inappropriately spaced to outline the material completely or to establish its grade throughout.
<b>Production stockpile</b>	A stockpile of ore which is stored until it can be processed.
<b>Proven reserves</b>	That material for which tonnage is computed from dimensions revealed in outcrops or trenches or underground workings or drill holes and for which (i) the grade is computed from the results of adequate sampling; (ii) the sites for inspection, sampling and measurement are so spaced and the geological character so well defined that the size, shape and mineral content are established; (iii) the computed tonnage and grade are judged to be accurate within limits which shall be stated; and (iv) it shall be stated whether the tonnage and grade of proven ore or measured ore are “in situ” or extractable.
<b>Radiometric separation</b>	A method of ore sorting which involves the identification of diamonds through the detection of their indicative range of emitted isotopes.
<b>Rock burst</b>	Small earthquakes or other seismic events caused by stress to rock in mining operations.
<b>Rock dump</b>	An area in which overburden is stored.
<b>Sinkhole</b>	A hollow place or depression in which drainage collects.
<b>Tailings</b>	The waste material discarded from an ore treatment plant after the extraction of a valuable concentrate from the ore fed to the plant.
<b>Ultramafic</b>	Rock that is rich in magnesium and iron.
<b>Wet x-ray sorting</b>	A process which allows wet ore emerging from sizing screens to be sorted immediately, without having to be dried.

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**Interim Consolidated Financial Statements**  
**(unaudited)**  
**for the nine months ended**  
**30 September 2002**

**AK “ALROSA”**

**INTERIM CONSOLIDATED FINANCIAL STATEMENTS FOR THE NINE MONTHS ENDED  
30 SEPTEMBER 2002**

(in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at  
30 September 2002, unless otherwise stated)

**INTERIM CONSOLIDATED BALANCE SHEET**

	<u>Notes</u>	<u>30 September 2002 (unaudited)</u>	<u>31 December 2001</u>
<b>Assets</b>			
<b>Non-current Assets</b>			
Restricted cash . . . . .	5	396	378
Equity accounted investments . . . . .	4	588	469
Available for sale investments . . . . .	4	2,227	2,301
Long-term accounts receivable . . . . .	8	2,192	1,797
Property, plant and equipment . . . . .	6	88,868	80,636
<b>Total Non-current Assets . . . . .</b>		<b>94,271</b>	<b>85,581</b>
<b>Current Assets</b>			
Inventories . . . . .	7	13,814	13,027
Trade and other receivables . . . . .	8	10,316	8,545
Prepaid profit tax . . . . .		743	724
Available for sale investments . . . . .		235	—
Cash and cash equivalents . . . . .	5	2,223	1,652
<b>Total Current Assets . . . . .</b>		<b>27,331</b>	<b>23,948</b>
<b>Total Assets . . . . .</b>		<b>121,602</b>	<b>109,529</b>
<b>Shareholders' Equity</b>			
Share capital . . . . .	9	11,022	11,022
Retained earnings . . . . .		42,457	40,577
<b>Total Shareholders' Equity . . . . .</b>		<b>53,479</b>	<b>51,599</b>
<b>Grant . . . . .</b>	10	<b>11,467</b>	<b>12,275</b>
<b>Minority Interest . . . . .</b>		<b>2,631</b>	<b>2,458</b>

The accompanying notes form an integral part of these interim consolidated financial statements.



**AK “ALROSA”**  
**INTERIM CONSOLIDATED FINANCIAL STATEMENTS FOR THE NINE MONTHS ENDED**  
**30 SEPTEMBER 2002 (Continued)**

(in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at  
30 September 2002, unless otherwise stated)

	<u>Notes</u>	<u>30 September 2002</u> (unaudited)	<u>31 December 2001</u>
<b>Liabilities</b>			
<b>Long-term liabilities</b>			
Long-term debt . . . . .	11	10,384	7,338
Provision for restoration liability . . . . .	12	2,614	2,923
Deferred tax liabilities . . . . .	14	3,614	2,457
<b>Total Long-term Liabilities . . . . .</b>		<b>16,612</b>	<b>12,718</b>
<b>Current Liabilities</b>			
Short-term loans and current portion of long-term debt . . . . .	15	25,583	18,506
Trade and other payables . . . . .	13	7,310	7,118
Taxes payable . . . . .	14	4,019	4,616
Dividends payable . . . . .		501	239
<b>Total Current Liabilities . . . . .</b>		<b>37,413</b>	<b>30,479</b>
<b>Total Liabilities . . . . .</b>		<b>54,025</b>	<b>43,197</b>
<b>Total Shareholders' Equity, Grant, Minority interest and Liabilities .</b>		<b>121,602</b>	<b>109,529</b>

Signed by the following members of management:

Vladimir T. Kalitin  
President, Chairman of the Board

Olga A. Lyashenko  
Chief Accountant

20 February 2003

The accompanying notes form an integral part of these interim consolidated financial statements.

**AK “ALROSA”**

**INTERIM CONSOLIDATED FINANCIAL STATEMENTS FOR THE NINE MONTHS ENDED  
30 SEPTEMBER 2002 (Continued)**

(in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at  
30 September 2002, unless otherwise stated)

**INTERIM CONSOLIDATED STATEMENT OF INCOME**

	Notes	Nine months ended 30 September 2002	Nine months ended 30 September 2001
		(unaudited)	(unaudited)
Sales . . . . .	16	42,045	47,694
Cost of sales . . . . .	17	(19,059)	(18,307)
<b>Gross profit . . . . .</b>		<b>22,986</b>	<b>29,387</b>
General and administrative expenses . . . . .	18	(1,817)	(1,778)
Other operating income . . . . .	19	1,068	1,105
Other operating expenses . . . . .	20	(16,027)	(19,175)
<b>Operating Profit . . . . .</b>		<b>6,210</b>	<b>9,539</b>
Finance costs, net . . . . .	21	(2,935)	(3,370)
Income from associates . . . . .	4	269	238
Monetary gain . . . . .		2,829	3,143
Foreign currency losses . . . . .		(739)	(461)
<b>Profit before Profit Tax . . . . .</b>		<b>5,634</b>	<b>9,089</b>
Profit tax . . . . .	14	(3,044)	(973)
<b>Profit after Profit tax . . . . .</b>		<b>2,590</b>	<b>8,116</b>
Minority interest . . . . .		(81)	(253)
<b>Net profit for the period . . . . .</b>		<b>2,509</b>	<b>7,863</b>
<b>Dividend per share . . . . .</b>		<b>RR 3,145</b>	<b>RR 2,375</b>

The accompanying notes form an integral part of these interim consolidated financial statements.

**AK “ALROSA”**  
**INTERIM CONSOLIDATED FINANCIAL STATEMENTS FOR THE NINE MONTHS ENDED**  
**30 SEPTEMBER 2002**

(in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at  
30 September 2002, unless otherwise stated)

**INTERIM CONSOLIDATED STATEMENT OF CASH FLOWS**

	<u>Notes</u>	<u>Nine months ended 30 September 2002</u>	<u>Nine months ended 30 September 2001</u>
		<u>(unaudited)</u>	<u>(unaudited)</u>
<b>Net Cash Inflow from Operating Activities</b> . . . . .	22	<b>5,969</b>	<b>2,315</b>
<b>Cash Flows from Investing Activities</b>			
Purchase of property, plant and equipment . . . . .		(10,811)	(7,748)
Acquisition of investments . . . . .		(142)	—
Interest received . . . . .		81	164
Dividends received from associate . . . . .		336	302
<b>Net Cash Outflow from Investing Activities</b> . . . . .		<b>(10,536)</b>	<b>(7,282)</b>
<b>Cash Flows From Financing Activities</b>			
Repayment of loans . . . . .		(31,024)	(21,659)
Loans received . . . . .		39,675	30,606
Interest paid . . . . .		(2,924)	(1,904)
Payment to restricted cash account . . . . .		(54)	(117)
Dividends paid . . . . .		(344)	(136)
<b>Net Cash Inflow from Financing Activities</b> . . . . .		<b>5,329</b>	<b>6,790</b>
Effects of inflation on cash and cash equivalents . . . . .		(191)	(279)
<b>Net Increase in Cash and Cash Equivalents</b> . . . . .		<b>571</b>	<b>1,544</b>
Cash and cash equivalents at the beginning of the period . . . . .		1,652	1,246
<b>Cash and cash equivalents at the end of the period</b> . . . . .		<b>2,223</b>	<b>2,790</b>

Significant non-cash transactions are discussed in note 26.

The accompanying notes form an integral part of these interim consolidated financial statements.

**AK “ALROSA”**

**INTERIM CONSOLIDATED FINANCIAL STATEMENTS FOR THE NINE MONTHS ENDED  
30 SEPTEMBER 2002 (Continued)**

(in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at  
30 September 2002, unless otherwise stated)

**INTERIM CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY**

	<u>Share capital</u>	<u>Retained Earnings</u>	<u>Total</u>
Balance at 1 January 2001 . . . . .	11,022	30,545	41,567
Dividends (note 9) . . . . .	—	(475)	(475)
Net profit for nine months ended 30 September 2001 . . . . .	—	7,863	7,863
<b>Balance at 30 September 2001 (unaudited) . . . . .</b>	<b><u>11,022</u></b>	<b><u>37,933</u></b>	<b><u>48,955</u></b>
Balance at 1 January 2002 . . . . .	11,022	40,577	51,599
Dividends (note 9) . . . . .	—	(629)	(629)
Net profit for nine months ended 30 September 2002 . . . . .	—	2,509	2,509
<b>Balance at 30 September 2002 (unaudited) . . . . .</b>	<b><u>11,022</u></b>	<b><u>42,457</u></b>	<b><u>53,479</u></b>

The accompanying notes form an integral part of these interim consolidated financial statements.

**AK “ALROSA”**  
**NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS FOR THE**  
**NINE MONTHS ENDED 30 SEPTEMBER 2002**  
**(UNAUDITED)**

(in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at  
30 September 2002, unless otherwise stated)

**1. ACTIVITIES**

The core activities of Closed Joint Stock Company AK “ALROSA” (“the Company”) and its subsidiaries and associates (“the Group”) are the exploration and extraction of diamond reserves and the marketing and distribution of raw and cut diamonds. The Company was registered on 13 August 1992 as a closed joint-stock company in the Republic of Sakha (Yakutia), which is located within the Russian Federation. The Group operates mining facilities in Mirny, Udachny, Aikhal, Nurba and Anabar (located in Eastern Siberia) and had 46,527 employees as at 30 September 2002 (31 December 2001 - 47,680). The Company is subject to special legislation issued by the Russian Federation and the Republic of Sakha (Yakutia) which significantly influences the Company’s core operating activities. This legislation includes but is not limited to the Law on State Secrets of the Russian Federation (note 2), and requirements to obtain annual quotas for export of diamonds from the government of the Russian Federation (note 16).

**2. RESERVES**

The Company’s diamond reserves and related production information are considered State secrets of the Russian Federation and cannot be disclosed to third parties. Management has considered such reserve and production information when assessing the recoverability and amortisation of production asset costs.

Management’s assessments with respect to reserve estimates have been confirmed by representatives of the State Committee on Natural Resources Reserves of the Ministry of Natural Resources of the Russian Federation.

**3. ACCOUNTING POLICIES**

**(a) Basis of presentation**

Group companies incorporated in Russia maintain their statutory accounting records and prepare statutory financial reports in accordance with the Regulations on Accounting and Reporting of the Russian Federation (“RAR”) and their measurement currency is the Russian rouble (“RR”). Group companies incorporated in other countries maintain their statutory accounting records in accordance with relevant legislation and in the appropriate measurement currency. The accompanying consolidated financial statements have been prepared under the historical cost convention as modified by the revaluation of available-for-sale investment securities and financial assets held-for-trading. The consolidated financial statements are based on the statutory accounting records, with adjustments and reclassifications for the purpose of presentation in accordance with International Accounting Standard 34 “*Interim Financial Reporting*” (“IAS”) issued by the International Accounting Standards Board (“IASB”).

Included in the above adjustments and reclassifications to the statutory accounts for IAS presentation is the restatement for changes in the general purchasing power of the Russian rouble based on IAS 29 “*Financial Reporting in Hyperinflationary Economies*”. IAS 29 requires that financial statements in the currency of a hyperinflationary economy be stated in terms of the measuring unit current at the latest balance sheet date. The restatement was calculated from conversion factors derived from the Russian Federation Consumer Price Index, published by the Russian State Committee on Statistics, and from indices obtained from other sources for years prior to 1992, which management believes represent the most appropriate measure of inflation in the economy.

# AK "ALROSA"

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS FOR THE NINE MONTHS ENDED 30 SEPTEMBER 2002 (Continued) (UNAUDITED)

(in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at  
30 September 2002, unless otherwise stated)

The indices and the respective conversion factors used to restate the consolidated financial statements, based on 1988 prices (1988=100) for the four years ended 31 December 2001 and nine months ended 30 September 2002, are:

Year	Index	Conversion Factors
1998 .....	1,216,400	2.15
1999 .....	1,661,481	1.58
2000 .....	1,995,937	1.31
2001 .....	2,371,572	1.1
Nine months 2002.....	2,618,690	1

The significant guidelines followed in restating the consolidated financial statements are:

- all amounts including corresponding figures are stated in terms of the measuring unit current at the latest balance sheet date;
- monetary assets and liabilities as at 30 September 2002 are not restated because they are already expressed in terms of the monetary unit current at the latest balance sheet date;
- non-monetary assets and liabilities (items which are not expressed in the monetary unit current at the balance sheet date) and components of shareholders' equity are restated by applying a conversion factor based on the age of the underlying asset, liability or component of shareholders' equity;
- all items in the statement of operations and cash flows are restated by applying the change in the general price index from the dates when the items were initially transacted to the balance sheet date; and
- the effect of inflation on the Group's net monetary position is included in the consolidated statement of income as a net monetary gain or loss.

The Group has adopted IAS 39, "*Financial Instruments: Recognition and Measurement*", which is effective for accounting periods beginning on or after 1 January 2001. The financial impact of adopting this standard was reported in the previous year's consolidated financial statements.

In accordance with IAS 39, the comparative financial statements for the year ended 31 December 2000 are not restated. As a result the reconciliation of profit before tax to the cash flow from operating activity is adjusted for the effect of applying IAS 39 on trade and other receivables in the amount totalling RR'mln 859 (see note 22).

In 2002, the Group changed its accounting policy to record the changes in accounting estimates of the discount rate, cash flows and their timing related to the provisions (note 3 (e)) in order to give a better presentation in the consolidated financial statements. Until 31 December 2001 the effects of changes in discount rates which would increase or decrease the determination of the present value of the provisions were recorded in the consolidated statement of income in the year of the change and changes in cash flow and their timing were recorded in correspondence with the related assets.



**AK “ALROSA”**

**NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS FOR THE  
NINE MONTHS ENDED 30 SEPTEMBER 2002 (Continued)  
(UNAUDITED)**

**(in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at  
30 September 2002, unless otherwise stated)**

Since January 2002 the effect of such changes were added to, or deducted from, the amount recognised as the related asset to the extent the change relates to future periods. The amount that relates to current and past periods was recorded in the statement of income in the year of the change.

In 2002 the Group also revisited the discount rates used in the past in order to better reflect the market assessments on the time value of money and risks specific to the liabilities. The new discount rates used in the previous years are disclosed in the previous year financial statements and the discount rate used at 31 December 2001 is disclosed in note 12.

The net effect of the change in accounting policy and the revision of the discount rates did not have a material impact on the current period or any other period presented and, accordingly, the comparative information has not been restated. Management is not able to determine whether this change will have a material effect in the subsequent periods.

The preparation of the consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities as at the date of the consolidated financial statements, and the reported amount of revenues and operating costs during the reporting period. The most significant estimates relate to realisation of inventories, investments, allowance for doubtful accounts, deferred taxation, reserve estimates used to calculate amortisation, retirement benefit costs and the evaluation of the provision for restoration liability. Actual results could differ from these estimates.

Certain amounts have been reclassified in the comparative financial information for the year ended 31 December 2001 to conform to the current year presentation.

The structure of the consolidated statement of income has been amended in order to present the information about the Group's activity in a format considered to be more useful to the users and more appropriate, as suggested by IAS 1 *“Presentation of Financial Statements”*, for a presentation by function. The change in structure, in addition to providing an additional line for “gross profit”, has resulted in the inclusion of “royalty payments”, “social costs” and “taxes and payments” within “other operating expense”.

In connection with the preparation of these financial statements, management have reconsidered the presentation of costs incurred in 2001 that were deemed to be extraordinary and disclosed as such in the consolidated financial statements for the year ended 31 December 2001. These amounts have been reclassified and reported as part of operating expenses to better reflect the nature of the costs under worldwide practice of IAS application.

**(b) Principles of consolidation**

The Group comprises the Company and its subsidiaries and associates. The effects of transactions between subsidiaries within the Group are eliminated and accounting policies of the subsidiaries and associates are conformed to those of the Company.

A subsidiary is an entity in which the Company has an interest of more than one half of the voting rights or otherwise has the power to exercise control over the operations.

Subsidiaries are consolidated from the date on which control is transferred to the Group and are no longer consolidated from the date that control ceases.

**AK “ALROSA”**

**NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS FOR THE  
NINE MONTHS ENDED 30 SEPTEMBER 2002 (Continued)  
(UNAUDITED)**

**(in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at  
30 September 2002, unless otherwise stated)**

Associated entities over which the Company has a significant but not a controlling influence are accounted for using the equity method. Significant influence is usually evidenced by the Company owning, directly or indirectly, between 20 per cent. and 50 per cent. of the voting share capital.

Equity accounting is discontinued when the carrying amount of the investment in an associate reaches zero, unless the group has incurred obligations or guaranteed obligations in respect of the associate.

For subsidiaries that are not wholly owned, the minority's interest is measured at the pre-acquisition carrying amount of the minority's share in the subsidiary at the acquisition date, amended for the minority's share of subsequent dividends, profits and losses.

**(c) Grant**

Production assets received from the Republic of Sakha (Yakutia) in 1993 under the terms of a mineral lease agreement to “transfer of rights to use and exploit land, diamond deposits, main production and non-production facilities”, are recorded in accordance with IAS 20 *“Accounting for Government Grants and Disclosure of Government Assistance”* at historical cost adjusted for the effects of inflation, with a corresponding credit reflected as a grant in the Group's balance sheet. The Grant is amortised in line with the reduction in the carrying value of the underlying assets, with the amortised portion recorded as an increase in income (see note 10).

Social assets received under the aforementioned mineral lease agreement have not been included in the accompanying consolidated financial statements since the majority of these assets have been or will be transferred free of charge to local administrations.

**(d) Property, plant and equipment**

Property, plant and equipment comprises costs incurred in developing areas of interest as well as the costs related to the construction and acquisition of mining assets. Expenditure related to geophysical analysis is deferred on a project-by-project basis until the viability of the project is determined. If a project is not determined to be economically viable the accumulated project costs are charged to operations in the year in which the determination is made. Costs associated with economically viable projects are depreciated over the economic useful life of those projects as set out below.

At each reporting date, management assesses whether there is any indication of impairment of property, plant and equipment. If any such indication exists, management estimates the recoverable amount which is determined as the higher of an asset's net selling price and its value in use. The carrying amount is reduced to the recoverable amount and the difference is recognised as an expense (impairment loss) in the statement of income. An impairment loss recognised for an asset in prior years is reversed if there has been a change in the estimates used to determine the asset recoverable amount.

***Depreciation and amortisation***

Property, plant and equipment is depreciated upon commencement of commercial mining activities at a specific area of interest.

# AK "ALROSA"

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS FOR THE NINE MONTHS ENDED 30 SEPTEMBER 2002 (Continued) (UNAUDITED)

(in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at  
30 September 2002, unless otherwise stated)

Depreciation and amortisation of buildings, land improvements and fixed plant related to extraction of minerals is calculated on a units-of-production basis for each area of interest over its expected economic useful life.

Depreciation of assets not directly associated with production is calculated on a straight-line basis over its estimated useful life. The depreciation rates applied are as follows:

	Assets related to extraction of minerals	Other assets
Buildings . . . . .	Units of production	8–50 years
Land improvements and fixed plant . . . . .	Units of production	8–50 years
Plant and equipment (moveable) . . . . .	5–13 years	5–13 years
Transport . . . . .	3–7 years	3–7 years
Other . . . . .	4–17 years	4–17 years

### *Disposals and retirement*

Items of property, plant and equipment that are retired or otherwise disposed of are eliminated from the balance sheet along with the corresponding accumulated depreciation (if any). Any gain or loss resulting from such retirement or disposal is included in the consolidated statement of income.

### *Repair and maintenance costs*

Maintenance and repairs are expensed as incurred.

### *Local infrastructure assets*

Local infrastructure assets constructed or purchased by the Group subsequent to 1 January 1993 (the date of privatisation) are included in the financial statements at historical cost adjusted for the effects of inflation, and are depreciated using the depreciation rates as set out above.

### **(e) Provisions**

Provisions are recognised when the Group has a present legal or constructive obligation as a result of past events and when it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and a reliable estimate of the amount of the obligation can be made.

Provisions are reassessed annually, and are included in the consolidated financial statements at their expected net present values using discount rates appropriate to the Group in the economic environment in the Russian Federation at each balance sheet date.

Changes in provisions resulting from the passage of time are reflected in the consolidated statement of income each year under financial items. Other changes in provisions, relating to a change in the discount rate applied, in the expected pattern of settlement of the obligation or in the estimated amount of the obligation, are treated as a change in accounting estimate in the period of the change. The effect of such changes are added to, or deducted from, the amount recognised as the related asset to the extent the change relates to future periods. The amount that relates to current and past periods is recorded in the statement of income in the year of the change.

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The provision for restoration liability is determined based on the terms of the mineral lease agreement (see note 10). Under this agreement the Company is obliged to transfer in 2017 property, plant and equipment subject to the mineral lease agreement to the Republic of Sakha (Yakutia) or settle its liability by effecting a cash payment.

Provision for restoration liability is recorded on the balance sheet, with a corresponding amount being recorded as part of property, plant and equipment in accordance with IAS 16 *“Property, Plant and Equipment”* (revised 1998) and amortized over the life of the property.

**(f) Inventories**

Inventories of diamonds, extracted ore and concentrates, mining and construction stores and consumable supplies are valued at the lower of the weighted average cost or net realisable value.

Cost of extracted ore and concentrates is calculated using the quantities determined based on surveyors’ measurements of the volumes of ore and concentrates remaining at the period end.

Cost of inventories include those directly attributable to mining the diamonds, extracting the ore and producing concentrates, and those directly attributable to bringing mining and construction stores and consumable supplies to their present location and condition.

Net realisable value is the estimated selling price in the ordinary course of business, less the cost of completion and selling expenses.

**(g) Investments**

At 1 January 2001, the Group adopted IAS 39 and classified its investments into the following categories: trading, held-to-maturity or available-for-sale. Investments that are acquired principally for the purpose of generating a profit from short-term fluctuations in price are classified as trading investments and included in current assets. Investments with fixed maturity that the management has the intent and ability to hold to maturity are classified as held-to-maturity and are included in non-current assets. During the period, the Group did not hold any investments classified as trading or held-to-maturity. Investments intended to be held for an indefinite period of time, which may be sold in response to needs for liquidity or changes in interest rates, are classified as available-for-sale; these are included in non-current assets unless management has the express intention of holding the investment for less than 12 months from the balance sheet date or unless they will need to be sold to raise operating capital, in which case they are included in current assets. Management determines the appropriate classification of its investments at the time of the purchase and re-evaluates such designation on a regular basis.

All purchases and sales of investments are recognised on the settlement date, which is the date that the investment is delivered to or by the Group. Cost of purchase includes transaction costs. Trading and available-for-sale investments are subsequently carried at fair value, whilst held-to-maturity investments are carried at amortised cost using the effective yield method. Realised and unrealised gains and losses arising from changes in the fair value of trading investments and of available-for-sale investments are included in the statement of income in the period in which they arise.

Since the majority of the Group’s investments are not publicly traded and no reliable method of fair value estimation exist for those investments, these investments are excluded from fair value valuation.

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Those financial assets that are excluded from fair valuation and that have a fixed maturity are measured at amortised cost using the effective interest rate method less impairment. Those that do not have a fixed maturity are measured at cost less impairment.

Unquoted available for sale equity investments are reviewed for impairment losses every balance sheet date and whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. When a review for impairment is conducted, the recoverable amount is assessed by reference to the net present value of expected future cash inflows. The discount rate applied is based upon the Group's weighted average cost of capital with appropriate adjustment for the risks associated with the investment under assessment. When the level of information available to calculate the net present value of expected future cash inflows makes this exercise unworkable, management use different valuation techniques to estimate whether there is an objective evidence of impairment and to determine the likely amount of impairment, if any.

**(h) Components of cash and cash equivalents**

Cash and cash equivalents consist of cash on hand and balances with banks with a maturity at the date of recognition of less than three months, which are considered by the Group at the time of deposit to have a minimal risk of default.

**(i) Deferred taxes**

Deferred tax is calculated at rates enacted or substantively enacted at the balance sheet date, using the liability method, for all temporary differences between the tax bases of assets and liabilities and their carrying values for financial reporting purposes. The principal temporary differences arise from application of IAS 29 *“Financial Reporting in Hyperinflationary Economies”*, depreciation on property, plant and equipment and provisions and expenses which are charged to the consolidated statement of income before they become deductible for tax purposes.

Deferred tax liabilities are recognised in respect of all taxable temporary differences relating to investments in subsidiaries, unless the Company is able to control the timing of the reversal of the temporary difference and it is probable that the difference will not reverse in the foreseeable future.

Deferred tax assets attributable to temporary differences, unused tax losses and credits are recognised only to the extent that it is probable that future taxable profit or temporary differences will be available against which they can be utilised.

Deferred tax assets and liabilities are offset when the Group has a legally enforceable right to set off current tax assets against current liabilities, when deferred tax balances relate to the same regulatory body (i.e., federal or republic), and when they relate to the same jurisdiction and taxable entity.

**(j) Foreign currencies**

Transactions denominated in foreign currencies are recorded, on initial recognition, in the measurement currency, by applying the exchange rate between the measurement currency and the foreign currency at the date of the transaction. Outstanding foreign currency monetary items at the balance sheet date are reported at the closing rate. Non-monetary items which are carried in terms of historical cost denominated in a foreign currency are reported using the exchange rate at the date of the transaction, and

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non-monetary items which are carried at fair value denominated in a foreign currency are reported using the exchange rates that existed when the values were determined.

Exchange differences arising on the settlement of monetary items or reporting monetary items at rates different from those at which they were initially recorded in the period are recognised in the statement of income in the period in which they arise.

**(k) Financial assets and liabilities**

Financial assets and liabilities carried in the consolidated balance sheet include cash and cash equivalents, investments, receivables, borrowings, and trade and other payables, and are initially recognised at cost, which is the fair value of the consideration given or received, on the date when the Group becomes a party to the contractual provisions of the instrument. Financial assets are partially or fully de-recognised only when the rights to the separable benefits under the relevant contract are lost, surrendered, or have expired or have been settled. Financial liabilities are de-recognised only when the obligation specified in the relevant contract is discharged, cancelled or has expired.

Financial assets are re-measured to fair value at each subsequent balance sheet date, unless they are loans and receivables originated by the Group, in which case they are measured at amortised cost if they have a fixed maturity date, or otherwise at cost.

Financial liabilities with fixed maturity dates are re-measured at each subsequent balance sheet date to amortised cost.

The re-measurement of financial assets and liabilities respectively to fair value, amortised cost, or cost is based on the receivable or payable amount at the expected settlement date, discounted to net present value. The discount rate used is that considered appropriate to the Group in the economic environment in the Russian Federation at each balance sheet date.

**(l) Revenue recognition**

Revenues are recognised when goods are shipped to the purchaser as this is the date that the risks and rewards of ownership are transferred to the customers. Sales are shown net of VAT and export duties, and after eliminating sales within the Group.

Revenue from rendering of transport services is recognized in financial statements in the period when the services are rendered.

Interest revenue is recognized on time proportion basis that takes into account the effective yield on the asset. Dividends revenue is recognized when the shareholder's right to receive payment is established.

**(m) Measurement of trade and other receivables**

Accounts receivable are recorded at original invoice amount and include value-added taxes. Accounts receivable are written down to estimated recoverable amount by recording an impairment for doubtful debts based on analysis of expected future cash flows relating to doubtful receivables. Bad debts are written off when identified.



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**(n) Value added taxes**

In the consolidated balance sheet and the consolidated statement of cash flows, transactions and balances are presented inclusive of the associated Value Added Tax (“VAT”) applicable under the legislation of the relevant jurisdiction in which the transaction occurred.

**(o) Retirement benefit obligations**

The Group makes contributions in accordance with statutory requirements, which are calculated as a percentage of current gross salary payments, in respect of its employees to the State Pension Scheme of the Russian Federation and such expense is charged to the consolidated statement of income.

**(p) Social obligations**

Social costs relating to the maintenance of housing are determined in accordance with agreements with the local authorities and expensed or capitalised as appropriate.

Discretionary and voluntary payments made to fund and support social programmes and related operations are expensed as incurred.

**(q) Non-cash transactions**

Non-cash transactions are measured at the fair value of consideration received or receivable. When it is not possible to measure the fair value of consideration received or receivable reliably, the non-cash transactions are measured at fair value of consideration paid.

Non-cash transactions have been excluded from the operating, investing and financing activities components in the accompanying consolidated statement of cash flows.

**(r) Share capital**

Share capital consists of ordinary shares, which are classified as equity.

**(s) Segment reporting**

Business segments provide products or services that are subject to risks and returns that are different from those of other business segments. Geographical segments provide products or services within a particular economic environment that is subject to risks and returns that are different from those of components operating in other economic environments.

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**4. GROUP STRUCTURE AND INVESTMENTS**

The Company’s significant consolidated subsidiaries and equity-accounted associate are as follows:

<u>Name</u>	<u>Country of Incorporation</u>	<u>Percentage ownership<sup>(2)</sup></u>
<b>Consolidated Subsidiaries</b>		
ZAO “Irelyakhneft” . . . . .	Russia	100
Pension Fund “Almaznaya Osen” . . . . .	Russia	97
OAO “Viluygesstroy” . . . . .	Russia	90
OAO “ALROSA-Nyurba” . . . . .	Russia	88
MAK-Bank . . . . .	Russia	82
OAO “Severalmaz” . . . . .	Russia	72
OAO “Vilyuiskaya GES-3” . . . . .	Russia	66
OAO “ALROSA-Gas” . . . . .	Russia	53
<b>Equity accounted associate</b>		
“Catoka Mining Ltd” <sup>(1)</sup> . . . . .	Angola	33

(1) “Catoka Mining Ltd” is a diamond mining venture located in Angola. Investment in this associate was accounted by the Group under the equity method. Income of RR’mln 269 was included in the Group’s financial statements for nine months ended 30 September 2002, with a corresponding income of RR’mln 238 included in financial statements for nine months ended 30 September 2001. The Group’s share of net assets in Catoka Mining Ltd included in these financial statements is RR’mln 588 and 469 as at 30 September 2002 and 31 December 2001, respectively. As at 31 December 2001, trade and other receivables include dividends receivable from Catoka Mining Ltd. totalling RR’mln 204 (see notes 8 and 25).

(2) The percentage ownership determined based on the Group investees’ charter documents equalled to that determined based on its voting share.

**Available-for-sale investments and gains (losses) on available-for-sale investments**

	<u>30 September 2002</u>	<u>31 December 2001</u>
	(unaudited)	
<b>Available-for-sale investments:</b>		
Investments in companies and banks for which fair value cannot be determined . . . . .	1,970	1,993
Marketable securities . . . . .	257	308
	<u>2,227</u>	<u>2,301</u>

As at 31 December 2001, investments totalling RR’mln 332 are carried net of provisions for impairment.

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Gains/(losses) on available-for-sale investments included above are as follows:

	<b>Nine months ended 30 September 2002</b>	<b>Nine months ended 30 September 2001</b>
	<b>(unaudited)</b>	<b>(unaudited)</b>
Fair value adjustments, net . . . . .	40	301

**5. CASH AND CASH EQUIVALENTS AND RESTRICTED CASH**

**Cash and cash equivalents**

As at 30 September 2002, cash and cash equivalents balance mainly represents current accounts of the Group with the weighted average interest rate approximating nil (31 December 2001: nil).

**Restricted cash**

Restricted cash of RR'mln 270 and RR'mln 291 as at 30 September 2002 and 31 December 2001, respectively, represent deposit accounts held with the Bank of New York and Chase Manhattan Bank. The Group is required to maintain a balance equal to the amount of its next scheduled principal and interest payment in accordance with its loan agreements with these banks. Furthermore, an additional RR'mln 126 (31 December 2001: RR'mln 87) represents mandatory reserve deposits that are not available for use in the Group's day to day operations, held in the Central Bank of the Russian Federation by MAK-Bank, a consolidated subsidiary.

Weighted average interest rate on the restricted cash balance at 30 September 2002 amounted to 1.3 per cent. (31 December 2001: 1.5 per cent.).

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**6. PROPERTY, PLANT AND EQUIPMENT**

	<u>Buildings</u>	<u>Land Improvement</u>	<u>Plant and Equipment</u>	<u>Transport</u>	<u>Assets under Construction</u>	<u>Other</u>	<u>TOTAL</u>
Cost at 31 December 2001 . . .	33,302	27,565	20,595	13,685	26,277	581	122,005
Additions through acquisition of subsidiaries . . . . .	14	4	33	73	53	7	184
Additions . . . . .	475	20	1,190	936	10,780	50	13,451
Transfers . . . . .	3,341	1,467	1,236	14	(6,103)	45	—
Disposals . . . . .	(396)	(275)	(200)	(686)	(600)	(83)	(2,240)
Change in estimate of provision for restoration liability (see note 12) . . . . .	(380)	(155)	(36)	(4)	—	(1)	(576)
<b>Cost at 30 September 2002 (unaudited) . . . . .</b>	<b><u>36,356</u></b>	<b><u>28,626</u></b>	<b><u>22,818</u></b>	<b><u>14,018</u></b>	<b><u>30,407</u></b>	<b><u>599</u></b>	<b><u>132,824</u></b>
Accumulated Depreciation at 31 December 2001 . . . . .	12,044	12,132	9,602	7,477	—	114	41,369
Charge for the year . . . . .	924	863	1,237	920	—	8	3,952
Disposals . . . . .	(292)	(228)	(179)	(659)	—	(7)	(1,365)
<b>Accumulated depreciation at 30 September 2002 (unaudited) . . . . .</b>	<b><u>12,676</u></b>	<b><u>12,767</u></b>	<b><u>10,660</u></b>	<b><u>7,738</u></b>	<b><u>—</u></b>	<b><u>115</u></b>	<b><u>43,956</u></b>
<b>Net book value at 31 December 2001 . . . . .</b>	<b><u>21,258</u></b>	<b><u>15,433</u></b>	<b><u>10,993</u></b>	<b><u>6,208</u></b>	<b><u>26,277</u></b>	<b><u>467</u></b>	<b><u>80,636</u></b>
<b>Net book value at 30 September 2002 (unaudited) . . . . .</b>	<b><u>23,680</u></b>	<b><u>15,859</u></b>	<b><u>12,158</u></b>	<b><u>6,280</u></b>	<b><u>30,407</u></b>	<b><u>484</u></b>	<b><u>88,868</u></b>

Refer to note 10 for property, plant and equipment included above which is subject to the mineral lease agreement with the Republic of Sakha (Yakutia).

Included in property, plant and equipment above are the local infrastructure assets (housing and civic amenities owned by the Group). The carrying value of these assets as at 30 September 2002 and 31 December 2001 is as follows:

	<u>30 September 2002 (unaudited)</u>	<u>31 December 2001</u>
Cost . . . . .	9,664	7,302
Accumulated depreciation . . . . .	(1,275)	(1,120)
Net book value . . . . .	<u>8,389</u>	<u>6,182</u>

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The Company assessed potential impairment for nine months ended 30 September 2002 on an aggregate basis and determined that the recoverable value ("value in use") of the property, plant and equipment exceeded its carrying value.

### 7. INVENTORIES

	30 September 2002	31 December 2001
	(unaudited)	
Diamonds . . . . .	2,503	2,681
Ores and concentrates . . . . .	1,600	1,477
Mining and construction materials . . . . .	8,770	7,954
Consumable supplies . . . . .	941	915
	<u>13,814</u>	<u>13,027</u>

### 8. TRADE AND OTHER RECEIVABLES

	30 September 2002	31 December 2001
	(unaudited)	
<b>Long-term accounts receivable</b>		
Long-term VAT recoverable . . . . .	852	584
Receivable from related parties . . . . .	819	929
Long-term prepaid taxes . . . . .	305	131
Loans . . . . .	125	153
Other long-term receivables . . . . .	91	—
	<u>2,192</u>	<u>1,797</u>
<b>Current accounts receivable</b>		
Accounts and notes receivable—trade . . . . .	2,062	2,503
Prepaid taxes . . . . .	1,757	586
Receivables from related parties . . . . .	1,552	1,818
Advances to suppliers . . . . .	1,319	1,356
Prepayment for commercial paper redemption . . . . .	1,110	—
Taxes recoverable . . . . .	894	855
Loans issued . . . . .	375	308
Notes receivable . . . . .	81	213
Other receivables . . . . .	1,166	906
	<u>10,316</u>	<u>8,545</u>

Taxes recoverable relate to input Value Added Tax (VAT) (see note 3(n)) incurred with respect to purchase and are available for offset against future output VAT following the settlement of outstanding balances payable in relation to the inventories purchased.

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Long-term VAT recoverable, which relates to the materials and services used for construction of property, plant and equipment, becomes available for offset against future output VAT after the respective asset is put into use.

Prepaid taxes mainly relate to a receivable from the Republic of Sakha (Yakutia) that the Company intends to offset against royalty (see note 10) and value-added tax that as at 30 September 2002 was not offset by the tax authorities.

Receivable for commercial paper redemption relates to a prepayment by the Company to the broker for redemption of its own commercial paper from third parties.

Impairment for bad debts offset against accounts receivable balances is as follows:

	30 September 2002 (unaudited)	Monetary effect	Interest on impaired receivables	Bad debt written- off	Bad debt expense	31 December 2001
<b>Long-term accounts receivable</b>						
Receivable from related parties . . . . .	163	(17)	—	—	—	180
Long-term VAT recoverable . . . . .	129	(19)	(87)	—	38	197
Long-term prepaid taxes . .	229	(6)	(26)	—	200	61
	<u>521</u>	<u>(42)</u>	<u>(113)</u>	<u>—</u>	<u>238</u>	<u>438</u>
<b>Current accounts receivable</b>						
Accounts and notes receivable—trade . . . . .	137	(10)	(6)	—	50	103
Prepaid taxes, other than profit tax . . . . .	121	(1)	—	—	109	13
Notes receivable . . . . .	187	(26)	—	(66)	7	272
Loans issued . . . . .	26	—	—	—	26	—
Other receivables . . . . .	322	(19)	(20)	—	161	200
	<u>793</u>	<u>(56)</u>	<u>(26)</u>	<u>(66)</u>	<u>353</u>	<u>588</u>

## 9. SHARE CAPITAL

	30 September 2002 (unaudited)		31 December 2001	
	Shares	Amount	Shares	Amount
Authorised, issued and fully paid ordinary share capital at RR 55,110 par value per share . . . .	200,000	11,022	200,000	11,022

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***Distributable profits***

The statutory accounting reports of the Company are the basis for profit distribution and other appropriations. Russian legislation identifies the basis of distribution as the current year net profit. For the nine months ended 30 September 2002 and for the year ended 31 December 2001, the statutory profit for the Company as reported in the published annual statutory reporting forms was RR'mln 5,987 and RR'mln 9,066, respectively. However, this legislation and other statutory laws and regulations dealing with the distribution rights are open to legal interpretation, and accordingly, management believes that at present it would not be appropriate to disclose an amount for the distributable reserves in these financial statements.

***Dividends***

On 30 June 2001, the Company's shareholders approved dividends for the year ended 31 December 2000 totalling RR'mln 475 (RR'mln 400 in historical terms).

On 29 June 2002, the Company's shareholders approved dividends for the year ended 31 December 2001 totalling RR'mln 629 (RR'mln 600 in historical terms).

**10. GRANT AND ASSETS SUBJECT TO MINERAL LEASE AGREEMENT**

On 19 January 1993, the Company entered into a mineral lease agreement (“the agreement”) with the Republic of Sakha (Yakutia) for the “transfer of rights to use and exploit land, diamond deposits, main production and non-production facilities”. This agreement has a term of 25 years and provides the Company with the right to use certain production and non-production assets for exploring, mining and operating diamond deposits.

The agreement stipulates that the terms should be re-negotiated every five years. The agreement also stipulates that the Company is subject to royalties and other taxes on the right to use the land and logging areas, disposal and burial of waste and contaminated materials and the use of mineral resources and water for industrial purposes. The main subject of the renegotiations related to the amount and timing of royalty and other payments.

Royalty payments expensed during the nine months ended 30 September 2002 totalled RR'mln 6,173 (nine months ended 30 September 2001: RR'mln 7,648). Ecology fund payments expensed during the nine months ended 30 September 2002 totalled RR'mln 535 (nine months ended 30 September 2001: RR'mln 773).

Pursuant to an addendum to the mineral lease agreement dated 1 March 2002, the Company and the Republic of Sakha (Yakutia) agreed that the royalty payments including ecology fund payments and recoverable value-added tax due in 2002 are fixed at RR'mln 10,070, and the resource recovery tax due in 2002 is fixed at RR'mln 914.

Pursuant to an addendum to the mineral lease agreement dated December 2002, the Company and the Republic of Sakha (Yakutia) agreed that the royalty payments including ecology fund payments and recoverable value added tax due in 2003 are fixed at RR'mln 10,680, with the amount of royalty payable in 2004-2005 to be determined in a separate addendum to the agreement.



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Recoverable value added tax for the nine months ended 30 September 2002 totalling RR'mln 361 is calculated at 16.7 per cent. of royalty payments (excluding non-reimbursable portion) and depends on the percentage of domestic diamond sales to the total diamond sales of the Company.

Carrying values of Company owned and granted assets subject to the mineral lease agreement with the Republic of Sakha (Yakutia) and Grant are as follows:

	30 September 2002 (unaudited)	31 December 2001
<b>Assets subject to the agreement with the Republic of Sakha (Yakutia)</b>		
Net book value of granted assets received in 1993 . . . . .	11,467	12,275
Net book value of Company owned assets subsequently transferred to leased (see note 12) . . . . .	3,659	3,781
	<u>15,126</u>	<u>16,056</u>

The Group is required to return certain production assets to the Republic of Sakha (Yakutia) at the end of the mineral lease term. The precise mechanism for determining the value and nature of the assets to be returned to the Republic of Sakha (Yakutia) under the terms of the mineral lease agreement is currently being negotiated between the parties.

Management have estimated the restoration liability based upon their interpretation of the mineral lease agreement and, in accordance with IAS 37 "*Provisions, Contingent Liabilities and Contingent Assets*", have calculated and recorded the net present value of the restoration liability (see notes 3 (e) and 12).

### 11. LONG-TERM DEBT

	30 September 2002 (unaudited)	31 December 2001
<b>Banks:</b>		
US\$ denominated floating rate . . . . .	1,055	1,452
US\$ denominated fixed rate . . . . .	6,912	1,390
RR denominated fixed rate . . . . .	3,111	1,985
	<u>11,078</u>	<u>4,827</u>
Non-convertible bonds (see note 15) . . . . .	4,208	1,877
Commercial paper . . . . .	184	414
Other . . . . .	328	1,652
	<u>15,798</u>	<u>8,770</u>
Less: current portion of long-term debt (see note 15) . . . . .	<u>(5,414)</u>	<u>(1,432)</u>
	<u>10,384</u>	<u>7,338</u>

Long-term commercial paper has defined maturity dates ranging between one and ten years, and is carried at amortised cost.

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The effective interest rates at the balance sheet dates were as follows:

	<u>30 September 2002</u>	<u>31 December 2001</u>
	(unaudited)	
Banks:		
US\$ denominated floating rate . . . . .	1.9%	2.5%
US\$ denominated fixed rate . . . . .	11.2%	14.8%
RR denominated fixed rate . . . . .	18.9%	20.1%
Non-convertible bonds (see note 15) . . . . .	20%	23.3%
Commercial paper . . . . .	41.5%	36%
Other . . . . .	20%	16%

At 30 September 2002 long-term loans have the following maturity profile:

	<u>Within 1 year</u>	<u>1 to 2 years</u>	<u>2 to 3 years</u>	<u>3 to 4 years</u>	<u>4 years and thereafter</u>	<u>Total (unaudited)</u>
Banks:						
US dollar denominated						
floating rate . . . . .	523	532	—	—	—	1,055
US dollar denominated fixed						
rate . . . . .	3,502	3,410	—	—	—	6,912
Russian rouble denominated						
fixed rate . . . . .	231	—	2,350	—	530	3,111
	4,256	3,942	2,350	—	530	11,078
Non-convertible bonds . . . . .	1,158	1,925	1,125	—	—	4,208
Commercial paper . . . . .	—	112	31	35	6	184
Other . . . . .	—	131	58	—	139	328
	5,414	6,110	3,564	35	675	15,798

The Group has not entered into any derivative contracts in respect of its foreign currency obligations or interest rate exposure.

The carrying amounts and fair values of long-term debt are as follows:

	<u>30 September 2002</u>		<u>31 December 2001</u>	
	<u>Carrying amounts</u>	<u>Fair values</u>	<u>Carrying amounts</u>	<u>Fair values</u>
	(unaudited)	(unaudited)		
Banks . . . . .	11,078	11,114	4,827	4,775
Non-convertible bonds (see note 15) . . . . .	4,208	4,275	1,877	2,073
Commercial paper . . . . .	184	450	414	616
Other . . . . .	328	354	1,652	1,500

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Fair value of long-term debt is estimated by discounting the future contractual cash outflows at the market interest rate available at the balance sheet date.

As at 30 September 2002, long term-debt totalling RR'mln 5,784 (31 December 2001: RR'mln 1,683) included above was secured with the assets of the Company. As separate loan agreements do not specify individual pledged items of assets; the carrying amount of pledged assets is not disclosed.

**12. PROVISION FOR RESTORATION LIABILITY**

	Nine months ended 30 September 2002	Year ended 31 December 2001
	(unaudited)	
At 1 January . . . . .	2,923	3,397
Change in the estimate of provision for restoration liability . . . . .	(576)	(606)
Increase in the discounted amount during the period . . . . .	267	132
At the end of the period . . . . .	<u>2,614</u>	<u>2,923</u>

The provision for restoration liability represents the net present value of the estimated future obligation to restore the property, plant and equipment received from the Republic of Sakha (Yakutia) under the terms of the mineral lease agreement (see notes 3(e) and 10). The discount rate used to calculate the net present value of the restoration liability was 10.5 per cent. (31 December 2001: 12.1 per cent.), which was considered appropriate to the Group in the economic environment in the Russian Federation at the balance sheet date.

Under the mineral lease agreement the Company is obliged to reimburse to the Republic of Sakha (Yakutia) the amount of accumulated depreciation on property, plant and equipment subject to the mineral lease agreement (leased property, plant and equipment) and the Republic of Sakha (Yakutia) is obliged to reimburse to the Company the amount of qualified repair and maintenance expense incurred by the Company in relation to the leased property, plant and equipment. The Company and the Republic of Sakha (Yakutia) determined the amount to be reimbursed by the Company on a net basis as the difference between the amount of depreciation on leased assets and the amount of repair and maintenance expense in relation to the leased property, plant and equipment. Reimbursement is effected by transfer of title of the Company's own items of property, plant and equipment to the Republic of Sakha (Yakutia) and consequently these assets are treated as leased property, plant and equipment (see note 10).

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**13. TRADE AND OTHER PAYABLES**

	30 September 2002	31 December 2001
	(unaudited)	
Trade . . . . .	2,735	2,519
Accrual for flights and holidays . . . . .	1,667	1,541
Wages . . . . .	613	973
Employee benefit payable . . . . .	561	531
Advances from customers . . . . .	504	289
Interest payable . . . . .	366	343
Payables to related parties . . . . .	220	236
Other payables and accruals . . . . .	644	686
	<u>7,310</u>	<u>7,118</u>

In accordance with Russian legislation, the Group entities are required to pay for the holiday entitlement and the cost of travel for employees and their family members to an agreed-upon destination and back, or a pre-determined allowance.

**14. PROFIT AND OTHER TAX ASSETS AND LIABILITIES**

Taxes payable comprise the following:

	30 September 2002	31 December 2001
	(unaudited)	
Penalties . . . . .	1,536	430
Royalty payments to Republic of Sakha (Yakutia) . . . . .	782	1,767
Pension tax . . . . .	574	637
Property tax . . . . .	273	253
Value added tax . . . . .	236	465
Extraction tax . . . . .	202	538
Income tax (employee) . . . . .	152	85
Profit tax . . . . .	109	31
Road use tax . . . . .	56	152
Other taxes and accruals . . . . .	99	258
Taxes payable . . . . .	<u>4,019</u>	<u>4,616</u>

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Taxes other than profit tax included in the statement of income comprise the following:

	Nine months ended 30 September 2002	Nine months ended 30 September 2001
	(unaudited)	(unaudited)
Extraction tax . . . . .	3,402	4,625
Tax penalties . . . . .	1,259	190
Property tax . . . . .	658	643
Ecology fund . . . . .	535	773
Road use tax . . . . .	428	473
Other taxes and accruals . . . . .	68	79
Taxes other than profit tax . . . . .	<u>6,350</u>	<u>6,783</u>

In accordance with legislation effective 1 January 2002, non-recoverable resource tax and resource recovery tax were replaced with an extraction tax, which amounted to 8 per cent. of value of extracted diamonds.

As result of a tax dispute, at 30 September 2002, the Company recorded liability for tax penalties totalling RR'mln 1,195, relating to 1999, 2000 and 2001.

In accordance with Resolution No. 1364 of the Government of the Russian Federation dated 9 December 1999, the Company is obliged to pay 6.5 per cent. on the value of diamonds sold for export in the form of an export duty in addition to the taxes noted above (note 16).

During 2001, the Company accrued profit tax at the rate of 35 per cent. According to legislation which became substantively enacted in the year ended 31 December 2001, profit tax payable by companies in the Russian Federation with effect from 1 January 2002 ranges from 20 per cent. to 24 per cent., depending on the decision each year of regional and local tax authorities, which can agree jointly on a supplementary amount of up to 4 per cent. above that set by the federal tax authorities. The rate used to compute the deferred tax assets and liabilities of the Group at 30 September 2002 and 2001 was 24 per cent., which reflects the fact that, based on their decisions in respect of tax rates for 2001, substantially all regional and local tax authorities in the regions in which the Group operates assessed the maximum supplementary amount in respect of the year 2002.

Profit tax expense comprises the following:

	Nine months ended 30 September 2002	Nine months ended 30 September 2001
	(unaudited)	(unaudited)
Current tax expense . . . . .	1,887	3,396
Deferred tax expense (benefit)—movement in temporary differences . . . . .	1,157	(1,448)
Effect of decrease in tax rate . . . . .	—	(975)
Profit tax . . . . .	<u>3,044</u>	<u>973</u>

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Net profit before taxation for financial statement reporting purposes is reconciled to tax expense as follows:

	Nine months ended 30 September 2002	Nine months ended 30 September 2001
	(unaudited)	(unaudited)
Profit before profit tax . . . . .	5,634	9,089
Theoretical tax charge at statutory rate of 24 per cent. (nine months ended 30 September 2001: 35 per cent.) thereon . . . . .	1,352	3,181
Profit tax concessions . . . . .	—	(2,564)
Income not assessable for profit tax purposes . . . . .	(213)	(429)
Expenses and losses not deductible for profit tax purposes . . . . .	611	2,285
Tax penalties and interest . . . . .	302	67
Non-temporary elements of monetary gain . . . . .	1,224	1,976
Inflation effect on deferred tax balance at the beginning of the year . . . . .	(232)	(562)
Statutory revaluation of property, plant and equipment . . . . .	—	(2,006)
Effect of increase (decrease) in tax rate on net deferred tax liability . . . . .	—	(975)
Profit tax . . . . .	3,044	973

The non-temporary impact of monetary gains and losses reflects the effect on the theoretical tax charge of inflation with respect to non-monetary items of a non-temporary nature (primarily equity and net deferred tax liability).

Differences between IAS and Russian statutory tax regulations give rise to certain temporary differences between the carrying value of certain assets and liabilities for financial reporting purposes and

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for profits tax purposes. The tax effect of the movement on these temporary differences is recorded at the rate of 24 per cent. (2001: 35 per cent.).

	<u>30 September 2002</u>	<u>Movement in temporary differences</u>	<u>31 December 2001</u>
	(unaudited)		
<b>Deferred tax liabilities</b>			
Property, plant and equipment . . . . .	4,220	1,354	2,866
Inventories . . . . .	115	(75)	190
Long-term investments . . . . .	177	55	122
Receivables . . . . .	216	10	206
Commercial papers . . . . .	—	(30)	30
<b>Deferred tax assets</b>			
Provision for employee benefits . . . . .	(479)	91	(570)
Research and development costs written-off . . . . .	(177)	(177)	—
Impairment of accounts receivable . . . . .	(315)	(315)	—
Write down of inventories . . . . .	(126)	225	(351)
Other deductible temporary differences . . . . .	(17)	19	(36)
Net deferred tax liability . . . . .	<u>3,614</u>	<u>1,157</u>	<u>2,457</u>

**15. SHORT-TERM LOANS AND CURRENT PORTION OF LONG-TERM DEBT**

	<u>30 September 2002</u>	<u>31 December 2001</u>
	(unaudited)	
Banks:		
US\$ denominated floating rate . . . . .	—	665
US\$ denominated fixed rate . . . . .	13,932	9,010
RR denominated fixed rate . . . . .	2,190	671
	<u>16,122</u>	<u>10,346</u>
Non-convertible bonds . . . . .	—	552
Commercial paper . . . . .	2,652	4,704
Other US\$ denominated fixed rate loans . . . . .	611	716
Other . . . . .	784	756
	<u>20,169</u>	<u>17,074</u>
Add: current portion of long-term debt (see note 11) . . . . .	5,414	1,432
	<u>25,583</u>	<u>18,506</u>



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The effective interest rates at the balance sheet dates were as follows:

	30 September 2002 (unaudited)	31 December 2001
Banks:		
US\$ denominated floating rate . . . . .	—	10.9%
US\$ denominated fixed rate . . . . .	10.3%	13.4%
RR denominated fixed rate . . . . .	18.2%	23.5%
Non-convertible bonds . . . . .	—	24.6%
Commercial paper . . . . .	34.1%	38.0%
Other US\$ denominated fixed rate loans . . . . .	10.9%	9.1%
Other . . . . .	nil	nil

Exchange rate for US dollar (US\$) effective at 30 September 2002 was RR 31.64 to US\$ 1.

As at 30 September 2002, short-term loans included above totalling RR'mln 11,977 were secured with the assets of the Company and RR'mln 3,559 were secured by diamond sales of the Company (31 December 2001: RR'mln 7,186 (assets) and RR'mln 807 (diamond sales)). As separate loan agreements do not specify individual pledged items of assets, the carrying amount of pledged assets is not disclosed.

**Commercial paper**

Commercial paper comprises unsecured notes, denominated in Russian roubles, issued by the Company to provide short- and medium-term working capital facilities. The short-term commercial paper is typically non-interest bearing, with defined maturity dates ranging from 1 month to 1 year, and is carried at amortized cost.

**Domestic non-convertible bonds**

	Long-term	Short-term	Total
Balance at 31 December 2001 . . . . .	1,877	552	2,429
Issuance (par value RR 1 thousand totalling RR'mln 2,550) . .	2,635	—	2,635
Repayment (par value 1 thousand totalling RR'mln 542) . . . .	(43)	(517)	(560)
Monetary effect . . . . .	(261)	(35)	(296)
Balance at 30 September 2002 (unaudited) . . . . .	4,208	—	4,208

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**16. SALES**

	<b>Nine months ended 30 September 2002</b>	<b>Nine months ended 30 September 2001</b>
	<b>(unaudited)</b>	
Revenue from diamond sales		
Export (predominantly one customer) . . . . .	18,840	24,355
Republic of Sakha (Yakutia) . . . . .	5,994	4,524
Other, domestic . . . . .	12,942	14,718
	<u>37,776</u>	<u>43,597</u>
Other revenue		
Transport . . . . .	1,169	1,238
Construction . . . . .	1,131	737
Trading . . . . .	895	740
Social infrastructure . . . . .	412	529
Exploration . . . . .	15	268
Other . . . . .	647	585
	<u>42,045</u>	<u>47,694</u>

Export duties totalling RR'mln 1,103 for nine months ended 30 September 2002 (nine months ended 30 September 2001: RR'mln 1,427) were netted against revenues from export of diamonds.

	<b>Nine months ended 30 September 2002</b>	<b>Nine months ended 30 September 2001</b>
	<b>(unaudited) US\$m</b>	
Hard currency revenue from export diamond sales including export duties (predominantly one customer) . . . . .	616	737
US dollar denominated domestic diamond sales settled in Russian roubles . .	591	550
	<u>1,207</u>	<u>1,287</u>

Pursuant to a trade agreement with De Beers, dated 3 November 1998 and covering the period from 1 January 2000 to 31 December 2001, the Company agreed to sell and De Beers agreed to buy a minimum of US\$m 550 (including the sales of diamonds on behalf of the Committee for Precious Metals and Stones under agency agreements concluded between the Company and the Committee) in value of the Company's annual diamond production at the current market prices.

During the nine months period ended 30 September 2002 sales to De Beers occurred on the basis of separate agreements for each individual shipment of diamonds. Contingencies related to the trade agreement with De Beers, covering the period from 1 January 2002 to 31 December 2006 are disclosed in note 24 (i).

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Pursuant to existing federal legislation, the Government of the Russian Federation issues, on an annual basis, a quota for export of rough diamonds. The quota stipulates the maximum amount of diamonds that may be exported in a given year. The amount provided in any quota constitutes a State secret.

### 17. COST OF SALES

	Nine months ended 30 September 2002	Nine months ended 30 September 2001
	(unaudited)	
Wages, salaries and other staff costs . . . . .	6,497	7,064
Depreciation . . . . .	3,719	3,721
Materials . . . . .	3,530	3,719
Fuel and energy . . . . .	2,946	3,228
Transport . . . . .	845	883
Services . . . . .	529	350
Other . . . . .	550	330
Write down (reverse) of inventory . . . . .	388	(301)
Movement in inventories . . . . .	55	(687)
	<u>19,059</u>	<u>18,307</u>

Depreciation totalling RR'mln 233 (nine months ended 30 September 2001: RR'mln 195) and staff costs totalling RR'mln 1,434 (nine months ended 30 September 2001: RR'mln 999) were incurred by the Company's construction division and included in capital costs for the year.

### 18. GENERAL AND ADMINISTRATIVE EXPENSES

	Nine months ended 30 September 2002	Nine months ended 30 September 2001
	(unaudited)	
Administrative expense . . . . .	1,226	1,122
Bad debt expense . . . . .	591	656
	<u>1,817</u>	<u>1,778</u>

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**19. OTHER OPERATING INCOME**

	<b>Nine months ended 30 September 2002</b>	<b>Nine months ended 30 September 2001</b>
	<u>(unaudited)</u>	
Amortisation of Grant (note 10) . . . . .	808	809
Other . . . . .	260	296
	<u>1,068</u>	<u>1,105</u>

**20. OTHER OPERATING EXPENSES**

	<b>Nine months ended 30 September 2002</b>	<b>Nine months ended 30 September 2001</b>
	<u>(unaudited)</u>	
Royalty (note 10) . . . . .	6,173	7,648
Taxes other than profit tax (note 14) . . . . .	6,350	6,783
Social costs . . . . .	988	1,091
Selling and marketing expenses . . . . .	860	836
Research and development expenses . . . . .	844	536
Loss on disposal of property, plant and equipment . . . . .	413	—
Loss from flooding in Lensk . . . . .	—	2,105
Other . . . . .	399	176
	<u>16,027</u>	<u>19,175</u>

**Loss from flooding in Lensk**

In May 2001, certain of the Group’s commodities in warehouse facilities, together with certain other Group’s assets, were damaged or destroyed by severe flooding in the town of Lensk, located within the Republic of Sakha (Yakutia). The expenses related to damaged inventories, compensating the flood victims for their property and repairing damaged assets are disclosed as other operating expense. Loss from flooding in Lensk includes loss on disposed assets in an amount totalling RR’mln 296.

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**Social costs**

	<b>Nine months ended 30 September 2002</b>	<b>Nine months ended 30 September 2001</b>
	<b>(unaudited)</b>	
Maintenance of local infrastructure .....	539	613
Charity .....	140	181
Hospital expenses .....	102	110
Education .....	55	55
Other .....	152	132
	<u>988</u>	<u>1,091</u>

**21. FINANCE COSTS, NET**

	<b>Nine months ended 30 September 2002</b>	<b>Nine months ended 30 September 2001</b>
	<b>(unaudited)</b>	
Interest expense:		
Bank loans .....	1,322	1,318
Commercial paper .....	916	1,874
Bonds .....	496	253
Provision for restoration liability .....	267	98
Other .....	245	292
	<u>3,246</u>	<u>3,835</u>
Interest income .....	(232)	(164)
Fair value (gains) losses on available for sale investments .....	(40)	(301)
Other finance income .....	(39)	—
	<u>2,935</u>	<u>3,370</u>

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### 22. CASH GENERATED FROM OPERATIONS

Reconciliation of profit before tax to cash generated from operations:

	Nine months ended 30 September 2002	Nine months ended 30 September 2001
	(unaudited)	
Profit before profit tax	5,634	9,089
Adjustments for:		
Interest income (note 21)	(232)	(164)
Income from associates	(269)	(238)
Interest expense (note 21)	3,246	3,835
Fair value (gains) losses on available for sale investments (note 21)	(40)	(301)
Other finance income (note 21)	(39)	—
Adjustments for non-cash investing activity (note 26)	(1,865)	(4,764)
Adjustments for non-cash financing activity (note 26)	2,538	1,820
Depreciation (note 17)	3,719	3,721
Amortisation of Grant (note 19)	(808)	(809)
Disposal of assets (note 20)	413	296
Monetary effect on non-operating balances	(1,947)	(2,230)
Net operating cash flow before changes in working capital	10,350	10,255
Net increase in inventories	(787)	(2,919)
Net increase in trade and other receivables, excluding dividends receivable and prepayment for own commercial paper redemption adjusted for the effect of applying IAS 39 on trade and other receivables (notes 3 (a), 4 and 8)	(1,260)	(2,920)
Net increase in trade and other payables, excluding interest payable	169	1,726
Net (decrease) increase in taxes payable other than profit tax	(675)	853
Net decrease in deferred royalty payable	—	(1,670)
<b>Cash generated from operations</b>	<b>7,797</b>	<b>5,325</b>
Profit tax paid	(1,828)	(3,010)
<b>Net cash flows from operating activities</b>	<b>5,969</b>	<b>2,315</b>

### 23. FINANCIAL RISKS MANAGEMENT

#### (a) Credit risk

Financial assets, which potentially subject Group entities to credit risk, consist principally of trade receivables. The Group has policies in place to ensure that sales of products and services are made to customers with an appropriate credit history. The carrying amount of accounts receivable represents the maximum amount exposed to credit risk. The Group has no other significant concentrations of credit risk.

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Although collection of receivables could be influenced by economic factors, management believes that there is no significant risk of loss to the Group beyond the provision already recorded.

Cash is placed in financial institutions, which are considered at time of deposit to have minimal risk of default.

**(b) Foreign exchange risk**

The Group exports production to European countries and the United States of America and attracts substantial amount of foreign currency denominated long-term borrowings and is thus exposed to foreign exchange risk. Foreign currency denominated liabilities (see notes 11 and 15) give rise to foreign exchange exposure.

The Group does not have formal arrangements to mitigate foreign exchange risks of the Group's operations.

**(c) Interest rate risk**

The Group's income and operating cash flows are substantially independent of changes in market interest rates. The Group is exposed to interest rate risk through market value fluctuations of interest-bearing long-term borrowings. The majority of interest rates on long-term borrowings are fixed, which are disclosed in notes 11 and 15. The Group has no significant interest-bearing assets.

**(d) Liquidity risk**

Prudent liquidity risk management implies maintaining sufficient cash and marketable securities, the availability of funding through an adequate amount of committed credit facilities and the ability to close out market positions. Due to the dynamic nature of the underlying businesses, the Group aims to maintain flexibility in its funding requirements by keeping committed credit lines available.

**(e) Fair value estimation**

The fair value of publicly traded trading and available-for-sale securities is based on quoted market prices at the balance sheet date.

The carrying amounts of financial assets and liabilities with maturity of less than one year are assumed to approximate their fair values.

**24. CONTINGENCIES, COMMITMENTS AND OTHER RISKS**

**(a) Operating environment**

Whilst there have been improvements in the economic situation in the Russian Federation in recent years, the country continues to display some characteristics of an emerging market. These characteristics include, but are not limited to, the existence of a currency that is not freely convertible in most countries outside of the Russian Federation, restrictive currency controls, and relatively high inflation.



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The prospects for future economic stability in the Russian Federation are largely dependent upon the effectiveness of economic measures undertaken by the government, together with legal, regulatory and political developments.

**(b) Taxes**

Russian tax legislation is subject to varying interpretations and changes occurring frequently. Further, the interpretation of tax legislation by tax authorities as applied to the transactions and activities of the Company and the Group's entities may not coincide with that of management. As a result, transactions may be challenged by tax authorities and the Company's group entities may be assessed additional taxes, penalties and interest, which can be significant. The periods remain open to review by the tax and customs authorities with respect to tax liabilities for three years.

Tax penalties that were assessed on the Company relating to a tax dispute were not recognised in the financial statements. The Company will be liable to pay penalties in an amount totalling RR'mln 358 if the tax authorities file a law suit against the Company and if the court makes a decision in favour of the authorities. Furthermore, if the Company is not successful in either the administrative appeal or in any court claim, then the Company will be potentially liable to pay additional penalties totalling RR'mln 299.

**(c) Legal proceedings**

The Group is a party to certain legal proceedings arising in the ordinary course of business. In the opinion of management, there are no current legal proceedings or other claims outstanding which could have a material adverse effect on the results of operations or financial position of the Group as at 30 September 2002.

In addition to litigation arising in the ordinary course of business, the Company is involved in a civil claim relating to the technologies used at the Nyurba mines. Bateman Projects Limited, a South African company, and its Dutch subsidiary, Bateman International B.V. (collectively, “Bateman”), the outside construction firms involved in the development of the Nyurba processing plant, have filed an arbitration claim against the Company which alleges that technology used in the Nyurba plant infringes Bateman's intellectual property rights. The claim seeks damages of approximately U.S.\$43 million and requests that a Stockholm-based arbitration panel issue an order to prevent the Company from performing further work on the construction of the Nyurba diamond processing plant. The Company intends to vigorously defend this action and management believes the resolution of this claim will not have a material adverse effect on the results of operations or the financial position of the Group.

**(d) Insurance**

The Group is assessing its policies for insuring assets and operations. At present, apart from the full insurance of movements of diamond inventory from the production location to the customers, very few assets and operations of the Group are insured and, in the instances where assets are insured, the amounts generally are not sufficient to cover all costs associated with replacing the assets.

**AK “ALROSA”**

**NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS FOR THE  
NINE MONTHS ENDED 30 SEPTEMBER 2002 (Continued)  
(UNAUDITED)**

**(in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at  
30 September 2002, unless otherwise stated)**

**(e) Social obligations**

The Group makes contributions to mandatory and voluntary local social programmes. The Group's local infrastructure assets as well as local social programmes benefit the local communities at large and are not normally restricted to the Group's employees. The Group is negotiating the transfer of certain social assets to the local authorities; however, the Group expects to continue funding these social programmes for the foreseeable future.

**(f) Capital commitments**

At 30 September 2002, the Group has contractual commitments for capital expenditures of approximately RR'mln 1,873 (31 December 2001: RR'mln 2,447).

**(g) Restoration, rehabilitation and environmental costs**

Under its license agreements, the Group is not responsible for any significant restoration, rehabilitation and environmental expenditures that may be incurred subsequent to the cessation of production at each mine, apart from the obligation to return assets received under the mineral lease agreement (see note 10). However, the Group is obliged to restore riverbeds and the surrounding areas. These expenses are not expected to be material to the Group and are expensed in the period incurred.

**(h) Guarantees**

As at 30 September 2002, the Group has guaranteed a US dollar denominated loan issued by Rosbank to OOO “Interrosleasing” totalling RR'mln 226.

**(i) Trade agreement with De Beers**

On 17 December 2001, a trade agreement between the Company and De Beers was signed, covering the period from 1 January 2002 to 31 December 2006. Pursuant to this agreement, the Company agreed to sell and De Beers agreed to buy up to US\$m 800 in value of the Company's annual diamond production at the current market prices. To be legally enforceable, this agreement requires the regulatory permission of the European Commission. Currently, the Company is in the process of negotiating objections raised by the European Commission. Management is unable to estimate the outcome of these negotiations.

In addition, the European Commission could seek to impose fines of up to 10 per cent. of the Company's sales in respect of the Company's previous trade agreements with De Beers, which were not notified to the European Commission.

**25. RELATED PARTY TRANSACTIONS**

The Company's principal shareholders are the Russian Federation and the Republic of Sakha (Yakutia).

IAS 24 “*Related Party Disclosures*” specifically excludes government departments and agencies in the course of their normal dealings with enterprise and government-controlled entities from the definition of

**AK “ALROSA”**  
**NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS FOR THE**  
**NINE MONTHS ENDED 30 SEPTEMBER 2002 (Continued)**  
**(UNAUDITED)**

(in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at  
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related parties, and therefore transactions under those exemptions between, and balances due to or from, entities under government or other state control and government departments and agencies in the course of their normal dealings and the Group's companies are not detailed in this note.

Information related to the mineral lease agreement with the Republic of Sakha (Yakutia) are disclosed in notes 10 and 12.

Remunerations to the members of Board of Directors and management of the Company incurred during the nine months period ended 30 September 2002 totalled RR'mln 48 (nine months ended 30 September 2001: RR'mln 49).

Significant related party transactions are summarised as follows:

	30 September 2002 (unaudited)	31 December 2001
<b>Long-term accounts receivable</b>		
OAo “Sobinbank” and its affiliates, receivable secured by the loan payable .	982	1,109
Less: provision for bad debt . . . . .	(163)	(180)
	<u>819</u>	<u>929</u>
<b>Current accounts receivable</b>		
OAo “Sobinbank” and its affiliates, receivable secured by the loan payable .	850	516
OAo “Tuymaada—Diamond” . . . . .	369	615
ZAO PIC “Orel-Almaz” . . . . .	109	170
Catoka Mining Ltd., an equity-accounted associate (see note 4) . . . . .	—	204
Other . . . . .	224	313
	<u>1,552</u>	<u>1,818</u>

Loans provided by related parties:

Name of bank	Interest Rate	30 September 2002 (unaudited)	31 December 2001
<i>US dollar denominated</i>			
OAo “Sobinbank” . . . . .	12 per cent.	632	812
Committee for Precious Metals and Stones (Komdragmet) of Republic of Sakha (Yakutia) . . . . .	10 per cent.	347	632
<i>Russian rouble denominated</i>			
OAo “Sobinbank” . . . . .	15–25 per cent.	1,579	1,936
		<u>2,558</u>	<u>3,380</u>

**AK "ALROSA"**

**NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS FOR THE  
NINE MONTHS ENDED 30 SEPTEMBER 2002 (Continued)  
(UNAUDITED)**

(in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at  
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**26. SIGNIFICANT NON-CASH TRANSACTIONS**

	Nine months ended 30 September 2002	Nine months ended 30 September 2001
	(unaudited)	
<b>Non-cash investing activities:</b>		
Inventory used in construction . . . . .	(1,486)	(1,323)
Non-cash settlements for property, plant and equipment acquisition . . . . .	(1,154)	(3,441)
Other . . . . .	775	—
	<u>(1,865)</u>	<u>(4,764)</u>
<b>Non-cash financing activities:</b>		
Non-cash commercial paper issuance . . . . .	4,028	4,998
Non-cash debt redemption . . . . .	(1,490)	(3,178)
	<u>2,538</u>	<u>1,820</u>

**27. SEGMENT INFORMATION**

The Group's primary format for reporting segment information is business segments. The Group has one reportable business segment, which is the production and sale of diamonds. The Group evaluates performance and makes investment and strategic decisions based upon review of profitability for the Group as a whole. The performance measurement systems employed by the Group to review overall profitability are based on the results of the Group determined using Russian statutory accounting books and records. Russian statutory accounting differs in many significant respects from IAS.

An analysis of revenue by type is disclosed in note 16. Revenue from sales by geographical location of the customer, and assets and capital expenditures by geographical location of the asset are as follows:

	Sales		Total assets		Capital expenditures	
	Nine months ended 30 September 2002	Nine months ended 30 September 2001	Balance as at 30 September 2002	Balance as at 31 December 2001	Nine months ended 30 September 2002	Nine months ended 30 September 2001
	(unaudited)	(unaudited)	(unaudited)		(unaudited)	(unaudited)
Russian Federation . .	23,205	23,339	119,977	106,996	13,451	12,512
Western Europe . . . .	15,267	19,859	24	1,019	—	—
Other countries . . . .	3,573	4,496	270	321	—	—
	<u>42,045</u>	<u>47,694</u>	<u>120,271</u>	<u>108,336</u>	<u>13,451</u>	<u>12,512</u>
Associates . . . . .			588	469		
Unallocated assets . .			<u>743</u>	<u>724</u>		
Total assets . . . . .			<u>121,602</u>	<u>109,529</u>		

Sales to De Beers are included in the geographical segment Western Europe.

The Company has one individual customer that accounts for greater than 10 per cent. of its revenue during the nine months ended 30 September 2002 (nine months 2001: 1 customer).

**Consolidated Financial Statements  
for the years ended  
31 December 2001, 2000 and 1999**

**ZAO PricewaterhouseCoopers Audit**  
Kosmodamianskaya Nab. 52, Bld. 5  
115054 Moscow  
Russia  
Telephone +7 (095) 967 6000  
Facsimile +7 (095) 967 6001

**AUDITORS' REPORT**  
**to the Shareholders and Board of Directors of**  
**Closed Joint Stock Company AK "ALROSA"**

1. We have audited the accompanying consolidated balance sheet of Closed Joint Stock Company AK "ALROSA" (the "Company") and its subsidiaries (the "Group") as at 31 December 2001, 2000 and 1999, and the related consolidated statements of income, of cash flows and of changes in shareholders' equity for the year then ended. These consolidated financial statements are the responsibility of the Group's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.
2. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.
3. In our opinion, the accompanying consolidated financial statements present fairly, in all material respects, the financial position of the Group as at 31 December 2001 and the results of its operations and its cash flows for the year then ended, in accordance with International Accounting Standards.
4. Without qualifying our opinion, we draw your attention to Note 28 to the consolidated financial statements. The consolidated financial statements as of 31 December 2001, 2000 and 1999, as previously issued, have been restated for changes in the general purchasing power of the Russian Rouble in accordance with International Accounting Standard 29 "Financial Reporting in Hyperinflationary Economies" with all amounts stated in terms of the measuring unit current as of 30 September 2002.

Moscow, Russian Federation  
10 June 2002, except for note 28, as to which the date is 20 February 2003

The firm is an authorised licensee of the tradename and logo of PricewaterhouseCoopers.

**AK “ALROSA”**

**CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001,  
31 DECEMBER 2000 AND 31 DECEMBER 1999**

(in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at  
30 September 2002, unless otherwise stated)

**CONSOLIDATED BALANCE SHEET**

	<u>Notes</u>	<u>31 December 2001</u>	<u>31 December 2000</u>	<u>31 December 1999</u>
<b>Assets</b>				
<b>Non-current Assets</b>				
Restricted cash . . . . .	5	378	349	331
Equity accounted investments . . . . .	4	469	1,623	627
Available for sale investments . . . . .	4	2,301	2,272	3,268
Long-term accounts receivable . . . . .	8	1,797	534	374
Property, plant and equipment . . . . .	6	80,636	67,712	58,126
<b>Total Non-current Assets . . . . .</b>		<b>85,581</b>	<b>72,490</b>	<b>62,726</b>
<b>Current Assets</b>				
Inventories . . . . .	7	13,027	11,735	7,431
Trade and other receivables . . . . .	8	8,545	13,081	9,346
Prepaid profit tax . . . . .		724	700	—
Cash and cash equivalents . . . . .	5	1,652	1,246	735
<b>Total Current Assets . . . . .</b>		<b>23,948</b>	<b>26,762</b>	<b>17,512</b>
<b>Total Assets . . . . .</b>		<b>109,529</b>	<b>99,252</b>	<b>80,238</b>
<b>Shareholders' Equity</b>				
Share capital . . . . .	9	11,022	11,022	10,933
Retained earnings . . . . .		40,577	30,162	18,285
<b>Total Shareholders' Equity . . . . .</b>		<b>51,599</b>	<b>41,184</b>	<b>29,218</b>
<b>Grant . . . . .</b>	10	<b>12,275</b>	<b>13,371</b>	<b>15,045</b>
<b>Minority Interest . . . . .</b>		<b>2,458</b>	<b>2,542</b>	<b>—</b>

The accompanying notes form an integral part of these consolidated financial statements.



**AK “ALROSA”**

**CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001,  
31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued)**

(in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at  
30 September 2002, unless otherwise stated)

	<u>Notes</u>	<u>31 December 2001</u>	<u>31 December 2000</u>	<u>31 December 1999</u>
<b>Liabilities</b>				
<b>Long-term liabilities</b>				
Long-term debt . . . . .	11	7,338	3,628	2,576
Provision for restoration liability . . . . .	12	2,923	3,397	6,854
Deferred tax liabilities . . . . .	14	2,457	4,554	2,767
Deferred royalties payable . . . . .	10	—	—	2,372
<b>Total Long-term Liabilities . . . . .</b>		<b><u>12,718</u></b>	<b><u>11,579</u></b>	<b><u>14,569</u></b>
<b>Current Liabilities</b>				
Short-term loans and current portion of long-term debt . . . . .	15	18,506	17,832	9,910
Trade and other payables . . . . .	13	7,118	6,626	4,979
Taxes payable . . . . .	14	4,616	4,396	5,033
Dividends payable . . . . .	10	239	51	491
Deferred royalties payable . . . . .		—	1,671	993
<b>Total Current Liabilities . . . . .</b>		<b><u>30,479</u></b>	<b><u>30,576</u></b>	<b><u>21,406</u></b>
<b>Total Liabilities . . . . .</b>		<b><u>43,197</u></b>	<b><u>42,155</u></b>	<b><u>35,975</u></b>
<b>Total Shareholders' Equity, Grant, Minority interest and Liabilities . . . . .</b>		<b><u>109,529</u></b>	<b><u>99,252</u></b>	<b><u>80,238</u></b>

Signed by the following members of management:

Vladimir T. Kalitin  
President, Chairman of the Board

Olga A. Lyashenko  
Chief Accountant

10 June 2002

The accompanying notes form an integral part of these consolidated financial statements.

**AK “ALROSA”**

**CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001,  
31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued)**

(in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at  
30 September 2002, unless otherwise stated)

**CONSOLIDATED STATEMENT OF INCOME**

	<u>Notes</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>
Sales . . . . .	16	64,309	68,729	67,318
Cost of sales . . . . .	17	(24,647)	(23,471)	(17,205)
<b>Gross profit . . . . .</b>		<b>39,662</b>	<b>45,258</b>	<b>50,113</b>
General and administrative expenses . . . . .	18	(2,416)	(1,071)	(510)
Other operating income . . . . .	19	1,415	1,867	2,066
Other operating expenses . . . . .	20	(25,144)	(26,711)	(27,663)
<b>Operating Profit . . . . .</b>		<b>13,517</b>	<b>19,343</b>	<b>24,006</b>
Finance costs, net . . . . .	21	(4,090)	(2,270)	(1,720)
Income from associates . . . . .	4	277	257	235
Monetary gain . . . . .		3,637	1,880	5,741
Foreign currency losses . . . . .		(822)	(117)	(3,137)
<b>Profit before Profit Tax . . . . .</b>		<b>12,519</b>	<b>19,093</b>	<b>25,125</b>
Profit tax . . . . .	14	(1,732)	(7,757)	(6,715)
<b>Profit after Profit tax . . . . .</b>		<b>10,787</b>	<b>11,336</b>	<b>18,410</b>
Minority interest . . . . .		(280)	627	—
<b>Net profit for the period . . . . .</b>		<b>10,507</b>	<b>11,963</b>	<b>18,410</b>
<b>Dividend per share . . . . .</b>		<b>RR 2,375</b>	<b>—</b>	<b>RR 2,369</b>

The accompanying notes form an integral part of these consolidated financial statements.

**AK "ALROSA"**

**CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001,  
31 DECEMBER 2000 AND 31 DECEMBER 1999**

(in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at  
30 September 2002, unless otherwise stated)

**CONSOLIDATED STATEMENT OF CASH FLOWS**

	<u>Notes</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>
<b>Net Cash Inflow from Operating Activities . . . . .</b>	<b>22</b>	<b>10,090</b>	<b>9,855</b>	<b>9,409</b>
<b>Cash Flows from Investing Activities</b>				
Purchase of property, plant and equipment . . . . .		(11,702)	(9,156)	(4,099)
Acquisition of investments . . . . .		(22)	(1,200)	(435)
Proceeds from sale of investments . . . . .		415	—	—
Interest received . . . . .		109	358	170
Dividends received from associate . . . . .		294	191	—
<b>Net Cash Outflow from Investing Activities . . . . .</b>		<b>(10,906)</b>	<b>(9,807)</b>	<b>(4,364)</b>
<b>Cash Flows From Financing Activities</b>				
Repayment of loans . . . . .		(33,774)	(32,649)	(28,935)
Loans received . . . . .		39,243	35,123	24,716
Interest paid . . . . .		(3,710)	(1,561)	(1,864)
Payment to restricted cash account . . . . .		(29)	63	(66)
Sale of treasury shares . . . . .		—	3	—
Dividends paid . . . . .		(255)	(393)	(89)
<b>Net Cash Inflow from Financing Activities . . . . .</b>		<b>1,475</b>	<b>586</b>	<b>(6,238)</b>
Effects of inflation on cash and cash equivalents . . . . .		(253)	(123)	(430)
<b>Net Increase in Cash and Cash Equivalents . . . . .</b>		<b>406</b>	<b>511</b>	<b>(1,623)</b>
Cash and cash equivalents at the beginning of the period . . . . .		1,246	735	2,358
<b>Cash and cash equivalents at the end of the period . . .</b>		<b>1,652</b>	<b>1,246</b>	<b>735</b>

Significant non-cash transactions are discussed in note 26.

The accompanying notes form an integral part of these consolidated financial statements.

**AK “ALROSA”**

**CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001,  
31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued)**

(in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at  
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**CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY**

	<u>Share capital</u>	<u>Retained Earnings</u>	<u>Total</u>
Balance at 1 January 1999 . . . . .	10,933	345	11,278
Dividends (note 9) . . . . .	—	(470)	(470)
Net profit for 1999 . . . . .	—	18,410	18,410
<b>Balance at 31 December 1999 . . . . .</b>	<b><u>10,933</u></b>	<b><u>18,285</u></b>	<b><u>29,218</u></b>
Balance at 1 January 2000 . . . . .	10,933	18,285	29,218
Sale of treasury shares . . . . .	89	(86)	3
Net profit for 2000 . . . . .	—	11,963	11,963
<b>Balance at 31 December 2000 . . . . .</b>	<b><u>11,022</u></b>	<b><u>30,162</u></b>	<b><u>41,184</u></b>
Balance at 1 January 2001 as previously reported . . . . .	11,022	30,162	41,184
Effect of adopting IAS 39, net of profit tax (note 3(a)) . . . . .	—	383	383
Balance at 1 January 2001 as restated . . . . .	11,022	30,545	41,567
Dividends (note 9) . . . . .	—	(475)	(475)
Net profit for 2001 . . . . .	—	10,507	10,507
<b>Balance at 31 December 2001 . . . . .</b>	<b><u>11,022</u></b>	<b><u>40,577</u></b>	<b><u>51,599</u></b>

The accompanying notes form an integral part of these consolidated financial statements.

## **AK “ALROSA”**

### **NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001, 31 DECEMBER 2000 AND 31 DECEMBER 1999**

**(in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at  
30 September 2002, unless otherwise stated)**

#### **1. ACTIVITIES**

The core activities of Closed Joint Stock Company AK “ALROSA” (“the Company”) and its subsidiaries and associates (“the Group”) are the exploration and extraction of diamond reserves and the marketing and distribution of raw and cut diamonds. The Company was registered on 13 August 1992 as a closed joint-stock company in the Republic of Sakha (Yakutia), which is located within the Russian Federation. The Group operates mining facilities in Mirny, Udachny, Aikhal, Nurba and Anabar (located in Eastern Siberia) and had 47,680 employees as at 31 December 2001 (31 December 2000: 45,666; 31 December 1999: 37,059). The Company is subject to special legislation issued by the Russian Federation and the Republic of Sakha (Yakutia) which significantly influences the Company’s core operating activities. This legislation includes but is not limited to the Law on State Secrets of the Russian Federation (note 2), and requirements to obtain annual quotas for export of diamonds from the government of the Russian Federation (note 16).

#### **2. RESERVES**

The Company’s diamond reserves and related production information are considered State secrets of the Russian Federation and cannot be disclosed to third parties. Management has considered such reserve and production information when assessing the recoverability and amortisation of production asset costs.

Management’s assessments with respect to reserve estimates have been confirmed by representatives of the State committee on Natural Resources Reserves of the Ministry of Natural Resources of the Russian Federation.

#### **3. ACCOUNTING POLICIES**

##### **(a) Basis of presentation**

Group companies incorporated in Russia maintain their statutory accounting records and prepare statutory financial reports in accordance with the Regulations on Accounting and Reporting of the Russian Federation (“RAR”) and their measurement currency is the Russian rouble (“RR”). Group companies incorporated in other countries maintain their statutory accounting records in accordance with relevant legislation and in the appropriate measurement currency. The accompanying consolidated financial statements have been prepared under the historical cost convention as modified by the revaluation of available-for-sale investment securities and financial assets held-for-trading. The consolidated financial statements are based on the statutory accounting records, with adjustments and reclassifications for the purpose of presentation in accordance with International Accounting Standards (“IAS”) issued by the International Accounting Standards Board (“IASB”).

Included in the above adjustments and reclassifications to the statutory accounts for IAS presentation is the restatement for changes in the general purchasing power of the Russian rouble based on IAS 29 *“Financial Reporting in Hyperinflationary Economies”*. IAS 29 requires that financial statements in the currency of a hyperinflationary economy be stated in terms of the measuring unit current at the latest balance sheet date. The restatement was calculated from conversion factors derived from the Russian Federation Consumer Price Index, published by the Russian State Committee on Statistics, and from

# AK "ALROSA"

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001, 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued) (in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at 30 September 2002, unless otherwise stated)

indices obtained from other sources for years prior to 1992, which management believes represent the most appropriate measure of inflation in the economy.

The indices and the respective conversion factors used to restate the consolidated financial statements, based on 1988 prices (1988 = 100) for the four years ended 31 December 2001 and nine months ended 30 September 2002, are:

Year	Index	Conversion Factors
1998 .....	1,216,400	2.15
1999 .....	1,661,481	1.58
2000 .....	1,995,937	1.31
2001 .....	2,371,572	1.1
Nine months 2002.....	2,618,690	1

The significant guidelines followed in restating the consolidated financial statements are:

- all amounts including corresponding figures are stated in terms of the measuring unit current at the latest balance sheet date;
- monetary assets and liabilities as at balance sheet date are not restated because they are already expressed in terms of the monetary unit current at the latest balance sheet date;
- non-monetary assets and liabilities (items which are not expressed in the monetary unit current at the balance sheet date) and components of shareholders' equity are restated by applying a conversion factor based on the age of the underlying asset, liability or component of shareholders' equity;
- all items in the statement of operations and cash flows are restated by applying the change in the general price index from the dates when the items were initially transacted to the balance sheet date; and
- the effect of inflation on the Group's net monetary position is included in the consolidated statement of income as a net monetary gain or loss.

The Group has adopted IAS 39, "*Financial Instruments: Recognition and Measurement*", which is effective for accounting periods beginning on or after 1 January 2001, in the preparation of these consolidated financial statements. The main impact of adopting IAS 39 was as follows:

- In accordance with the requirements of IAS 39, the Group classified all of its long-term investments as being available-for-sale. No adjustment resulted to retained earnings at 1 January 2001 as there was no change from the previous measurement principle (see note 3(g)).
- Long-term receivables and commercial paper balances have been stated at amortised cost using the effective interest rate method, with the resulting adjustment to opening balances, net of deferred tax effects, credited to retained earnings.

## AK "ALROSA"

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001, 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued) (in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at 30 September 2002, unless otherwise stated)

The impact of adopting IAS 39 on retained earnings as at 1 January 2001 is summarized as follows:

Trade and other receivables measured at amortized cost . . . . .	(859)
Commercial paper balances measured at amortized cost . . . . .	1,242
Total, net of profit tax . . . . .	<u>383</u>

In accordance with IAS 39, the comparative financial statements for the year ended 31 December 2000 and 1999 are not restated. As a result the reconciliation of profit before tax to the cash flow from operating activity is adjusted for the effect of applying IAS 39 on trade and other receivables in the amount totalling RR'mln 859 (see note 22).

In 2002, the Group changed its accounting policy to record the change in accounting estimates of the discount rate, cash flows and their timing related to provisions (note 3(e)) in order to give a better presentation in the consolidated financial statements. Until 31 December 2001 the effects of changes in discount rates which would increase or decrease the determination of the present value of the provisions were recorded in the consolidated statement of income in the year of the change and changes in cash flow and their timing were recorded in correspondence with the related assets.

Since January 2002 the effect of such changes are added to, or deducted from, the amount recognized as the related asset to the extent the change relates to future periods. The amount that relates to current and past periods is recorded in the income statement in the year of the change.

In 2002 the Group also revisited the discount rates used in the past in order to better reflect the market assessments on the time value of money and risks specific to the liabilities. The new discount rates used are disclosed in note 12.

The net effect of the change in accounting policy and the revision of the discount rates did not have a material impact on the current period or any other period presented and accordingly the comparative information has not been restated. Management is not able to determine whether this change will have a material effect in the subsequent periods.

In 2000, the Group implemented IAS 10 (revised) and changed its accounting policy with respect to the recognition of the liability for dividends declared. Since 1 January 2000, dividends are recognised as a liability in the year in which they are proposed and declared.

The preparation of the consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities as at the date of the consolidated financial statements, and the reported amount of revenues and operating costs during the reporting period. The most significant estimates relate to realisation of inventories, investments, allowance for doubtful accounts, deferred taxation, reserve estimates used to calculate amortisation, retirement benefit costs and the evaluation of the provision for restoration liability. Actual results could differ from these estimates.

Certain reclassifications have been made to prior year balances to conform to the current year presentation.

The structure of the consolidated statement of income has been amended in order to present the information about the Group's activity in a format considered to be more useful to the users and more



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### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001, 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued) (in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at 30 September 2002, unless otherwise stated)

appropriate, as suggested by IAS 1 "*Presentation of Financial Statements*", for a presentation by function. The change in structure, in addition to providing an additional line for "gross profit", has resulted in the inclusion of "royalty payments", "social costs", "taxes and payments" within "other operating expense".

In connection with the preparation of these financial statements, management have reconsidered the presentation of costs incurred in 2001 that were deemed to be extraordinary and disclosed as such in the consolidated financial statements for the year ended 31 December 2001. These amounts have been reclassified and reported as part of operating expenses to better reflect the nature of the costs under worldwide practice of IAS application.

#### (b) Principles of consolidation

The Group comprises the Company and its subsidiaries and associates. The effects of transactions between subsidiaries within the Group are eliminated and accounting policies of the subsidiaries and associates are conformed to those of the Company.

A subsidiary is an entity in which the Company has an interest of more than one half of the voting rights or otherwise has the power to exercise control over the operations.

Subsidiaries are consolidated from the date on which control is transferred to the Group and are no longer consolidated from the date that control ceases.

Associated entities over which the Company has a significant but not a controlling influence, are accounted for using the equity method. Significant influence is usually evidenced by the Company owning, directly or indirectly, between 20 per cent. and 50 per cent. of the voting share capital.

Equity accounting is discontinued when the carrying amount of the investment in an associate reaches zero, unless the group has incurred obligations or guaranteed obligations in respect of the associate.

For subsidiaries that are not wholly owned, the minority's interest is measured at the pre-acquisition carrying amount of the minority's share in the subsidiary at the acquisition date, amended for the minority's share of subsequent dividends, profits and losses.

#### (c) Grant

Production assets received from the Republic of Sakha (Yakutia) in 1993 under the terms of a mineral lease agreement to "transfer of rights to use and exploit land, diamond deposits, main production and non-production facilities", are recorded in accordance with IAS 20 "*Accounting for Government Grants and Disclosure of Government Assistance*" at historical cost adjusted for the effects of inflation, with a corresponding credit reflected as a grant in the Group's balance sheet. The Grant is amortised in line with the reduction in the carrying value of the underlying assets, with the amortised portion recorded as an increase in income (see note 10).

Social assets received under the aforementioned mineral lease agreement have not been included in the accompanying consolidated financial statements since the majority of these assets have been or will be transferred free of charge to local administrations.

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### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001, 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued) (in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at 30 September 2002, unless otherwise stated)

#### (d) Property, plant and equipment

Property, plant and equipment comprises costs incurred in developing areas of interest as well as the costs related to the construction and acquisition of mining assets. Expenditure related to geophysical analysis is deferred on a project-by-project basis until the viability of the project is determined. If a project is not determined to be economically viable the accumulated project costs are charged to operations in the year in which the determination is made. Costs associated with economically viable projects are depreciated over the economic useful life of those projects as set out below.

At each reporting date, management assesses whether there is any indication of impairment of property, plant and equipment. If any such indication exists, management estimates the recoverable amount which is determined as the higher of an asset's net selling price and its value in use. The carrying amount is reduced to the recoverable amount and the difference is recognised as an expense (impairment loss) in the statement of income. An impairment loss recognised for an asset in prior years is reversed if there has been a change in the estimates used to determine the asset recoverable amount.

#### *Depreciation and amortisation*

Property, plant and equipment is depreciated upon commencement of commercial mining activities at a specific area of interest.

Depreciation and amortisation of buildings, land improvements and fixed plant related to extraction of minerals is calculated on a units-of-production basis for each area of interest over its expected economic useful life.

Depreciation of assets not directly associated with production is calculated on a straight-line basis over its estimated useful life. The depreciation rates applied are as follows:

	<u>Assets related to extraction of minerals</u>	<u>Other assets</u>
Buildings . . . . .	Units of production	8–50 years
Land improvements and fixed plant . . . . .	Units of production	8–50 years
Plant and equipment (moveable) . . . . .	5–13 years	5–13 years
Transport . . . . .	3–7 years	3–7 years
Other . . . . .	4–17 years	4–17 years

#### *Disposals and retirement*

Items of property, plant and equipment that are retired or otherwise disposed of are eliminated from the balance sheet along with the corresponding accumulated depreciation (if any). Any gain or loss resulting from such retirement or disposal is included in the consolidated statement of income.

#### *Repair and maintenance costs*

Maintenance and repairs are expensed as incurred.

#### *Local infrastructure assets*

Local infrastructure assets constructed or purchased by the Group subsequent to 1 January 1993 (the date of privatisation) are included in the financial statements at historical cost adjusted for the effects of inflation and depreciated using the depreciation rates as set out above.

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### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued)

(in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at  
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#### (e) Provisions

Provisions are recognised when the Group has a present legal or constructive obligation as a result of past events and when it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and a reliable estimate of the amount of the obligation can be made.

Provisions are reassessed annually, and are included in the consolidated financial statements at their expected net present values using discount rates appropriate to the Group in the economic environment in the Russian Federation at each balance sheet date.

Changes in provisions resulting from the passage of time are reflected in the consolidated statement of income each year under financial items. Other changes in provisions, relating to a change in the discount rate applied, in the expected pattern of settlement of the obligation or in the estimated amount of the obligation, are treated as a change in accounting estimate in the period of the change. The effect of such changes are added to, or deducted from, the amount recognised as the related asset to the extent the changes relate to future periods. The amount that relates to current and past periods is recorded in the statement of income in the year of the change.

The provision for restoration liability is determined based on the terms of the mineral lease agreement (see note 10). Under this agreement the Company is obliged to transfer in 2017 property, plant and equipment subject to the mineral lease agreement to the Republic of Sakha (Yakutia) or settle its liability by effecting a cash payment.

Provision for restoration liability is recorded on the balance sheet, with a corresponding amount being recorded as part of property, plant and equipment in accordance with IAS 16 "*Property, Plant and Equipment*" (revised 1998) and amortized over the life of the property.

#### (f) Inventories

Inventories of diamonds, extracted ore and concentrates, mining and construction stores and consumable supplies are valued at the lower of the weighted average cost or net realisable value.

Cost of extracted ore and concentrates is calculated using the quantities determined based on surveyors' measurements of the volumes of ore and concentrates remaining at the period end.

Cost of inventories include those directly attributable to mining the diamonds, extracting the ore and producing concentrates, and those directly attributable to bringing mining and construction stores and consumable supplies to their present location and condition.

Net realisable value is the estimated selling price in the ordinary course of business, less the cost of completion and selling expenses.

#### (g) Investments

At 1 January 2001, the Group adopted IAS 39 and classified its investments into the following categories: trading, held-to-maturity or available-for-sale. Investments that are acquired principally for the purpose of generating a profit from short-term fluctuations in price are classified as trading investments and included in current assets. Investments with fixed maturity that the management has the intent and ability to hold to maturity are classified as held-to-maturity and are included in non-current assets. During the period, the Group did not hold any investments classified as trading or held-to-maturity. Investments intended to be held for an indefinite period of time, which may be sold in response to needs for liquidity or

## **AK “ALROSA”**

### **NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued)**

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changes in interest rates, are classified as available-for-sale; these are included in non-current assets unless management has the express intention of holding the investment for less than 12 months from the balance sheet date or unless they will need to be sold to raise operating capital, in which case they are included in current assets. Management determines the appropriate classification of its investments at the time of the purchase and re-evaluates such designation on a regular basis.

All purchases and sales of investments are recognised on the settlement date, which is the date that the investment is delivered to or by the Group. Cost of purchase includes transaction costs. Trading and available-for-sale investments are subsequently carried at fair value, whilst held-to-maturity investments are carried at amortised cost using the effective yield method. Realised and unrealised gains and losses arising from changes in the fair value of trading investments and of available-for-sale investments are included in the statement of income in the period in which they arise.

Since the majority of the Group's investments are not publicly traded and no reliable method of fair value estimation exist for those investments, these investments are excluded from fair value valuation.

Those financial assets that are excluded from fair valuation and that have a fixed maturity are measured at amortised cost using the effective interest rate method less impairment. Those that do not have a fixed maturity are measured at cost less impairment.

Unquoted available-for-sale equity investments are reviewed for impairment losses every balance sheet date and whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. When a review for impairment is conducted, the recoverable amount is assessed by reference to the net present value of expected future cash inflows. The discount rate applied is based upon the Group's weighted average cost of capital with appropriate adjustment for the risks associated with the investment under assessment. When the level of information available to calculate the net present value of expected future cash inflows makes this exercise unworkable, management use different valuation techniques to estimate whether there is an objective evidence of impairment and to determine the likely amount of impairment, if any.

#### **(h) Components of cash and cash equivalents**

Cash and cash equivalents consist of cash on hand and balances with banks with a maturity at the date of recognition less than three months, which are considered by the Group at the time of deposit to have a minimal risk of default.

#### **(i) Deferred taxes**

Deferred tax is calculated at rates enacted or substantively enacted at the balance sheet date, using the liability method, for all temporary differences between the tax bases of assets and liabilities and their carrying values for financial reporting purposes. The principal temporary differences arise from application of IAS 29 *“Financial Reporting in Hyperinflationary Economies”*, depreciation on property, plant and equipment and provisions and expenses which are charged to the consolidated statement of income before they become deductible for tax purposes.

Deferred tax liabilities are recognised in respect of all taxable temporary differences relating to investments in subsidiaries, unless the Company is able to control the timing of the reversal of the temporary difference and it is probable that the difference will not reverse in the foreseeable future.

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### **NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued)**

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Deferred tax assets attributable to temporary differences, unused tax losses and credits are recognised only to the extent that it is probable that future taxable profit or temporary differences will be available against which they can be utilised.

Deferred tax assets and liabilities are offset when the Group has a legally enforceable right to set off current tax assets against current liabilities, when deferred tax balances relate to the same regulatory body (i.e., federal or republic), and when they relate to the same jurisdiction and taxable entity.

#### **(j) Foreign currencies**

Transactions denominated in foreign currencies are recorded, on initial recognition, in the measurement currency, by applying the exchange rate between the measurement currency and the foreign currency at the date of the transaction. Outstanding foreign currency monetary items at the balance sheet date are reported at the closing rate. Non-monetary items which are carried in terms of historical cost denominated in a foreign currency are reported using the exchange rate at the date of the transaction, and non-monetary items which are carried at fair value denominated in a foreign currency are reported using the exchange rates that existed when the values were determined.

Exchange differences arising on the settlement of monetary items or reporting monetary items at rates different from those at which they were initially recorded in the period are recognised in the statement of income in the period in which they arise.

#### **(k) Financial assets and liabilities**

Financial assets and liabilities carried in the consolidated balance sheet include cash and cash equivalents, investments, receivables, borrowings, and trade and other payables, and are initially recognised at cost, which is the fair value of the consideration given or received, on the date when the Group becomes a party to the contractual provisions of the instrument. Financial assets are partially or fully de-recognised only when the rights to the separable benefits under the relevant contract are lost, surrendered, or have expired or have been settled. Financial liabilities are de-recognised only when the obligation specified in the relevant contract is discharged, cancelled or has expired.

Financial assets are re-measured to fair value at each subsequent balance sheet date, unless they are loans and receivables originated by the Group, in which case they are measured at amortised cost if they have a fixed maturity date, or otherwise at cost.

Financial liabilities with fixed maturity dates are re-measured at each subsequent balance sheet date to amortised cost.

The re-measurement of financial assets and liabilities respectively to fair value, amortised cost, or cost is based on the receivable or payable amount at the expected settlement date, discounted to net present value. The discount rate used is that considered appropriate to the Group in the economic environment in the Russian Federation at each balance sheet date.

#### **(l) Revenue recognition**

Revenues are recognised when goods are shipped to the purchaser as this is the date that the risks and rewards of ownership are transferred to the customers. Sales are shown net of VAT and export duties, and after eliminating sales within the Group.

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### **NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued)**

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Revenue from rendering of transport services is recognized in financial statements in the period when the services are rendered.

Interest revenue is recognized on a time proportion basis that takes into account the effective yield on the asset. Dividends revenue is recognized when the shareholder's right to receive payment is established.

#### **(m) Measurement of trade and other receivables**

Accounts receivable are recorded at original invoice amount and include value-added taxes. Accounts receivable are written down to estimated recoverable amount by recording an impairment for doubtful debts based on analysis of expected future cash flows relating to doubtful receivables. Bad debts are written off when identified.

#### **(n) Value added taxes**

In the consolidated balance sheet and the consolidated statement of cash flows, transactions and balances are presented inclusive of the associated Value Added Tax ("VAT") applicable under the legislation of the relevant jurisdiction in which the transaction occurred.

#### **(o) Retirement benefit obligations**

The Group makes contributions in accordance with statutory requirements, which are calculated as a percentage of current gross salary payments, in respect of its employees to the State Pension Scheme of the Russian Federation and such expense is charged to the consolidated statement of income.

#### **(p) Social obligations**

Social costs relating to the maintenance of housing are determined in accordance with agreements with the local authorities and expensed or capitalised as appropriate.

Discretionary and voluntary payments made to fund and support social programmes and related operations are expensed as incurred.

#### **(q) Non-cash transactions**

Non-cash transactions are measured at the fair value of consideration received or receivable. When it is not possible to measure the fair value of consideration received or receivable reliably, the non-cash transactions are measured at fair value of consideration paid.

Non-cash transactions have been excluded from the operating, investing and financing activities components in the accompanying consolidated statement of cash flows.

#### **(r) Share capital**

Share capital consists of ordinary shares, which are classified as equity.

#### **(s) Segment reporting**

Business segments provide products or services that are subject to risks and returns that are different from those of other business segments. Geographical segments provide products or services within a particular economic environment that is subject to risks and returns that are different from those of components operating in other economic environments.



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## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001, 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued) (in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at 30 September 2002, unless otherwise stated)

### 4. GROUP STRUCTURE AND INVESTMENTS

The Company’s significant consolidated subsidiaries and equity-accounted associate are as follows:

Name	Country of Incorporation	Percentage ownership <sup>(5)</sup>
<b>Consolidated Subsidiaries</b>		
ZAO “Irelyakhneft” . . . . .	Russia	100
Pension Fund “Almaznaya Osen” . . . . .	Russia	97
OAO “Viluygesstroy” . . . . .	Russia	90
OAO “ALROSA-Nyurba” . . . . .	Russia	88
MAK-Bank . . . . .	Russia	82
OAO “Severalmaz” <sup>(1)</sup> . . . . .	Russia	72
OAO “Vilyuiskaya GES-3” <sup>(2)</sup> . . . . .	Russia	66
OAO “ALROSA-Gas” <sup>(3)</sup> . . . . .	Russia	48
<b>Equity accounted associate</b>		
“Catoka Mining Ltd” <sup>(4)</sup> . . . . .	Angola	33

- (1) During 2000, the Company increased share holdings from 12 per cent. up to 39 per cent. in OAO “Severalmaz”, which is a diamond mining company located in Arkhangelsk region in Russia. Subsequent to this additional acquisition, the Group accounts for this investment using the equity method. The Group’s share of OAO “Severalmaz” net assets included in the consolidated financial statements totalled RR’mln 948 at 31 December 2000. In December 2001, the Company increased its share holdings in OAO “Severalmaz” from 39 per cent. up to 72 per cent. This transaction was accounted for as an acquisition in accordance with IAS 22 (revised) “Business Combinations” using the benchmark treatment. Under this treatment the identifiable assets and liabilities of OAO “Severalmaz” were recognised at the aggregate of the fair value of the identifiable assets and liabilities acquired as at the date of acquisition to the extent of the acquirer interest and the minority’s portion of the pre-acquisition carrying amounts of the identifiable assets and liabilities of the subsidiary. Total purchase consideration paid for additional shares was RR’mln 1,225, and in aggregate with consideration paid in previous periods was allocated against property plant and equipment totalling RR’mln 2,468 and assumed liabilities (mainly payables to the Group) totalling RR’mln 295. At 31 December 2001 the financial position of OAO “Severalmaz” had not changed significantly since the date of acquisition.
- (2) On 1 July 2000, the Company purchased from Yakutskenergo their 66% voting share in OAO “Vilyuiskaya GES-3”, an electricity producing entity constructing a hydro power station in the Republic of Sakha (Yakutia). Purchase consideration included commercial paper of the Company and settlements of accounts receivable with fair value at the date of acquisition totalling RR’mln 940. This transaction was accounted for as an acquisition in accordance with IAS 22 (revised) “Business Combinations” using the benchmark treatment. Under this treatment the identifiable assets and liabilities of OAO “Vilyuiskaya GES-3” were recognised at the aggregate of the fair value of the identifiable assets and liabilities acquired as at the date of acquisition to the extent of the acquirer interest and the minority’s portion of the pre-acquisition carrying amounts of the identifiable assets and liabilities of the subsidiary. Total purchase consideration paid was allocated against property plant and equipment totalling RR’mln 1,755, assumed liabilities (mainly payables to the Group) totalling RR’mln 345 and minority interest totalling RR’mln 470. As at 31 December 2000 the financial position of OAO “Vilyuiskaya GES-3” included property plant and equipment totalling RR’mln 2,601, accounts payable (mainly to the Group) totalling RR’mln 1,121, retained earnings totalling RR’mln 52, minority interest totalling RR’mln 488 and the Company’s investment totalling RR’mln 940.
- (3) The effective holding of the Group in OAO “ALROSA-Gas” does not exceed 50 per cent.; however, it is considered a subsidiary as the Group can exercise control over its operations through majority membership in the Board of Directors.
- (4) “Catoka Mining Ltd” is a diamond mining venture located in Angola. Investment in this associate was accounted by the Group under the equity method. Income of RR’mln 277 was included in the Group’s financial statements for the year ended 31 December 2001 (2000: RR’mln 257; 1999: RR’mln 235). The Group’s share of net assets in Catoka Mining Ltd included in



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### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001, 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued) (in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at 30 September 2002, unless otherwise stated)

these financial statements is RR'mln 469 as at 31 December 2001 (2000: RR'mln 675; 1999: RR'mln 627). As at 31 December 2001, trade and other receivables include dividends receivable from Catoka Mining Ltd. totalling RR'mln 204 (31 December 2000 and 1999: nil; notes 8 and 25).

- (5) The percentage ownership determined based on the Group investees' charter documents equalled to that determined based on its voting share.

#### Available-for-sale investments and gains (losses) on available-for-sale investments

	2001	2000	1999
<b>Available-for-sale investments:</b>			
Investments in companies and banks for which fair value cannot be determined . . . . .	1,993	2,070	3,033
Marketable securities . . . . .	308	202	235
	2,301	2,272	3,268

As at 31 December 2001, investments totalling RR'mln 332 are carried net of provisions for impairment (31 December 2000: 1,946; 31 December 1999: 1,220).

Gains/(losses) on available-for-sale investments included above are as follows:

	2001	2000	1999
Fair value adjustments, net . . . . .	478	(337)	97

## 5. CASH AND CASH EQUIVALENTS AND RESTRICTED CASH

### Cash and cash equivalents

As at 31 December 2001, cash and cash equivalents balance mainly represents current accounts of the Group with the weighted average interest rate approximating nil (31 December 2000: nil; 31 December 1999: nil).

### Restricted cash

Restricted cash of RR'mln 291, RR'mln 268 and RR'mln 331 as at 31 December 2001, 31 December 2000 and 31 December 1999, respectively, represent deposit accounts held with the Bank of New York and Chase Manhattan Bank. The Group is required to maintain a balance equal to the amount of its next scheduled principal and interest payment in accordance with its loan agreements with these banks. Furthermore, an additional RR'mln 87 (31 December 2000: RR'mln 81; 31 December 1999: nil) represents mandatory reserve deposits that are not available for use in the Group's day to day operations, held in the Central Bank of the Russian Federation by MAK-Bank, a consolidated subsidiary.

Weighted average interest rate on the restricted cash balance at 31 December 2001 amounted to 1.5 per cent. (31 December 2000: 4.2 per cent.; 31 December 1999: 6.8 per cent.).

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## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001, 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued) (in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at 30 September 2002, unless otherwise stated)

### 6. PROPERTY, PLANT AND EQUIPMENT

	Buildings	Land Improvement	Plant and Equipment	Transport	Assets under Construction	Other	TOTAL
Cost at 31 December 1998 . . . . .	34,347	23,053	14,934	10,632	12,122	294	95,382
Additions . . . . .	309	—	2,032	2,501	3,261	31	8,134
Transfers . . . . .	2,429	6,610	3	—	(9,042)	—	—
Disposals . . . . .	(1,863)	(381)	(1,163)	(2,344)	(177)	(13)	(5,941)
Change in estimate of provision for restoration liability (see note 12)	(1,801)	(887)	(200)	(83)	—	(4)	(2,975)
Cost at 31 December 1999 . . . . .	33,421	28,395	15,606	10,706	6,164	308	94,600
Additions through acquisition of subsidiaries . . . . .	314	2,032	131	54	5,703	33	8,267
Additions . . . . .	667	66	2,674	2,999	6,733	165	13,304
Transfers . . . . .	1,298	622	589	—	(2,509)	—	—
Disposals . . . . .	(880)	(106)	(501)	(680)	(1,931)	(14)	(4,112)
Change in estimate of provision for restoration liability (see note 12)	(2,184)	(1,076)	(243)	(100)	—	(5)	(3,608)
Cost at 31 December 2000 . . . . .	32,636	29,933	18,256	12,979	14,160	487	108,451
Additions through acquisition of subsidiaries . . . . .	—	105	94	40	2,420	41	2,700
Additions . . . . .	343	290	2,465	1,231	12,481	190	17,000
Transfers . . . . .	1,255	536	350	7	(2,198)	50	—
Disposals . . . . .	(531)	(3,136)	(532)	(568)	(586)	(186)	(5,539)
Change in estimate of provision for restoration liability (see note 12)	(401)	(163)	(38)	(4)	—	(1)	(607)
<b>Cost at 31 December 2001 . . . . .</b>	<b>33,302</b>	<b>27,565</b>	<b>20,595</b>	<b>13,685</b>	<b>26,277</b>	<b>581</b>	<b>122,005</b>
Accumulated Depreciation at 31 December 1998 . . . . .	11,648	11,187	6,814	7,252	—	76	36,977
Charge for the year . . . . .	961	1,282	1,060	918	—	16	4,237
Disposals . . . . .	(1,485)	(190)	(844)	(2,211)	—	(10)	(4,740)
Accumulated Depreciation at 31 December 1999 . . . . .	11,124	12,279	7,030	5,959	—	82	36,474
Charge for the year . . . . .	970	1,919	1,421	1,328	—	25	5,663
Disposals . . . . .	(474)	(81)	(306)	(529)	—	(8)	(1,398)
Accumulated Depreciation at 31 December 2000 . . . . .	11,620	14,117	8,145	6,758	—	99	40,739
Charge for the year . . . . .	819	1,101	1,925	1,186	—	23	5,054
Disposals . . . . .	(395)	(3,086)	(468)	(467)	—	(8)	(4,424)
<b>Accumulated depreciation at 31 December 2001 . . . . .</b>	<b>12,044</b>	<b>12,132</b>	<b>9,602</b>	<b>7,477</b>	<b>—</b>	<b>114</b>	<b>41,369</b>
<b>Net book value at 31 December 1998 . . . . .</b>	<b>22,699</b>	<b>11,866</b>	<b>8,120</b>	<b>3,380</b>	<b>12,122</b>	<b>218</b>	<b>58,405</b>
<b>Net book value at 31 December 1999 . . . . .</b>	<b>22,297</b>	<b>16,116</b>	<b>8,576</b>	<b>4,747</b>	<b>6,164</b>	<b>226</b>	<b>58,126</b>
<b>Net book value at 31 December 2000 . . . . .</b>	<b>21,016</b>	<b>15,816</b>	<b>10,111</b>	<b>6,221</b>	<b>14,160</b>	<b>388</b>	<b>67,712</b>
<b>Net book value at 31 December 2001 . . . . .</b>	<b>21,258</b>	<b>15,433</b>	<b>10,993</b>	<b>6,208</b>	<b>26,277</b>	<b>467</b>	<b>80,636</b>

Refer to note 10 for property, plant and equipment included above which is subject to the mineral lease agreement with the Republic of Sakha (Yakutia).

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## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001, 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued) (in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at 30 September 2002, unless otherwise stated)

Included in property, plant and equipment above are the local infrastructure assets (housing and civic amenities owned by the Group). Carrying value of these assets is as follows:

	2001	2000	1999
Cost as at 31 December . . . . .	7,302	6,344	5,189
Accumulated depreciation as at 31 December . . . . .	(1,120)	(995)	(577)
Net book value as at 31 December . . . . .	<u>6,182</u>	<u>5,349</u>	<u>4,612</u>

The Company assessed potential impairment for years ended 31 December 2001, 2000 1999 on an aggregate basis and determined that the recoverable value ("value in use") of the property, plant and equipment exceeded its carrying value.

### 7. INVENTORIES

	2001	2000	1999
Diamonds . . . . .	2,681	1,932	2,854
Ores and concentrates . . . . .	1,477	2,031	299
Mining and construction materials . . . . .	7,954	7,115	3,835
Consumable supplies . . . . .	915	657	443
	<u>13,027</u>	<u>11,735</u>	<u>7,431</u>

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**8. TRADE AND OTHER RECEIVABLES**

	2001	2000	1999
<b>Long-term accounts receivable</b>			
Receivable from related parties . . . . .	929	417	310
Long-term VAT recoverable . . . . .	584	—	—
Loans . . . . .	153	—	—
Long-term prepaid taxes . . . . .	131	117	64
	<u>1,797</u>	<u>534</u>	<u>374</u>
<b>Current accounts receivable</b>			
Accounts and notes receivable—trade . . . . .	2,503	1,633	1,246
Receivables from related parties . . . . .	1,818	2,340	2,359
Advances to suppliers . . . . .	1,356	2,003	2,053
Taxes recoverable . . . . .	855	416	205
Prepaid taxes . . . . .	586	2,668	702
Loans issued . . . . .	308	2,087	391
Notes receivable . . . . .	213	453	1,027
Receivable for domestic bond issued . . . . .	—	—	273
Other receivables . . . . .	906	1,481	1,090
	<u>8,545</u>	<u>13,081</u>	<u>9,346</u>

Taxes recoverable relate to input Value Added Tax (VAT) (see note 3(n)) incurred with respect to purchase and are available for offset against future output VAT following the settlement of outstanding balances payable in relation to the inventories purchased.

Long-term VAT recoverable, which relates to the materials and services used for construction of property, plant and equipment, becomes available for offset against future output VAT after the respective asset is put into use.

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Impairment for bad debts offset against accounts receivable balances is as follows:

	31 December 2001	Monetary effect	Bad debt written-off	Bad debt expense	31 December 2000
<b>Long-term accounts receivable</b>					
Receivable from related parties . . .	180	—	—	180	—
Long-term VAT recoverable . . . . .	197	—	—	197	—
Long-term prepaid taxes . . . . .	61	—	—	61	—
	<u>438</u>	<u>—</u>	<u>—</u>	<u>438</u>	<u>—</u>
<b>Current accounts receivable</b>					
Accounts and notes receivable—					
trade . . . . .	103	(33)	(27)	29	134
Advances to suppliers . . . . .	—	(2)	—	(11)	13
Prepaid taxes, other than profit tax	13	—	—	13	—
Notes receivable . . . . .	272	—	—	272	—
Other receivables . . . . .	200	(34)	(47)	(6)	287
	<u>588</u>	<u>(69)</u>	<u>(74)</u>	<u>297</u>	<u>434</u>
	31 December 2000	Monetary effect	Bad debt written-off	Bad debt expense	31 December 1999
<b>Current accounts receivable</b>					
Accounts and notes receivable—					
trade . . . . .	134	(41)	(67)	—	242
Advances to suppliers . . . . .	13	—	—	13	—
Other receivables . . . . .	287	(56)	—	—	343
	<u>434</u>	<u>(97)</u>	<u>(67)</u>	<u>13</u>	<u>585</u>

**9. SHARE CAPITAL**

	2001		2000		1999	
	Shares	Amount	Shares	Amount	Shares	Amount
Authorised ordinary share capital at RR 55,110 par value per share . . . . .	200,000	11,022	200,000	11,022	200,000	11,022
Treasury shares . . . . .	—	—	—	—	(1,621)	(89)
Issued and fully paid share capital . . . . .	<u>200,000</u>	<u>11,022</u>	<u>200,000</u>	<u>11,022</u>	<u>198,379</u>	<u>10,933</u>

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### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001, 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued) (in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at 30 September 2002, unless otherwise stated)

#### *Distributable profits*

The statutory accounting reports of the Company are the basis for profit distribution and other appropriations. Russian legislation identifies the basis of distribution as the current year net profit. For the years ended 31 December 2001, 31 December 2000 and 31 December 1999, the statutory profit for the Company as reported in the published annual statutory reporting forms was RR'mln 9,066, RR'mln 9,934 and RR'mln 10,474, respectively. However, this legislation and other statutory laws and regulations dealing with the distribution rights are open to legal interpretation, and accordingly, management believes at present it would not be appropriate to disclose an amount for the distributable reserves in these financial statements.

#### *Dividends*

Dividends totalling RR'mln 470 (RR'mln 298 in historical terms) in respect of the financial year ended 31 December 1999 were approved in the shareholders' annual general meeting held on 17 June 2000 and have been included in consolidated financial statements for the year ended 31 December 1999.

On 30 June 2001, the Company's shareholders approved dividends for the year ended 31 December 2000 totalling RR'mln 475 (RR'mln 400 in historical terms) and have been included in consolidated financial statements for the year ended 31 December 2001.

On 18 May 2002, the Company's Board of Directors proposed the dividends for the year ended 31 December 2001 at RR 3 thousand per share, totalling RR'mln 600, which are not included as liabilities in these consolidated financial statements as they will be voted on by the shareholders in their Annual General Meetings in June 2002.

#### **10. GRANT AND ASSETS SUBJECT TO MINERAL LEASE AGREEMENT**

On 19 January 1993, the Company entered into a mineral lease agreement ("the agreement") with the Republic of Sakha (Yakutia) for the "transfer of rights to use and exploit land, diamond deposits, main production and non-production facilities". This agreement has a term of 25 years and provides the Company with the right to use certain production and non-production assets for exploring, mining and operating diamond deposits.

The agreement stipulates that the terms should be re-negotiated every five years. The agreement also stipulates that the Company is subject to royalties and other taxes on the right to use the land and logging areas, disposal and burial of waste and contaminated materials and the use of mineral resources and water for industrial purposes. The main subject of the renegotiations related to the amount and timing of royalty and other payments.

Under the terms of the agreement the Republic of Sakha (Yakutia) has the right to:

- Receive 19.8 per cent. of the Company's revenue from diamond sales (royalty payments) in 2001 (2000 and 1999: 19.5 per cent.). Royalty payments expensed during the year ended 31 December 2001 totalled RR'mln 10,075 (2000: RR'mln 11,531; 1999: RR'mln 11,518);
- Receive 2 per cent. of Company's revenue from diamond sales (ecological fund).

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## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001, 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued) (in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at 30 September 2002, unless otherwise stated)

- Purchase 25 per cent. of the Company's diamond production at 100 per cent. of the Company's diamond export sales prices in 1999 and 2000;
- Receive 3.5 per cent. of the Company's revenue from diamond sales (resource recovery tax); and
- Receive 7 per cent. of the Company's revenue from diamond sales (non-recoverable resource tax).

Pursuant to an addendum to the mineral lease agreement dated 24 January 1998, the Company deferred 4.5 per cent. of its revenue from diamond sales from the years ended 31 December 1999 and 1998 until 2001 and 2000, respectively. As at 31 December 2000, the balance of deferred royalty payable totalled RR'mln 1,671 (1999: RR'mln 3,365).

Pursuant to an addendum to the mineral lease agreement dated 1 March 2002, the Company and the Republic of Sakha (Yakutia) agreed that the royalty payments including ecology fund payments and recoverable value-added tax due in 2002 are fixed at RR'mln 10,070, and the resource recovery tax due in 2002 is fixed at RR'mln 914, with the amount of royalty payable in 2003–2005 to be determined in a separate addendum to the agreement.

Carrying values of Company owned and granted assets subject to the mineral lease agreement with the Republic of Sakha (Yakutia) and Grant are as follows:

	2001	2000	1999
<b>Assets subject to the agreement with the Republic of Sakha (Yakutia)</b>			
Net book value of granted assets received in 1993 as at			
1 January . . . . .	13,371	15,045	16,835
Depreciation charge . . . . .	(1,096)	(1,674)	(1,790)
Net book value of granted assets received in 1993 as at			
31 December . . . . .	12,275	13,371	15,045
Net book value of Company owned assets subsequently transferred to leased (see note 12) . . . . .	3,781	3,959	—
Net book value at 31 December . . . . .	16,056	17,330	15,045

The Group is required to return certain production assets to the Republic of Sakha (Yakutia) at the end of the mineral lease term. The precise mechanism for determining the value and nature of the assets to be returned to the Republic of Sakha (Yakutia) under the terms of the mineral lease agreement is currently being negotiated between the parties.

Management have estimated the restoration liability based upon their interpretation of the mineral lease agreement and, in accordance with IAS 37 "*Provisions, Contingent Liabilities and Contingent Assets*", and have calculated and recorded the net present value of the restoration liability (see notes 3(e) and 12).



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## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001, 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued) (in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at 30 September 2002, unless otherwise stated)

### 11. LONG-TERM DEBT

	2001	2000	1999
Banks:			
US\$ denominated floating rate . . . . .	1,452	1,574	2,114
US\$ denominated fixed rate . . . . .	1,390	1,008	—
RR denominated fixed rate . . . . .	1,985	199	—
	4,827	2,781	2,114
Non-convertible bonds (see note 15) . . . . .	1,877	—	—
Commercial paper . . . . .	414	829	990
Diamond loan . . . . .	—	—	2,117
Other . . . . .	1,652	627	—
	8,770	4,237	5,221
Less: current portion of diamond loan (note 15) . . . . .	—	—	(2,117)
Less: current portion of other long-term debt (note 15) . . . . .	(1,432)	(609)	(528)
	7,338	3,628	2,576

Long-term commercial paper has defined maturity dates ranging between one and ten years, and is carried at amortised cost.

In April 1993, the Company entered into an agreement with the Russian Federation for the loan of 7.857 million carats of gem quality diamonds (the "diamond loan") at a fixed US dollar amount of US\$394,600 thousand. The agreement required the Company to deliver in 2000, 850 thousand carats of gem quality diamonds to the Russian Federation.

The effective interest rates at the balance sheet dates were as follows:

	2001	2000	1999
Banks:			
US\$ denominated floating rate . . . . .	2.5%	5.4%	6.8%
US\$ denominated fixed rate . . . . .	14.8%	7.0%	—
RR denominated fixed rate . . . . .	20.1%	26.3%	—
Non-convertible bonds (see note 15) . . . . .	23.3%	—	—
Commercial paper . . . . .	36.0%	66.0%	—
Other . . . . .	16.0%	24.0%	—

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## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001, 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued) (in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at 30 September 2002, unless otherwise stated)

At 31 December 2001 long-term loans have the following maturity profile:

	2002	2003	2004	2005	2006 and thereafter	Total
Banks:						
US dollar denominated floating rate . . . . .	549	553	140	140	70	1,452
US dollar denominated fixed rate . . . . .	103	455	123	709	—	1,390
Russian rouble denominated fixed rate . .	659	692	—	—	634	1,985
	1,311	1,700	263	849	704	4,827
Non-convertible bonds . . . . .	—	1,877	—	—	—	1,877
Commercial paper . . . . .	—	282	35	38	59	414
Other . . . . .	121	374	594	375	188	1,652
	1,432	4,233	892	1,262	951	8,770

The Group has not entered into any derivative contracts in respect of its foreign currency obligations or interest rate exposure.

The carrying amounts and fair values of long-term debt are as follows:

	2001		2000		1999	
	Carrying amounts	Fair values	Carrying amounts	Fair values	Carrying amounts	Fair values
Banks . . . . .	4,827	4,775				
Non-convertible bonds (see note 15) . . . . .	1,877	2,073	—	—	—	—
Commercial paper . . . . .	414	616	829	829	990	990
Diamond loan . . . . .	—	—	—	—	2,117	2,117
Other . . . . .	1,652	1,500	627	627	—	—

Fair value of long-term debt is estimated by discounting the future contractual cash outflows at the market interest rate available at the balance sheet date.

As at 31 December 2001, long-term debt totalling RR'mln 1,683 (31 December 2000: RR'mln 1,542; 31 December 1999: RR'mln 1,586) included above was secured by the assets of the Company. As separate loan agreements do not specify individual pledged items of assets, the carrying amount of pledged assets is not disclosed.

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## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001, 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued) (in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at 30 September 2002, unless otherwise stated)

### 12. PROVISION FOR RESTORATION LIABILITY

	2001	2000	1999
At 1 January . . . . .	3,397	6,854	9,532
Change in the estimate of provision for restoration liability . . .	(607)	(3,608)	(2,975)
Increase in the discounted amount during the period . . . . .	133	151	297
At the end of the period . . . . .	<u>2,923</u>	<u>3,397</u>	<u>6,854</u>

The provision for restoration liability represents the net present value of the estimated future obligation to restore the property, plant and equipment received from the Republic of Sakha (Yakutia) under the terms of the mineral lease agreement (see notes 3(e) and 10). The discount rate used to calculate the net present value of the restoration liability at 31 December 2001 was 12.1 per cent. (31 December 2000: 14.5 per cent. and 31 December 1999: 18 per cent.), which was considered appropriate to the Group in the economic environment in the Russian Federation at the balance sheet date.

Under the mineral lease agreement the Company is obliged to reimburse to the Republic of Sakha (Yakutia) the amount of accumulated depreciation on property, plant and equipment subject to the mineral lease agreement (leased property, plant and equipment) and the Republic of Sakha (Yakutia) is obliged to reimburse to the Company the amount of qualified repair and maintenance expense incurred by the Company in relation to the leased property, plant and equipment. The Company and the Republic of Sakha (Yakutia) determined the amount to be reimbursed by the Company on a net basis as the difference between the amount of depreciation on leased assets and the amount of repair and maintenance expense in relation to the leased property, plant and equipment. Reimbursement is effected by transfer of title of the Company's own items of property, plant and equipment to the Republic of Sakha (Yakutia) and consequently these assets are treated as leased property, plant and equipment (see note 10).

### 13. TRADE AND OTHER PAYABLES

	2001	2000	1999
Trade . . . . .	2,519	2,327	1,233
Accrual for flights and holidays . . . . .	1,541	1,660	1,578
Wages . . . . .	973	368	558
Employee benefit payable . . . . .	531	447	—
Interest payable . . . . .	343	264	61
Advances from customers . . . . .	289	303	479
Payables to related parties . . . . .	236	467	535
Other payables and accruals . . . . .	686	790	535
	<u>7,118</u>	<u>6,626</u>	<u>4,979</u>

In accordance with Russian legislation, the Group entities are required to pay for the holiday entitlement and the cost of travel for employees and their family members to an agreed-upon destination and back, or a pre-determined allowance.

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## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001, 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued) (in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at 30 September 2002, unless otherwise stated)

### 14. PROFIT AND OTHER TAX ASSETS AND LIABILITIES

Taxes payable comprise the following:

	2001	2000	1999
Royalty payments to Republic of Sakha (Yakutia) . . . . .	1,767	696	1,498
Pension tax . . . . .	637	700	1,078
Extraction tax . . . . .	538	729	863
Value added tax . . . . .	465	24	84
Penalties . . . . .	430	610	995
Property tax . . . . .	253	147	107
Road use tax . . . . .	152	462	131
Income tax (employee) . . . . .	85	359	74
Profit tax . . . . .	31	29	82
Community tax . . . . .	—	120	—
Other taxes and accruals . . . . .	258	520	121
Taxes payable . . . . .	<u>4,616</u>	<u>4,396</u>	<u>5,033</u>

Taxes other than profit tax included in the statement of income comprise the following:

	2001	2000	1999
Extraction tax . . . . .	6,053	6,687	6,910
Ecology fund . . . . .	943	1,187	1,185
Property tax . . . . .	845	540	450
Road use tax . . . . .	628	1,565	1,542
Tax penalties . . . . .	179	(88)	784
Other taxes and accruals . . . . .	40	354	36
Taxes other than profit tax . . . . .	<u>8,688</u>	<u>10,245</u>	<u>10,907</u>

In accordance with legislation effective 1 January 2002, non-recoverable resource tax and resource recovery tax were replaced with an extraction tax, which amounted to 8 per cent. of value of extracted diamonds. Accordingly, in these consolidated financial statements non-recoverable resource tax and resource recovery tax were reclassified and presented as extraction tax.

In accordance with the Resolution No. 1364 of the Government of the Russian Federation dated 9 December 1999, the Company in 2001 and 2000 is obliged to pay 6.5 per cent. (1999: 5 per cent.) on the value of diamonds sold for export in the form of an export duty in addition to the taxes noted above (see note 16).

During 2001, the Company accrued profit tax at the rate of 35 per cent. According to legislation which became substantively enacted in the year ended 31 December 2001, profit tax payable by companies in the Russian Federation with effect from 1 January 2002 ranges from 20 per cent. to 24 per cent., depending on the decision each year of regional and local tax authorities, which can agree jointly on a supplementary amount of up to 4 per cent. above that set by the federal tax authorities. The rate used to compute the deferred tax assets and liabilities of the Group at 31 December 2001 was 24 per cent., which reflects the

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fact that, based on their decisions in respect of tax rates for 2001, substantially all regional and local tax authorities in the regions in which the Group operates assessed the maximum supplementary amount in respect of the year 2002.

During 2000, the Company accrued profit tax at the rate of 30 per cent. (1999: 35 per cent. before 1 April and 30 per cent. until 31 December 1999). On 5 August 2000, the Federal Law #118-FZ “On Introduction of the Second Part of the Tax Code”, introduced certain changes to the Russian Tax Code allowing local authorities to levy an additional 5 per cent. of profit tax starting 1 January 2001. As at 31 December 2000, the local authorities in the regions where the Group companies are registered for tax purposes have issued decrees obligating them to pay an additional 5 per cent. of profit tax starting 1 January 2001. Therefore, for the purposes of determining deferred profit tax liability as at 31 December 2000, a rate of 35 per cent. was used.

As a result of the changes in the Russian tax legislation, a profit tax rate of 30 per cent. has been enacted effective from 1 April 1999 and compares to 35 per cent. in prior years. The net effect on deferred tax recognised as at 31 December 1998 of the change in tax rate amounted to RR'mln 415 and has been credited to the tax expense for the year ended 31 December 1999.

Profit tax expense comprises the following:

	<u>2001</u>	<u>2000</u>	<u>1999</u>
Current tax expense . . . . .	3,903	5,970	6,834
Deferred tax expense (benefit)—movement in temporary differences . . . . .	(1,047)	1,325	296
Effect of (decrease) increase in tax rate . . . . .	(1,124)	462	(415)
Profit tax . . . . .	<u>1,732</u>	<u>7,757</u>	<u>6,715</u>

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Net profit before taxation for financial statement reporting purposes is reconciled to tax expense as follows:

	2001	2000	1999
Profit before profit tax . . . . .	12,519	19,093	25,125
Theoretical tax charge at statutory rate of 35 per cent. (2000: 30 per cent.; 1999: 31.25 per cent.) thereon . . . . .	4,382	5,728	7,852
Profit tax concessions . . . . .	(3,503)	(1,682)	(1,342)
Income not assessable for profit tax purposes . . . . .	(590)	(905)	(723)
Expenses and losses not deductible for profit tax purposes . . .	2,616	3,036	2,258
Tax penalties and interest . . . . .	63	(27)	(202)
Non-recognised deferred tax asset movement . . . . .	—	—	(861)
Non-temporary elements of monetary gain . . . . .	2,535	1,608	921
Inflation effect on deferred tax balance at the beginning of the year . . . . .	(721)	(463)	(773)
Statutory revaluation of property, plant and equipment . . . . .	(1,926)	—	—
Effect of increase (decrease) in tax rate on net deferred tax liability . . . . .	(1,124)	462	(415)
Profit tax . . . . .	1,732	7,757	6,715

The non-temporary impact of monetary gains and losses reflects the effect on the theoretical tax charge of inflation with respect to non-monetary items of a non-temporary nature (primarily equity and net deferred tax liability).

Differences between IAS and Russian statutory tax regulations give rise to certain temporary differences between the carrying value of certain assets and liabilities for financial reporting purposes and for profits tax purposes. The tax effect of the movement on these temporary differences is recorded at the rate of 35 per cent. (2000: 35 per cent.; 1999: 30 per cent.).

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	2001	Effect of applying IAS 39	Change in tax rate	Movement in temporary differences	2000	Change in tax rate	Movement in temporary differences	1999
<b>Deferred tax liabilities</b>								
Property, plant and equipment . . . . .	2,866	—	(1,313)	(933)	5,112	544	1,291	3,277
Inventories . . . . .	190	—	(87)	(108)	385	81	(184)	488
Long-term investments . . . . .	122	—	(56)	(168)	346	104	(374)	616
Receivables . . . . .	206	—	(95)	20	281	—	281	—
Commercial papers . .	30	74	(13)	(31)	—	—	—	—
<b>Deferred tax assets</b>								
Provision for employee benefits .	(570)	—	(262)	(65)	(767)	(102)	(49)	(616)
Write down of inventories . . . . .	(351)	—	(161)	89	(601)	(110)	171	(662)
Other deductible temporary differences . . . . .	(36)	—	(17)	149	(202)	(55)	189	(336)
Net deferred tax liability . . . . .	<u>2,457</u>	<u>74</u>	<u>(1,124)</u>	<u>(1,047)</u>	<u>4,554</u>	<u>462</u>	<u>1,325</u>	<u>2,767</u>



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## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001, 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued) (in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at 30 September 2002, unless otherwise stated)

### 15. SHORT-TERM LOANS AND CURRENT PORTION OF LONG-TERM DEBT

	2001	2000	1999
Banks:			
US\$ denominated floating rate . . . . .	665	739	213
US\$ denominated fixed rate . . . . .	9,010	5,542	3,718
Deutsche mark denominated fixed rate . . . . .	—	—	80
RR denominated fixed rate . . . . .	671	741	76
	10,346	7,022	4,087
Non-convertible bonds . . . . .	552	929	695
Commercial paper . . . . .	4,704	5,894	2,117
Other US\$ denominated fixed rate . . . . .	716	2,636	—
Other . . . . .	756	742	366
	17,074	17,223	7,265
Add: current portion of diamond loan (see note 11) . . . . .	—	—	2,117
Add: current portion of long-term debt (see note 11) . . . . .	1,432	609	528
	18,506	17,832	9,910

The effective interest rates at the balance sheet dates were as follows:

	2001	2000	1999
Banks:			
US\$ denominated floating rate . . . . .	10.9%	7.3%	15.4%
US\$ denominated fixed rate . . . . .	13.4%	14.5%	15.0%
Deutsche mark denominated fixed rate . . . . .	—	—	15.0%
RR denominated fixed rate . . . . .	23.5%	25.3%	45.0%
Non-convertible bonds . . . . .	24.6%	26.6%	39.5%
Commercial paper . . . . .	38.0%	—	—
Other US\$ denominated fixed rate . . . . .	9.1%	9.0%	—
Other . . . . .	nil	nil	8.5%

Exchange rate for US dollar (US\$) effective at 31 December 2001 was RR 30.14 to US\$ 1 (31 December 2000: RR 28.16 to US\$ 1; 31 December 1999: RR 27 to US\$ 1).

As at 31 December 2001, short-term loans included above totalling RR'mln 7,186 were secured with the assets of the Company and RR'mln 807 were secured by diamond sales of the Company (31 December 2000: RR'mln 6,153 (assets) and RR'mln 1,007 (diamond sales); 31 December 1999: RR'mln 3,981 (assets) and RR'mln nil (diamond sales)). As separate loan agreements do not specify individual pledged items of assets, the carrying amount of pledged assets is not disclosed.

# AK "ALROSA"

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001, 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued) (in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at 30 September 2002, unless otherwise stated)

### Commercial paper

Commercial paper comprises unsecured notes, denominated in Russian roubles, issued by the Company to provide short- and medium-term working capital facilities. The short-term commercial paper is typically non-interest bearing, with defined maturity dates ranging from 1 month to 1 year, and is carried at amortized cost.

### Domestic non-convertible bonds

	Long-term	Short-term	Total
Balance at 1 January 1999 . . . . .	—	—	—
Issuance (par value RR 1 thousand totalling RR'mln 500) . . . .	—	702	702
Amortization of discount . . . . .	—	26	26
Monetary effect . . . . .	—	(33)	(33)
Balance at 31 December 1999 . . . . .	—	695	695
Issuance (par value RR 1 thousand totalling RR'mln 1,000) . .	—	1,240	1,240
Repayment (par value RR 1 thousand totalling RR'mln 745) . .	—	(1,075)	(1,075)
Amortization of discount . . . . .	—	235	235
Monetary effect . . . . .	—	(166)	(166)
Balance at 31 December 2000 . . . . .	—	929	929
Issuance (par value RR 1 thousand totalling RR'mln 2,200) . .	2,016	593	2,609
Repayment (par value RR 1 thousand totalling RR'mln 755) . .	—	(895)	(895)
Amortization of discount . . . . .	—	44	44
Monetary effect . . . . .	(139)	(119)	(258)
Balance at 31 December 2001 . . . . .	1,877	552	2,429

# AK "ALROSA"

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001, 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued) (in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at 30 September 2002, unless otherwise stated)

### 16. SALES

	2001	2000	1999
Revenue from diamond sales			
Export (predominantly one customer) . . . . .	34,945	19,577	15,971
Republic of Sakha (Yakutia) . . . . .	5,403	20,632	22,854
Other, domestic . . . . .	18,144	23,533	25,738
	<u>58,492</u>	<u>63,742</u>	<u>64,563</u>
Other revenue			
Transport . . . . .	1,611	1,216	750
Trading . . . . .	988	891	997
Construction . . . . .	960	976	208
Social infrastructure . . . . .	730	632	135
Exploration . . . . .	331	367	181
Other . . . . .	1,197	905	484
	<u>64,309</u>	<u>68,729</u>	<u>67,318</u>

Export duties totalling RR'mln 2,047 for the year ended 31 December 2001 (2000: RR'mln 1,020; 1999: RR'mln 735) were netted against revenues from export of diamonds.

	2001 US\$m	2000 US\$m	1999 US\$m
Hard currency revenue from export diamond sales including export duties (predominantly one customer) . . . . .	1,067	510	384
US dollar denominated domestic diamond sales settled in Russian roubles . . . . .	680	1,091	1,125
	<u>1,747</u>	<u>1,601</u>	<u>1,509</u>

Pursuant to a trade agreement with De Beers, dated 3 November 1998 and covering the period from 1 January 2000 to 31 December 2001, the Company agreed to sell and De Beers agreed to buy a minimum of US\$m 550 (including the sales of diamonds on behalf of the committee for Precious Metals and Stones under agency agreements concluded between the Company and the committee) in value of the Company's annual diamond production at the current market prices.

Contingencies related to the trade agreement with De Beers, covering the period from 1 January 2002 to 31 December 2006 are disclosed in note 24 (i).

Pursuant to existing federal legislation, the Government of the Russian Federation issues, on an annual basis, a quota for export of rough diamonds. The quota stipulates the maximum amount of diamonds that may be exported in a given year. The amount provided in any quota constitutes a State secret.

# AK "ALROSA"

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001, 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued) (in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at 30 September 2002, unless otherwise stated)

### 17. COST OF SALES

	2001	2000	1999
Wages, salaries and other staff costs . . . . .	9,133	9,716	5,992
Depreciation . . . . .	4,751	5,269	3,592
Materials . . . . .	5,211	4,314	4,356
Fuel and energy . . . . .	4,347	3,811	2,242
Transport . . . . .	937	765	791
Services . . . . .	410	374	564
Other . . . . .	278	285	123
Write down (reverse) of inventory . . . . .	(312)	(331)	375
Movement in inventories . . . . .	(108)	(732)	(830)
	<u>24,647</u>	<u>23,471</u>	<u>17,205</u>

Depreciation totalling RR'mln 303 (2000: RR'mln 394; 1999: RR'mln 645) and staff costs totalling RR'mln 1,551 (2000: RR'mln 1,105; 1999: RR'mln 1,126) were incurred by the Company's construction division and included in capital costs for the year.

### 18. GENERAL AND ADMINISTRATIVE EXPENSES

	2001	2000	1999
Administrative expense . . . . .	1,681	1,058	458
Bad debt expense . . . . .	735	13	52
	<u>2,416</u>	<u>1,071</u>	<u>510</u>

### 19. OTHER OPERATING INCOME

	2001	2000	1999
Amortisation of Grant (note 10) . . . . .	1,096	1,674	1,790
Other . . . . .	319	193	276
	<u>1,415</u>	<u>1,867</u>	<u>2,066</u>

### 20. OTHER OPERATING EXPENSES

	2001	2000	1999
Royalty (note 10) . . . . .	10,075	11,531	11,518
Taxes other than profit tax (note 14) . . . . .	8,688	10,245	10,907
Loss from flooding in Lensk . . . . .	2,105	—	—
Social costs . . . . .	1,927	1,230	2,418
Selling and marketing expenses . . . . .	1,218	1,124	714
Research and development expenses . . . . .	926	828	708
Loss on disposal of property, plant and equipment . . . . .	2	1,600	1,216
Other . . . . .	203	153	182
	<u>25,144</u>	<u>26,711</u>	<u>27,663</u>

# AK "ALROSA"

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001, 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued) (in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at 30 September 2002, unless otherwise stated)

### Loss from flooding in Lensk

In May 2001, certain of the Group's commodities in warehouse facilities, together with certain other Group's assets, were damaged or destroyed by severe flooding in the town of Lensk, located within the Republic of Sakha (Yakutia). The expenses related to damaged inventories, compensating the flood victims for their property and repairing damaged assets are disclosed as other operating expense. Loss from flooding in Lensk include loss on disposed assets in the amount totalling RR'mln 296.

### Social costs

	2001	2000	1999
Maintenance of local infrastructure . . . . .	818	404	1,235
Charity . . . . .	693	321	415
Hospital expenses . . . . .	166	145	22
Education . . . . .	100	74	241
Other . . . . .	150	286	505
	<u>1,927</u>	<u>1,230</u>	<u>2,418</u>

### 21. FINANCE COSTS, NET

	2001	2000	1999
Interest expense:			
Bank loans . . . . .	1,898	1,237	1,270
Commercial paper . . . . .	2,211	370	360
Bonds . . . . .	438	235	26
Provision for restoration liability . . . . .	133	151	297
Other . . . . .	337	47	34
	<u>5,017</u>	<u>2,040</u>	<u>1,987</u>
Fair value (gains) losses on available for sale investments . . . .	(478)	337	(97)
Interest income . . . . .	(216)	(107)	(170)
Other finance income . . . . .	(233)	—	—
	<u>4,090</u>	<u>2,270</u>	<u>1,720</u>

## AK "ALROSA"

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001, 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued) (in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at 30 September 2002, unless otherwise stated)

#### 22. CASH GENERATED FROM OPERATIONS

Reconciliation of profit before tax to cash generated from operations:

	2001	2000	1999
Profit before profit tax . . . . .	12,519	19,093	25,125
Adjustments for:			
Interest income (note 21) . . . . .	(216)	(107)	(170)
Income from associates . . . . .	(277)	(257)	(235)
Interest expense (note 21) . . . . .	5,017	2,040	1,987
Fair value (gains) losses on available for sale investments (note 21) . . . . .	(478)	337	(97)
Other finance income (note 21) . . . . .	(233)	—	—
Non-cash profit tax settlements . . . . .	—	(4,214)	(5,121)
Adjustments for non-cash investing activity . . . . .	(7,541)	(6,482)	(2,120)
Adjustments for non-cash financing activity . . . . .	4,031	10,558	5,673
Depreciation (note 17) . . . . .	4,751	5,269	3,592
Amortisation of Grant (note 19) . . . . .	(1,096)	(1,674)	(1,790)
Disposal of assets (note 20) . . . . .	298	1,600	1,216
Repayment of diamond loan (note 26) . . . . .	—	(1,773)	(4,172)
Monetary effect on non-operating balances . . . . .	(3,046)	(2,476)	(5,369)
Net operating cash flow before changes in working capital . . .	13,729	21,914	18,519
Net increase in inventories . . . . .	(1,292)	(4,304)	(548)
Net decrease (increase) in trade and other receivables, excluding dividends and interest receivable adjusted for the effect of applying IAS 39 on trade and other receivables (notes 3(a), 4 and 25) . . . . .	2,618	(4,251)	(3,318)
Net (decrease) increase in deferred royalty payable . . . . .	(1,671)	(1,694)	1,959
Net increase (decrease) in trade and other payables, excluding interest payable . . . . .	413	1,444	(5,564)
Net increase (decrease) in taxes payable other than profit tax .	218	(584)	531
<b>Cash generated from operations . . . . .</b>	<b>14,015</b>	<b>12,525</b>	<b>11,579</b>
Profit tax paid . . . . .	(3,925)	(2,670)	(2,170)
<b>Net cash flows from operating activities . . . . .</b>	<b>10,090</b>	<b>9,855</b>	<b>9,409</b>

#### 23. FINANCIAL RISKS MANAGEMENT

##### (a) Credit risk

Financial assets, which potentially subject Group entities to credit risk, consist principally of trade receivables. The Group has policies in place to ensure that sales of products and services are made to customers with an appropriate credit history. The carrying amount of accounts receivable represents the maximum amount exposed to credit risk. The Group has no other significant concentrations of credit risk.

## **AK "ALROSA"**

### **NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001, 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued) (in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at 30 September 2002, unless otherwise stated)**

Although collection of receivables could be influenced by economic factors, management believes that there is no significant risk of loss to the Group beyond the provision already recorded.

Cash is placed in financial institutions, which are considered at time of deposit to have minimal risk of default.

#### **(b) Foreign exchange risk**

The Group exports production to European countries and the United States of America and attracts substantial amount of foreign currency denominated long-term borrowings and is thus exposed to foreign exchange risk. Foreign currency denominated liabilities (see notes 11 and 15) give rise to foreign exchange exposure.

The Group does not have formal arrangements to mitigate foreign exchange risks of the Group's operations.

#### **(c) Interest rate risk**

The Group's income and operating cash flows are substantially independent of changes in market interest rates. The Group is exposed to interest rate risk through market value fluctuations of interest-bearing long-term borrowings. The majority of interest rates on long-term borrowings are fixed, which are disclosed in notes 11 and 15. The Group has no significant interest-bearing assets.

#### **(d) Liquidity risk**

Prudent liquidity risk management implies maintaining sufficient cash and marketable securities, the availability of funding through an adequate amount of committed credit facilities and the ability to close out market positions. Due to the dynamic nature of the underlying businesses, the Group aims to maintain flexibility in its funding requirements by keeping committed credit lines available.

#### **(e) Fair value estimation**

The fair value of publicly traded trading and available-for-sale securities is based on quoted market prices at the balance sheet date.

The carrying amounts of financial assets and liabilities with maturity of less than one year are assumed to approximate their fair values.

## **24. CONTINGENCIES, COMMITMENTS AND OTHER RISKS**

### **(a) Operating environment**

Whilst there have been improvements in the economic situation in the Russian Federation in recent years, the country continues to display some characteristics of an emerging market. These characteristics include, but are not limited to, the existence of a currency that is not freely convertible in most countries outside of the Russian Federation, restrictive currency controls, and relatively high inflation.



## **AK "ALROSA"**

### **NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001, 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued) (in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at 30 September 2002, unless otherwise stated)**

The prospects for future economic stability in the Russian Federation are largely dependent upon the effectiveness of economic measures undertaken by the government, together with legal, regulatory, and political developments.

#### **(b) Taxes**

Russian tax legislation is subject to varying interpretations and changes occurring frequently. Further, the interpretation of tax legislation by tax authorities as applied to the transactions and activities of the Company and the Group's entities may not coincide with that of management. As a result, transactions may be challenged by tax authorities and the Company's group entities may be assessed additional taxes, penalties and interest, which can be significant. The periods remain open to review by the tax and customs authorities with respect to tax liabilities for three years.

#### **(c) Legal proceedings**

The Group is a party to certain legal proceedings arising in the ordinary course of business. In the opinion of management, there are no current legal proceedings or other claims outstanding which could have a material adverse effect on the results of operations or financial position of the Group as at 31 December 2001.

#### **(d) Insurance**

The Group is assessing its policies for insuring assets and operations. At present, apart from the full insurance of movements of diamond inventory from the production location to the customers, very few assets and operations of the Group are insured and, in the instances where assets are insured, the amounts generally are not sufficient to cover all costs associated with replacing the assets.

#### **(e) Social obligations**

The Group makes contributions to mandatory and voluntary local social programmes. The Group's local infrastructure assets as well as local social programmes benefit the local communities at large and are not normally restricted to the Group's employees. The Group is negotiating the transfer of certain social assets to the local authorities; however, the Group expects to continue funding these social programmes for the foreseeable future.

#### **(f) Capital commitments**

At 31 December 2001, the Group has contractual commitments for capital expenditures of approximately RR'mln 2,447 (2000: RR'mln 1,380; 1999: RR'mln 1,361).

#### **(g) Restoration, rehabilitation and environmental costs**

Under its license agreements, the Group is not responsible for any significant restoration, rehabilitation and environmental expenditures that may be incurred subsequent to the cessation of production at each mine, apart from the obligation to return assets received under the mineral lease agreement (see note 10). However, the Group is obliged to restore riverbeds and the surrounding areas. These expenses are not expected to be material to the Group and are expensed in the period incurred.

## AK “ALROSA”

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001, 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued) (in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at 30 September 2002, unless otherwise stated)

#### (h) Guarantees

As at 31 December 2001, the Group has guaranteed a US dollar denominated loan issued by Rosbank to OOO “Interrosleasing” totalling RR'mln 183. In addition, the Company guaranteed a US dollar denominated loan issued by Sobinbank to the Ministry of Finance of the Republic of Sakha (Yakutia) totalling RR'mln 71, and a US dollar denominated loan issued by Doveritelny Investitsionny Bank to Almazzolotokomplekt, totalling RR'mln 275.

#### (i) Trade agreement with De Beers

On 17 December 2001, a trade agreement between the Company and De Beers was signed, covering the period from 1 January 2002 to 31 December 2006. Pursuant to this agreement, the Company agreed to sell and De Beers agreed to buy up to US\$'mln 800 in value of the Company's annual diamond production at the current market prices. To be legally enforced this agreement requires the regulatory permission of the European Commission. Currently, the Company is in the process of negotiating objections raised by the European Commission. Management is unable to estimate the outcome of these negotiations.

In addition, the European Commission could seek to impose fines of up to 10 per cent. of the Company's sales in respect of the Company's previous trade agreements with De Beers, which were not notified to the European Commission.

## 25. RELATED PARTY TRANSACTIONS

The Company's principal shareholders are the Russian Federation and the Republic of Sakha (Yakutia).

IAS 24 “*Related Party Disclosures*” specifically excludes government departments and agencies in the course of their normal dealings with enterprise and government-controlled entities from the definition of related parties, and therefore transactions under those exemptions between, and balances due to or from, entities under government or other state control and government departments and agencies in the course of their normal dealings and the Group's companies are not detailed in this note.

Information related to the mineral lease agreement with Republic of Sakha (Yakutia) are disclosed in notes 10 and 12.

# AK "ALROSA"

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001, 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued) (in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at 30 September 2002, unless otherwise stated)

Significant related party transactions are summarised as follows:

	2001	2000	1999
<b>Long-term accounts receivable</b>			
OA0 "Sobinbank" and its affiliates, receivable secured by the loan payable . . . . .	1,109	230	—
OA0 "Severalmaz" . . . . .	—	187	—
Catoka Mining Ltd., an equity-accounted associate, loan receivable . . . . .	—	—	221
Other . . . . .	—	—	89
Less: provision for bad debt . . . . .	(180)	—	—
	<u>929</u>	<u>417</u>	<u>310</u>
<b>Current accounts receivable</b>			
OA0 "Sobinbank" and its affiliates, receivable secured by the loan payable . . . . .	516	292	—
OA0 "Tuymaada—Diamond", trade receivable . . . . .	615	947	903
ZAO PIC "Orel-Almaz", trade receivable . . . . .	170	232	169
Catoka Mining Ltd., an equity-accounted associate, dividends receivable (1999: interest receivable) . . . . .	204	—	356
Committee for Precious Metals and Stones (Komdragmet) of Republic of Sakha (Yakutia) . . . . .	31	358	178
Other . . . . .	282	511	753
	<u>1,818</u>	<u>2,340</u>	<u>2,359</u>

Loans provided by related parties:

	Interest Rate	2001	2000	1999
<b>Name of bank</b>				
<i>US dollar denominated</i>				
OA0 "Sobinbank" . . . . .	7–16 per cent.	812	1,490	1,789
Committee for Precious Metals and Stones (Komdragmet) of Republic of Sakha (Yakutia) . . . . .	10 per cent.	632	—	—
Derzhava bank . . . . .	45 per cent.	—	—	36
<i>Deutsche mark denominated</i>				
Yakimanka bank . . . . .	15 per cent.	—	—	80
<i>Russian rouble denominated</i>				
OA0 "Sobinbank" . . . . .	15–35 per cent.	1,936	342	—
		<u>3,380</u>	<u>1,832</u>	<u>1,905</u>

# AK "ALROSA"

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001, 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued) (in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at 30 September 2002, unless otherwise stated)

### 26. SIGNIFICANT NON-CASH TRANSACTIONS

The Company offset RR'mln 1,783 of tax liabilities in 2001 (2000: RR'mln 21,006; 1999: RR'mln 18,505). The taxes were offset against the following:

	2001	2000	1999
Diamond sales to the Republic of Sakha (Yakutia) . . . . .	—	16,202	14,939
Diamond sales to "Tuymaada-Diamond" . . . . .	—	—	173
Diamond sales to "SAPI" fund . . . . .	—	—	1,080
Commercial paper . . . . .	986	2,182	710
Other sales . . . . .	797	2,622	1,603
	<u>1,783</u>	<u>21,006</u>	<u>18,505</u>

During 2000, diamond sales to the Republic of Sakha (Yakutia) include the repayment of the diamond loan totalling RR'mln 1,773 (1999: RR'mln 4,172).

Additionally, diamond sales of RR'mln 803 in 2000 (1999: RR'mln 1,864) were settled by notes receivable or redemption of commercial paper issued by the Company.

During 2001, the Group issued commercial paper totalling RR'mln 7,722 (2000: RR'mln 7,976; 1999: RR'mln 7,388) to satisfy taxes, trade and other payables.

### 27. SEGMENT INFORMATION

The Group's primary format for reporting segment information is business segments. The Group has one reportable business segment, which is the production and sales of diamonds. The Group evaluates performance and makes investment and strategic decisions based upon review of profitability for the Group as a whole. The performance measurement systems employed by the Group to review overall profitability are based on the results of the Group determined using Russian statutory accounting books and records. Russian statutory accounting differs in many significant respects from IAS.

An analysis of revenue by type is disclosed in note 16. Revenue from sales by geographical location of the customer and assets and capital expenditures by geographical location of the assets are as follows:

	Sales			Total assets			Capital expenditures		
	2001	2000	1999	2001	2000	1999	2001	2000	1999
Russian									
Federation . . .	29,366	49,151	51,347	106,996	96,679	79,192	18,519	14,589	8,134
Western Europe	28,371	14,496	14,054	1,019	—	47	—	—	—
Other countries .	6,572	5,082	1,917	321	250	372	—	—	—
	<u>64,309</u>	<u>68,729</u>	<u>67,318</u>	<u>108,336</u>	<u>96,929</u>	<u>79,611</u>	<u>18,519</u>	<u>14,589</u>	<u>8,134</u>
Associates . . . . .				469	1,623	627			
Unallocated assets . . . . .				724	700	—			
Total assets . . . . .				<u>109,529</u>	<u>99,252</u>	<u>80,238</u>			

## **AK “ALROSA”**

### **NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED 31 DECEMBER 2001, 31 DECEMBER 2000 AND 31 DECEMBER 1999 (Continued) (in millions of Russian roubles expressed in terms of the purchasing power of the Russian rouble at 30 September 2002, unless otherwise stated)**

Sales to De Beers that accounts for greater than 10 per cent. of the Company's revenue during the years ended 31 December 2001, 2000 and 1999 are included in the geographical segment Western Europe.

Sales to the Committee for Precious Metals and Stones (Komdragmet) of Republic of Sakha (Yakutia) that accounts for greater than 10 per cent. of the Company's revenue during the years ended 31 December 2000 and 1999 are included in the geographical segment Russian Federation.

#### **28. ADJUSTMENTS FOR HYPERINFLATION**

In accordance with IAS 29, the consolidated financial statements as of and for the years ended 31 December 2001, 2000 and 1999 were originally prepared in terms of the measuring unit current at the balance sheet date. The restatement was calculated from the conversion factors derived from the Russian Federation Consumer Price Index, published by the Russian State Committee on Statistics (“Goskomstat”).

All amounts originally stated in the consolidated financial statements in terms of the measuring unit current at the balance sheet date have been subsequently restated using the conversion factor of 1.10, 1.31 and 1.58 for the years ended 31 December 2001, 2000 and 1999 in order to state them in terms of the monetary unit current at 30 September 2002. The restatement makes the consolidated financial statements more meaningful when compared to the information for the nine months ended 30 September 2002.

The indices used to restate the consolidated financial statements are based on 1988 prices (note 3(a)).

The consolidated statement of income includes net monetary gains of RR'mln 3,637, RR'mln 1,880 and RR'mln 5,741 for the years ended 31 December 2001, 2000 and 1999, respectively, because on average the Group had net monetary liabilities in the reporting years.

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